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

MACROCOSM

# Stocks Don't Need a Rate Cut

Friday, August 31, 2007

**Donald Luskin**

**There are other tools for the job. In fact, when easing expectations rise, stocks go down.**

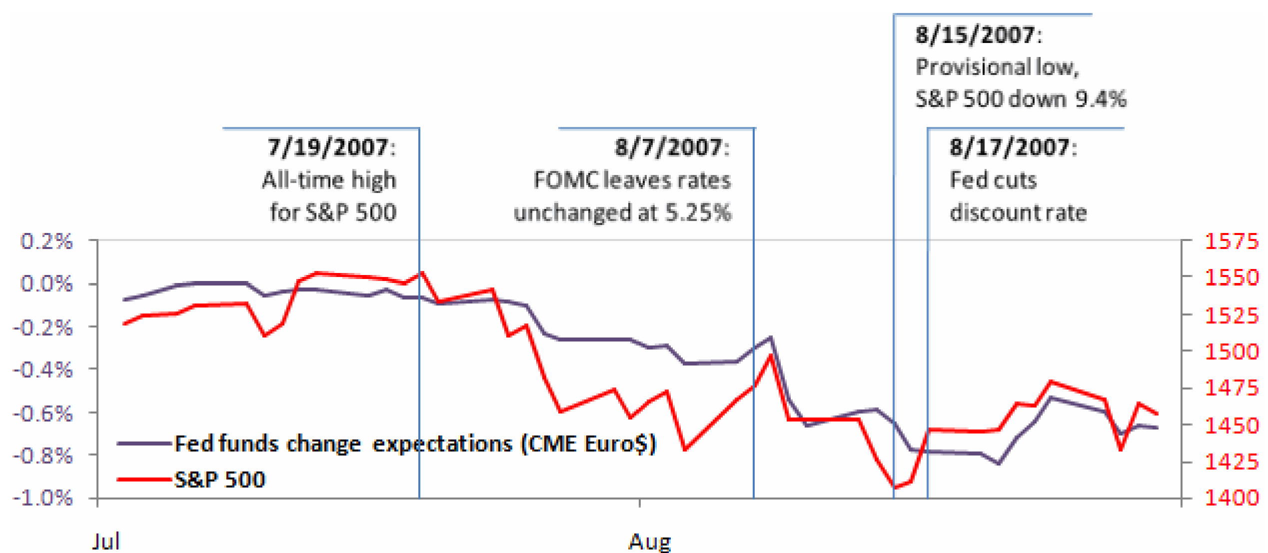
**Update to strategic view**

**US STOCKS:** Stock prices are not driven by fed rate cut expectations -- when easing expectations increase, stocks fall (and vice versa). As the present crisis passes, we expect the Fed not to cut rates, and for stocks -- the leading value proposition in the market -- to continue to rise from the August lows.

[see Investment Strategy Dashboard]

We must seem like those Japanese soldiers who kept fighting on their Pacific islands, not knowing that World War II was over. We're the last analysts in the market who still think the Fed isn't going to cut the funds rate at the September 18 FOMC meeting, and probably not for a long time after (see "Don't Count Your Doves" August 30, 2007). We've stood alone for more than three years now believing the Fed wouldn't cut rates, throughout the hiking cycle that began in June 2004. The conventional wisdom and the futures markets finally came around to our point of view three months ago (see "Doves Eat Crow" June 6, 2007), only to completely reverse themselves in the present credit panic. At least we're consistent. And so far, we've been completely right.

If we're right again, we don't see that as a problem for stocks. Far from being *supported* by Fed easing expectations, stocks have *fallen* from all-time highs in tandem with the deepening of those expectations. Day by day since the July top, stocks fell when expectations deepened, or rallied when expectations diminished, on 70% of days.




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

Copyright 2007 Trend Macrolytics LLC. All rights reserved. This document is not to be forwarded to individuals or organizations not authorized by Trend Macrolytics LLC to receive it. For information purposes only; not to be deemed to be recommendations for buying or selling specific securities or to constitute personalized investment advice. Derived from sources deemed to be reliable, but no warranty is made as to accuracy.

This isn't 1998, when by this stage in a similar crisis stocks had already fallen almost 20% while the Fed did nothing (see "2007 and the Ghosts of 1998" August 16, 2007). Then the Fed was too tight coming into the crisis -- indeed, the Fed's deflationary policies triggered the crisis in the first place. Then cutting rates was the right thing to do for growth. But coming into the present crisis, the Fed was too accommodative -- indeed, *that's* what triggered *this* crisis. And in 1998 stocks were deeply overvalued in relation to earnings and too-high interest rates. Coming into the present crisis, stocks were extremely cheap by the same metrics. In the present crisis, stocks have gotten even cheaper as prices have fallen, Treasury yields have fallen, and forward earnings have increased -- to all-time highs. No wonder stocks are off less than 6% from their all-time highs -- barely enough of a move to deserve being regarded as a serious correction (see "Where's the There There?" August 23, 2007).

With forward earnings at all-time highs, why do stocks need a rate cut? And if those forward earnings are correctly forecasting continued robust growth (see "Earnings to Economy: 'No Recession'" April 20, 2007) -- supporting the unanimously strong macroeconomic data we've seen so far in this crisis -- then what would make Ben Bernanke want to cut rates in the first place? A credit crisis doesn't in and of itself give him a reason -- until and unless it is seen as imperiling growth. In a 2002 speech, Bernanke said:

> My suggested framework for Fed policy regarding asset-market instability can be summarized by the adage, *Use the right tool for the job.*
>
> …By using the right tool for the job, I mean that, as a general rule, the Fed will do best by focusing its monetary policy instruments on achieving its macro goals--price stability and maximum sustainable employment--while using its regulatory, supervisory, and lender-of-last resort powers to help ensure financial stability… [the] lender-of-last resort function made operational by the Fed's ability to lend through its discount window.

We expect that Bernanke's highly anticipated speech this morning will make much the same point. The continuing large scale of Fed open market operations at the existing rate of 5.25% implies that no lower rate is necessary to meet the market's liquidity requirements. The discount rate now at 5.75%, and the liberalized term provisions and criteria for collateral for discount window loans, provide a strong backstop for distress situations -- which, notably, has so far scarcely been used (see "A Surgical Strike" August 17, 2007).

Further, yesterday evening the White House leaked a series of initiatives to be announced today, designed to relieve distress among subprime borrowers. We generally don't look favorably on government intervention in such matters, and we harbor some worries that these initiatives could grow into a "Sarbanes Oxley of mortgages," unleashing all manner of negative unintended consequences -- especially if Congress and the White House get in a "can you top this" competition to see who can offer the most generous bail-out and the most punitive regulations. But for the moment, the salient element is that these initiatives are part of a series of focused efforts -- including the Fed's steps taken thus far -- to address the subprime lending problem at its root, rather than simply printing money and dropping it from helicopters (to hark back to another 2002 speech by Bernanke).

**BOTTOM LINE:** We don't want to be naïve about the risks to growth arising from the current credit crisis. But we see the credit markets stabilizing with, so far, only appropriate interventions from the Fed -- and with little or no damage to forward-looking growth indicators such as consensus earnings or, for that matter, the stock market itself. We think the Fed won't cut the funds rate, because it won't have to. If true, that happy fact will support stocks rather than undermine them. Stocks are the leading value proposition in markets with forward earnings at all-time highs and Treasury yields low, and as the credit crisis passes, we expect stocks to continue to gain from their August lows.