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MACROCOSM

Footprints of the Black Swans

Thursday, June 30, 2011

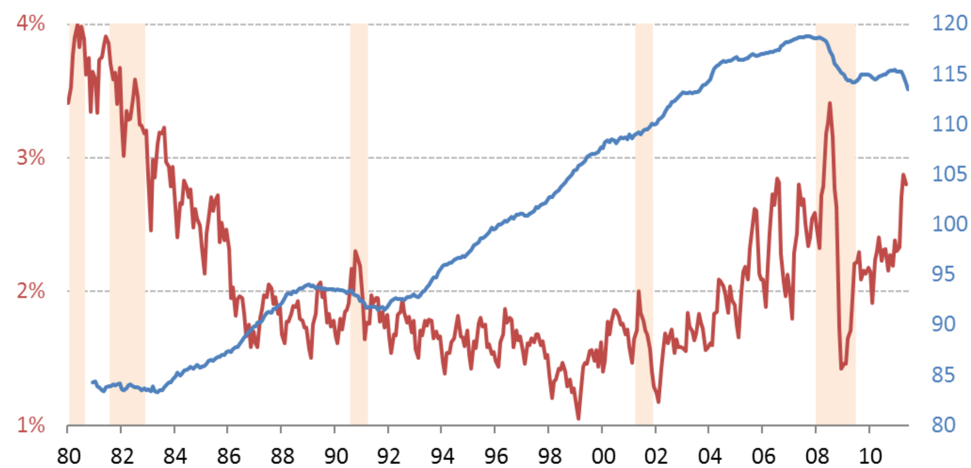
Donald Luskin

Keep it simple. Two factors caused this slowdown. And we're moving past both of them.

You are the first investigator to arrive at a crime scene. A man lays on the ground with two bullet wounds, alive but unconscious. Next to him on the floor are two smoking guns. On both guns you discover fragments of black feathers, and you notice webbed footprints nearby. What do you conclude? Simple: this was the work of black swans. You could torture yourself with more elaborate explanations, but this is really open-and-shut.

And so it is with the economy. We are in a slowdown, but not a recession. There are two obvious causes -- the 25% jump in world oil prices over six weeks starting in mid-February, and the collapse in Japanese manufacturing following the Sendai earthquake in mid-March. Both were black swans: by their nature, unpredictable and unpredicted.

- The jolt in oil prices driven by political turmoil in the Middle East has been enough of a shock to induce a slowdown, but not a recession (see "The Libyan Connection" February 22, 2011 and "An Oil Shock Tipping Point?" March 3, 2011). It's not just that gasoline spending at almost 3% of GDP crowds out other consumption (please see the chart below). It's that while we're spending more on



Source: EIA, BEA, NBER, TrendMacro calculations

Update to strategic view

US MACRO, US STOCKS, US BONDS: As the effects of high oil prices and the Japan quake recede, the economy is poised to get back to the normal growth-rates it was achieving before those shocks hit. Fear is still running high, and the world is rife with potential shocks -- all substantially anticipated at this point. But with forward earnings at all-time highs and rising, stocks should work back to new recovery highs, and a challenge to the 2007 all-time highs. As recession fears ebb, the 10-year yield should work back toward 4%.

