Happy Birthday, Bull

By RANDALL W. FORSYTH

Events and policies have conspired to propel the stock market to new heights. Will it keep rising? And, a look at the "fluky" labor report.

Sweet, well behaved one day, an unruly hellion the next? It's about what you'd expect from a 5-year-old.

And so it has been recently with the stock market, which marks the fifth anniversary on March 9 of its bear-market lows, when the Standard & Poor's 500 index touched 666, the mark of the Devil from the Book of Revelation, following a near-biblical set of plagues loosed on the financial system and the world economy in 2007-08. Since that time, the S&P 500 has come roaring back by 175% in round numbers, in what might be the best bull market money can buy.

The pattern continued last week, when stocks swooned on Monday in reaction to the movement of Russian troops in Crimea, only to come roaring back on Tuesday. Then, it became apparent that Vladimir Putin didn't see the need to get into a shooting match, especially when the Russian stock market lost an estimated $58 billion the previous day, even more than the massive $51 billion tab for the Sochi Winter Olympics.

The slide in the ruble also accelerated, forcing the Russian central bank to expend upward of an estimated $12 billion of its reserves to defend the currency, in addition to hiking short-term interest rates sharply. But by week's end, Putin hadn't backed down, and Russian troops were still in Crimea, notwithstanding President Barack Obama's demand that they leave and U.S. threats of sanctions.

The S&P 500 managed on Friday to eke out a gain of a point to mark the bull's birthday with yet another record. More importantly, the five-year advance has increased the value of investors' holdings in U.S. equities by some $16 trillion, according to Wilshire Associates.

Moreover, the Federal Reserve reported last week that U.S. households' net worth surged nearly $3 trillion in the fourth quarter of last year, to a record $80.6 trillion -- some $11.8 trillion above the $68.8 trillion reached in the second quarter of 2007, notes David Rosenberg, chief economist and strategist at Gluskin Sheff. Pacing the gains in the latest quarter were corporate stocks, up $1.3 trillion, and real estate, up $456 billion.

Based on those results, it would seem the expansion of the Fed's balance sheet -- to more than $4 trillion from less than $1 trillion prior to the full fury of the financial crisis starting in
September 2008 -- has paid handsomely. As Rosenberg previously noted in this space, there has been a more than 90% correlation between the growth of the central bank's assets and the S&P 500 since the bull market began five years ago.

What's less recognized is the impact that the Fed's quantitative easing has had on interest rates. Perhaps that's because, despite the massive purchases of Treasury and U.S. agency mortgage-backed securities, the benchmark 10-year T-note yield ended the week at 2.79% -- all of four basis points lower than the 2.83% five years earlier.

The real decline has been in private borrowing costs, which is reflected in the collapse in risk spreads on corporate bonds, both investment grade and high yield. High-grade bond spreads have plunged to about 125 basis points over comparable Treasuries, from 600 basis points in March 2009 and 850 basis points at the peak of the crisis in late 2008. Junk spreads have shriveled to about 400 basis points -- which hardly qualifies as "high yield" any more -- from more than 1,800 basis points five years ago and nearly 2,200 basis points in late 2008.

That has been a key element in the equity bull market, allowing quality companies to borrow billions for next to nothing, which they can return to shareholders as dividends or share repurchases, or use to make mega-acquisitions. Think Verizon Communications' (ticker: VZ) recent purchase of Vodafone's (VOD) stake in Verizon Wireless, which was funded in part by the biggest U.S. corporate bond offering ever last year, totaling some $49 billion.

To be sure, financial engineering abetted by the Fed's QE also has had real effects. Steven Ricchiuto, Mizuho Securities U.S. chief economist, notes that the central bank's actions allowed auto makers to resume offering cut-rate car loans, which has boosted auto demand to precrisis levels. Institutional investors' access to inexpensive debt helped them scoop up large numbers of single-family homes to rent out, while individuals with top credit scores could avail themselves of record-low mortgages rates, helping to clear the housing market.

**THE FED IS ON TRACK** to wind down its bond purchases and is widely expected to trim another $10 billion from its current $65 billion-a-month pace at the March 18-19 Federal Open Market Committee meeting. Various officials, from Fed Chair Janet Yellen on down, have indicated it would take a lot to depart from the tapering path embarked upon late last year. The February employment data released on Friday did nothing to alter that.

