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MACROCOSM

From Pessimism to Populism

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Today's fears are overwrought, but they're laying the groundwork for serious future risk.

With stocks dropping again this morning, I'm trying to remember that I spent last week on vacation -- in Hawaii, on the Kona Coast, a boomtown fueled by new wealth from California and Asia, with gigantic homes, ultra-luxe resorts and sprawling golf courses going up everywhere, driving more than full local employment in the process of making the black lava desert bloom. On the flight home to San Francisco, in a plane packed with happy passengers despite fuel and luggage surcharges, a man seated in first class was reading *Newsweek's* cover story on the economy, with the blaring headline "Why It's Worse Than You Think." After what I saw in Kona at the crossroads of a global boom, it's hard to believe that anyone could think it's bad at all. But then again, considering the horrible sentiment in markets this year and the polls that have shown for several years that a majority of Americans believe the economy is in recession, it's just as hard to believe that anyone could be persuaded to think it's any worse than they already think it is.

Update to strategic view
US STOCKS: The correction we expected drags on nastily, but with forward earnings surging while sentiment remains horribly pessimistic, we continue to hope it's only a correction. That said, today's pessimism is fueling a political lurch toward the populist left. In the short term this may be a restorative to sentiment, but longer term it poses a serious threat to growth and to stock prices.
[see Investment Strategy Dashboard]

From the beach in Hawaii, the relentless pessimism fueling the present stock market correction (see "The Next Thing to Worry About" May 8, 2008) seemed like a deliberate exercise in mass self-torture. Consider the market's enduring obsession with the financial sector. A full quarter after the Fed's deft handling of the orderly liquidation of Bear Stearns (see "Bernankruptcy" March 17, 2008), markets still hang on every fact -- or if facts are unavailable, every rumor -- about such things as Lehman's earnings and capital structure, as though this broken company representing only 11 bp of S&P 500 market cap, and now with access to Fed liquidity that Bear Stearns didn't have, had the potential to cripple the entire world financial system. And at the same time that investors fear the financial sector, they are engaged in an unrequited love affair with it -- always trying to catch an ever-elusive bottom, imagining that salvation is just around the corner -- though in our view the whole sector is as broken as Lehman (see "Inflation Inflection" March 25, 2008). Next time you consider buying, count to ten, remind yourself that *subprime lending was their best idea*, and wait for the impulse to pass (see "Subprime Lending Was Their Best Idea" June 4, 2008).

