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In Synch

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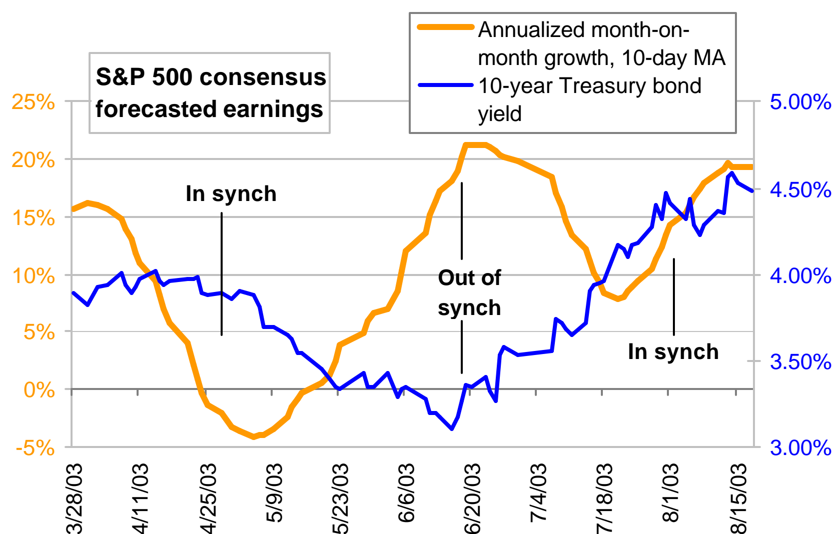
Earnings revisions and bond yields are telling the same pro-growth story.

As long-term interest rates have risen over the summer, stocks have been able to do little better than to hang on their gains from the March lows. Yet we have consistently argued against the conventional wisdom that higher rates will act as inhibitors of continued recovery. Rather, we've said that rising rates are among the many signs that growth is accelerating.

The pace of earnings forecast revisions this year tends to validate our view that the economy is accelerating. The pattern of revisions suggests that the market is finally beginning to adopt our view that higher interest rates won't stand in the way. And set in relation to the pattern of long-term interest rates, the pattern of revisions also reveals the colossal error made by **the Fed** -- and a credulous bond market that followed the Fed -- in May and June (see "Fed Cred" August 13, 2003).

The chart at right tracks the growth rate of consensus forecasted earnings for the S&P 500. The orange line is the 10-day moving average of annualized month-on-month forecast revisions. When revisions are accelerating, the line rises; when they are decelerating, the line falls. The blue line on the chart is the 10-year Treasury bond yield.



As the invasion of **Iraq** commenced in late March, the pace of revisions fell, and by the end of April was actually negative -- *i.e.*, earnings forecasts were being revised downward. Bond yields moved downward as well. Both, at that time, suggested a consensus for the deceleration of economic growth.

Then earnings forecasts and bond yields got badly out of synch. At the conclusion of war, earnings forecasts were rapidly revised sharply upward. Yet bond yields continued sharply lower. In fact, just as the pace of upward earnings revisions briefly topped an annualized rate of 20%, bond yields were making historic lows. Why? Because this was the height of the bond market's belief in the Fed's promise to lower short-term rates to 1% or beyond, and keep them there for an indefinite future, come hell or high water. This otherwise insupportable policy commitment was rationalized by the Fed and the bond market as enabled -- no, necessitated! --

by the specter of monetary deflation risk. Thus what seemed at the time to be a rock-solid standby bid by the Fed created an arbitrage opportunity that trumped any other valuation considerations -- the Fed's short end of the curve dragged down the long end.

After the June **FOMC** meeting and statements by **Alan Greenspan** that growth prospects were greater than the Fed had reckoned, the bond market rapidly reassessed the credibility and longevity of the Fed's bid -- and its own naiveté in imagining that the Fed's baseless deflation rationale could hold down short-terms rates in the face of accelerating growth. Long-term rates shot up.

Yet just as the bond market was forced to consider the prospect of greater than expected growth, the pace of upward earnings revisions declined. It would seem that the consensus stopped to assess the meaning and impact of the sudden interest rate regime change. But then, in mid-July, as 10-year rates moved up through the 4% level, the pace of upward earnings revisions picked up again -- validating our view that the regime change in rates was not itself inimical to growth, but rather a symptom of expectations for growth. And ever since then, bond yields and earnings revisions have been back in synch -- very much to the upside.

With the disorderly oscillation in interest rates induced by the Fed's clumsy intervention out of the way (and with the bond market even sadder and wiser than it normally is) equity and fixed income markets are now both free to continue to reflect --together -- the ongoing acceleration of economic growth. TM