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A Break in Trend

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Stocks have drooped just as investors had become complacent, and growth visibly reaccelerates.

It's not a good sign that stocks started 2007 with a failed attempt to make new highs, right out of the gate in the new year's first two hours of trading, and have traded lower ever since. In the lingo of technical analysis, this rally failure is the first time since the mid-June bottom that the chart of the S&P 500 shows a pattern of tops-below-tops and bottoms-below-bottoms. This apparent breaking of trend comes three weeks after we warned about the complacency we were sensing from equity investors (see "Paradox Friday" December 18, 2006). At year-end, surveys of economists were unanimous in their complacent commitment to various flavors of "Goldilocks" and "soft landing" scenarios in which, magically, growth reaccelerates *and* the Fed cuts interest rates (see "New Year, New Day?" January 4, 2007). The CBOE Volatility Index (VIX) languished at levels lower than any seen in but a handful of trading days in the Index's 21-year history. And the equity risk premium -- the difference between the forward earnings yield of the S&P 500 and the yield of the 30-year Treasury -- though still quite elevated by long-term historical standards, fell to its lowest level since the top early last May.

Maybe the downside bias of the first week of the new year is just a healthy reaction to complacency. But it could be more than that, especially since complacency right now hinges on consensus beliefs about the economy and the Fed that are in the process of being proven to be untrue. The last several weeks of growth data has done exactly what we said it would do -- surprise on the upside (see "Gut Check for Growth" November 2, 2006). Expectations for rates cuts embodied in fixed income markets are being accordingly reduced and deferred. Similarly, prices of commodities have been falling, suggesting that these inflation-sensitive markets are also moving to more hawkish Fed expectations. Tangible evidence of the nexus between expectations for growth, the Fed and inflation can be seen in the fact that gold, the most inflation-sensitive commodity, fell almost $20 on Friday shortly after the surprisingly upbeat payroll jobs report.

Update to strategic view

US STOCKS: Against a backdrop of complacency, stocks have started the new year by breaking the uptrend of the last six months. This is likely a reaction to a shift in expectations away from Fed rate cuts, based on mounting evidence of reaccelerating growth. Given the recent fall in commodities prices, the pace at which the Fed will actually move toward rate hikes is likely to be gradual. That opens up enough time for accelerating growth to lift earnings expectations, which in turn should lift stocks. With the eventual prospect of rate hikes coming closer, it makes sense for long-term equity investors to take a little off the table here. More trading oriented investors will likely have another chance to sell into new highs.

[see Investment Strategy Dashboard]

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For stocks, this shift in expectations offers a mixture of positive and negative drivers. The positive driver is that the growth showing up in the data is good for the earnings growth that has been the sole explanator of rising stock prices (in 2006, S&P 500 earnings and market cap both grew by about 14%). And the decline in commodities prices, especially crude oil, is both a growth accelerant and a signal of declining inflation risk. The negative driver is that a more aggressive Fed means higher discount rates applied to future earnings. And far more significant, if the Fed resumes hiking rates, and those rates reach restrictive levels, then the economy and its ability to produce earnings growth will be damaged. We have argued ever since the Fed paused prematurely last August that, eventually, a tipping point in expectations would likely come in which the negative drivers will dominate -- and then stocks will top out (see "Bernanke's Quagmire" August 7, 2006).

Are we at that tipping point right now? We can't rule it out, and we are certainly moving *toward* it. It wouldn't be a mistake for equity investors to take a little off the table here just in case, but we don't think we're there yet. It will take time for the Fed to be convinced that the economy is safe from the risk of contagion from the housing slowdown. And with oil prices having fallen again, it's likely that the next round of backward-looking official inflation statistics will be benign enough to not force the Fed's hand. In the meantime, earnings growth should continue to provide a gradually rising floor under stock prices, which suggests that any short-term weakness here would be temporary -- a replay of the weakness of last May and June, in which stock prices ultimately had to sprint to catch up with earnings. The tipping point will come when there's a real risk to earnings. That will happen as growth continues to come in strong, and inflation proves to be persistent at unacceptably high levels.

The best-case scenario from here would be one in which commodities prices continue to fall. If they fall far enough -- providing that their fall can't be interpreted as an indicator of a global growth problem -- that would signal the true triumph of "Goldilocks," in which inflation-sensitive markets would be telling us that the Fed didn't have to hike rates very much, or perhaps at all, to reverse its inflationary error of having remained excessively easy for too long. We're definitely not *there* yet -- a continued sharp drop in commodities prices is required. We'd need to see gold, for example, fall back to the mid-400's. At current levels around 600, gold, which has an unparalleled track record of forecasting long-term inflation trends, is indicating far less inflation risk than it did last May at 725. But it is still pointing toward a decade of core inflation averaging 5% or more. The levels of other commodities such as crude oil -- even copper, after its significant drop of the last several weeks -- suggest even worse inflation rates.

The worst-worst-case scenario is stagflation, in which the data starts to tell us that we were wrong about reaccelerating growth -- *and* we don't get a continued fall in commodities prices. But we see virtually no reason to expect that -- all the likely scenarios are based on continuing growth reacceleration. Within that context, the realistic worst-case scenario is one in which commodities reverse their recent decline and head back upward. A coming reversal in commodities prices could have the same trigger as the reversal after the May/June drop -- a Fed that treats the decline in commodities prices as evidence of declining inflation, rather than of declining *inflation expectations* which require Fed follow-through to fulfill. A reversal would put tangible pressure on the Fed to act, and act aggressively.

BOTTOM LINE: Our expectations tend in the direction of the worst-case scenario of both reaccelerating growth and inflation, leading to rate hikes at restrictive levels. Even if inflation is nothing worse than persistent, as long as growth surprises on the upside, the Fed will resume hiking rates. Either way, it's only a question of time. The Fed is not likely to act quickly or preemptively, so we will have to wait for the data to evolve. As long as growth reaccelerates while the Fed does nothing, time is first a friend to stocks but later an enemy. In the short term, earnings growth will trump gradually shifting Fed expectations. But longer term, by the Fed having waited, inflation pressures will continue to build, and expectations will shift toward a more aggressive Fed that poses a risk to future earnings growth. Weakness in stocks in the first week of the new year intimates these future risks, and there is a good case for taking a little off the table here with the long-term in mind. But for investors who want to play it a little closer to the edge, we would be buyers of near-term weakness. We are likely to get one more chance to sell into strength.