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

MACROCOSM

The Bear Stearns Bottom: One Month Later

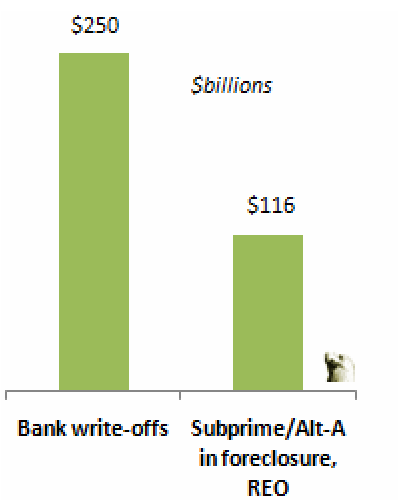
Thursday, April 17, 2008

Donald Luskin

The economy stabilizes short of recession, and "inflation plays" emerge as "growth plays."

It feels like longer, but it's been one month now since the panic bottom in equities following the Fed-assisted collapse of Bear Stearns (see "Bernankruptcy" March 17, 2008). Our call to buy weakness then has been correct, though not spectacular, with the S&P 500 now having returned 7.0% -- similar to the 7.8% rally in late November 2007, and the 6.5% rally in January. Those two earlier rallies didn't last, with each one followed by a subsequent new low. But this time there's reason to think that we could be on a sustainable path, if a rocky one, to recovery.

The macroeconomic picture supports continued recovery in equities. The data is not unanimous, but things appear to be brightening somewhat, overall (see "It Doesn't Look As Bad Now As it Did Then" April 10, 2008). As the data stands, we are still only in a slowdown -- recession, despite a widening consensus in favor, remains only just another prediction that may or may not come true. Even with this morning's rise in jobless claims (which was less of a rise than expected), claims remain significantly below levels typically seen in the first several months of recession. Yesterday, industrial production surprised on the upside with a gain for March, rather than an expected decline (with high-tech IP, the most growth-sensitive component, moving to new all-time highs). This morning's Philadelphia Fed survey was a downside surprise, but earlier this week the Empire State survey was an even larger surprise, and to the upside. Last week General Electric's earnings miss and lowered guidance shocked markets -- but much of the depth of the market's reaction, and perhaps the motive of the downshift in guidance, may have been chagrin that GE's management failed to pre-announce. Now Intel and IBM have surprised on the upside, and given testimony that IT demand remains strong. And



Update to strategic view

US STOCKS: As the economy stabilizes and macro data surprises mildly on the upside, we expect the March bottom to hold, and for stocks to grudgingly work higher.

US RESOURCE STOCKS: While inflation expectations have lessened, the inflation-sensitive energy and materials sector have nevertheless been the best performing in the S&P 500. We maintain our neutral position, but with the economy stabilizing, we may have to start calling them "growth plays" instead of "inflation plays."

[see Investment Strategy Dashboard]

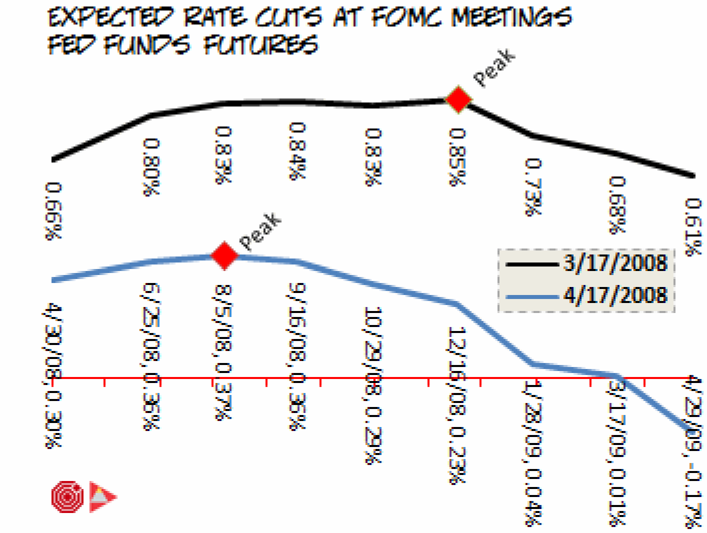
http://www.trendmacro.com
don@trendmacro.com
dgitlitz@trendmacro.com
tdemas@trendmacro.com

