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MARKET CALLS

Update to Our US Equity Outlook

Friday, April 13, 2007

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The correction was a correction -- it has about run its course, with inflation plays in the lead.

Update to strategic view
US STOCKS: The correction appears to have run its course, and we expect stocks will gradually trudge higher as forward earnings reaccelerate and sentiment continues to provide a useful wall of worry. **INFLATION PLAYS (US RESOURCE STOCKS, US ENERGY STOCKS, GOLD, COMMODITIES, US DOLLAR):** The Fed is increasingly wary of inflation risk, but at the same time increasingly ambivalent about risking growth to deal with it. Inflation-sensitive assets will continue to appreciate (and the dollar will continue to weaken) until they force the Fed's hand.
[see Investment Strategy Dashboard]

As of this writing stocks are challenging the highs attained on February 20, confirming our view expressed since then that the decline was nothing more than a correction (see "Are We Scared Yet?" February 28, 2007). Whether it's today or whether it takes a little longer, from here we think stocks can move to new highs, probably in the same grudging manner in which they have trudged higher since the bottom last June. With the dollar making new lows, we continue to expect that inflation-sensitive sectors will be the best performers, as they have been throughout the correction.

VALUATION We predicted this correction one market day before the February 20 top, citing concerns with valuation and sentiment (see "Enough Good News for a Correction" February 16, 2007). On the surface, valuation hasn't changed much since then according to our model based on market capitalization, forward earnings and long-term interest rates. With stock prices back to where they were at the top, obviously market cap hasn't changed on net. Long-term interest rates are slightly higher, by 13 basis points, and that's a negative for valuation. But it's offset by 1% growth in consensus forward earnings, a positive for valuation. But a little below the surface valuation has considerably improved. That 1% growth in forward earnings was an important upside surprise. At the February 20 top, upward revisions were coming in so anemically that, at that pace, it looked like it would take eight months to tack on the 1% growth that, in fact, arrived in just seven weeks. The annualized rate of estimate revisions is now running at 7.1%. What looked in February like it could turn into a downright decline in forward earnings appears to have been averted. That was a near-death experience -- historically, every time forward earnings growth has turned negative, a recession followed one year later (see "The Out-of-Consensus Consensus" June 26, 2006).

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SENTIMENT Just before the February 20 top sentiment was too complacent -- recession risk was seen to be low, the macro news flow had been consistently surprising on the upside, and confidence in stocks was running high. The subprime crisis, which was the initial news catalyst for the correction and a renewed wave of recession fears, was just beginning to emerge as a story line (see "Subprime Time" February 26, 2007). Today our intuitive sense is that, while stock prices and valuations have recovered, sentiment is considerably more pessimistic than it was at the February top. For example, yesterday's release of the *Wall Street Journal's* monthly poll of professional economists showed a lowering of growth expectations, and reported that a widespread concern about capital spending has joined the housing slowdown as a reason for pessimism. That tells us that the upside surprises in macro data that we expect -- which will serve to lower recession risk -- can have real upside impact on stock prices.

THE INFLATION PLAYS We said that the inflation-sensitive sectors -- energy and materials -- would be the first to recover in the correction (again, see "Are We Scared Yet?" February 28, 2007). They were, and we continue to see mounting inflation risk as a salient equity theme, underscored by this morning's move by the dollar on foreign exchange markets to new 2-year lows, and gold above $680. Since the day of the bottom on March 13, energy has been the best performing S&P 500 sector (up 11.6%, and making new highs), and materials has been the third best performing sector (up 6.1%, and also making new highs). As the heightened recession fears that animated the correction in stocks also served to keep the Fed on hold longer at an accommodative funds rate of 5.25%, inflation pressures have intensified. This is a continuation of the dynamic that was set in motion last summer as the Fed began to prepare to pause at the August 8 FOMC meeting, as the housing slowdown first began to be felt. We said then that the Fed was giving inflation plays a "new lease on life" (see "Inflection Point Deflected" July 11, 2006). After the speculative purge in the aftermath of the Amaranth fiasco, we said it was "time to catch the falling knife" (see "The Frustrated Fed" September 28, 2006). Since then, the inflation plays -- including short the dollar -- have been the place to be. And with the Fed on hold for the indeterminate future, they remain the place to be (see "Of Two Minds" April 12, 2007).

As of April 12, 2007 (dividends not included)

		Energy sector	Materials sector	Dollar Index	Gold	Oil	S&P 500
9/28/2006	"Catch a falling knife"	17.9%	21.6%	-3.6%	2.2%	11.9%	8.1%
2/20/2006	February top	9.0%	1.6%	-2.2%	10.0%	3.1%	-0.8%
3/13/2007	March bottom	11.6%	6.1%	-1.7%	10.2%	5.3%	5.1%

THE MACRO BACKDROP Our optimistic short-term view of equities matches our outlook for the economy. We are forecasting strong growth, predicated on a belief that super-abundant financial liquidity is sufficient to buffer the shocks of the housing slowdown and the subprime collapse, and keep them from infecting the rest of the economy (see "All Tip, No Iceberg" March 16, 2007). In one sense we have been frustrated by the moderate GDP growth rates reported over the last three quarters, when we had expected better. But in all three quarters, overall growth was held back by the poor performance of a single sector -- housing. Ex-housing, GDP growth has accelerated throughout 2006. On a trailing 4-quarter basis, *every* quarter in 2006 was better than *any* quarter in 2005. Housing has been and continues to be a wildcard, with the

power to perturb almost randomly our otherwise correct forecast that the core economy -- responsible for 98% of S&P 500 earnings -- is still experiencing robust growth.

BOTTOM LINE We have called this period in the stock market and the economy "Indian summer," a time when true summer has passed yet the days remain balmy -- and winter is nearing (see "Indian Summer" November 21, 2006). By winter we mean the time when the Fed eventually resumes its prematurely paused rate-hiking cycle, to tardily deal with the inflation it set in motion by being too accommodative for too long starting in 2002. Ever since the Fed went on pause we've known winter was coming, and said that long-term investors who trade gradually should be scaled sellers into strength, to be ready for winter (see "Bernanke's Quagmire" August 7, 2006). For everyone else, we've hung in there with our bullish call on stocks, since the day before the bottom last June 13 (see "The May 10 Inflection Point" June 12, 2006) -- until we called for a correction in mid-February. The housing wildcard has prolonged Indian summer longer than we initially expected. For now, that's a good thing. But it may mean that the eventual winter will be more severe and longer-lasting. Games played with wildcards are particularly risky.