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

MACROCOSM

Markets Speak, Bernanke Needs to Act

Friday, June 27, 2008

Donald Luskin

We worry about the banks a little. The Fed should worry about an oil price spiral a lot.

Update to strategic view
US STOCKS: The continuing tragedy in financials and the panic in oil have turned a correction into a test of the March lows. With earnings strong outside the financial sector, we see values stretched to the point where the downside is limited. But a durable bottom can't come now until Bernanke signals he will act decisively to normalize rates in order to stabilize the dollar and oil. If he doesn't do so soon, then all bets are off. **US FINANCIAL STOCKS:** If stocks find a bottom here, then this beaten down sector could be good for a very exciting trading play. But beyond the scope of mere weeks, we see this as a broken sector, and the least compelling value play in the equity markets. **GOLD, OIL, COMMODITIES, US DOLLAR:** Inflation-sensitive markets are violently rebuking the Fed for not showing sufficient inflation-fighting resolve, threatening a 1970-style oil price spiral. If Bernanke listens, and moves to reassure markets that rate hikes are on the way, then the panic in oil, the resurgence of other commodities and the deterioration of the dollar will all be abruptly reversed. Bernanke's capacity to disappoint is nearly inexhaustible, but we would assign a 75% chance to his sending the right signal in a matter of days.
[see Investment Strategy Dashboard]

A lot went very wrong yesterday, and the magnitude of it was surprising and troubling. As forecasters we can take some satisfaction in having predicted a correction in stocks pretty much right at the top in early May (see "The Next Thing to Worry About" May 8, 2008), and having said throughout that the financial sector would be an accident that would keep on happening (see, for example, "Subprime Lending Was Their Best Idea" June 4, 2008). We've maintained that, for stocks overall, it would just be a correction, yet it has clearly become more than that -- it is a serious test of the March bottom. Ironically, the deepening loss of confidence in financials -- which we expected -- has played a large role, at least in terms of sentiment, in making the correction into a test -- which we didn't expect.

At the same time events are throwing into question our proposition that the worst-case inflation scenario is off the table (see "Inflation Inflection" March 25, 2008), and this played into yesterday's stock market rout as well. While the surge in crude oil prices to all-time highs has focused popular attention on inflation risks, we have emphasized how the most acutely inflation-sensitive markets -- gold and forex -- have pulled back considerably from their alarming levels of mid-March, as the Fed developed non-monetary and non-inflationary tools for dealing with the credit crisis, and prepared to stop using the blunt instrument of too-low interest rates (see "Three Quarter Profile In Courage" March 19, 2008).

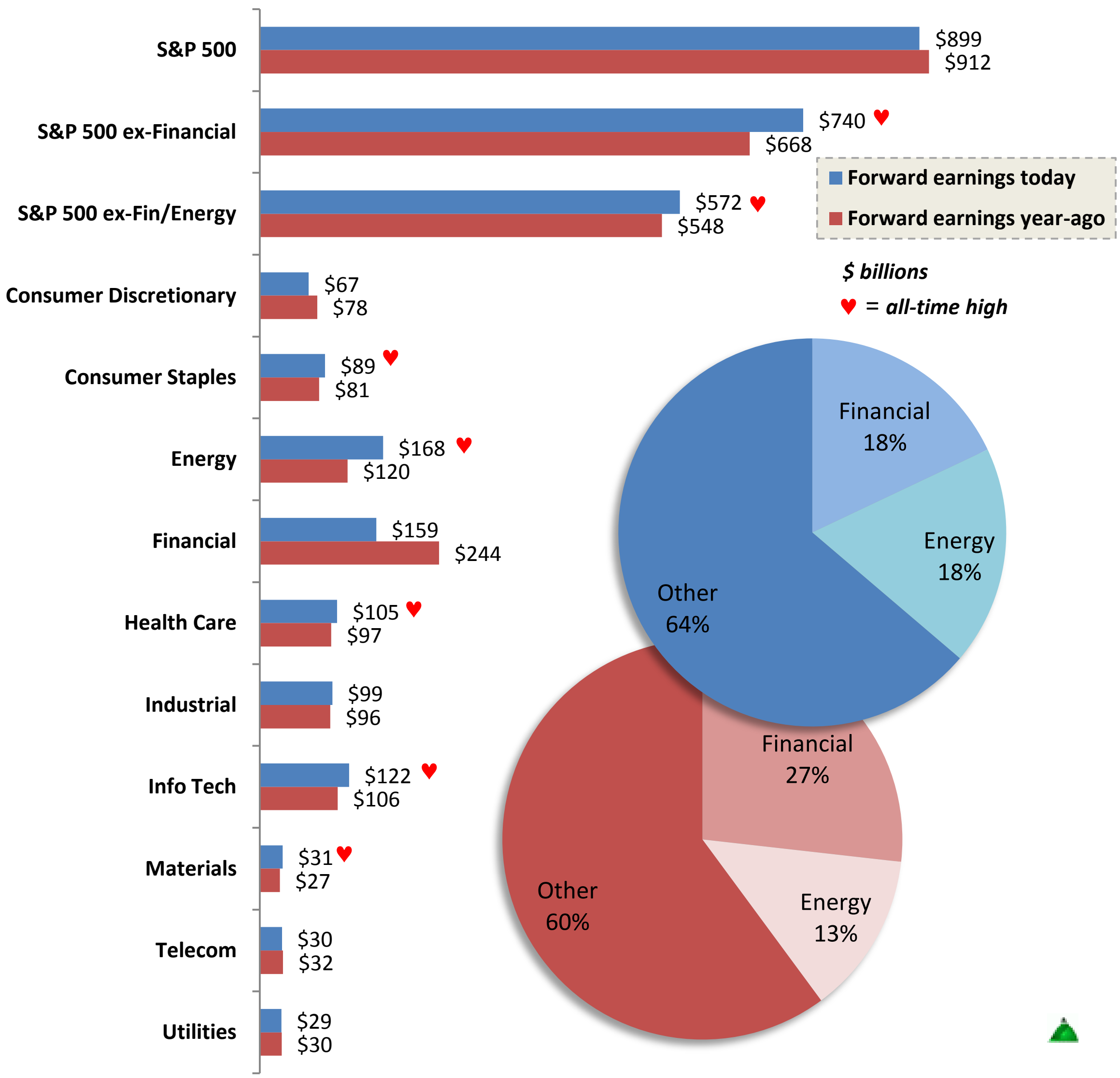
http://www.trendmacro.com
don@trendmacro.com
dgitlitz@trendmacro.com
tdemas@trendmacro.com

