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MACROCOSM

The End of the World, Part 3

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Another market "tantrum" tests the August/November lows for stocks.

It's the end of the world again, as the S&P 500 nears for the third time the level of the twin bottoms made in the two worst moments of the credit panic -- August 15 and November 26. From an equity investor's standpoint, all the volatility in the meantime hasn't necessarily been in vain -- there have been some notable bright spots.

We said in August that the inflation-sensitive resource sectors -- energy and basic materials -- would be the strongest coming off that month's panic bottom (see "Where's the There There?" August 23, 2007), and this has been exactly right. Since the August 15 bottom, the energy sector has been the best performer in the S&P 500, 17.9% higher today than it was then (and it's now the sector closest to its all-time highs, off only 2.3%). Energy is also the best performing sector off the November 26 bottom, higher by 8.8%. The basic materials sector is the second-best performer from both bottoms, higher by 13.3% and 6.0% respectively. It would seem that however much remains a mystery about where the economy is headed from here, one thing is certain: inflation is a force to be reckoned with.

This third time around, the equity market sell-off would seem to be less about credit fears and more about growth fears, triggered by a weak ISM manufacturing survey on Tuesday, and a soft jobs report on Friday (see "High Anxiety" January 3, 2008). During last week's sell-off, little credence was given to signs of healing in credit markets, such as the sharp uptick in asset-backed commercial paper outstanding, the drop in LIBOR and the TED spread, and the new all-time highs for bank lending. Good macroeconomic news such as the robust growth in construction spending, the new all-time highs for S&P 500 forward earnings outside the financial sector, and the strong ISM services survey was ignored, too. All of that was drowned out by worries about recession, with the usual suspects in the financial media disagreeing only about whether recession is imminent or has already arrived. It's the end of the world.

Update to strategic view

US RESOURCE STOCKS, GOLD, OIL, COMMODITIES, US DOLLAR: Another market "tantrum" has rendered the Fed unable to do anything but keep cutting rates, regardless of the obvious evidence of rising inflation risk. Inflation-sensitive commodities markets and resource stocks should continue to be strong performers, and the US dollar should continue to be weak.
US STOCKS, US BONDS: The equity risk premium is back to historic highs. With relative valuations stretched this far, we expect a successful test of the August/November lows for stocks, and a move higher in Treasury yields.

[see Investment Strategy Dashboard]

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In our view, last week's mixture of weak and strong data is consistent with the kind of temporary soft spot we've been expecting now for almost two months (see "Fear Itself" November 16, 2007). We think the slowdown we're beginning to see is based more on sentiment than reality. It's a self-fulfilling prophecy fueled by six months of relentless fear-mongering by Wall Street, the media, politicians, and even the Fed. But it's set ironically against the backdrop of financial conditions that make an actual recession extremely unlikely. Since the 1960s, there's never yet been a recession that was not preceded by real interest rates above 4% -- they never got above 3.3% even when the Fed was at its tightest, and now they're at 2.3% (see "Hell of a Year?" December 27, 2007). So for us, the weaker components of last week's data aren't "news" that causes us to revise downward our growth forecasts -- they're right at expectations.

It may also be the case that this third visit to the lows in equities is part of another market "tantrum" or "speculative attack" (see "'Act As Expected'" November 28, 2007), intended to elicit the most generous possible easing response from the Fed at the January FOMC meeting. In the last week of 2007, as it became clear that emergency facilities put in place by the world's central banks would get the credit markets through a difficult turn-of-the-year, expectations in futures markets for a 25 bp January rate cut fell to only a 60% to 70% probability. Now, after a week of new market turbulence, it's *a 50 bp cut* that is assigned a 60% to 70% probability, with a 25 bp cut deemed a sure thing. The "tantrum" has had its desired effect -- to move rate cut expectations that the Fed won't dare disappoint.

There are side-effects, too. Long term, an already easy Fed driven to be even easier will have to allow mounting inflation risks to continue to compound. We expect that the inflation-sensitive resource sectors will continue to benefit. And the present market "tantrum" has left the equity risk premium -- the difference between the forward earnings yield of the S&P 500 and the yield of long-term Treasury bonds -- at its highest ever since high-quality data began in 1984, with the exception of the single day of November 26, 2007. Based on historical norms, for such a high risk premium to justified, we would have to see some combination of the S&P 500 rallying 55%, long-term bond yields rising 255 bp, and/or forward earnings falling 41%. No one of those things is likely to happen, not in full, and not anytime soon. But unless we are utterly wrong and the present soft spot turns into a full-blown recession, we think that relative valuations are stretched so far that, within a matter of days, we should see a successful test of the August/November lows for the S&P 500, and a move higher in Treasury yields.

BOTTOM LINE: Another market "tantrum" has rendered the Fed unable to do anything but keep cutting rates, regardless of the obvious evidence of rising inflation risk. Inflation-sensitive commodities markets and resource stocks should continue to be strong performers, and the US dollar should continue to be weak. The equity risk premium is back to historic highs. With relative valuations stretched this far, we expect a successful test of the August/November lows for stocks, and a move higher in Treasury yields.