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MACROCOSM

Oil, Jobs and Equities

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Oil and jobs mean higher levels of political and monetary risk -- but the economy is still robust and stocks are very cheap.

At this moment "early" is the most flattering word we can use to describe our trading call for equities to bounce off the lower bound of the year-to-date trading range (see "On the No-Bounce Bounce" August 3, 2004). With oil having hit new highs yesterday and a disappointing payroll jobs number this morning, that lower bound has just gotten lower, especially for technology (the out-of-favor sector we have expected to lead the bounce).

We think the reaction is overdone, and is likely to be reversed at least to some extent. To be clear, we've never said that equities would make a bull move to new highs here, only that improving political and monetary policy developments and deep undervaluation ought to be enough for a tradable move back up through the year-to-date range. With this week's developments in oil and jobs, our political and monetary cases may be somewhat compromised, but our value case is still intact. That lowers the upper target for a trading move here, but we nevertheless feel we're probably closer to the bottom than the top.

Both the oil price and the jobs number are conceptually problematic, and in both cases the most significant risks are not the obvious ones.

As we have pointed out, the oil price is to some considerable extent the result of the decline in the value of the dollar, which itself is the result of **the Fed's** inflationary posture (see "Inflation: That '70s Show?" August 2, 2004). Priced in euros, for example, a barrel of oil is only slightly higher today than it was 18 months ago. Yes, increasing global demand plays a role in rising prices, but that's a good thing -- a sign of prosperity. And supply glitches such as the **Yukos** bankruptcy are factors too, but they are just temporary. But the inflation component of the oil price is a real risk. If the Fed delays its rate-hiking program for fear that rising oil prices will stall the economy, then it will surely exacerbate the considerable inflationary forces already in the pipeline. That would be a serious error, which would amount to attempting to ward off the effects of inflation by creating more inflation. So the risk here isn't so much the oil price itself, as how the Fed may mistakenly react to it.

The payroll jobs number brings us back to concerns that dogged the markets all last year. It's not just poor jobs growth *per se*, but the fact that we couldn't really tell what the jobs situation even was because the **Department of Labor's** two employment surveys differed so sharply. For July, the "establishment survey" of employers showed employment growth of only 32 thousand. But the "population survey" of the labor force showed not only 629 thousand new jobs, but also the labor force itself expanding by 577 thousand workers. Here, too, there is risk of inflationary error. The Fed has been obsessed for the last year with poor job growth, treating it in public statements as a virtual synonym for deflation. Two back-to-back poor payroll numbers may well make the Fed's "measured" approach to rate-hiking even more measured.

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Indeed, future markets this morning have repriced to take one of the rate hikes that had been expected by year end pretty much off the table. Big mistake. Poor job growth is *not* a synonym for deflation, and two months of bad payroll numbers do not give the Fed a get-out-of-inflation-free card. The sharp pop in the gold price today and the equally sharp drop in the dollar on forex markets point to the risk of an inflationary error.

The oil price and the poor jobs numbers will have political risk as well. Both will be used against **President Bush** as evidence of "middle class misery." The futures contract on Bush's re-election probability, traded online at **Tradesports.com**, are trading lower today at 52.5%. That's still higher than the **Democratic** convention lows of 49% last week, but well off this week's no-bounce bounce that took Bush's re-election probability as high as 57%. We've often pointed out the correlation between the equity market and Bush's probability. Citing better growth prospects with Bush's tax policies in place and poorer prospects with them repealed under **John Kerry**, we've argued that the election is driving the market. But we've also noted that, to a not inconsiderable extent, the lines of causation go the other way, too: the market drives the election -- and that may well be the dominant direction this week.

Ultimately, the lines of causation running both ways can get tangled under the "Theory of Reflexivity," propounded by **George Soros** twenty years ago. The theory holds that real events change prices in the financial markets, and that changes in prices themselves then influence subsequent real events -- and so on, in a positive feedback loop. A long-shot risk to our generally bullish take on the market and the economy is that a reflexive loop of this kind gets started here. We aren't all that worried about it, though. While we may indeed have just come through a brief soft-spot in the economy, there is little objective reason to think an outright reversal of the expansion is going on. It will be difficult to convince swing voters that the economy is worsening when, in the experience of their daily lives, it is not. Yes, higher gasoline prices are a tangible reality. And much has been made recently of this year's decline in average real hourly wages for production workers. But much of that has been politically motivated analysis. The reality is that real disposable income -- a broader measure of income that includes tips, bonuses, and benefits -- is higher on the year, despite the recent uptick in inflation.

Political and inflationary risks are very real, but we don't see the economy rolling over here. We are probably going through a soft-spot, or growth plateau, and today's poor payroll jobs number (if we are to believe it, as opposed to the more robust number from the population survey), is part of the evidence for that, and higher oil prices may be to blame. It's not that a robust economy can't tolerate somewhat higher oil prices -- the economy's robustness is one of the reasons why oil prices are higher in the first place (remember, oil bottomed precisely when the economy did, in November 2001). The real problem with today's oil price is uncertainty -- the fear that it will go higher yet. Uncertainty like that makes companies not want to make hiring commitment, but the good news is that we think that uncertainty will be resolved soon, and favorably

If you agree with us that growth is only plateauing, then you have to think that stocks are very cheap here. As of this writing mid-Friday, we calculate the S&P 500 to be more than 30% undervalued -- a level that discounts, effectively, *negative* earnings growth of 12% over the coming 12 months. *That's* overdone, and suggests both a floor for stock prices here, and the potential still for a tradable bounce from these lower levels on the slightest whiff of good news.

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