Offices:
Menlo Park CA
Parsippany NJ
Charlotte NC

Phone:
650 429 2112
973 335 5079
704 552 3625

Yesterday gold surged and the dollar fell sharply -- while oil made new all-time highs -- in the aftermath of an FOMC statement which, while objectively hawkish-leaning, was evidently far less so than markets felt they needed (see "Bonds Wish, Stocks Worry" June 26, 2008). With fed funds futures now priced for *less than two* 25 bp rate hikes by year-end -- when they had been priced for *more than three* hikes just two weeks ago -- markets are aggressively second-guessing the Fed's inflation-fighting resolve, and that could lead to a serious problem with the oil price.

FINANCIALS: HOW BAD FOR THE MARKET AND THE ECONOMY? Of all the dynamics in play yesterday, we regard the continuing debacle in the financial sector as the least important thing to worry about (we'll get to what concerns us more in a moment). To be sure, it's been a true debacle, and it's become a near obsession for investors (see "From Pessimism to Populism" June 20, 2008). Financials are off a horrific 40.1% (including dividends) since the S&P 500's all-time high last October, and off 9.5% since the March 17 bottom. Forward earnings



for the financial sector are off 36% since their peak last September when the scope of the credit crisis was just beginning to be grasped. For all that, the financial sector is no bargain here -- so the debacle is likely not over. The financial sector's forward price/earnings multiple now is 10.5, actually slightly *higher* than the 10.4 multiple of last September at peak earnings. And today's multiple is based on forward earnings that are probably utterly fantastical at this point, implying a 78% growth rate above trailing earnings.

A year ago, the financial sector was the S&P 500's largest by market capitalization, and now it has fallen to third (the information technology sector surpassed it last December and is now first, and the energy sector surpassed it earlier this month and is now second). But it's still a large sector, so cumulatively its negative impact on the overall market has been profound. Including financials, the S&P 500 is off 16.7% (including dividends) from last October's all-time high; ex-financials, it's only off 11.1%. Since the March 17 bottom, the S&P 500 including financials is up 1.0%; ex-financials, it's up 3.1%. Yet the S&P 500 ex-financials has become a better value, too. Last September when the financial sector was at peak earnings, the forward multiple of the S&P 500 ex-financials was 15.9. While, perversely, the multiple has *risen* for the financial sector since then, for the S&P 500 ex-financials it has *fallen* to 13.4.

The reason is that forward earnings for the S&P 500 ex-financials have grown, at the same time as market capitalization has fallen. There's not a single S&P 500 sector that stands today at all-time highs in terms of market capitalization. But of the nine sectors other than financials, five of them are at or are just basis points away from all-time highs in forward earnings. It's not just the energy sector -- it's also consumer staples, health care, information technology, and materials. It's difficult for us to believe that the economy is falling into recession -- or that the stock market has a lot of downside left here -- when fully half the sectors in the S&P 500 are not only at all-time high forward earnings, but when those forward earnings are also rapidly growing. Even including financials, where forward earnings are falling, month-over-month estimate revisions are growing at a 6% annual rate. Ex-financials, the rate is a very brisk 16%.

