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Commentary

Market Opinions and Topics of Interest

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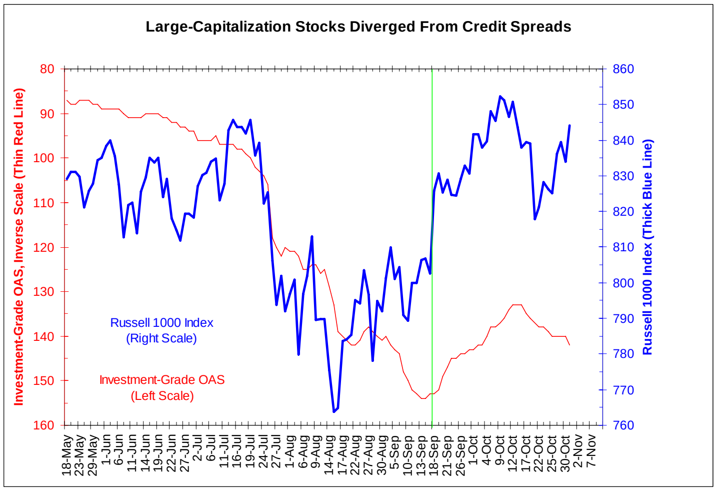
The Helicopter Has Landed Again

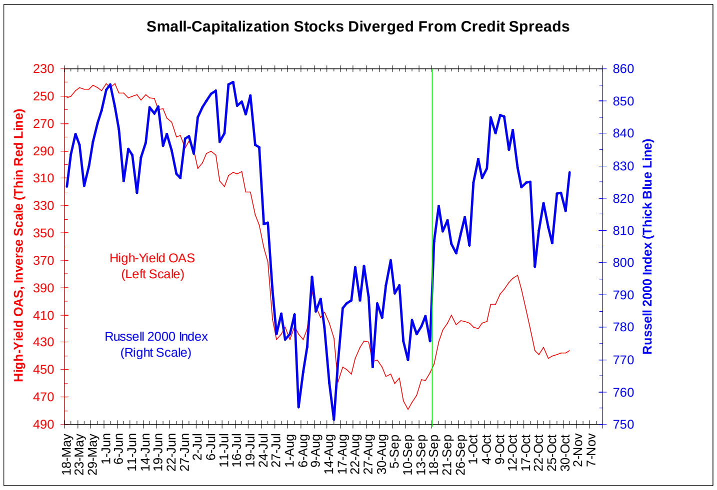
Let's update a September Commentary issued in the aftermath of the Federal Reserve's September 18th cut in the target federal funds rate to 4.75%. The structure will be kept parallel to that piece until an addendum updating the most recent Market Facts on relative valuation. The September 18th decision is marked with a green vertical line in all charts.

First, yesterday's cut to 4.50% was, as noted in a recent Market Facts, the most likely course of action. The bond market's reaction was negative; ten-year Treasury yields rose 9.2 bp.

Second, corporate credit spreads scarcely moved. While these credit spreads have not defined "the credit crunch," that being defined as the short-term TED spread, illiquidity in asset-backed commercial paper and the latest sleight of hand in all manifestations of the mortgage-backed securities market, it is noteworthy both investment-grade and high-yield OAS levels (thin red line, inverse scale, left- and right-hand charts, respectively) have yet to retract.

The U.S. equities market, as measured by the large-capitalization Russell 1000 index and the small-capitalization Russell 200 index (thick blue line, left- and right-hand charts, respectively) have diverged upwards from their reference corporate bond markets. The aphorism, "stocks float on a sea of bonds," might need to be updated for hovercraft technology if both markets are to be correct simultaneously. **We tried having stocks disconnect from bonds in 1987. The experience was fun until October of that year.**