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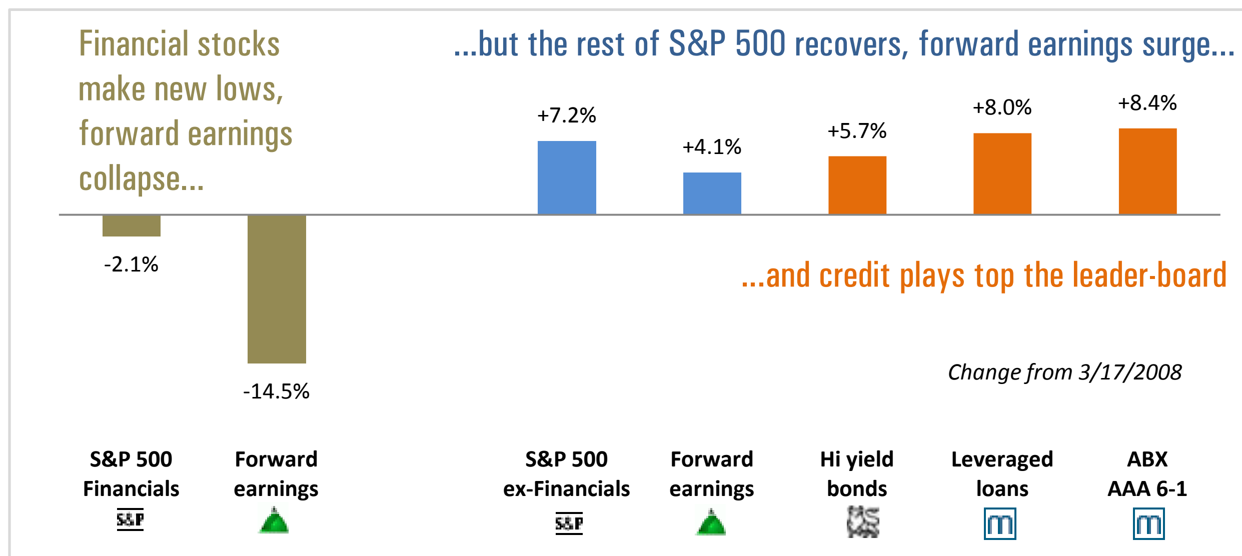
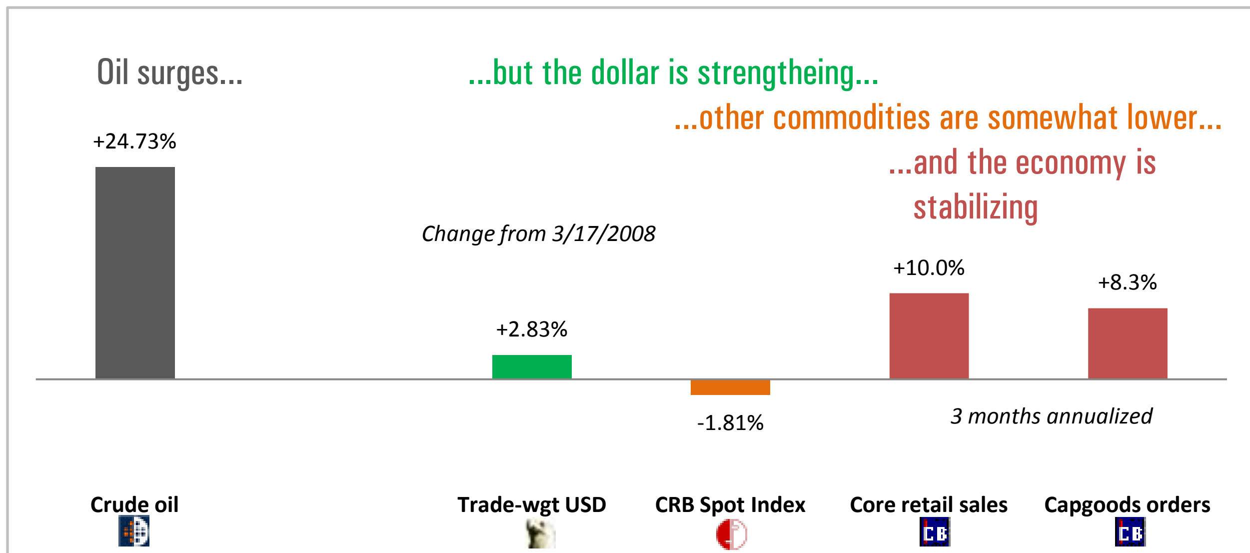
So investors are somewhere between disappointed and panicked that the S&P financial sector has fallen to new lows 2.1% below the mid-March stock market bottom -- and further this morning -- and the sector's forward earnings have imploded with a drop of 14.4% in just three months. Be disappointed, but don't panic: the rest of the world has quietly been doing just fine. The S&P 500 ex-financials has returned 7.2% since the mid-March bottom, and in just three months its forward earnings have surged 4.2% to new all-time highs. And that's not just because of the energy sector. Forward earnings for not only energy but also consumer staples, health care, technology and materials -- in all, five out of ten S&P 500 sectors -- are either literally at all-time highs or within basis points of it.



At the same time as the financial sector has failed to recover from the March bottom, some of the risky credit products that got it into trouble in the first place have been among the best-performing asset classes in the markets, as we expected (again, see "Inflation Inflection"). Plain-vanilla junk bonds have returned 5.7%, bringing them to within about a percentage point of all-time highs. Leveraged loans have returned 8.0%. And the highest-quality tranches of CDOs of subprime MBS have done best of all, returning 8.4%.

Another element of extreme pessimism that seemed overdone from my perspective in Hawaii is the threat of high oil prices. It's not hard to be worried about the sudden run-up in the price of the second most important ingredient in global growth (the first being human knowledge). And in one sense that run-up is all the more troubling for the lack of a robust explanation for it. The idea that it reflects an expectation that the US or Israel will attack Iran as the US election approaches is especially horrific, and especially nerve-wracking because the odds of it are so hard to handicap -- *that's* motivating this morning's move higher in oil. But today's palpable mood of impending disaster is surely aggravated by hand-wringing over factors that manifestly are *not* an explanation. The recent surge in oil prices is not the result of a permanent adverse change in market structure brought on by commodity index funds, because among many other reasons there has not been a comparable surge in other commodities in which these funds invest (see "Commodity Prices: Blame the Indexers?" May 28, 2008). And the surge can't be the result of an alarming collapse of the dollar on forex markets, though this claim is heard all the time, because no collapse has occurred. Yes, over the last five years rising oil and a falling dollar have had a common cause -- excessive ease from the Fed. But in the last three months, while the crude oil price has risen 24.7%, the trade-weighted forex value of the dollar has risen 2.8%, not fallen. And we're still waiting for the supposedly inexorable collapse in spending and

investment as energy prices crowd out everything else. Over the last three months as oil prices have surged, core retail sales (that is, excluding gasoline, autos and building materials) have surged as well, growing at an annual rate of 10%; and new orders for non-defense capital goods excluding aircraft have grown at an annual rate of 8.3%.