Notwithstanding the wicked winter weather that was expected to hurt the numbers, nonfarm payrolls increased by 175,000, a bit better than the forecasts, while the two preceding months' totals were revised up by a total of 25,000. The headline unemployment rate ticked up by a tenth, to 6.7%, but for a good reason -- a 0.2% increase in the labor force.

As has been discussed ad infinitum, much of the decline in the jobless rate has been because of dropouts from the labor force. Still, the labor-force participation rate remains at 63% of the working-age population, while the employment-to-population rate is at 58.8%, near where it was when the expansion began in June 2009, three months after the bull market's liftoff.
Another positive sign was a 0.4% rise in average hourly earnings, but that's where the weather effect might be visible. As JPMorgan Chase economist Michael Feroli writes, the average workweek slipped 0.1 hours, to 34.2 hours, almost certainly because of folks putting in fewer hours because of the weather. But if they got their full week's paycheck nonetheless, it would add up to higher average hourly earnings. While the trend in earnings is higher, Feroli calls last month's jump "fluky."

The consensus view is that the Fed's tapering is a vindication of the economy's ability to stand on its own two feet. Ricchiuto, however, says that auto makers' cheap-financing spurs resulted in General Motors (GM) and Fiat, Chrysler's parent, overproducing and now having to offer incentives to trim inventories. In the housing market, the withdrawal of nontraditional buyers will slow the rise in home prices, "and the cracks in the housing recovery will begin to widen," he says, with real growth slowing from the economy's current 2.25% trend rate.

For that reason, and with official inflation readings well within the Fed's 2% target, there's little reason to expect the monetary authorities to depart from their current glide path for securities purchases. And as New York Fed President William Dudley said on Friday, he favors continued stimulus for "a considerable time," with the first increase in the central bank's key interest-rate targets coming "around the middle of 2015" as "a reasonable set of expectations."

Does that mean the bull will see a sixth birthday? Dudley pointed the previous day to a few areas of excess, according to colleague Brendan Conway on Barrons.com -- biotechnology stocks, leveraged loans, and farmland. The first asset class, coincidentally or not, came under considerable pressure late in the week. While it might have been a throwaway line, Dudley, the former chief U.S. economist at Goldman Sachs (GS), can't be unaware of the market impact of utterances of Fed officials.

In any case, biotechs have been among the market's leaders. And as Doug Kass of Seabreeze Partners relates, one of the deans of market analysis (now retired) thinks the stumble in the formerly highflying group is a significant tell for the overall market -- even as it celebrates the fifth anniversary of the rally that has put stock prices at a peak.

NEXT WEEK WILL MARK another, rather less joyous anniversary -- the collapse of Bear Stearns, which happened six years ago and is viewed in hindsight as the beginning of the slide into the credit crisis that erupted full blown the following fall. At the time, however, it was thought absorption of Bear into JPMorgan Chase (JPM) was a one-off thing and that everything was well under control.

That precedent was being invoked last week with the first default on a publicly traded corporate bond in China, of Chaori Solar, which, as its name suggests, flew Icarus-like and crashed. Most commentary suggested it was a good thing to allow the solar-panel maker to fail (see Tech Trader for more questions about solar) rather than for Chinese authorities to risk the moral hazard resulting from bailing out feckless borrowers.

But Citigroup's global macrostrategy team led by Jeremy Hale says not so fast, warning that "this default may be the tip of the iceberg." While the missed interest payment is trivial at about $15 million, "the symbolic significance is much bigger."
Chinese officials face a dilemma, the team writes. "Setting a precedent that investors will always get bailed out is not long-term sustainable policy. Equally, there is no particularly good way to engineer the deflation of a credit bubble."

At the time of the Bear Stearns bust, the cost of insuring U.S. government debt in the credit-default swaps market initially rose in expectation of more bailouts, but then subsided as markets breathed a sigh of relief. But credit-default swap spreads on U.S. debt ultimately widened sharply later in the year, when the crisis was raging.

The Citi team says the default of the Chinese solar company won't necessarily result in a rerun of 2008. But they conclude there may be more corporate credit events ahead than investors expect now.

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