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MACROCOSM

Number of the Beast

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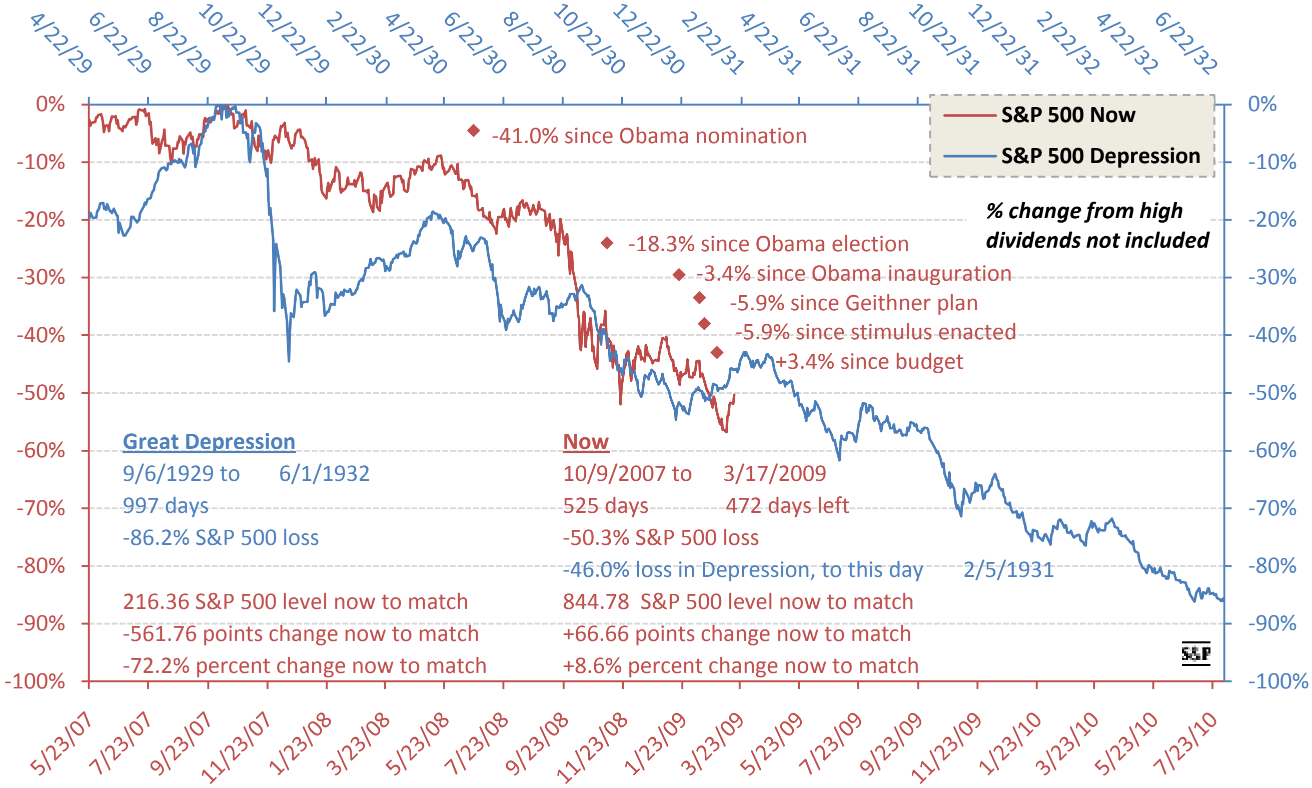
Nice rally. But how high is the upside when economic policy is at the edge of chaos?

Update to strategic view
Please see the top of the following page

Before the opening Tuesday of last week, 517 days into the second worst bear market since 1900 -- and with the S&P 500 having traded as low as the ominous 666 index level the Friday before -- we said "any shred of good news, any little decrease in uncertainty, could trigger a tradable rally commencing almost immediately" (see "Quantum of No Solace" March 10, 2009). The shred was Citigroup CEO Vikram Pandit's memo the same day, claiming his bank has been profitable this quarter. Now, from Monday's low, stocks have surged 16.66% (also ominous). But at a 50.3% loss over the now 525 days since the 2007 highs, they're *still* underwater compared to the 46.0% loss 525 days into the bear market of the Great Depression (see chart below). The



