TrendMacrolytics

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Paradox Friday

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Mixed signals prolong "Indian summer," but they're no cause for complacency.

> **Update to strategic view**
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> **US STOCKS:** With stocks at new highs, it's still "Indian summer," in which surprisingly good economic news bolsters stock prices, and seemingly benign inflation news defers the day of reckoning with the Fed. But the inflation news is not really so benign. Even if inflation stabilizes here -- a long shot -- it's still too high for the Fed, and a surprisingly robust economy will give the Fed both the scope and the reason to raise rates to take on the unfinished business of inflation-fighting. The economy, and stocks, will be collateral damage. It's too soon to panic, but we caution against the complacency we're seeing from some investors.
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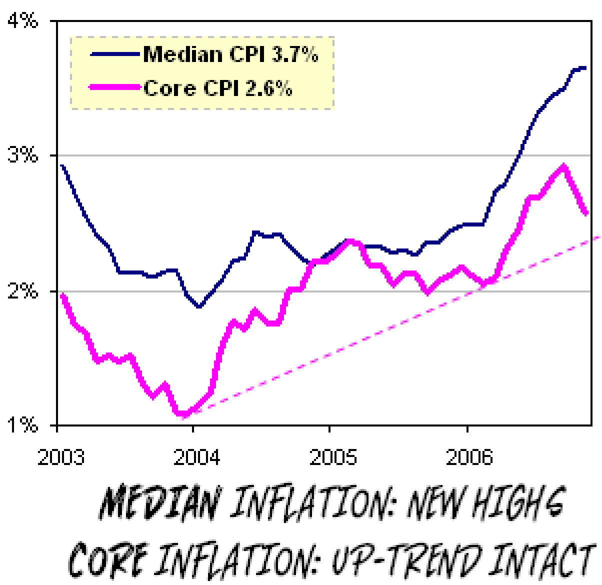
> [see Investment Strategy Dashboard]

GROWTH AND INFLATION We have steadfastly maintained that the economy would reaccelerate in the fourth quarter, and that all growth surprises would be on the upside (see "Gut Check for Growth" November 2, 2006). Now, with a stream of surprisingly robust data over the last two weeks, it seems that we've been right, with retail sales and net import data pointing toward real GDP in the fourth quarter coming in above 3%. At the same time, the core Consumer Price Index was reported Friday at about unchanged for November, lowering year-over-year inflation to 2.6% from 2.9% two months ago. From the Fed's point of view, this presents a paradox: the Fed's models have been forecasting slower growth, and a consequent fall in inflation. Now growth isn't slowing -- but inflation appears to be falling anyway.

For us that's no paradox at all, since we don't believe there is any causal connection between growth and inflation. Further, we pretty much dismiss November's seemingly benign core CPI as an anomaly, based as it is on fluky data outliers not likely to be sustained -- and not confirmed by the Cleveland Fed's more robust "median CPI," which has moved to new cycle highs at 3.7% year-over-year (see "On November CPI" December 15, 2006). Even at today's lower levels of reported core CPI growth, inflation is running above the high end of the Fed's "comfort zone." If it stabilizes here -- or, as we see more likely, if it reaccelerates from here -- then, against the backdrop of reaccelerating growth, there's no reason for the Fed to *cut* interest rates, as the consensus continues to expect. *At best*, the case for *hiking* rates is somewhat blunted, or at least deferred. But our forecast is for both continuing growth acceleration and higher inflation, so in our view rate hikes aren't likely to be deferred for long.



BONDS AND INFLATION Friday's core CPI

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report should have been the very best possible news for bonds. By rights, yields should have *fallen*, and indeed they did immediately after the core CPI data was released. But another paradox: by the end of the day, yields at the long end of the Treasury curve were slightly *higher* than they'd been the day before. The usual explanation for this kind of disappointment probably applies here: simply that bonds had become unsustainably overbought, and had therefore already discounted any possible good news. From our perspective, we have seen among investors that we talk to what can only call outright capitulation in bonds. Over the last two weeks we've seen long-time shorts finally cover to stop the pain. And we've heard over and over -- both from investors who trade bonds and those who don't -- that no matter what the Fed does, long term yields will stay low because bonds are now driven by technical factors: momentum, globalization, private equity, index fund activity and more -- we've heard it all. Some of the factors we've heard cited are more plausible than others, in our view, but they all have in common that they render bonds virtually impervious to significant decline. With that kind of sentiment as background -- and the bond market's non-reaction to Friday's core CPI news -- the December 1 low at 4.40% may well end up having been the bottom for yields.