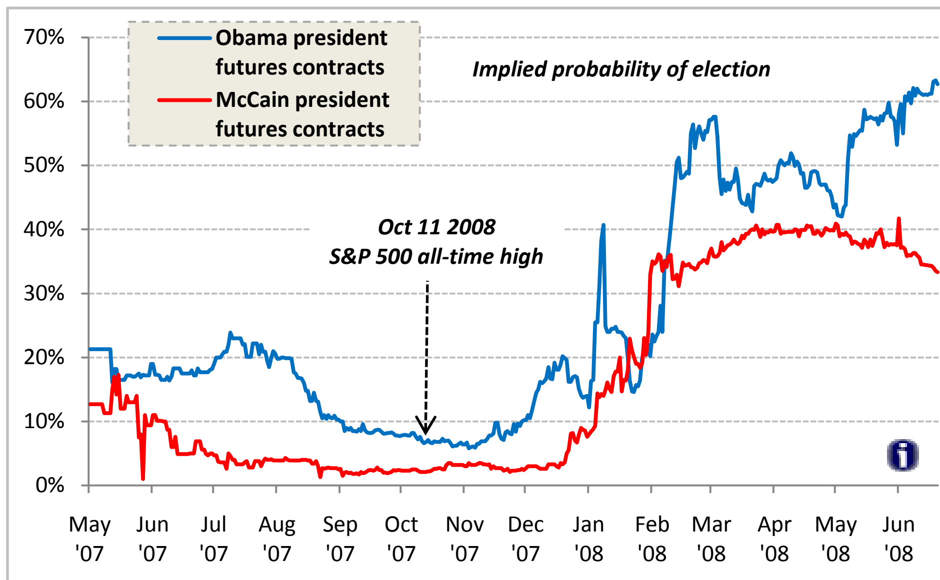


And then there's been the Fed and interest rates. It's seemed as though markets are just as worried that the Fed *won't* raise rates as that they *will*, reacting adversely as rate hike expectations have both risen and fallen the last two weeks. If you like having your worries both ways, then you can fret that if the Fed *doesn't* raise rates inflation will surge, while if they do then the economy will weaken further. In our view, the Fed must raise rates back toward normal levels, and quickly, in order to deal with already pipelined inflation pressures. We aren't worried that this will have any adverse impact on growth, as rates are starting from extremely low levels, especially when measured in real terms (see "Hikes Are Coming, and Not a Moment Too Soon" June 19, 2008). We're confident that the Fed will do it, if only because its hand will be forced by worsening inflation data and improving economic performance over the coming months.

With pessimism too rampant -- and, in our view, so unfounded -- it's not hard for us to continue to regard the current correction in stocks as just that, a correction. But longer term, pessimism itself looks like it may be responsible for creating a very negative situation for the economy and for stocks. The wearying sense of impending doom that overhangs the economy is playing into a tremendous appetite for political "change," and an apparent willingness to embrace populist government programs to solve problems -- whether or not the problems really exist, and whether or not the programs can really solve them.

For example, Barack Obama has announced a plan to assess payroll taxes on wages above $250,000, which amounts to over 0.4% of GDP annually -- and in combination with Obama's other tax proposals would raise the top marginal rate on labor income to above 60%. And the campaign has let it be known that it may consider assessing the tax not just on wages, but on interest and capital gains income as well. According to a very high-level source within the campaign, Obama's economic advisers haven't run any calculations to see whether or not, and to what extent, this expensive measure would shore up Social Security's long-term solvency. Normally such an expensive and casually conceived proposal would be political suicide. Yet in today's atmosphere of desperation for "change" and for solutions to frightening economic

problems, cost appears to be no object and benefit is apparently not even worth measuring. Much the same can be said of some of John McCain's policy proposals.



In the near-term, we entertain the possibility that the expectation that "change" is in the offing could improve sentiment, and conceivably even lift depressed price/earnings multiples enough to move stocks to new all-time highs (see "The Upside of Obamanation" May 22, 2008). But we can't help but be cognizant of the reality that stocks were already at all-times highs last October when Barack Obama and John McCain were both highly unlikely to be the next president. As the chart at left shows, as their probability of being elected has risen, stocks have fallen. In the end, one of them will be elected, and the populist economic policies being touted now by both of them will be bad for growth, and for stocks. The game will be to find the right moment to get out of stocks generally, and to identify the few sectors most likely to benefit, or be hurt the least, or that have already discounted the worst.

BOTTOM LINE: The correction we expected drags on nastily, but with forward earnings surging while sentiment remains horribly pessimistic, we continue to hope it's only a correction. That said, today's pessimism is fueling a political lurch toward the populist left. In the short term this may be a restorative to sentiment, but longer term it poses a serious threat to growth and to stock prices.