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Stocks are Cheap, But the Fed's Asleep

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Hard to believe, but a rally is imminent. But long-term, the Fed has tragically missed the inflation-fighting window.

Markets are not acting reassured by the Fannie/Freddie rescue announced last Sunday night (see "Will the GSE Rescue Work?" July 14, 2008). Such rescues are tricky things. They effectively foreclose worst-case systemic risk, and that ought to bolster confidence. But at the same time the rescue is a blow to confidence, by focusing investors on the terrible risks that made the rescue necessary in the first place. So when the plan to rescue Bear Stearns from bankruptcy was announced on Sunday night, March 16, stocks closed sharply lower on Monday, March 17, even though the rescue surely spared the world financial system untold grief. Then stocks traded sharply higher on Tuesday, and that launched a substantial rally that lasted the better part of two months. Will we see the same pattern this time -- first shock, then relief?

One can hope -- though hope seems to be in short supply this Tuesday morning. The equity risk premium is off the chart -- which is to say that stocks are insanely cheap in relation to forward earnings (which are rising dramatically) and long-term interest rates (which are falling). And it's not just the result of the beleaguered financial sector. The risk premium is even more compelling if you take financials out of the calculation. And that's ironic, because as of yesterday's close, without financials the S&P 500 still hasn't made new lows below the March 17 lows (they have now done so, as of this morning's opening). The reason the ex-financials risk premium is so wide, even though ex-financials have fallen much less than financials, is that forward earnings for five of the nine non-financial sectors are at, or within basis points of, all-time highs. Ex-financials, month-over-month earnings revisions are now surging at nearly a nearly

Update to strategic view

US STOCKS: Blood is starting to fill the streets, and the equity risk premium is now insanely wide. Stocks are due for a powerful bounce very soon. Long-term, tragically, the Fed's manifest failure to rein in inflation risk is eroding upside potential for stocks and the economy.
US RESOURCE STOCKS, GOLD, OIL, COMMODITIES, US DOLLAR: Barring a death-bed conversion, it appears the Fed has given up on taking any steps to stabilize the dollar and commodity prices. Time to return to investing for extreme inflation risk, getting back into most "inflation plays" about where we got out four months ago. Care should be taken with oil and with energy-related stocks, as these have shown the greatest appreciation over recent months of otherwise falling inflation expectations.

[see Investment Strategy Dashboard]

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30% annual rate. Even with financials dragging down the average, earnings revisions for the overall S&P 500 are growing at almost a 15% annual rate. Stocks are cheap. The downside here is limited. They are due for a very meaningful bounce, and soon.

But there is another area in which it is probably time to abandon hope. It now seems nearly certain that the Fed will fail to begin moving interest rates back up to more normal levels on a timely basis, thus opening the door to another round of intensifying inflation expectations. It didn't have to be this way. In early June, confidence in markets and the economy was improving, so Ben Bernanke gave a speech strongly indicating that he would take action to strengthen the dollar and re-anchor inflation expectations (see "The Bernanke Awakening" June 5, 2008). Shortly after that speech, fed funds futures were priced for more than three rate hikes by year-end. Now they are priced for only a 40% probability of even one, and there is market chatter that the next move from the Fed will be a rate cut, not a hike. So inflation expectations are becoming unmoored. The dollar now hovers within basis points of all-time lows. Gold is making another run at all-time highs. Oil is already there.

The conventional wisdom is that the Fed has no choice now but to leave rates unchanged, or even lower them, because the credit crisis had intensified again. But the lines of causation probably run another way. Maybe the credit crisis has intensified, and the S&P 500 has fallen 11% since Bernanke's speech, precisely because he didn't follow through on his promise to act to defend the dollar. After all, credit markets are undermined by falling confidence in the dollar --- and the economy is undermined by rising commodities prices, especially energy. The conventional wisdom is probably right that Bernanke won't dare to fulfill his June promise now. If that's so, then he "missed the window" when circumstances would have permitted him to act (much as Freddie and Fannie "missed the window" to raise new capital several months ago when investor confidence would have permitted them to do so at a non-ruinous cost).

It's ironic that on March 18, the second day after the Bear Stearns rescue was announced, the FOMC had the courage to cut the funds rate only 75 bp, when the highly distressed markets were expecting a cut of more than 100 bp (see "Three Quarter Profile In Courage" March 19, 2008). That was an act of courage that had significant pay-offs. Inflation expectations immediately collapsed. Stocks rallied. Credit markets stabilized. We applauded the Fed for recognizing that it had engineered new tools for dealing with the credit crisis such as the Primary Dealer Credit Facility and the Term Securities Lending Facility, and that it could now set aside the ineffective and inflationary tool of rate-cuts. We forecasted an end to the risk of a worst-case inflation scenario and went neutral on the "inflation plays" (see "Inflation Inflection" March 25, 2008), saying that they should be seen now only as "growth plays" (see "2 + 2 = 3 and 3 - 2 = 2" April 7, 2008). At this point it would seem that we overestimated the Fed's continuing courage, and barring a miracle, it is probably time to go back to investing with an eye toward worsening inflation expectations -- lower dollar, higher commodity prices, and a return to leadership by resource stocks (many of which have become great bargains over the last couple months when it seemed that inflation risk was receding).

BOTTOM LINE: Blood is starting to fill the streets, and the equity risk premium is now insanely wide. Stocks are due for a powerful bounce very soon. Long-term, tragically, the Fed's manifest failure to rein in inflation risk is eroding upside potential for stocks and the economy. Barring a death-bed conversion, it appears the Fed has given up on taking any steps to stabilize the dollar and commodity prices. Time to return to investing for extreme inflation risk, and in most "inflation plays" get back in about where we got off four months ago. Care should be taken with oil and with energy-related stocks, as these have shown the greatest appreciation over recent months of otherwise falling inflation expectations.