

MACROCOSM

Resilience or Folly?

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Stocks have weathered well this week, but we're suspicious.

The resilience of **equities** this week to disappointing **earnings** headlines, rising **crude** prices and the whiff of panic in **Japan** is testimony to what we've been saying all along. First, stocks are **cheap** relative to **consensus forward earnings** and **bond yields**, and their extreme **undervaluation** puts a **floor** under any **potential downside**. And second, the **global liquidity glut** that is the consequence of **the Fed** having been so **easy** for so long means **volatility** will stay low -- there's enough money around to dampen big moves in either direction. Beyond that, **sentiment** among **professional investors** seemed to us so terribly negative in the closing days of 2005 it was almost inevitable that 2006 would get a strong start and be robust to garden-variety **news shocks**.

Yet all that said, we are uncomfortable with this **New Year's rally**. For one thing, sentiment has swung strongly to the positive. In 77 years, there have been only a dozen in which the first four days of January performed better than this year -- a fact that animated much non-fact in the media about the "**January Indicator**." That was topped for sheer silliness the following week by the hoopla surrounding the arbitrary but widely followed **Dow Jones Industrial Average** surpassing the arbitrary but widely followed 11000 mark.

Most disturbing, though, is the fact that more than all the gains year-to-date were made during those celebrated first four trading sessions. Those days coincided with a surge of confidence that the Fed would conclude its **rate-hiking cycle** with the January 31 **FOMC** meeting. **Fed funds futures** -- a proxy for those **expectations** -- hit their year-to-date highs on the fourth trading day. They've been drifting lower ever since, as confidence that the Fed is "**done**" has been somewhat eroded. And stocks have been in a choppy stall-out ever since. That's not to say that "done" expectations couldn't improve again -- with a commensurate resumption of the up-move in stocks. That may happen if, as we expect, the Fed is more than usually opaque around the January 31 meeting, out of respect for preserving degrees of freedom in **policy options** for **incoming chairman Ben Bernanke**. **Bond bulls** and **macroeconomic pessimists** have shown a boundless capacity to underestimate this hiking cycle, and right now the Fed may do little to correct them -- with stocks the beneficiary.

But we strongly disagree that the Fed is finished raising rates. We become more confident of that with each tick higher in **energy** and **commodity prices**, which makes us ever more confident in our longstanding prediction of rising **reported inflation**. Even this week's seemingly benign **CPI** report revealed that **core inflation** on a three-month annualized basis is, with the exception of a single month, now running higher than it has at any time since 2001. And we become more confident with each piece of new evidence of the strength of **economic growth** (see "[Slowdown?](#)" January 19, 2006). At this point the so-called **output gap** is closed, and any acceleration is **macroeconomic variables** such as **employment** or **capacity utilization** will put the Fed's models into the danger zone, driving rates at least to the high end of **neutral** (see "[Accidentally on Purpose](#)" January 11, 2006). We expect that Bernanke will start guiding

expectations toward the mildly **hawkish** shortly after he gets his feet under his new desk. That sets the far limit on how long stocks can persist in a rally based on the incorrect notion that the Fed is done.

Bottom line: The resilience to shocks shown by stocks this week is encouraging evidence of strong fundamentals, but we fear that the January rally is based largely on erroneous expectations that the Fed is done hiking interest rates. Perhaps sooner, but surely later, those expectations will be corrected -- and so will stocks (especially the **inflation plays** that have led the way year-to-date, feeding on fears that the Fed will make a large inflationary error). At this point it's a tricky short-term game of trying to guess exactly how long erroneous expectations can be preserved. Stepping back and looking at the larger picture beyond this fluctuation in sentiment, we continue to be positive on the economy (believing that the next few rate hikes, at least, will be useful and appropriate adjustments in light of inflationary risks) and positive on stocks (believing that they remain deeply undervalued, especially in an environment in which we forecast the the economy will surprise on the upside). **IM**