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Ben the Benign

Ben Bernanke delivered a soothing message to the markets in his semi-annual testimony to Congress last week. Along with other news that suggested the economy was moderating and inflation was waning, the Chairman's comments stoked the underlying bullish sentiment to push stocks higher.

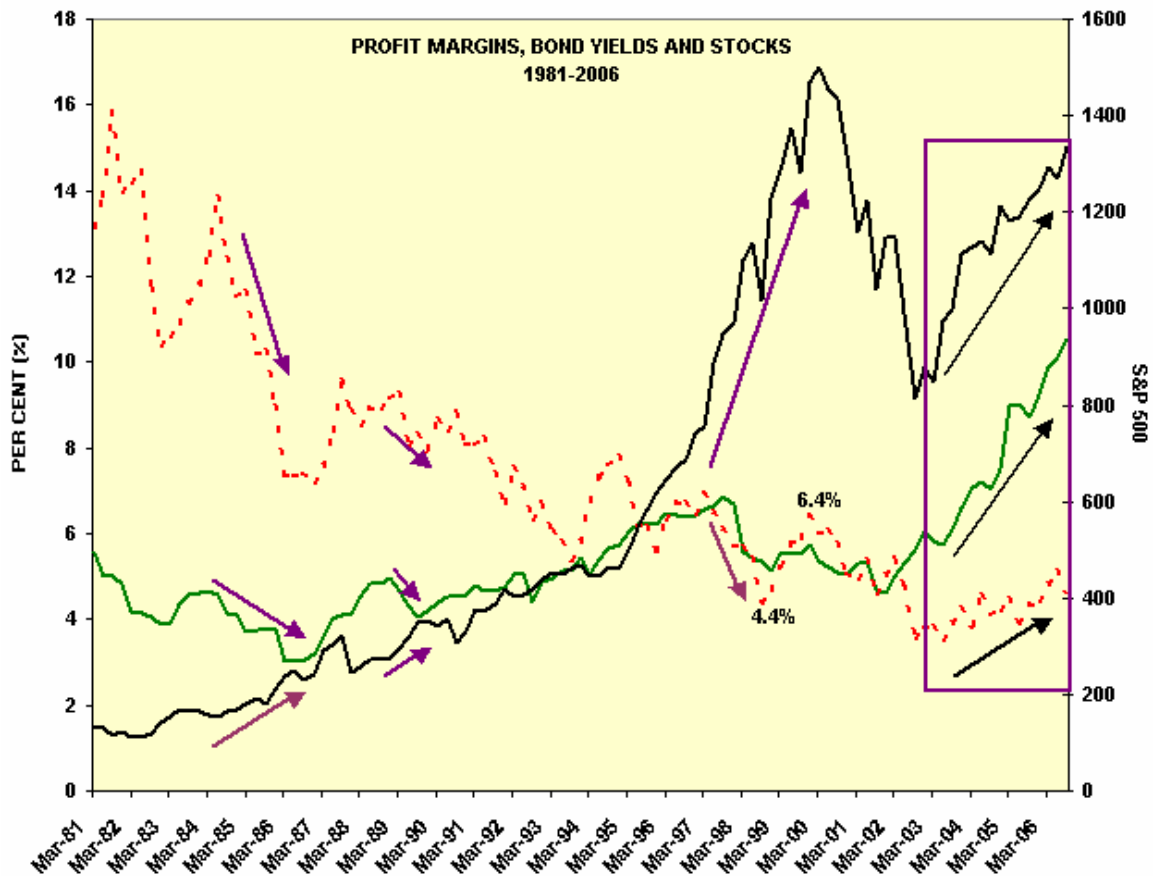
The important phrase in his prepared testimony, released shortly after the market opened last Tuesday, was that there are "some indications that inflation pressures are beginning to diminish." This was the first time since the economy picked up steam in the late summer that Bernanke suggested that inflation was becoming less of a problem for the Fed. His was a much more accommodative tone than the markets expected, and within minutes of the release of his prepared remarks, the Dow shot up over 80 points, and ended Tuesday ahead by 102 points. The market tacked on another 87 points on Wednesday, the last day of the Chairman's Congressional testimony. His comments reinforced market expectations that the Fed will not raise rates any time soon, and left the door ajar for a rate cut later this year.

The bond market reaction to Bernanke's testimony was more subdued at first, as the Chairman's upbeat remarks on the economy and his expectations for 2.5 - 3% economic growth did not give much support for lower bond yields. But data released around the Fed chief's testimony lit a fire under the bond market as January's industrial production fell a larger-than-expected 0.5%, January retail sales were disappointing, the trade deficit worsened in December, and inventory growth slowed as well. These last two data points suggest that the 3.5% economic growth preliminary estimate for fourth quarter's GDP will be revised down under 3% and perhaps as low as 2.5%. Along with weekly first-time claims for unemployment compensation rising sharply, these economic releases forced a bond market re-assessment of the economic outlook and the trend of interest rates. Ten-year bond yields dropped from 4.8% on Tuesday to 4.69% by Friday.

The macroeconomic backdrop for stocks continues to be favorable, and is tracking eerily close to the Fed's expectations. On the corporate earnings front, profits are likely to have posted gains of 10% in the fourth quarter, 2-3% higher than analysts' estimates. The run-up in stocks since July of last year has likely discounted that result already. The worry for the bears is that company earnings momentum and profit margins are about to slow down sharply as a result of the robust profit gains experienced this time last year. So comparisons are going to look modest for the next couple quarters—corporate profit growth in the 5-7% range. If the economy only remains in a 2-3% growth zone, worry warts see a sizable market correction.

While a market retreat can't be ruled out, especially given the age of the advance (4 1/2 years), and rising bullish sentiment, slowing corporate profits growth and falling margins alone do not end bull markets—rising interest rates and inflation, and restrictive monetary policy are usually the culprits.

The chart below, though busy, shows the interplay between corporate profit margins, bond yields, and stock prices covering the period 1981 to the end of 2006.



The black line is the S&P 500, the dotted red line is 10-year bond yields, and the green line is corporate profit margins. Notice that, when profit margins decline along with falling bond yields, stocks rise. It happened in the mid-1980s pretty regularly. In the late 1990s, from 1997-1999, bond yields fell and profit margins contracted, but stocks rose very sharply. When the Fed tightened monetary policy, from 1999 to early 2001, bond yields shot up from 4.4% to 6.4% (indicated on the chart) and stocks got crushed. The size of the decline in stocks was magnified by the gross overvaluation of technology stocks during the late 1990s, so even the eventual change in monetary policy toward ease in 2001 didn't stem the fall in the S&P 500 until late 2002/early 2003.

The boxed area on the chart highlights the profits, interest rate, and market environment since the 2002 S&P 500 bottom. Notice that profit margins have expanded significantly to historic highs, but bond yields have also risen from 3.5% to 4.7%. Clearly, the stock market has responded more to the sharp rise in profitability which has dwarfed the back up in bond yields. Though not highlighted, you can spot the same relationships during the 1980s and 1990s in the chart. The bearish argument that falling profitability will sink stocks depends solely on the trend of bond yields. If interest rise over the coming weeks and months as profit margins contract, stocks will be under downward pressure. But Bernanke's testimony and the action of the bond market in response to a moderating economy suggest bond yields could have further to fall. A slower economy with declining bond yields equals rising stock prices even in the midst of slowing profits growth and declining profit margins. Pretty benign.

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