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Stocks Unfazed

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Neither a new anti-China bill nor the latest leg in the four-year bear market in bonds will crack the stock market.

Update to strategic view
US STOCKS: The recent decline in stocks corresponding to the mini-crash in bonds has been just a correction, not a permanent change in trend. The Fed is a long way off from growth-threatening rate hikes. And yesterday's anti-China bill in the Senate is likely to have little material impact on trade.
[see Investment Strategy Dashboard]

Stocks rallied yesterday after senators Max Baucus, Chuck Grassley, Chuck Schumer and Lindsey Graham revealed the details of their long-awaited bill to deal with China's supposed undervaluation of its currency. While the bill, if passed into law, would throw sand in the gears of global trade, we interpret it as another example of more bark than bite from this congress (see "Upside Surprise on Trade" May 14, 2007). Requiring a complex and subjective judgment by Treasury that a foreign country's currency is "fundamentally misaligned," the bill triggers an array of mostly symbolic consequences (such as requiring the Treasury secretary to "consult" with the Federal Reserve concerning "undertaking remedial intervention in the currency market"). As we have expected, this hodge-podge has turned out to be far cry from the dangerous across-the-board 27.5% tariff that two of this bill's sponsors had advocated before (see "Trade in the Balance" April 5, 2007). It remains to be seen which of the current deal's many complex provisions will make their way into final legislation sent to the president for signature, whether the president would veto it, whether a veto would be overridden or if, in the end, any of it will matter. Judging by the stock market's reaction, it won't.

Stocks have been similarly unfazed by the mini-crash in bonds of the last two weeks, and what has now become the complete abandonment of long-standing Fed rate cut expectations in the fixed income futures markets (see "Doves Eat Crow" June 6, 2007). The S&P 500 stood at yesterday's close only 1.5% below the all-time high water mark set on June 4, even though long-term Treasury yields have risen a much as 33 basis points over the intervening seven trading days. With stocks up strongly again today, the small decline of the last couple weeks appears to have been only the brief correction we expected (see "Washington on Hold" May 10, 2007). One explanation for the stock market's stalwart performance is that the bond market has given up its easing expectations in the fundamentally optimistic context of an upward reappraisal of growth prospects, making equities more attractive (see "Rodney Revisited" Tuesday, May 29, 2007).

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A deeper yet simpler explanation is that, for the past four years, rising bond yields and a rising stock market have happily coexisted -- so why expect that to change now? Four years ago yesterday the 10-year Treasury yield bottomed at 3.1%. Since then, with yields now more than 200 basis points higher, holders of the 10-year have approximately broken even, considering both income and capital losses. Holders of the S&P 500, on the other hand, have earned 62.5% over the same period, considering both dividends and capital gains. Why? Because the four-year bear market in bonds has not been a journey from low rates to *high* rates, but rather from low rates toward *normal* rates. While the conventional wisdom has maintained throughout that economic growth and the stock market were being propped up by low interest rates, we have been consistent stock bulls and bond bears over these four years. During that time there have been some big counter-trend bull moves in bonds, and smaller bear moves in stocks. But overall, the best US macro trade has been to short Treasuries and reinvest the proceeds in stocks. Stocks have proven to be the "king of carry trades" (see "The King of Carry Trades" June 14, 2005). In that larger context, it's not such a mystery that stocks have shrugged off the mini-crash in bonds. Why should stocks care if there's another little leg in a four-year bear market in bonds -- especially when it was triggered by better growth expectations?

If the Fed were to hike rates beyond normal, it would be a different story. But though very modest rate hike expectations are beginning to show up in the fixed income futures markets, at this point markets have no reason to look much beyond that -- to rates high enough to cripple growth. Even as growth visibly reaccelerates, the Fed is likely to wait several months before venturing a rate hike or two, just to be sure that the risk of contagion from the housing slowdown has really passed -- especially with the possibility that higher long-term consumer interest rates driven by the recent back-up in Treasury yields could prolong or even worsen the housing sector's problems. With no newly urgent manifestations of inflation pressures, the Fed probably feels it has the luxury of time to wait and see. While that plays out, in the absence of an eruption in measured inflation, stocks don't need to worry about an overly aggressive Fed.

That's a real risk for the longer term, because we don't think the inflation pressures set in motion during the last several years of the Fed's excessive accommodation will give up without a fight. Some evidence of that can be inferred from the performance of inflation-sensitive equity sectors -- energy and basic materials -- during the recent bond mini-crash. We have warned that the elimination of rate cut expectations takes away some of the bull case for these "inflation plays" (see "Inflation Plays Revisited" May 31, 2007). Somewhat surprisingly, since the interim top in the S&P 500, they've performed pretty much at-market (energy slightly out-performing the S&P 500, materials slightly under-performing). This may be signaling that while there's little chance the Fed will make the worst-case inflationary error of cutting rates, it is very likely to make the inflationary error of staying on pause while growth reaccelerates, making the funds rate of 5.25% increasingly accommodative versus the rates of return available in the economy.

BOTTOM LINE: The recent decline in stocks corresponding to the mini-crash in bonds has been just a correction, not a permanent change in trend. The Fed is a long way off from growth-threatening rate hikes. And yesterday's anti-China bill in the Senate is likely to have little material impact on trade.