Offices:
Menlo Park CA
Parsippany NJ
Charlotte NC

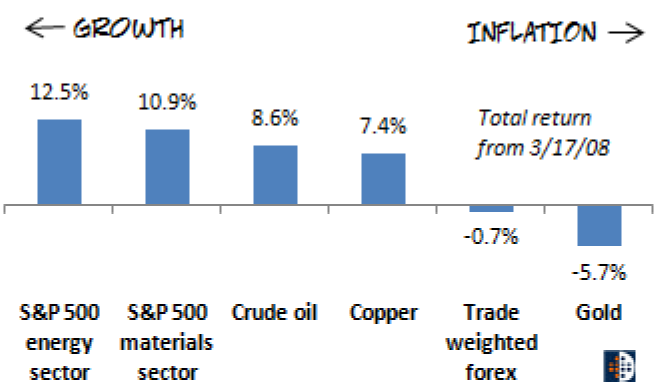
Phone:
650 429 2112
973 335 5079
704 552 3625

throughout it all, cap-weighted consensus forward earnings outside the financial sector continue to eke out new all-time highs.

Credit markets have improved substantially over the last month. AAA-rated ABX indices have returned about as much as the S&P 500. High yield bond spreads have narrowed sharply. Discounts on leveraged loans have shrunk. And the S&P 500 financial sector has outperformed the broad market, returning 9.8%. Bank earnings reports continue to feature massive write-downs. But the edge seems to be off --they now seem to lack the capacity to shock. At least now they have risen to levels that meet or exceed what is required to be seen as a full admission of the depth of the losses involved. After all, how much more is required now, with something in the neighborhood of $250 billion having already been written off -- when the total value of US subprime and Alt-A mortgages in foreclosure or REO is only $116 billion?



Happily, this has all happened against the backdrop of decreasing expectations for further Fed rate cuts. A month ago, futures markets were expecting 66 bp in cuts at the April FOMC meeting (i.e., a 50 bp cut with full certainty, with a 50% chance of a 75 bp cut) -- with the easing cycle expected to peak in December with 85 bp in rate cuts, and with 61 bp in cuts still persisting one year out. Today the markets expect only a 30 bp cut this month (i.e., a 25 bp cut with full certainty, with a 20% chance of a 50 bp cut) -- with the easing cycle expected to peak now in August with only 37 bp in rate cuts, and with any cuts from today having been more than taken back with hikes one year out. In fact, markets assign a better than 50% probability to rates being *higher* a year from now than they are today. So much for the conventional wisdom that the markets and the economy are dependent on further sharp rate cuts in order to sustain recovery prospects. Quite the contrary. The clear implication is that the Fed's new non-monetary tools -- the TAF, the TSLF and the PDCF -- are succeeding in solving the credit crisis, and are substituting for monetary tools that have proven less effective.



We continue to believe that the sharp pullback in rate cut expectations over the last month implies that the Fed has retreated from the brink of a major inflationary error, which inflation-sensitive markets had previously been pricing (see "Three Quarter Profile In Courage" March 19, 2008). We have accordingly moved to a neutral position on "inflation plays" (see "Inflation Inflection" March 25, 2008). But remember, some inflation-sensitive markets are also growth-sensitive -- and growth prospects are improving as the economy recovers and the credit crisis heals, and as the implicit threat to growth from inflation itself recedes (see "2 + 2 = 3 and 3 - 2 = 2" April 7, 2008). So over the last month, the growth-sensitive energy and materials sectors have been the best-performing in the S&P 500, up 12.5% and 10.9% respectively, beating even the financial sector as it bounces back from panic lows. We think it's the growth component in energy and materials, not the inflation component, that has been responsible for those sectors' performance. Looking at an array of assets that are both inflation-sensitive and growth-sensitive, performance over the last month has lined up perfectly with the more growth-sensitive performing best and the more inflation-sensitive performing worse.

BOTTOM LINE: As the economy stabilizes and macro data surprises mildly on the upside, we expect the March bottom to hold, and for stocks to grudgingly work higher. While inflation expectations have lessened, the inflation-sensitive energy and materials sector have nevertheless been the best performing in the S&P 500. We maintain our neutral position, but with the economy stabilizing, we may have to start calling them "growth plays" instead of "inflation plays."