TrendMacrolytics

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INTELLECTUAL AMMUNITION

Gut Check for Growth

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Our growth forecast is getting increasingly out of consensus -- and that's just where we like it.

Our expectations for reaccelerating growth in the second half of 2006 have been frustrated by last week's third quarter GDP report and this week's several reports on manufacturing activity. We love opposing the consensus, but we hate it when the consensus wins a round. When it does, we ask ourselves tough questions. If, after that, we come out sticking by our forecasts, then we relish the opportunity to double down against the consensus. It's an uncomfortable position to be in -- and make no mistake about it, right now we're uncomfortable. But as contrarian investors, we should only be truly comfortable when we're truly uncomfortable. So with this report, we ask the tough questions and reexamine our outlook. We screw our courage to the sticking place, and end up reiterating our forecast for growth.

WHAT ABOUT THE DATA? First, have the several recent reports of slow growth been accurate portrayals? No question we're not yet seeing in the numbers the reacceleration of growth we've been forecasting. But at the same time, we think the consensus has over-interpreted the negative implications in recent reports. For example, we think the third quarter GDP report was strongly influenced downward by factors that we think are anomalous (see "Better Than It Looks" October 30, 2006). And yesterday's ISM manufacturing report came in lower than expected, but was nevertheless at a level consistent with 3%-plus real GDP growth.

BACK TO THE FUTURE More important, even accepting for the moment these reports at face value, they certainly don't tell us in and of themselves that growth is slowing *in the future*. They only tell us that growth has already slowed *in the past*. From the standpoint of past data, the future is a random walk. To extrapolate trends from past data is nothing more than technical analysis. It is seductive because it satisfies cognitive biases that perceive patterns in randomness, but it can only tell you what everyone already knows. Thus, even accepting the recent data uncritically, we by no means concede that they imply that the economy is set to remain slow or slow further.

Update to strategic view
US MACRO: The causal factors that underlie future growth are all strong. Prohibitive factors that restrict growth are absent. And market-based growth expectations are robust. Despite seeming setbacks in recent backward-looking data, we reiterate our increasingly out-of-consensus view that the economy is not heading into a serious slowdown, and indeed that growth is very likely to surprise on the upside. **US STOCKS:** The slowdown consensus is pricing for an earnings contraction that is unlikely to materialize. Any substantial correction here should be bought. But prohibitive interest rates are still in the cards long-term, so any substantial rally to new highs is an opportunity for scaled selling. **US BONDS:** The slowdown consensus is pricing for 2-plus rate cuts that are unlikely to materialize, and would result in only a breakeven for bond bulls even if they do. All the potential profits are on the short side.
[see Investment Strategy Dashboard]

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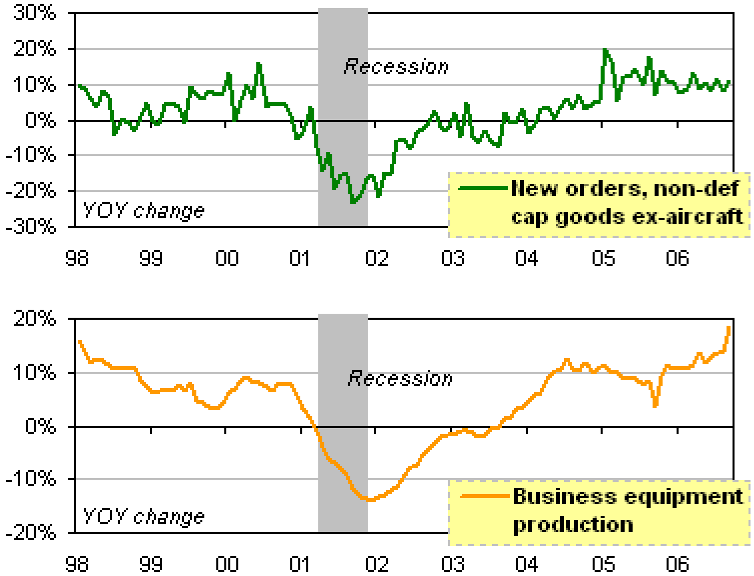
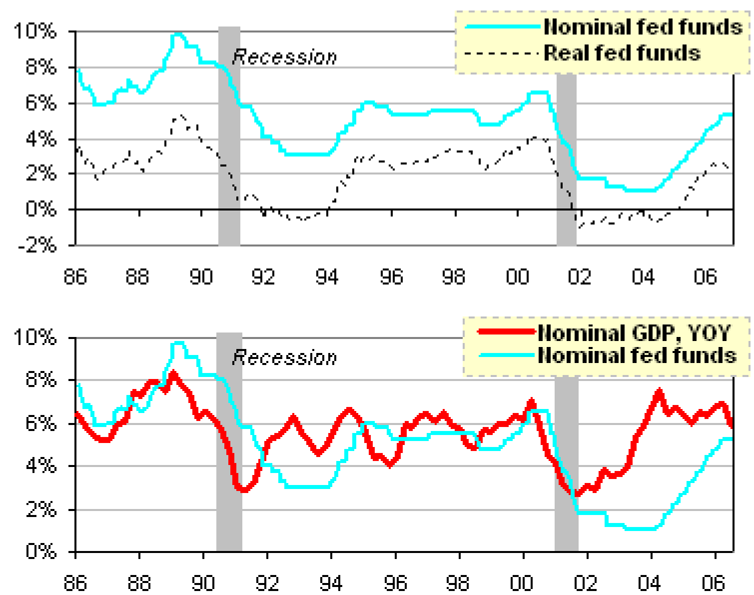
OUR MODEL Rather than extrapolating from past data, our model looks at statistics that reveal the state of the *causal factors* that actually determine future growth and the state of *prohibitive factors* that could undermine growth. And our model looks at indicators from which we can infer unbiased market-based *growth expectations*. Our model has produced a record of out-of-consensus forecasts that have been mostly both correct and actionable. Today our model continues to unambiguously point to faster growth.



