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MARKET CALLS

Burned Out

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Panic was ignited by Bill Gross and it burned out with Jim Cramer.

The panic in stocks triggered by turbulence in credit markets has burned itself out for the time being. We date the panic's beginning to July 24, when bond manager Bill Gross published a report declaring a "liquidity crisis" (see "Bill Gross Shoots, But Can't Hit" July 25, 2007). It seems its end came in the final hour of trading Friday afternoon when another investment celebrity, James Cramer, experienced an on-air meltdown on CNBC, shrieking "we have Armageddon." Anyone who was going to panic and sell stocks, who hadn't done so already, surely did on Friday, egged on by Cramer's histrionics. With all possible sellers out of the way, Monday's rally was inevitable.

Update to strategic view

US STOCKS: The edge of panic is off stocks. As the turbulence in credit markets plays out it will remain a rocky road, but the worst is over. The stage is now set for confidence to gradually rebuild, and for stocks to gradually work their way back to the highs, lifted on the rising floor of growing earnings.

[see Investment Strategy Dashboard]

The S&P 500 corrected 7.0% in the 11 days from Gross's "liquidity crisis" report through Friday (and 7.7% in the 15 days since the very top). That's not as brutal as the drop following Gross's "Dow 5000" report in September 2002. Then the October bottom didn't come for 40 days, after a 15.2% loss in the S&P 500. Gross was right before he was wrong in 2002, as we think it will turn out this time, but probably without as much blood-letting. By the softer standards of this bull market, the present correction has been the real thing, out-doing the 5.9% loss over 13 days in the February/March adjustment. The drop in stock prices, the drop in Treasury yields, and the continued acceleration of forward earnings (now growing at better than a 20% annualized rate) have brought the equity risk premium back to near historic levels, with the S&P 500 about 40% undervalued on Friday versus historic norms. Unless Cramer is right about "Armageddon" (bear in mind that he was saying "sell when you can" the day before the October 2002 bottom), stocks have seen about as much pain as they are going to have to.

The exhaustion of panic isn't the same thing as the restoration of confidence, but its a necessary precondition. Willing for the first time in two weeks to see the glass being half-full, markets seized on a rumor yesterday that Fannie Mae and Freddie Mac were seeking the lifting of regulatory restrictions on the size of their portfolios, suggesting that they would be eager

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buyers of mortgages at today's distress prices. This is precisely the kind of thing the credit markets so desperately need -- evidence of strong hands willing to come forward and grab some risk, after a two-week boycott against risk-taking. Alone, the Fannie/Freddie rumor, even if true, isn't the catalyst for confidence we're looking for. But if we are right that there is no genuine liquidity crisis in the fundamental monetary sense (see "Fever of Fear" July 26, 2007), strong hands will indeed come forward. As they do, stocks should gradually work their way back to the highs.

BOTTOM LINE: The edge of panic is off stocks. As the turbulence in credit markets plays out it will remain a rocky road, but the worst is over. The stage is now set for confidence to gradually rebuild, and for stocks to gradually work their way back to the highs, lifted on the rising floor of growing earnings.