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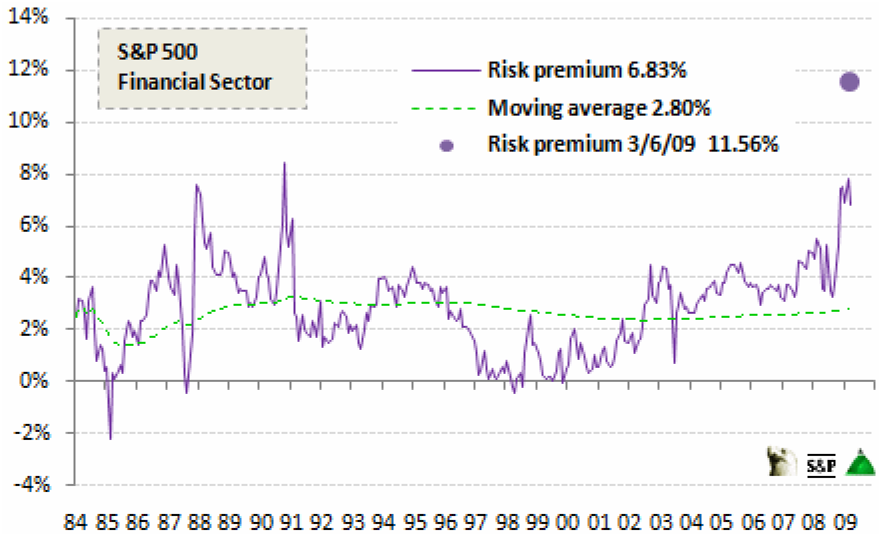
Depression benchmark is for the moment an upward-moving target, stocks having been in a three-month bear market rally at this point back then (the S&P 500 would have to rise 66.66 points to match it -- now *that's* ominous). But even after the 16.66% gain of the last eight days, stocks are still behind even the greater 49.0% loss eight days earlier in the Depression.

Update to strategic view

US STOCKS: The "tradable rally" we expected is well underway. With stocks already in the second worst bear market since 1900, out of all proportion to conditions on the ground, there is no reason *not* to believe that the S&P 500 low at 666 will last. But while there is plenty of room for a continuing rally driven by sheer exhaustion of negative sentiment, we are concerned that the upside is ultimately limited by the sheer size and speed of the destabilizing agenda of "change" -- most of it anti-growth -- coming from the Obama administration and the Congress.

[see Investment Strategy Dashboard]

Will the 666 bottom endure? And how high can this rally go? Let's look at its proximate trigger, Pandit's happy memo. It came, in one sense, at the perfect moment. The day before, the equity risk premium of the S&P 500 financial sector reached all-time highs, indicating panic undervaluation even more intense than the previous record peak last November 20 (see "At Least They're Cheap" November 20, 2008). That previous peak came at another climax of uncertainty, the day before the nomination of Tim Geithner for Obama's Treasury secretary, and three days before the Treasury/Fed rescue of Citigroup (see "Another Rescue, A New Rescue Ranger" November 24, 2008). It was the launch-pad for a 37.7% rally in financial stocks, and a 24.7% rally in the S&P 500 -- virtually a whole bull market, albeit a modest one, in just 47 days. Now, from a slightly greater point of undervaluation, financials have rallied more than they did then -- 40.2% -- in just eleven days.



That said, in another sense, Pandit's memo came at just the *wrong* moment. Just ten days before writing it, Pandit had put in a place a preferred-for-common exchange offer that horribly diluted common shareholders in order to bolster the firm's tangible common equity (see "Citi's Common Misconception" March 2, 2009). If the quarter is really going to profitable -- that is, if there are no new losses to absorb -- then what was gained by diluting the common by nearly as great a factor as did the government's takeover of AIG last September? Measured from just before the announcement of the exchange offer, the financial sector is up 13.4% -- therefore much of the 36.8% rally of the last eight days is little more than recouping the losses triggered by Citi's bizarre act of corporate self-mutilation. As to Citi shareholders, as of this writing they now a $3.00 stock on their hands, when without the exchange offer it would likely now be $12.00. The hell of it is, they probably feel lucky -- with the stock having traded as low as $0.97 a week ago Monday.

