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Redoubling Down

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Donald Luskin

Bernanke promises redoubled ease. The White House promises redoubled "change."

Support for Ben Bernanke's confirmation for a second term as Fed chair is pouring in from President Obama, influential senators Harry Reid (D-NV), Chris Dodd (D-CT), Judd Gregg (R-NH), Dick Durbin (D-IL) and John Kerry (D-MA) -- and even Alan Greenspan and Paul Krugman. So the crisis of Fed leadership has likely passed. At the same time, there are some signs that Republicans will resist being drawn by the White House into a race-to-the-bottom in anti-Wall Street populism, even if it's dressed up in Reagan-era nostalgia as "the Volcker rule" (see ""On Obama's Bank Regulation Proposal" January 21, 2010). These developments point to a restoration of political equilibrium after the shock of last Tuesday's upset win by Republican Scott Brown in Massachusetts's special US Senate election (see "A Scott Heard 'Round the World?" January 19, 2010). That should take some of the edge of panic off stocks, and cool the downward momentum of last week's rout.

Update to strategic view

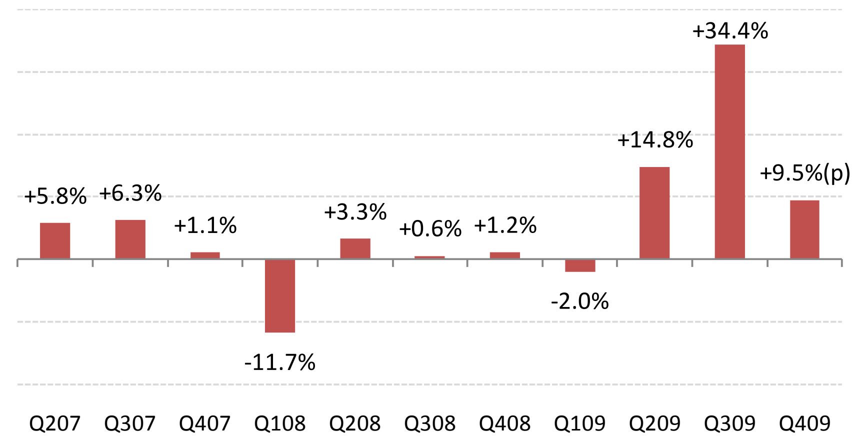
GOLD, FED FUNDS: After a near-death political experience, the already easy Bernanke Fed is going to be easier, and stay easier longer. This week's FOMC meeting will likely give no substantive indication of any "exit strategy," and the "extended period" of low rates will be promised once again. After the brief deflationary shock of last week's political panic, and with the Fed "redoubled" in its inflationary mission, we expect gold to mount a move to new highs.

US STOCKS: The Bernanke crisis seems to be over, and there appears to be no rush to judgment to enact "the Volcker rule" into law. With some restoration of political equilibrium after Tuesday's upset election in Massachusetts, the edge of panic should come off stocks. But policy risk remains, and stocks still have to deal with an earnings season that is failing to satisfy impossibly high expectations. We continue to call for correction and consolidation.

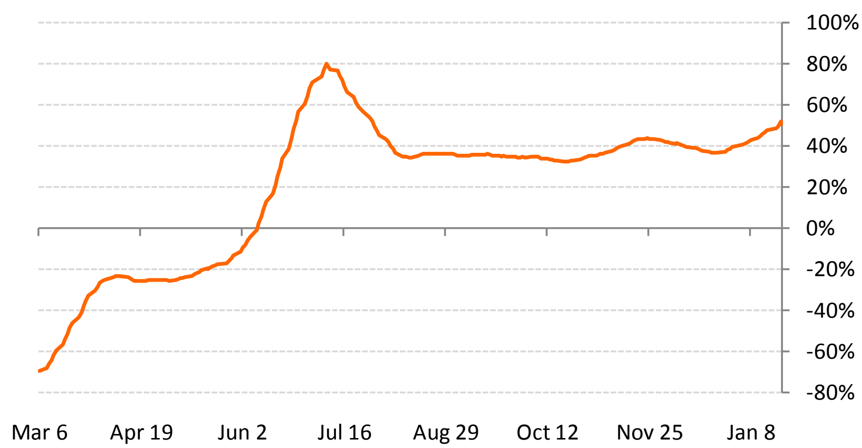
[see Investment Strategy Dashboard]

All that said, even putting political considerations aside, we don't see stocks as being in the clear. We're in the midst of an earnings season that can't possibly fail to disappoint the market's impossibly high expectations (see "Under-Seasoned" January 15, 2010). With about 15% of S&P 500 companies with December quarters having reported -- including most of the largest-cap names -- the theme is well established. The average company has beaten consensus expectations by 9.5%, which is a big number compared to the persistent misses or small beats that characterized the recession. But it's small compared to the 14.8% average beat of last year's third quarter, and downright tiny compared to the 34.4% average beat of the fourth quarter -- the first two quarters coming out of recession (see the first chart on the following page). With the exception of General Electric, every large company that has reported better-

S&P 500 earnings surprise
Actual versus consensus, equal-weighted, (p)=preliminary to 1/22/10



S&P 500 upgrade rate
Annualized month-over-month change in consensus forward earnings



Source: Zacks, TrendMacro calculation

than-expected earnings -- Google, Intel, JP Morgan, Freeport McMoran, among others -- has been rewarded with a sharp sell-off. No wonder, against an expectations environment in which consensus S&P 500 earnings are already calling for 37% growth over trailing actuals -- with the consensus itself rising at an annualized month-on-month rate in excess of 30% since last June (see the bottom chart at left). To be sure, it's the stuff recoveries are made of. But when expectations rise this intensely -- and stocks are driven to one of the most intense rallies in the recorded history of US stock prices, it's a set-up for disappointment. That's what corrections are made of.