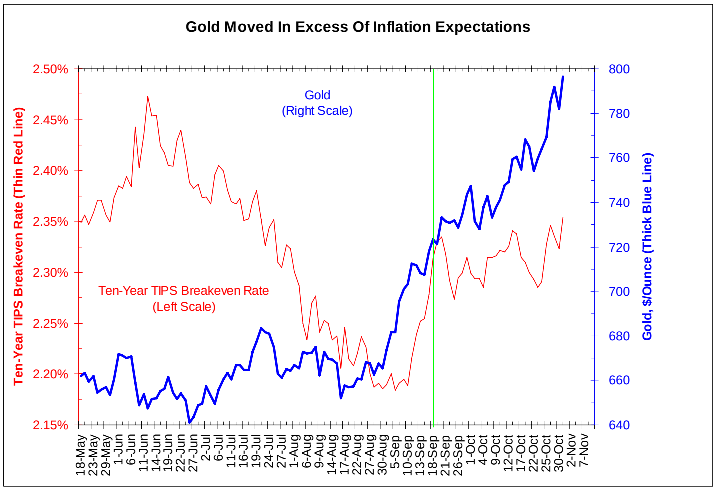


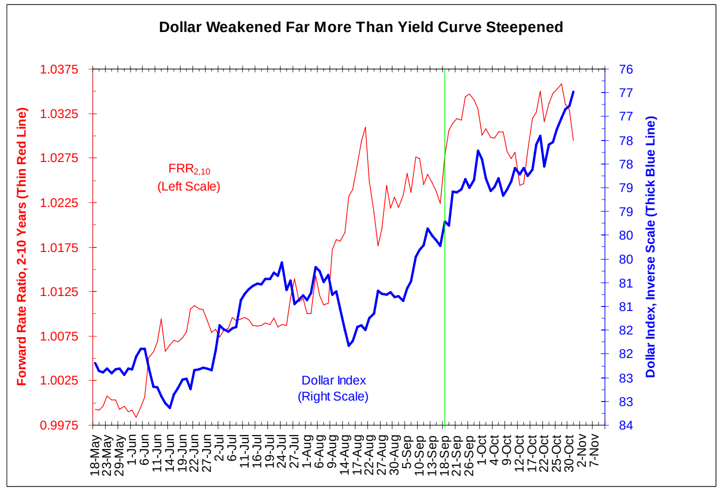
Excess Liquidity and Inflation

The ten-year TIPS breakeven rate of inflation (thin red line, left-hand chart, following page) rose 3 bp. Gold (thick blue line), as we noted in a recent Market Facts, continued to rise much fast than did inflation expectations.

The yield curve as measured by the forward rate ratio between two and ten years (thin red line, right-hand chart) actually narrowed somewhat. While the dollar index (thick blue line, inverse scale) sold off once again.

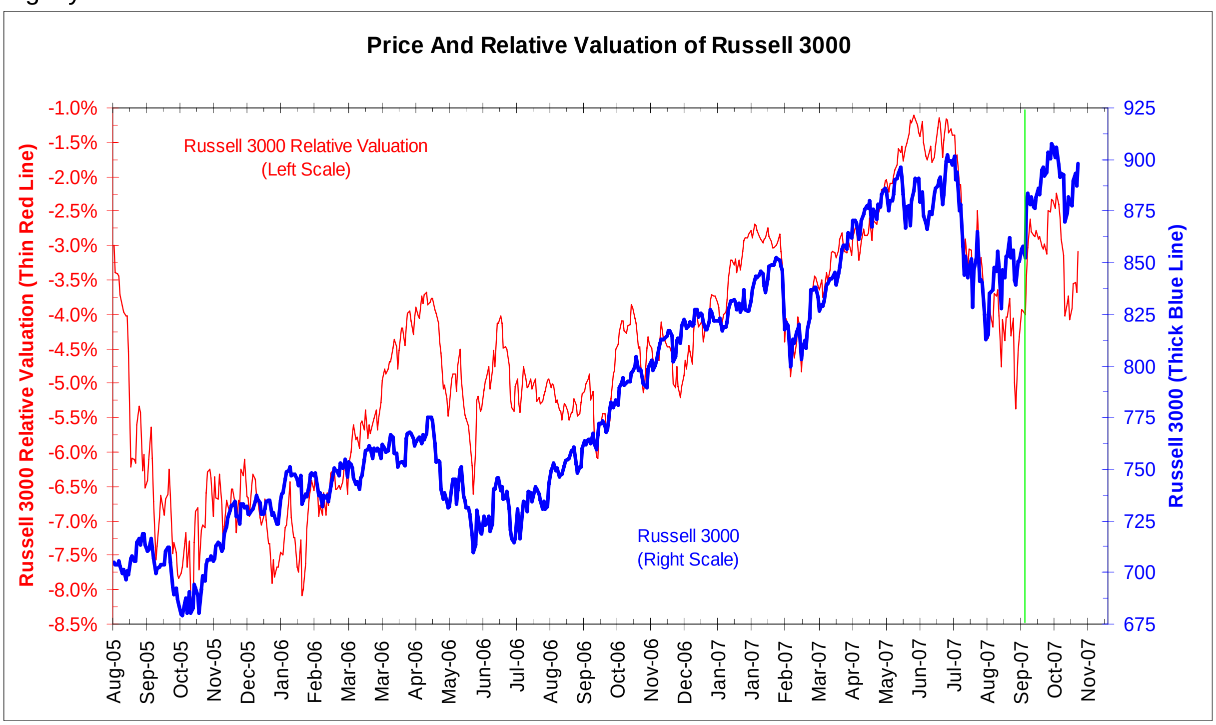
The statements made in recent Market Facts on the net impact of higher crude oil prices and a stronger euro on U.S. equities were confirmed in yesterday's market action. Some remember when a $4 increase in crude oil prices would have been considered a sign of the apocalypse or perhaps worse.