So apparently, despite the often-heard fears that the wheels of commerce will grind to a halt because debt securitization markets are impaired and shell-shocked banks have stopped lending, corporate America is finding a way to stay very much in business. That's because overall lending may have slowed -- certainly, several forms of risky lending at peak volumes a year ago simply don't exist anymore -- but legitimate lending hasn't dried up by any means. Plain-vanilla consumer lending is growing at a three-month annual rate of 11%. Commercial and industrial lending has grown at a modest 4% rate, but normally in a recession that rate would be negative. Even if such lending were to fall to a zero rate, that would be more of an earnings problem for lenders than a financing problem for corporate borrowers. Outside the financial sector, S&P 500 companies currently have $761 billion in cash on hand. To put that in perspective, that's $21 billion more than the same companies' aggregate one-year forward earnings.

THE ENERGY/INFLATION NEXUS -- THE REAL PROBLEM We are much more disturbed by the possibility that yesterday's market action signals a turn away from inflation-vigilance at the Fed. With interest rates as low as they are now, in both real and nominal terms, the Fed has already unleashed considerable inflationary pressures that haven't yet shown up in lagging official statistics (see "Facing the Music" May 29, 2008). The conventional wisdom is that these pressures can't possibly amount to much, since there's nothing resembling a 1970's-style wage/price spiral in the offing. But nobody is talking about the other 1970's-style spiral that is very much in danger of being set in motion -- an oil price spiral. In that highly inflationary decade, oil prices rose to keep pace with the falling value of the dollar. When higher oil prices slowed the US economy, the Fed responded with easy money, causing the value of the dollar to fall further and the oil price to rise higher.

We've pointed out for years now that the rising oil price has been, to a large extent, the result of inflation pressures. But we hadn't particularly regarded the run-up in oil over just the last three months as an inflation story, because over the same period almost all other inflation-sensitive markets -- notably gold and forex -- had gone the other way. But yesterday they all got in synch in a big way, and all pointing toward heightened inflation risk. Indeed, it had the stench of panic about it, as though the markets were telling the Fed that this had been the key moment to do something substantive about inflation risk, but instead the Fed just talked. It's especially unfortunate because incoming macro data -- such as this morning's strong income and spending numbers -- is confirming that the economy is stabilizing, so the Fed surely has the scope to move rates from today's ultra-low levels.

Missing the moment here wouldn't be the first time for the Bernanke Fed. In the spring of 2006, shortly after Ben Bernanke was made chairman, there was an outbreak of both statistical inflation and market-based inflation indicators. In May, gold traded as high as $730, crude oil traded as high as $75 for the first time, and the dollar fell to 13-month lows on forex markets. In early June, Bernanke gave a forceful speech about the prime importance of keeping inflation expectations contained, and all the inflation-sensitive markets subsided for a while (see "Bernanke Arrives" June 6, 2006). Even after the Fed paused its rate-hiking cycle at 5.25% (a pause which would turn out later to have been the end of that cycle) and the core Consumer Price Index printed within basis points of 3%, a continuing flow of tough talk from the Fed seemed for a while to keep a lid on inflation pressures. But we warned that this couldn't last, and that eventually words would have to be matched by hawkish action (see "Inflection Point Deflected" July 11, 2006). Ultimately the action Bernanke took was in the opposite direction, when the Fed began a panicked rate-cutting cycle in response to the credit crisis that began a year ago. We said that this would ignite a new round of inflation, with gold and oil breaking to new highs and the dollar to new lows (see "Honey, I Shrunk The Dollar" September 28, 2007).

Are we there again? Perhaps, as it would seem that with Wednesday's FOMC statement Bernanke was trying to talk down inflation pressures -- but in an absurd way, by at the same time sounding both worried ("uncertainty about the inflation outlook remains high…and the upside risks to inflation and inflation expectations have increased") and nonchalant ("The Committee expects inflation to moderate later this year and next year"). But this time it's different. This time the market isn't falling for it, as it did in 2006. Then, for example, after several months of Bernanke's inaction disguised by tough talk, oil fell from $75 to $51. This time it's not falling at all. Quite the opposite. This time it's the markets that are doing the talking, and they're talking about a very dangerous oil price spiral. It's up to Bernanke to listen. If he doesn't want to have to deal with the economic fallout of $150 oil, he'd better find a way to leak to the press -- perhaps Mario Bartiromo is available -- that he was "misunderstood" this week, and that rate hikes are just around the corner.

BOTTOM LINE: The continuing tragedy in financials and the panic in oil have turned a correction into a test of the March lows. With earnings strong outside the financial sector, we see values stretched to the point where the downside is limited. But a durable bottom can't come now until Bernanke signals he will act decisively to normalize rates in order to stabilize the dollar and oil. If he doesn't do so soon, then all bets are off. If stocks find a bottom here, then this beaten down sector could be good for a very exciting trading play. But beyond the scope of mere weeks, we see this as a broken sector, and the least compelling value play in the equity markets. Inflation-sensitive markets are violently rebuking the Fed for not showing sufficient inflation-fighting resolve, threatening a 1970-style oil price spiral. If Bernanke listens, and moves to reassure markets that rate hikes are on the way, then the panic in oil, the resurgence of other commodities and the deterioration of the dollar will all be abruptly reversed. Bernanke's capacity to disappoint is nearly inexhaustible, but we would assign a 75% chance to his sending the right signal in a matter of days.