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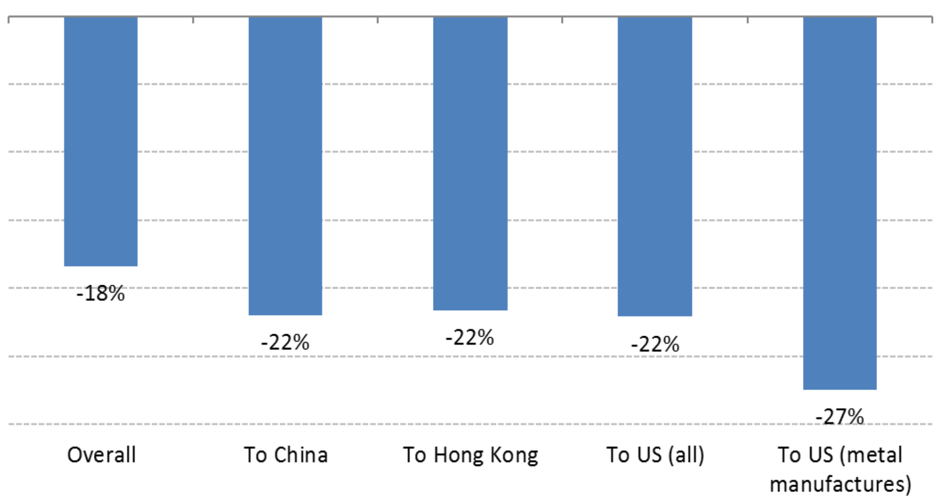
gasoline than we were in the late stages of the last expansion, we're using about 9% less of it. Using less sounds good in the abstract. But when you use less energy, you get less of the economic activity that energy makes possible. And when at the same time you are *spending more* to *get less* energy, that's a double-drag on both productivity and growth.

- The Sendai earthquake has been a significant blow to the global supply chain, as Japan originates high-value components that are assembled in other countries, and then re-exported. Since the quake Japan's exports have fallen 18% overall, while its exports to the US and China have both fallen 22% (please see the chart below). That's an especially heavy blow to China, where the drop in imports from Japan explains more than half of a 5% drop in overall imports -- feeding into, and explaining to some extent, the China slowdown that appears on many worry-lists. In the US, the blow has been heaviest in auto manufacturing, where parts imported from Japan have fallen 27% since the quake.

Change in exports from Japan, March to May 2011



Source: Japan Ministry of Finance, TrendMacro calculations

We note that these two black swan events have been impactful psychically as much as economically. Their very randomness -- given the impression that fate itself is conspiring against recovery -- has contributed, we think, to the pervasive and particular sense of gloom and resignation we sense among our clients (see "Tear Down This Wall of Worry" May 20, 2011). Against such a backdrop, the many other issues that make up everybody's worry-list -- default contagion in Europe (see "Black Wednesday in Greece" June 16, 2011), budget impasse in Washington (see "Chaos in Athens, Progress in Washington" June 20, 2011), end of QE2 (see "FOMC Preview: In Praise of Ben Bernanke" June 22, 2011), and so on -- seem dire out of all proportion to their actual likely risks.

- Obviously, worst-case outcomes in one or more of these would have a real impact. But such outcomes are quite unlikely, precisely

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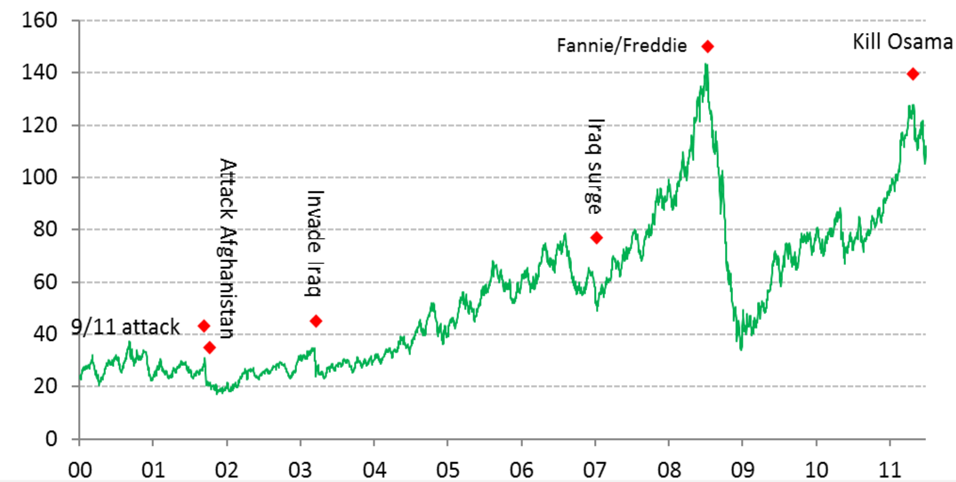
because these are not black swans. They are very well known to actors within the event-dynamics themselves, and to investors observing them -- to the point of tedium.