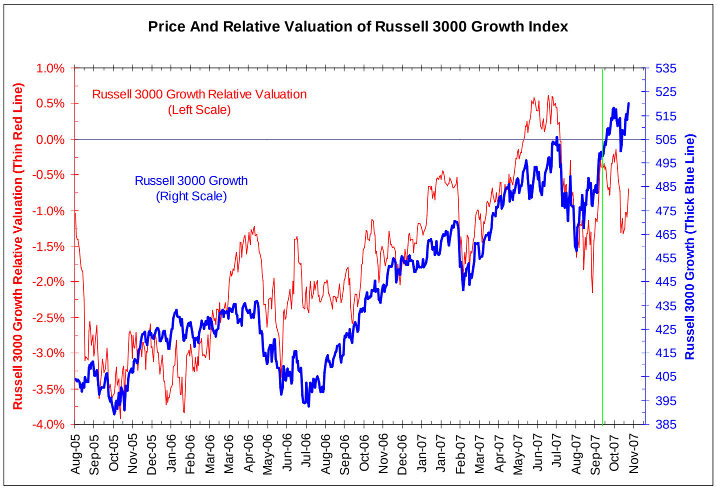


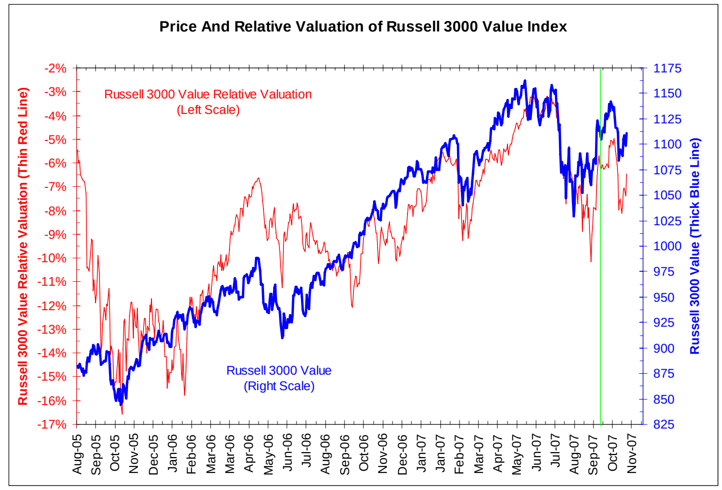
Relative Stock-Bond Valuation

The relative valuation of U.S. equities (thin red line) using a methodology described first in a July Market Facts has the broad Russell 3000 index (thick blue line) slightly undervalued to where it was after the last FOMC rate cut. **This is wholly a function of expected earnings growth as the ten-year Treasury yield is just 0.1 bp lower than it was on September 18.**



The same conclusion is reached if we look at the Russell 3000 Growth and Value indices (left- and right-hand charts) separately. Both are valued more attractively now than after the September 18th rate cuts.





Conclusion

The impulse to join the party is a powerful one, as is the impulse to impute divine forecasting skills to the stock market. These impulses need to be resisted at all costs.

So, too, should the impulses to be a scold, to don sackcloth-and-ashes and bitterly recount the next uptick in gold or some other datum demonstrating the credit crunch is not over.

Perma-bulls and perma-bears are perma-worthless.

The conclusion from the September Commentary is repeated below:

> *If you could not price a complex CDO yesterday, will you be able to price one tomorrow? Will inventories of unsold homes disappear? Will mortgagors facing ARM resets avoid further stress? Will LIBOR, which had ballooned as banks recognized the, um, garbage on each others' balance sheets narrow as if this offal never was, and will the asset-backed commercial paper market find itself reinvigorated?*
>
> *The answers here are, "No." However, as the 2001 experience with post rate-cut rallies taught us, stay off the railroad tracks when the train is moving.*
>
> *Over the intermediate and longer-terms, inflation will poison all financial assets as it always does. Unless the real macroeconomic concerns enumerated above are rectified, the present euphoria will be short-lived.*

It seems correct after a month and one-half. The rate cuts did not solve the credit crunch. While growth stocks are at new highs, value stocks are not, and the sectoral differences in the U.S. market are getting wider.

What is clear is the Federal Reserve seems ready, willing and perhaps able to keep injecting liquidity into the system indefinitely. Why not; look at how successful Japan's policies of 0% interest rates and quantitative easing were.

However, until this policy proves an inflationary failure, the best course of action is to pretend it will work while all the while being ready to be the first to exit the game. And be ready to sell too soon; Bernard Baruch was willing to let the other fellow wait for the last eighth and we rather suspect that strategy will serve us well before we know it.

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