Reasons To Cheer After A Dreadful Year

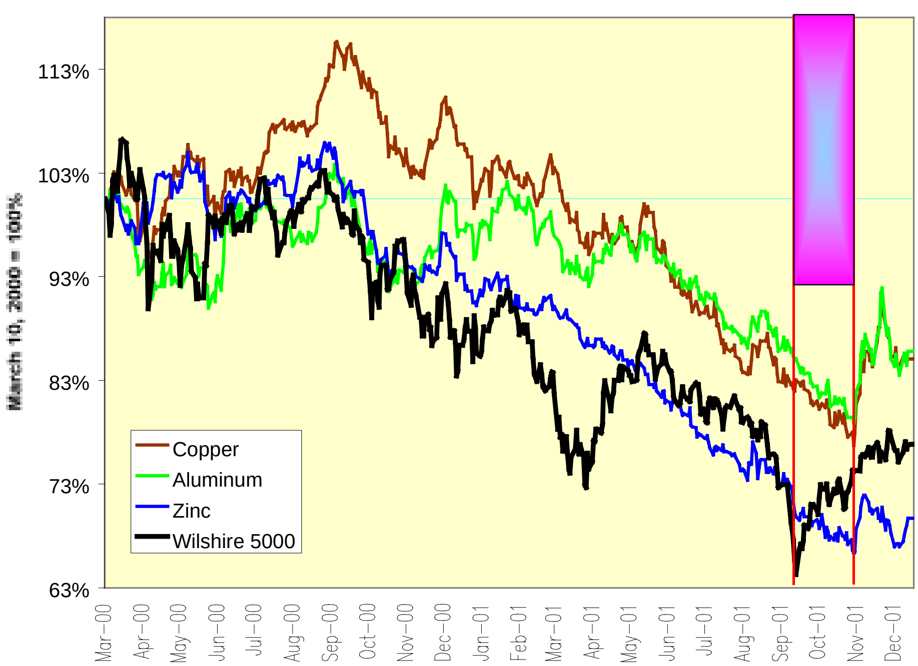
You can lead a bourse to water, but you can't make it zinc... anon.

Markets supposedly are bound by the extremes of fear and greed, but a better description may be hope and reality. Financial markets are discounting mechanisms wherein we're all allowed to pay our money and take our chances. The theoretical value of any stock is the discounted stream of future dividends, and if there's any operating definition of anything with two feet planted more solidly on a cloud, please let me know. While selling cash and buying hope has outperformed all other asset classes since 1926 – shall we all chant the Ibbotson data in unison? – this trade occasionally reminds us that the Greater Fool might in fact be someone we know.

Commodity markets and economic data generated from those folks on the front lines such as purchasing agents and shipping schedulers, as I've pointed out on more than one occasion, allow no such detours into the Fantasy Factory. Anyone can sell a dream on a new technology – I myself am working on a wireless cable system – but the fellow who can work the public into a frenzy over nickel briquettes or titanium sponges is someone I want working for me.

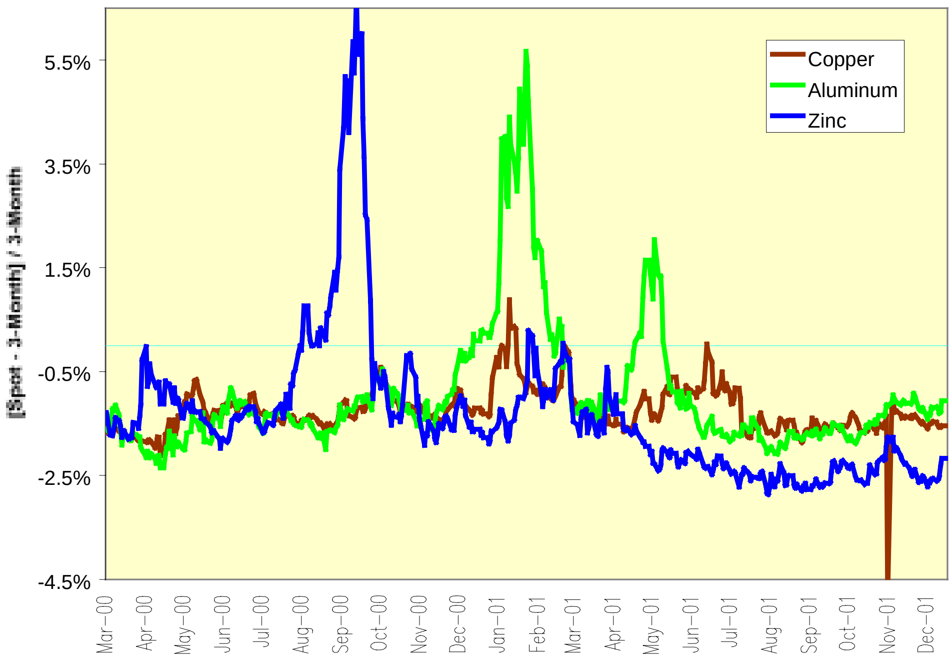
The good news is reality, in the form of commodity prices, is starting to be encouraging. This is said with no small sense of irony; during the inflationary 1970s and for years thereafter, any suggestion higher commodity prices might signal good news economically would have been greeted with stunned disbelief. But firmer commodity prices are a necessary confirmation of stronger current economic activity. Several times during the bear market of March 2000 - September 2001, stocks rallied without later confirmation from metals prices. This time, the upturn in stocks was followed six weeks later by an upturn in the prices of copper and aluminum, and to a lesser extent zinc.