CAPITAL INVESTMENT IS BOOMING

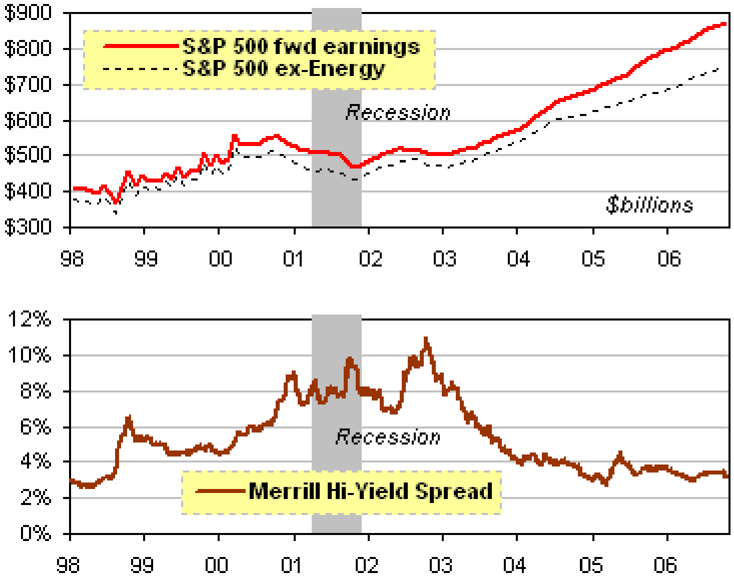
CAUSAL FACTORS In our model, the most important causal growth factor is expansion of the economy's ability to produce through capital formation, and today capital investment is growing at boom levels. In the present, this activity itself is a form of growth. But what's important to our model is that capital investment today secures future economic growth. Prior to recession, we typically see rates of growth of capital investment falling -- as we saw happen to new orders for non-defense capital goods and business equipment production as the economy topped out during 2000. We simply see nothing like that today -- quite the opposite. The present-day factors that cause future growth are solidly in place. This goes a long way to explain why, even as we had been overoptimistic about third quarter growth -- which came in soft due to the housing cool-off -- we were correct that employment and consumption would continue to be very strong (see ["Immaculate Consumption"] September 19, 2006).

PROHIBITIVE FACTORS Major slowdowns generally do not occur for reasons intrinsic to the economy -- expansions don't just roll over and die all by themselves. Instead, slowdowns are usually caused by exogenous shocks that act to prohibit growth. The most common prohibitive shocks are sudden adverse changes in tax or tariff policy, or restrictive monetary policy from the Fed. Today taxes on incomes are low, and taxes on capital are at the lowest level in two generations. While there are long-term risks on taxes and tariffs -- as always -- we see no adverse changes on the near horizon -- even if the Democratic party captures control of Congress (see ["Speaker Pelosi"] October 12, 2006). And we believe that the posture of Fed monetary policy is not prohibitive at all, but instead is still somewhat accommodative (see ["The Price of the Pause"] October 20, 2006).



THE FED IS NOT PROHIBITIVE

The fed funds rate at 5.25% is not high by historical standards, either on a nominal or a real basis; the last two recessions occurred following the real funds rate topping 4%, and today the real rate stands at only 2.3%. Further, the nominal funds rate remains almost one percentage point below the nominal GDP growth rate; the last two recessions occurred after prolonged periods of the funds rate being *above* nominal GDP.