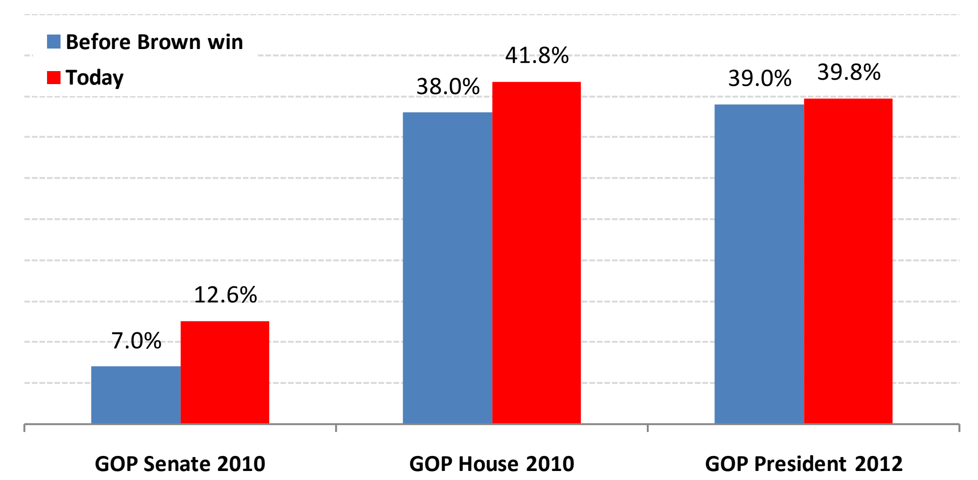
On the plus side for stocks, Bernanke's near-death political experience surely means an extension, if not an intensification, of the Fed's already extraordinarily accommodative policy posture. The independence of the Fed was already compromised by its partnership with the Treasury in the rescue of shadow banking system. Now it's even worse, with Senate majority leader Reid boasting that his endorsement of Bernanke was conditioned on a commitment to greater ease. According to a statement by Reid,

> I made it clear that to merit confirmation, Chairman Bernanke must redouble his efforts to ensure families can access the credit they need to buy or keep their home, send their children to college or start a small business. He has assured me he will soon outline plans for making that happen, and I eagerly await them.

The mind boggles -- how could the Fed possibly "redouble" its already historic "efforts"? The balance sheet could be made bigger, one supposes. Buy enough mortgage-backed securities, and the Fed could even make possible Barney Frank's long-term plan floated last week for "abolishing Fannie Mae and Freddie Mac in their current form and coming up with a whole new system of housing finance." But it's simpler than that. Monetary ease is, in part, a function of *time*. All the Fed would actually have to do to redouble its efforts would be to keep today's easy policy in place for even longer than the oft-promised "extended period."

That's good for the economy and for stocks, at least in the short-run, because it keeps intense monetary stimulus in place, and eases uncertainty about how quickly an "exit strategy" might be activated. But such stimulus is subject to diminishing returns. The first dose can save the world, and indeed it did (see "Ben Boldly Goes" March 19, 2009). But with each successive dose, salutary reflation becomes poisonous inflation. Don't pin too much hope on the idea that, once confirmed, Bernanke will renege on his apparent commitment to Reid. He may be out of political danger personally, but the Fed remains in intense political danger institutionally. The Senate version of proposed financial reregulation legislation put forward by Chris Dodd strips the Fed of its bank regulatory powers, and guts its time-tested regional structure. Bernanke has plenty of motivation to stay compliant, and the Congress will be sure to keep him that way at least through the election. We expect this will be reflected in this week's FOMC meeting, with the "extended period" language retained, and no concrete indications of an imminent "exit."

Political futures contracts
Implied probabilities



Source: Intrade

And policy risk outside the monetary realm hasn't gone away, either. Top Obama administration strategists, assigned to assist Democrats in November's mid-term elections, have indicated they intend to press ahead with all their "change" initiatives. This is welcome news for those of us who welcome divided government (see "Divided Government Is Best for the Market" September 12, 2008), because after Tuesday's Massachusetts election, such a strategy would seem likely to increase the odds that the GOP will retake control of the House of Representatives this year. As the Democrats seem to have learned all the wrong lessons from Massachusetts, the probabilities of a GOP resurgence have grown noticeably in the online political futures contracts traded at Intrade (see the chart at left). In the meantime, though we now relegate it to the domain of tail-risk, the pressure will remain intense for health care "reform," financial reregulation, cap-and-trade, card check, and all the rest.

BOTTOM LINE: After a near-death political experience, the already easy Bernanke Fed is going to be easier, and stay easier longer. This week's FOMC meeting will likely give no substantive indication of any "exit strategy," and the "extended period" of low rates will be promised once again. After the brief deflationary shock of last week's political panic, and with the Fed "redoubled" in its inflationary mission, we expect gold to mount a move to new highs. The

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