What was Pandit thinking? If he knew when he announced the exchange offer that the quarter was coming in profitable, did he make the offer nevertheless in order to get out ahead of the Treasury's so-called "stress test" (see "Two Strikes for Tim" February 11, 2009), which will emphasize the adequacy of tangible common equity under extreme duress? But why wasn't he clearer about the bank's profit outlook *then*? He must not have known. But how could he not have? If he *did* know, his actions are inexplicable. If he *didn't*, then he's completely out of control of his bank. And if he's out of control, then we have no idea whether the quarter is or is not profitable so far, because *he* has no idea. But that fits, because whatever he may or may not know about his own bank, he *surely* has no idea exactly what the regulators' "stress test" will really entail. It will no doubt be a matter of which accounting fad is dominant at the moment the test is completed. Will tangible common equity be the totem to be worshipped, or will cash flow -- that is, will the standard be solvency or liquidity? Will today's mark-to-market standards be assumed, or will hints from Ben Bernanke, Barney Frank and the FASB that these arbitrary rules need to be loosened somehow be incorporated? Will some kind of "public/private partnership" to take troubled assets off banks' books be assumed -- *that* assuming that Tim Geithner, all alone in that big Treasury building, can finally deliver the long-promised plan for such a thing? Under such chaos, banks live or die by grace of bureaucratic whim. As the Bible says, "no man might buy or sell, save he that had the mark, or the name of the beast."

Recommended reading
Clients are talking about: *The Obama Rosetta Stone* Daniel Henninger *Wall Street Journal*, March 13, 2009 **We recommend:** *A (Mostly) Private Capital Assistance Programme* Ricardo Caballero VoxEU, March 17, 2009 *The Global Banking Community Had a Heart Attack* Interview with Bryan Marsal Spiegel Online, March 13, 2009
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Wells Fargo's chairman Richard Kovacevich was right last week when he called the whole thing "asinine." And it's emblematic of the political confusion that is crippling the critical process of financially stabilizing and restoring confidence in the global credit system. The latest symptom is the flap over AIG's payments to derivatives counterparties. It's one thing for politicians to act outraged about bonuses, in order to establish a populist fig-leaf so that rescue money can keep flowing as necessary. But the whole notion of rescue is imperiled when politicians, and even some in the better-informed analytical community, act shocked -- *shocked!* -- that the bail-out of this "systemically important" company would result in its meeting obligations to other members of the "system." Wasn't that the whole point?

Since the present rally started eight days ago, there has also been a bit of slowing in the runaway train of anti-growth economic policy -- the "change" being imposed on the economy wholesale in the name of "emergency" (again, see "Quantum of No Solace"). It's all to the good that anti-growth initiatives currently in the legislative pipeline such has mortgage "cramdown" and union "card-check" are at least now being questioned by moderate Democrats. It's all to the good that President Obama met with the Business Roundtable and tried to send a few faint signals of moderation in his anti-business agenda. Yet at the same time, Congress inserted into last week's spending bill a restriction on Mexican trucks using US highways, a flat violation of NAFTA. Obama supposedly opposes the restriction, but he signed the bill anyway -- as he supposedly opposed the restriction on bank bonuses slipped at the last minute into the so-called "stimulus" bill last month, but which he also signed anyway (see "On the New Bank Bonus Restrictions" February 15, 2009). Now Mexico has announced it will impose $2.1 billion in retaliatory tariffs on US-made products. So add protectionism to the long list of things to worry about.

Our sense is that the political class realized it had pushed things too far as the stock market plunged with each new pronouncement of "change" over the last month. Yes, the political agenda is enabled by "emergency," but there is a limit on the extent to which politicians can be seen as aggravating it at the same time as they claim to rescue us from it. According to complexity theory, a complex self-organizing system reaches its maximum computational power right at the "edge of chaos" -- the point just before the system blows itself up. For the political system, seeking to maximize its own power, the art is to keep the economy at the "edge of chaos" without pushing it over the edge altogether -- but at the same time, when the system pulls back too far from the edge, it has to be pushed toward it again. A dangerous game, and one that suggests a limit to the upside we can expect from this rally.

Objectively, stocks got way oversold two weeks ago in relation to conditions on the ground. There are signs of moderation in the present recession, including two months of strong core retail sales, relief from deflation as measured by the CPI, and a slight improvement in the rate of payroll job losses. We've had an uptick in housing starts, believe it or not, and a slowing in the terribly steep rate of decline in consensus earnings downgrades. We see no strong reason to think that 666 was *not* the bottom. But how high can stocks go, under the Sword of Damocles of so much "change" coming so fast, and so much of it strongly anti-growth?

BOTTOM LINE: The "tradable rally" we expected is well underway. With stocks already in the second worst bear market since 1900, out of all proportion to conditions on the ground, there is no reason not to believe that the S&P 500 low at 666 will last. But while there is plenty of room for a continuing rally driven by sheer exhaustion of negative sentiment, we are concerned that the upside is ultimately limited by the sheer size and speed of the destabilizing agenda of "change" -- most of it anti-growth -- coming from the Obama administration and the Congress.