GROWTH EXPECTATIONS ARE ROBUST

GROWTH EXPECTATIONS Markets themselves can act as "canaries in the mineshaft," revealing changes in growth expectations that foreshadow changes in the economic environment well before they become obvious. Two canary markets that we believe are particularly valuable are consensus S&P 500 forward earnings, and the high yield bond spread. The bottoms-up cap-weighted average of all Wall Street estimates for earnings one year in the future continues to rise to record levels every day. Today they are rising more slowly than their torrid pace of the last three years, but they are still rising. We are not trying to make a case for the point accuracy of the dollar level of the consensus's forecast. We are simply noting that, from the grass roots, one company at a time, and without much explicit thinking about macroeconomic factors, the consensus is continuing to call for ever-higher year-ahead earnings -- and, implicitly, ever-higher growth (see "The Out-of-Consensus Consensus" June 26, 2006). One year before the onset of both of the last two recessions, the earnings consensus not just slowed, but actually turned lower. The Merrill Lynch High Yield Spread remains in the region of the near-historic lows it has occupied for much of the last two years. We interpret this as the market's judgment that cash flow will remain strong (thus no substantial default risk) and that liquidity will continue to be plentiful (thus no substantial refinancing risk). Before the last recession, when cash flow and liquidity were about to dry up, the spread doubled -- and that starting from a level higher than today's level.

THE FLY IN THE OINTMENT We will pull in our horns on growth when our model tells us to. We already have a pretty good idea of how that will eventually happen. Throughout this expansion, we have worried that the Fed has been too accommodative (see "Desperately Seeking Inflation" October 29, 2003), embedding inflation pressures in the economy that would someday have to be dealt with by prohibitive interest rates (see "Judgment Day" August 3, 2006). While the consensus insists that inflation is not a problem, core CPI is now just basis points away from 3%; unit labor costs are at their highest levels since 1982; and gold, along with most other non-petroleum commodities, remains at very elevated levels. When the economy fails to slow from here -- indeed, when it more likely reaccelerates -- the Fed will have to abandon its worries about the downside to growth and its hope that slowing growth will serve to moderate inflation. The Fed will have no choice but to bring interest rates up to equilibrium levels sufficient to stop imparting further inflationary pressures, and probably to prohibitive levels to reverse some of the inflationary pressures already imparted. The emergence of that powerful prohibitive factor will surely impact growth negatively, potentially ending the expansion altogether. But that's the next act -- for the moment, continued growth is still onstage.

BOTTOM LINE: It's getting increasingly uncomfortable here, well out of the consensus that the economy is already heading into a sharp slowdown -- and that's the way we like it. We can't control the quarter-to-quarter noise that comes from the distressed housing market, but a reexamination of our macro model reaffirms for us that the present economic expansion is still very much intact, and that growth is likely to surprise on the upside in the coming months. The causal factors that underlie future growth are all strong. Prohibitive factors that restrict growth are absent. And market-based growth expectations are robust. We admit that the slowdown consensus won this last round. We're delighted by the opportunity this gives us to double down. At this point we think the slowdown consensus will be at pains to come up with news bad enough to justify bearish expectations already in securities prices. So even if the consensus continues to be right for a while, it will hard to profit from it. But if the consensus is wrong, as we expect, then there would be substantial gains to be had from having taken the contrarian side of the bet.

Though hovering near recovery highs, stocks continue to impound a near-historic equity risk premium, pricing for a sharp year-ahead earnings contraction (see "Highs for Stocks, Lows for Sentiment" Monday, October 9, 2006). Forward earnings are still rising, and this should provide a rising floor for stock prices. If stocks extend the correction that has gotten started over the last week as slowdown fears embed themselves in the consensus, there will be a near-term buying opportunity for nimble investors. Longer term, we continue to believe that when growth reemerges and inflation continues to build, the Fed will have to raise interest rates to prohibitive levels, and that stocks will have to move lower in response -- thus rallies to new highs are an opportunity for scaled selling.

Bonds are already priced for two or more Fed rate cuts in 2007. Unless there turns out to be *more* rate cuts than that, one will be hard pressed to profit from buying bonds here. While the data of the last week has surely emboldened the slowdown consensus at the Fed, at the very most it has moved the central bank toward neutral from what had already been an overtly hawkish bias (see "The Frustrated Fed" September 28, 2006). Unless both growth and inflation data substantially and unexpectedly weakens from here, we continue to believe that the next Fed move will be to higher rates, not lower. Remember, even if growth does weaken considerably, the Fed will be hamstrung from cutting rates unless inflation weakens too. This morning's report of unit labor costs hitting their highest levels since the hyperinflation years of the early 1980's puts the lie to the Fed's avowed belief that slowing growth necessarily slows inflation -- and the Fed is unlikely to be able to wave this one away by arguing, as it did last quarter, that the jump in unit labor costs was an anomaly due to one-time exercise of stock options. With nothing to be gained in bonds if the Fed cuts rates, and a great deal to be lost if the Fed hikes them -- or even stays where it is for a long period -- we continue to see bonds as ripe for selling or shorting. TM