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

MACROCOSM

Rodney Revisited

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David Gitlitz

For four years, this expansion got no respect. What happens to stocks when it finally does?

> **Update to strategic view**
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> **US MACRO:** Housing remains a wildcard for overall reported growth, but for the other 95% of the economy all signs point to a reacceleration of the expansion.
> **US STOCKS:** With rate cut expectations all but flushed out of the bond market, it's absurd to think that stocks are flirting with all time highs based on hopes for an easing Fed. Born of the recognition of reaccelerating growth, a Fed on hold at current rates, or just a hike or two, would be unlikely to derail the bull market. A growth surge coupled with rising inflation could draw a more draconian Fed response.
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> [see Investment Strategy Dashboard]

As bond yields rise in accord with the whittling away of Fed easing expectations, the rally footing of equities so far shows little sign of faltering. The 10-year Treasury note hit its low yield for the year at 4.49% on March 13, which was also the date December Eurodollar futures peaked with an implied yield pricing for about 60 basis points in rate cuts this year. Since then, the 10-year yield has risen to nearly 4.9%, the bet on expected rate cuts for the year has unwound to just 10 basis points, and the S&P 500 has rallied by 10%.

According to many analysts and financial media types, this apparent contradiction is explained by the idea that equities continue to anticipate that Fed rate cuts are coming, driving stock prices higher, in apparent ignorance of the reversal of easing expectations seen in fixed income markets. Over the weekend, the *Wall Street Journal* ran a piece asserting that stocks are still rallying on the outcome of the March 21 FOMC meeting, which removed the specific reference to the possibility of "additional firming" from the post-meeting statement, thus purportedly opening the door to potential rate cuts. However, as we suggested at the time, and as has become abundantly clear in the weeks since, the March statement represented no real policy shift as the committee signaled a heightened concern about inflation risk at the same time it tailored the language to provide some additional flexibility (see "On Second Thought…" March 23, 2007). That conclusion was reinforced by the results of the subsequent meeting, on May 9, which failed to provide any nod to the possibility of lower rates while at the same time reiterating the caution about inflation risk.

To a considerable extent, the formulation maintaining that stocks can only be rallying on anticipation of Fed rate relief is consistent with the long-held view of conventional economic wisdom, which is why we have referred to this as the "Rodney Dangerfield expansion" -- it don't

http://www.trendmacro.com
don@trendmacro.com
dgitlitz@trendmacro.com
tdemas@trendmacro.com

Offices:
Menlo Park CA
Parsippany NJ
Charlotte NC

Phone:
650 429 2112
973 335 5079
704 552 3625

get no respect (see "No Respect" December 1, 2005). It remains an article of faith among the economic establishment that soon enough the Fed will be called upon to come to the rescue of a faltering economy. What opaque surroundings in these quarters must be filtering out the news? Over the past several weeks, the preponderance of data -- including the ISM surveys, jobless claims, inventories, and new orders -- capture an economy in the process of reacceleration. Housing remains a source of uncertainty, with some indications that a process of stabilization may be in the works, while other signs point to the downturn continuing unabated. But we have yet to see any evidence suggesting that the housing bust is having any impact on the broader economy (see "Two Economies, One Funds Rate" May 1, 2007).

AFTER A NEAR-DEATH EXPERIENCE, AN EARNINGS SURGE

One of the more compelling indicators that we have been monitoring is the company-level changes in forward earnings estimates for the S&P 500. The annualized growth rate of forward earnings revisions slumped to lows not seen since 2001 at around the same time bond yields bottomed and Fed rate-cut expectations peaked. This was in the wake of the brief speculative purging in late February on fears of a subprime mortgage blowup, Chinese meltdown, termination of the yen carry trade and generalized economic pessimism. Since then, however, forward earnings estimate revisions have accelerated and are growing at a 19.5% rate on an annualized one-month moving average basis. This robust turn higher in the earnings outlook explains why stocks have been able to withstand the sharp erosion of Fed rate cut expectations. Absent this improved growth outlook, if stocks were relying on anticipation of rate cuts, they would have fallen -- not rallied to near all-time highs, as they have (see "Earnings to Economy: 'No Recession'" April 20, 2007).

All in all it's not implausible to think that we could now be in the midst of a 3%-plus quarter for real GDP growth, with further improvements likely in the second half as the effect of housing on overall reported growth eventually begins to wane. Not only will this eliminate outright any possibility of Fed ease, over the next several months we expect the expectations environment to begin to turn toward anticipation of rate hikes. Going forward, we see several different scenarios potentially playing out.

- Should growth accelerate into the 3% to 3.5% range, with core inflation remaining at current levels just below 2.5%, additional Fed action could be limited to one or two rate hikes. Should the funds rate top out no higher than 5.75%, the current expansion should be sustained and equities should avoid a sustained sell-off.

- Should growth return to above-trend levels while core inflation picks up to levels above 2.5%, hikes in the overnight target rate to at least 6% would be likely. The economy might withstand such action, but equities could be hard pressed to avoid slumping into at least a bear market interval.

- Finally, if growth picks up while core inflation resumes its trend higher, approaching or exceeding 3%, a sustained course of tightening becomes inevitable, potentially taking the funds rate above 6.5% when all is said and done. At that point, for the economy and markets, all bets are off.

BOTTOM LINE: In assessing the scenarios outlined above, unfortunately we view the final one as the most likely, but don't exclude the possibility of a more benign outcome. Our market price indicators continue to convey a strong probability, based on historical experience, that significant inflationary impulses have been embedded which have yet to surface, pointing to core inflation rising to at least 3.5%. Still, we don't rule out the possibility that maybe we'll be lucky, and this time will be different. The lags normally associated with market prices presaging higher inflation readings have already been exceeded, so maybe the worst was seen last year when core CPI hit 2.9% year-on-year. Again, we don't rule it out, but we'd advise recalling the proverb about the four most dangerous words in investing: "this time it's different."