This Time Metals Follow Stocks' Lead



The shape of the forward curve for these metals provides some comfort that the price rally is for real. A price rally in metals that is accompanied by an increase in backwardation, or the premium of the spot price to the three-month forward price, is suspect. Buyers in this situation are maintaining a just-in-time inventory policy, while sellers are selling into the higher three-month forward prices. This situation is not present at the moment.

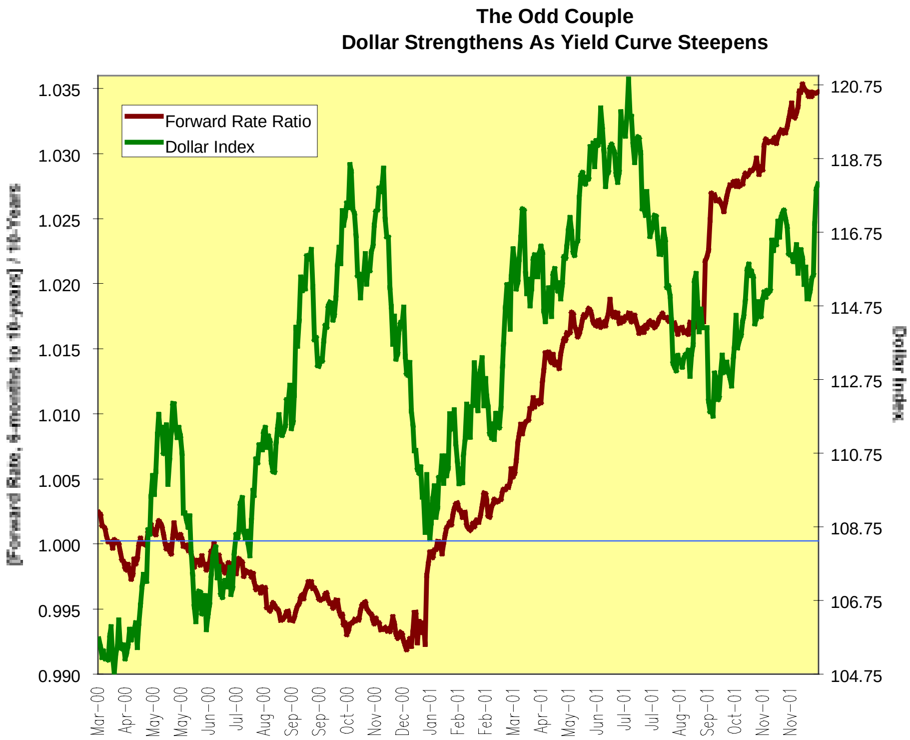
Comfort In The Forward Curve



Money For Nothing... For Now

If the industrial economy is starting to rev up, do we see any confirming signs from financial indicators derived from the actions of the just and sober? Yes, and it's an odd combination. The Fed's aggressive rate-cutting policy and the stubbornness of longer-term note yields have propelled the yield curve into an unsustainably steep positive slope. This is measured by the ratio of the forward rate between six months and ten years, the rate at which we can lock in money starting six months from now in the 10-year note market, to the 10-year note rate itself. For those of you interested in this measure, send me an e-mail, and I'll send you a template file for the asking.

