Donald Luskin, Chief Investment Officer
David Gitlitz, Chief Economist
Thomas Demas, Managing Director

MARKET CALLS

Enough Good News for a Correction

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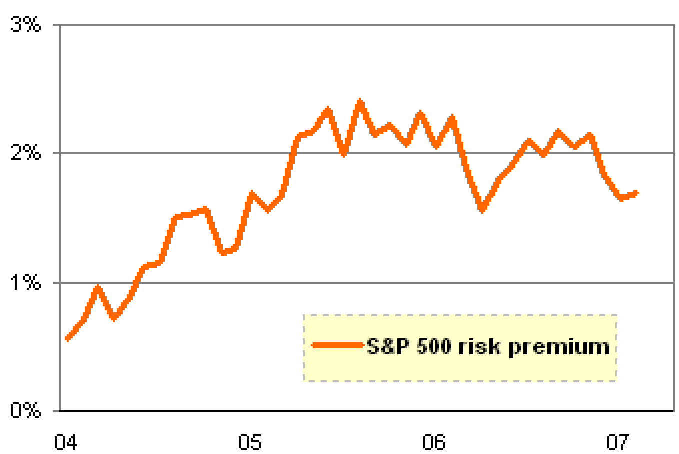
Donald Luskin

With Bernanke on indefinite hold and tax risk reduced, what's left to rally stocks?

Stocks have advanced to new highs -- with the inflation-sensitive materials sector continuing to lead the way -- just as we have expected, as we wait for that inevitable day when events force the Fed to resume hiking interest rates (see "Gold Versus Goldilocks" February 2, 2007). But while the push to new highs occurred on the day of Ben Bernanke's Senate testimony that was less hawkish than feared (see "On Bernanke's Testimony" February 14, 2007), perhaps some of the impetus for the up-move came from an entirely different source.

On that day the press carried reports of an initiative supported by congressional leaders of both parties, and President Bush, to narrow the so-called "tax gap" -- the approximately $300 billion of taxes owed but not collected each year. This may well be a trial balloon for a compromise permitting an extension this year of relief from Alternative Minimum Tax treatment for upper middle class taxpayers -- without requiring as an offset the repeal of low 2003 tax rate on dividends and capital gains. President Bush would have a no-win veto decision if faced with a bill that traded off AMT relief for dividends and capgains repeal. Failure to extend AMT relief would immediately expose millions of taxpayers to higher marginal income tax rates, which is a dangerous disincentive to labor force participation. But a hike in tax rates on dividends and capital gains would be even worse, effectively decreasing the



RISK PREMIUM ELEVATED IN HISTORIC TERMS, BUT ON THE LOW END OF RECENT EXPERIENCE

Update to strategic view
US STOCKS: The Fed seemingly indefinitely on hold, and the lessening of the risk of a congressional tax showdown, have propelled stocks to new highs. With so much good news out, and with valuations now at their least attractive since last May, sentiment may be setting up stocks for a long-overdue correction. But macro fundamentals still favor stocks. Until events more visibly move the Fed closer to inevitable rate hikes, a sentiment-driven correction will be a buying opportunity. **INFLATION PLAYS (US RESOURCE STOCKS, US ENERGY STOCKS, GOLD, COMMODITIES, US DOLLAR):** With Bernanke's testimony having put the Fed on hold as far as the eye can see, inflation pressures will continue to mount and inflation-sensitive markets will continue their move back toward their highs (and the dollar back toward its lows).
[see Investment Strategy Dashboard]

:
Park CA
Parsippany NJ
Charlotte NC
tdemas@trendmacro.com
Phone:
650 429 2112
973 335 5079
704 552 3625

after-tax return on invested capital, imposing a direct penalty on growth -- and on stock prices -- by depreciating the after-tax present value of the nation's capital stock and raising the cost of new capital.

Because AMT relief is most important to residents of "blue states" where state and local taxes tend to be higher, and because the low 2003 tax rate on dividends and capgains is one of the few bright spots in President Bush's economic policy legacy, having to choose between them is a risk that neither party wants to take. We speculated several weeks ago that a relatively harmless way out of this Hobson's choice would be to offset the "revenue costs" of AMT relief with regulations that purport to beef up enforcement (see "Tax Wars" January 22, 2007). The next few months won't be a riskless path to that kind of solution -- in fact, today's *Wall Street Journal* carries a story of the possibility of offsetting the costs of AMT relief for the upper middle class with higher AMT rates on the upper class. We doubt the GOP in the Senate will let the process go there ultimately, but even that would be better than repealing the 2003 dividend and capgains rates. At least at the margin, this week we've seen the lessening of a significant worst-case risk overhanging the stock market.

With stocks at new highs -- with the risk of a more aggressive Fed deferred, and the risk of an anti-growth tax showdown reduced -- it's a good time to warn one's self against complacency. We note that while the equity risk premium -- the difference between the forward earnings yield of stocks and the income yield of long-term Treasuries -- is quite elevated by historical standards, it is actually narrower now than it has been at any time in the last two years, except just before the correction that began last May (please see the chart on the previous page). Stocks have been pretty much straight up since the bottom last June, when we opined that the steep correction that began in early May was a buying opportunity (see "The May 10 Inflection Point" June 12, 2006). Since the New Year the conventional wisdom has been calling for a correction that has refused to come. Now, with so much good news out, and the conventional wisdom starting to talk about a breakaway bull market, perhaps a correction really is finally due.

BOTTOM LINE: Our view on stocks is getting complicated. The macro preconditions for growth remain in place, so we remain positive on stocks on fundamental grounds. But as a matter of short-term sentiment, we fear that stocks are vulnerable to correction. Longer term, we fear that persistent inflation and stronger than expected growth will draw the Fed back into hiking rates, probably to levels that will pose a threat to stocks and the economy. Trading-oriented investors should look to buy a correction here, provided it is not obviously connected to the immediate prospect of Fed policy reversal. We continue to favor the sectors that are both inflation-sensitive and growth-sensitive, including materials and energy.TM