COMMODITIES, MATERIALS STOCKS AND INFLATION Gold and many commodity prices fell on Friday, and the dollar rallied. This comports with the conventional wisdom that would have a monetary commodity like gold fall on the news of a lessening of inflation risk. But in our model this is a paradox. We regard commodities and the forex value of the dollar to be sensitive leading indicators of future inflation, not passive followers of backward-looking official statistics. If anything, we would have expected to see gold and other commodities rally, and the dollar fall, in anticipation that the seemingly benign core CPI report might lull the Fed into falling even further behind the curve, as future rate hikes are deferred. We have no robust explanation for this paradox, except to speculate that perhaps these inflation-sensitive markets were not reacting to the core CPI news at all, but rather were breathing a collective sigh of relief that Henry Paulsen's and Ben Bernanke's trip to China had concluded without any concrete plan to devalue the dollar. From here it would not surprise us one bit to see Friday's action in all these markets reversed over the next several days. Our expectation remains for higher commodity prices and a lower dollar, until the Fed is finally forced to catch up from behind the curve. Commodity-driven stocks seem to agree. Paradoxically, even while commodities fell on Friday, basic materials was the best-performing S&P 500 sector on the day. The sector is now up 11.8% since the speculative purging following the Amaranth hedge fund's blow-up, when we said to "catch the falling knife" in both materials and energy stocks (see "The Frustrated Fed" September 28, 2006) -- it is the second-best performing since then, after the energy sector, which is up 14.8%.

ENERGY AND ENERGY STOCKS A pair of paradoxes on Friday: while most commodities were lower, crude oil was higher -- and while crude oil was higher, energy stocks were lower. Crude was higher on the news of OPEC production cuts. Oil producers seem not to be seduced by backward-looking inflation statistics, but rather remain intent on maintaining the real purchasing power of their resources. And energy stocks were lower because five major producers agreed to pay royalties to the federal government on leases negotiated in the late 1990s, mistakenly omitting standard provisions for increasing royalties as crude prices rose. After years of refusing to re-negotiate to redress the error, it appears that these companies have decided to appease the incoming Democratic congress. New House speaker Nancy Pelosi has vowed to address the matter with legislation in the first 100 hours of the the new congress. Exxon-Mobil, Chevron, and about fifty other companies have yet to step forward -- but we expect they will shortly. All told, the cost to the sector will be something on the order of $8 billion. That's a pretty penny -- but If this appeasement strategy works for the industry as a means of blunting the worst the Democratic congress might try (see "Stock Market Exit Poll" November 15, 2006), it would be a small one-time price to pay.

THE RISK OF COMPLACENCY Friday's illusorily benign inflation reading dangerously plays into a mood of complacency about stocks we are beginning to detect among investors we talk to. We're hearing all manner of "Goldilocks" and "soft landing" scenarios of moderate growth and no inflation. We're hearing that there is an inexhaustible supply of liquidity at play in the market. And we're hearing repeatedly that stocks are now so cheap, that they are virtually invulnerable. Growth, we believe, will be more than moderate, and inflation will not go away. Robust growth will give the Fed the scope to deal with the unfinished business of stamping out the inflationary impulses born of having been too easy for too long. When it does that, the excessive liquidity the Fed created will be mopped up. As one voting member of the FOMC put it to us in sketching out just this view, the economy would be "collateral damage." Stocks are indeed cheap, based on today's interest rates and today's consensus forward earnings, which are an heroic 13.2% above today's *trailing* earnings. For years we've shouted to deaf ears that stocks were undervalued, and the "king of carry trades" (see "The King of Carry Trades" June 14, 2005) -- and with stocks at new highs, we've been proven right. But now it seems that investors are finally believing us, and in spades, just when we see a longer-term path to a a Fed-induced slowdown with lower earnings and higher rates, a dangerous combination that would trump stocks' apparent undervaluation.

BOTTOM LINE: We have expected stocks to attain new highs, as a stronger than expected economy keeps forward earnings moving higher (see "Update to Our US Equity Forecast" August 23, 2006). The economic reacceleration underway sharpens the earnings-driven case for stocks. At the same time, every day the Fed stays on pause as the economy reaccelerates represents a form of policy overshoot -- a passive form, doing nothing for too long -- but overshoot nevertheless. Inflation pressures will continue to build -- especially if data like yesterday's core CPI keep the Fed on hold even longer. We're still in "Indian summer" -- it's pleasant while it lasts, but it leads directly to winter (see "Indian Summer" November 21, 2006). At some point over the next several months today's "Goldilocks" scenarios will give way to a grimmer view -- an economy so healthy that it gives the Fed the scope to *hike* rates. Then stocks would drop, cheap or not -- and the inflation-sensitive resource sectors would get hit hardest of all. For the moment we continue to look for new highs for stocks. Nimble investors willing to play timing calls closely should try to stay long until the last moment. But winter is coming. Investors with more gradual trading styles should be scaled sellers into strength. TM