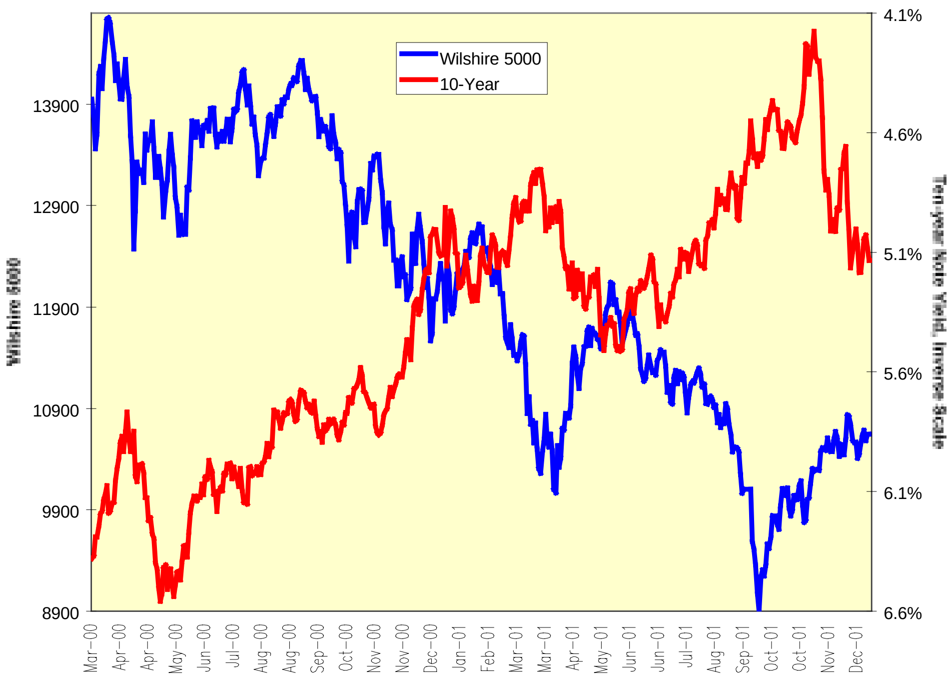
We can see how abruptly the yield curve steepened once the cuts began one year ago. This can be interpreted as the bond market anticipating higher credit demands ahead. We also see how the trade-weighted U.S. dollar index has maintained its high levels in spite of the Fed's efforts to flood the economy with liquidity. This can be interpreted as the global market continuing to expect higher returns on U.S. assets than elsewhere.



Once acceleration in credit demands becomes obvious for several months, we should expect the yield curve to start flattening in anticipation of a reversal of the Fed's policies. We also, as noted here last November, should expect to see the dollar weaken in anticipation of higher inflation in the U.S. This weakening of the dollar will, at last, produce some of the intended stimulus in the industrial economy, as noted here a year ago. A weakening of the dollar in the face of accelerating economic growth can produce an explosive rally in stocks, as was seen during early 1987 and early 1995.

Stocks Versus Bonds
Since the tech bubble burst in March 2000, stocks and bonds have moved in an inverse fashion. Should the scenario for a stronger economy unfold as suggested, the issue of whether stocks will outperform bonds will be settled quickly in stocks' favor. Once again, we can point to early 1987 and virtually all of 1999 for examples when stocks soared in the face of rising bond yields.

Stocks Poised To Outperform



What About Valuations?

A final word on valuations is in order as we head into 2002. Yes, they are high at present, and yes, they are high in the light of anticipated earnings. No one can argue otherwise. However, this does not mean that we cannot move higher. Even beyond the mountain of cash sitting on the sidelines, a reason we could move back to the land of the silly is that there are so few alternatives available. Advertising rates for football games rose in the face of declining viewership because this was the one place where advertisers could be sure of hitting the young male demographic. Similarly, P/E's can rise for stocks because they are the one place where the public has experience with the thrill of victory (and the agony of 2000-2001).

Reasons for cheer? Yes, I think so. We may be in one of those periods in which reality surprises to the upside. And here's a New Year's resolution: The minute I'm wrong with this optimism, I'll admit the error and get right with the market.