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MARKET CALLS

It Was a Very Good Year

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Donald Luskin

We were right that stocks would dominate in 2006 -- the trick in 2007 will be to call the top.

US STOCKS We've been bullish on stocks in various degrees all year. With one day to go, it looks like the S&P 500 will deliver a total return of about 16% in 2006. Early on, when the conventional wisdom was that the Fed would be done hiking rates at 4.25%, we cautioned that stocks would have a short-term setback when it became clear that rates would have to go higher (see "Don't Put a Fork In It" January 6, 2006). That proved to be the case, though we didn't specifically call the interim top in early May (see "On Tax Bill Progress" May 3, 2006). But shortly before the June bottom we dismissed the pessimism about stocks that was rampant at the time, and identified the decline as a strong buying opportunity -- which has proven to be correct (see "Today and 1987: Ominous Parallels? Part 2" June 2, 2006). Since what we believe was the mistaken decision by the Fed to pause at a 5.25% funds rate, we've cautiously looked for stocks to continue to gradually be lifted to new highs on the rising floor of expanding forward earnings. Indeed, in 2006, the increase in earnings of about 16% entirely explains the S&P 500's total return. At the same time, we've kept a wary eye toward that inevitable day when the Fed has to raise rates again, this time to levels that are likely to be damaging to growth and to stocks (see "Foreshocks" September 7, 2006). Our call has been for nimble investors to stay long stocks till the last possible moment, but for those not disposed to play timing games to sell gradually into strength. That remains our view heading into 2007. The top in stocks may well come in the first two quarters -- our challenge is to see it coming and nail it.

US BONDS The resilience of the bond market in 2006, in the face of rising short-term rates, has admittedly been a surprise and a frustration for us. But the dollar and cents reality is that our reiteration this year of our longstanding market call to be short long-term Treasuries (see "Grasping At Straws" January 12, 2006) has been a winner. With one day to go in the year, it looks like the total return to the 10-year Treasury for the year will be about 2.6%. Remarkable under the circumstances to be sure, yet at the same time overnight money invested this year at the fed funds rate would have earned about 5.1%. Thus a short position

Update to strategic view

US STOCKS: Stocks have been lifted on the rising floor of growing forward earnings, which should continue in the new year as the economy reaccelerates. But we look for an important top over the coming months as it becomes obvious that Fed rate hikes will resume in earnest.
US BONDS: Profits for 2006 ended up going to the shorts. The macro environment will only get more difficult for bonds, and momentum appears to have broken. The short side is still the right side coming into the new year.
US MACRO: The economy is now visibly reaccelerating, just as inflation appears to have abated. We look for growth to continue to accelerate into the new year, but for inflation statistics to turn back upward once the perturbation from volatile oil prices has worked its way out of the numbers.
FED FUNDS: The reacceleration of growth, the stabilization of the housing market, and inflation statistics that are unlikely to moderate further will put the Fed back into rate-hiking mode in the first half of the new year.

[see Investment Strategy Dashboard]

in the 10-year would have shown a net gain of about 2.5%. Since the zenith of bullish bond sentiment at the beginning of this month, when the 10-year yield at 4.4% almost made new lows for the calendar year, it seems there has been a palpable tone change. Suddenly a market that used to rally on both good news and bad sits still on the best possible news and collapses on the least bad news (see "Inflation Flu" December 21, 2006). When a market is as momentum-driven as this bond market has been, it can be a fool's errand to try to call the exact top -- but it's tempting to say we've now seen it. Momentum notwithstanding, at the very least the longs are going to have to contend with a continuing challenge in the cost of carry imposed by the inverted yield curve. And we think the best of the inflation news is already behind us, and that the reacceleration of growth now underway will deprive bonds of their expectations for Fed rate cuts in 2007 (see below). Top or no top, it's going to be very tough going for bonds in the coming quarters.