- We note as a contrary indicator that black swan-watching has gone mainstream. A disciple of Nassim Taleb, who popularized the term, will bring out next month a black swan ETF for retail investors.

So we expect substantial improvement in the economy and in markets in the latter half of the year as oil prices and Japanese production both return to normal.

- What seemed at first like rapidly contagious revolution in the Middle East has now stabilized considerably.
- And we continue to foresee, on a long-term secular basis, a decline in oil prices as the US withdraws its combat presence from the Middle East. This would be a double peace dividend -- first in the form a lower oil prices, and again in the form of reduced defense spending (see "The bin Laden Commodities Crash" May 6, 2011, and the chart below).

Crude oil price, Brent, nominal ◆ Event shocks

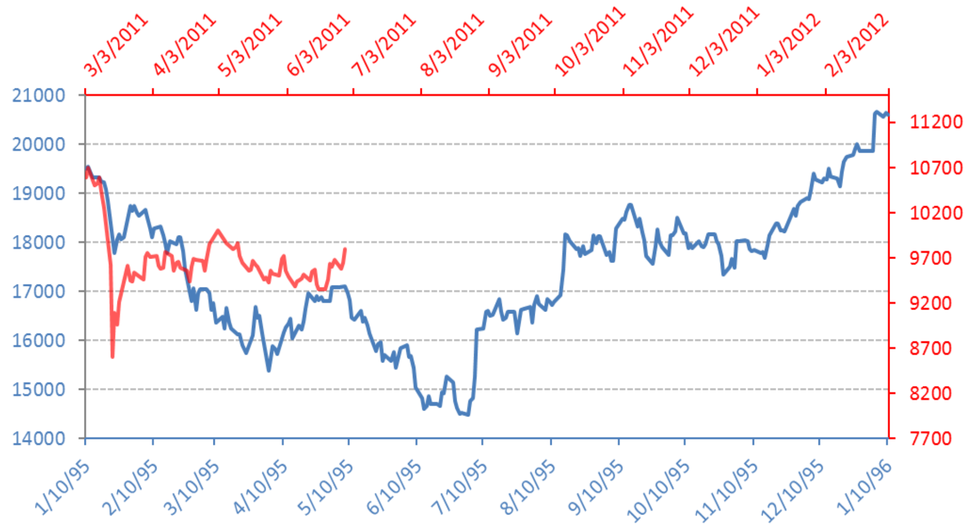


Source: Reuters, TrendMacro calculations

- As an aside, we don't assign any particular value to last week's decision to release oil from global strategic reserves. With the geopolitical risk premium in the oil price already narrowing, the strangely-timed gesture served more to make the political elites responsible for it look desperate and incompetent, which only undermines already shaky confidence. And given that supplies were not especially constrained to begin with, there logically shouldn't be any price impact associated with an SPR release anyway -- since any oil released today will only have to be acquired again in the future.
- Japan is making considerable progress in recovering from the blow of the Sendai quake, underscored by yesterday's record 5.7% monthly jump in industrial production.

- The best forward-looking indicator is the Japanese stock market, which has recovered more than half its losses since we called the bottom at the worst moment of the post-quake panic in March (see "Meltdown in Japan" March 15, 2011). As a matter of benchmarking, Japanese stocks are performing better, on net, than they did in the aftermath of the Kobe earthquake in 1995 (please see the chart below).

Nikkei 225 Index — After Kobe quake 1995 — After Sendai quake 2011



Source: Reuters, TrendMacro calculations

Bottom line

As the effects of high oil prices and the Japan quake recede, the economy is poised to get back to the normal growth-rates it was achieving before those shocks hit. Fear is still running high, and the world is rife with potential shocks -- all substantially anticipated at this point. But with forward earnings at all-time highs and rising, stocks should work back to new recovery highs, and a challenge to the 2007 all-time highs. As recession fears ebb, the 10-year yield should work back toward 4%.