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Weekly Commentary
by Bill Sullivan, JVB Chief Economist

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Stocks: Getting ahead of themselves?

It is amazing what investors will accept as good news at any given point during the business cycle. Indeed, if it were four or five years ago, one could only imagine the reaction in the nation's stock and bond markets to the awareness that the Federal Government is a major player in many key private sector industries and that the United States Treasury would be obligated to finance trillion dollar deficits for the indefinite future. Adding to the confusing environment is the apparent benign reaction within the investment community to the fact that the politics of Washington, D.C. seem aligned in favor of health care and climate reform programs that will inevitably lead to visibly higher taxes for many households and businesses. At some point, financial asset values will have to acknowledge the huge imbalances that seem to be developing vis-à-vis the Federal sector of the economy. Perhaps the only question is whether these changes will ultimately lead to lower equity prices or higher interest rates, as arguments for both outcomes can be made.

The conventional wisdom on Wall Street would probably regard these events as favoring higher yields on Treasury securities. Indeed, the traditional response to rising deficits is that the additional supplies forthcoming from the Government will require higher returns in order to entice new buyers into the marketplace. This widely held opinion however ignores a long history of declining yields in the face of rising cash needs from the Treasury, suggesting that in the long run supply is a residual influence on overall interest rate trends. Clearly, when evaluating the impact of the Treasury's financing burden, consideration needs to be given to the ongoing changes in private credit demands as well as to the outlook for inflation, which can affect real returns. More recently, the preference for quality, safety and liquidity can be a major determinant of how yields fluctuate in an environment of record deficits.

The fact that the equity market has had such a sharp rally since late winter would seemingly suggest that shareholders have embraced the Government's interventionist policies and don't appear intimidated by the prospect of higher tax burdens. In many respects, the stock market's improvement of late is probably viewed by most elected officials as a tacit approval of the legislative agenda that is now going through Congress. In theory, if investors were deeply disturbed by the prevailing agenda, there would be a higher degree of concern about the economic and profits outlook that would ultimately be associated with lower share values.

From our perspective, the biggest challenge looming ahead, given the historical changes that are developing in the nation's Capitol, will be for equity investors to maintain their enthusiasm for higher valuations. The willingness to embrace these huge adjustments may prove to be a temporary reaction that has been engendered by the avoidance of a complete meltdown of the financial system and a concomitantly reduced risk of another Great Depression. However, as time goes by, there may be an increased awareness that the current legislative approach is unlikely to restore a great deal of upside momentum for the economy or for corporate profitability.

At a minimum, the huge slate of programs that are being debated in the House and Senate are adding to the uncertainties that business planners and households will confront later this year and beyond. As an example, will health care

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ABOUT
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William V. Sullivan, Jr. serves as Chief Economist at JVB Financial Group, working closely with the firm's trading desk, providing analysis and commentary on the U.S. economy and the financial markets. Among his duties are authoring a weekly report on credit market trends and maintaining a regular schedule of conference calls that focus on interest rate developments. He appears frequently on Bloomberg TV and is often quoted in Barron's.

Mr. Sullivan is the familiar voice that JVB features on our weekly conference call, where he discusses the economy and the events that affect the marketplace.

He was previously associated with Morgan Stanley in New York City for more than twenty years, where he was an Executive Director and a Senior Economist in the firm's Retail Fixed Income Division. Bill published a widely quoted weekly letter on the financial markets and was a frequent guest commentator on several business networks, including Bloomberg TV, CNBC, and Fox News.

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reform lead to payroll surcharges for smaller establishments that will delay any willingness to hire new workers? In addition, it is very clear that tax rates are going higher for businesses and consumers as the Government attempts to raise funds to lower carbon emissions and to reduce the number of families without health insurance. Higher tax rates rarely provide the foundation for a solid recovery process, especially when they are being imposed in a setting of tremendous economic slack.

Another interesting attribute to the current environment that will shape the timing and magnitude of any recovery process is the strong inverse relationship that now exists between stock and bond prices. For the most part, rallies in the equity arena thus far this year have been associated with higher yields on Government debt. Conversely, when the stock market sells off, a bid for Treasury securities develops that helps to push interest rates lower. As long as this linkage persists, it is very apparent that there will be major limits placed on the economy's ability to recover. In particular, should the stock market register additional improvements over the period ahead, Treasury rates are likely to climb well above current postings. The upturn in rates will elevate the cost of private borrowing and, most importantly, will raise the expense of housing-related credit. As mortgage rates climb, home prices are apt to fall even more than they already have and there will be major restraints imposed once again on residential construction activity. The potential for higher interest rates will eventually become an obstacle to sustaining the equity market rally, as the added expense of credit will place significant limitations on any recovery process.

Needless to say, asset valuations can become very extended in either direction and as July comes to a close, further upside momentum for the equity market can't be ruled out. However, the prevailing optimism may be ignoring the reality that an important shift in the nation's legislative approach is now underway. Whereas the first half of 2009 was dominated by actions to rescue the economy and the financial system, the latest debate centers on higher taxation, increased Government intervention in the private sector and an unwillingness to tackle the rising level of joblessness throughout the country with relevant policies. On balance, the recovery that the equity market seems to be anticipating is likely to fall well short of expectations. If anything, the potential for a renewed setback in the economy is genuine as spending commitments by both households and business firms are held in check until a clearer picture of the nation's political agenda emerges. ■

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