GROWTH We correctly forecasted booming real GDP for the first quarter, when the consensus was sure that the aftermath of Hurricanes Katrina and Rita would tip the economy into recession (see "Slowdown?" January 19, 2006). We didn't anticipate the full extent of the reported weakness in the second and third quarters (see "On April Jobs Data" May 5, 2006). But throughout that time of disappointment, we consistently urged that we were not looking at a persistent or sharp slowdown, and that weakness was encapsulated mostly within the housing sector, with the broad background economy remaining largely unaffected (see "The Housing Cool-off In Perspective" June 22, 2006). The steadfastness of the broad economy was captured in the low unemployment rate, which actually outperformed our already bullish 2006 forecast of 4.5% (see "Sorry -- Still Not Done Yet" April 20, 2006). Even at the nadir of negative consensus sentiment, we argued unequivocally that growth would end up surprising on the upside (see "Immaculate Consumption" September 19, 2006). That analysis appears to have been correct, with much of the data now pointing to fourth quarter real GDP above 3%, and increasing evidence that the consensus is grudgingly coming around to seeing that the economy is reaccelerating.

INFLATION Core CPI bottomed on a year-on-year basis in December 2003, as we forecasted it would two months before that (see "Desperately Seeking Inflation?" October 29, 2003). Shortly after, we forecasted that core CPI would reach 3% basis (see "Surprises in Store" May 27, 2004). So far we've fallen short of that prediction by only 7 basis points, with year-on-year core CPI having touched 2.93% in September of this year. Today we are astonished by the seeming unanimity of the consensus that inflation is no longer a threat. Yes, core inflation by most measures has ticked down over the last two months, but for these two downticks to signify a definitive change in direction seems to us to be purely wishful thinking. More likely it's the result of statistical perturbations induced by the volatile fluctuation of crude oil prices since summer. It remains that case that, although they are off their extremes of the year, market prices of inflation-sensitive commodities such as gold and oil are still far above their long-term averages -- and the dollar is still far *below* its long-term average. These are the indicators that led us to forecast the resurgence of inflation in this first place, three years ago. Now those same indicators point to a substantial backlog of inflationary pressure destined to show up in higher published inflation statistics over the coming months -- and, indeed, for many years. Nothing can prevent that pressure from coming through the pipeline, but the Fed could substantially ameliorate it by raising interest rates in order to move to neutral or tight from its present accommodative position.

THE FED Throughout the rate-hiking cycle beginning in June 2004 -- during which the consensus expected the Fed to be "one and done" virtually the whole way up -- we were correct to faithfully maintain that rates would be hiked at each FOMC meeting. This year we expected that the hiking cycle would go to a funds rate something north of 5% (see "How Much More?" April 13, 2006), finally settling on a predicted end-point of 5.5% at the August 8, 2006 meeting (see "The Hawk Has Landed" June 16, 2006). We missed by one meeting -- we were disappointed when it became clear that the Fed would pause at 5.25% in August, delaying and raising the cost of the inevitable reckoning with the inflation set in motion by having stayed so easy for so long (see "Judgment Day" August 3, 2006). Since then, we have steadfastly maintained that the Fed's next rate move will be higher, even as market expectations have at various points called for more than three rate cuts in 2007 (see "Surprise on the Doveside" August 9, 2006). Those expectations have moderated markedly this month as evidence of reaccelerating growth has accumulated, even though inflation readings have been benign. Over the coming quarter we expect those expectations to completely reverse as growth continues to accelerate and the inflation readings take a turn for the worse -- and it becomes clear that the Fed may have to push the funds rate to at least 6%.

BOTTOM LINE: Though long-term bonds performed better than we had expected given the macroeconomic backdrop in 2006, the profits were made on the short side. The macro environment will only get more challenging for bonds in the coming quarters, and we think the short side is still the right play. Stocks were lifted by strong earnings performance, which should continue as the economy reaccelerates. But as the consensus awakes to the fact that the Fed will have to begin raising rates again, perhaps quite sharply, we look toward an important top in the coming quarters. Growth is reaccelerating, and recent seemingly benign inflation readings will prove only temporary. We expect the Fed to resume its prematurely aborted rate-hiking cycle during the coming quarters, which may well lead to an important blow to growth. TM