TrendMacrolytics

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MARKET CALLS

Are We Scared Yet?

Wednesday, February 28, 2007

Donald Luskin

We got the correction we expected -- but is that really all it is?

Twelve days ago, one day before the S&P 500 logged its highest close in more than six years, we wrote that "a correction really is finally due" -- with all possible good news already out, with valuations rich by recent standards, and against a backdrop of widespread complacency (see "Enough Good News for a Correction" February 16, 2007). In one sense yesterday's steep sell-off requires no more explanation than that. But its severity begs the question of whether this is about more than just sentiment, and whether something has gone seriously and fundamentally wrong. We have been out-of-consensus bulls on the economy and the stock market, having called the bottom last June within a day (see "The May 10 Inflection Point" June 12, 2006). Now it's time to examine the bear case and see if there's reason to think that we're not just in a correction of an uptrend here, but rather in a new downtrend.

Update to strategic view

US STOCKS: For now we are treating yesterday's drop as part of the correction we anticipated 12 days ago. In a single day our valuation concerns have been erased, but we are not yet prepared to call the bottom. We reject the conventional explanations for the sharp sell-off, though we remain on alert for potential worsening of our concerns about forward earnings deceleration, and tax or trade policy risks.

INFLATION PLAYS (US RESOURCE STOCKS, US ENERGY STOCKS, GOLD, COMMODITIES, US DOLLAR): Inflation-sensitive markets got caught up in the "sell everything" mentality of yesterday's global decline. But if the Fed is now more inclined to stay on pause or cut rates, then inflation pressures are intensified and the inflation-sensitive markets should be the first to recover (and the dollar should continue lower).

[see Investment Strategy Dashboard]

VALUATION But first a word for the bulls. Our expectation of a correction was based in part on the narrowing of the S&P 500 risk premium to the lowest levels since just before the correction that began last May. Yesterday's 3.5% decline covered in a single day almost half the 7.7% decline that took more than five weeks to evolve last year. Combining that drop in market capitalization with the sharp drop in long-term bond yields yesterday, the S&P 500 risk premium has now expanded back to near the levels it attained at the June bottom of last year's decline. Valuation is off the table as an argument for the bears.

HOUSING, SUBPRIME, AND ALL THAT We acknowledge that there has been a housing slowdown, and we acknowledge that there is distress in subprime lending and the associated market for credit derivatives. But most of the evidence is that the housing market has stabilized, or at least that the pace of deterioration has slowed -- and it has not impacted other sectors of the economy at all (see "On GDP and FOMC" January 31, 2007). And we believe that the vast pool of global liquidity is more than sufficient to absorb the losses being borne in the subprime sector

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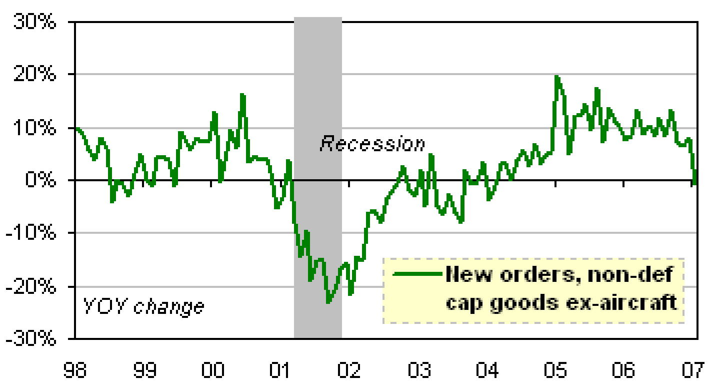
(see "Subprime Time" February 26, 2007). While fears about subprime distress have surely played a role in the recent deterioration of sentiment, we don't think that yesterday's steep sell-off was specifically driven by those fears. It's noteworthy that the stocks of the major subprime lending companies all outperformed the S&P 500 yesterday (that is, they declined less). And while the credit spread between junk bonds and Treasuries widened yesterday, just as the price of risk when up in all markets, this key indicator of global liquidity remains near all-time lows, and shows no signs whatsoever of systemic distress.

CHINA IMPLODING We don't doubt that the sharp drop in the Shanghai stock market had a major role to play in shaping yesterday's negative sentiment. Having experienced dramatic speculative gains over the last year, that market was overdue for a speculative correction. US investors seem to have taken Shanghai's drop as the cue to sell anything and everything that has recently gone up. We have no reason to think that the trivial measures being contemplated by Chinese authorities to keep the economy from "overheating" are likely to have any significant anti-growth effects, and thus pose little risk to the global economy. The biggest risk to China's growth comes from potential protectionist legislation in the US. We have heard that Treasury Secretary Paulson is scheduled to make "trade remarks" today. We will be surprised if those remarks turn out to be a significant escalation in the effort to force China to more rapidly revalue its currency -- but if they are, that would be a powerful explanator of yesterday's global sell-off.



GENERAL RECESSION FEARS Yesterday's durable goods report for January was a disappointment to us -- at least on the surface. We have long regarded the growth in non-defense capital goods orders as important evidence that the causal factors underlying overall economic growth were alive and well (see "Gut Check for Growth" November 2, 2007). But one month's interruption in that trend is not evidence that the trend is over. This is a very volatile series, which experienced several interruptions worse than January's during the heady growth years of the late 1990s. In contrast, the recession of 2001 was preceded by a persistent collapse in shipments.

This morning's downward revisions to fourth quarter 2006 GDP were in line with the market's expectations, and with ours (see "Paper Tiger?" February 22, 2007). The most salient component of the revision reflects December's decline in wholesale inventories. We regard this as a temporary effect that sets the stage for faster reported growth in the current quarter. As noted last week, the ISM inventory index has fallen to its lowest levels since the immediate aftermath of the 2001 recession, so it appears that inventories have become lean again, with inventory/sales ratios declining after moving higher for a number of months. From this point, inventories will probably be a net plus for growth. Excluding inventories, final sales grew at a 3.6% annual rate.

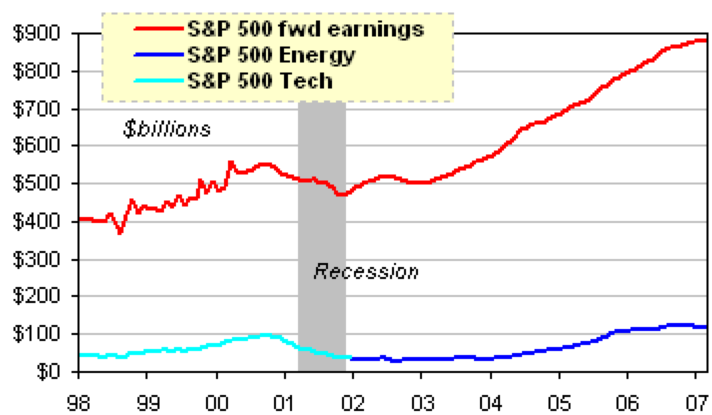
And we give little credence to Alan Greenspan's bearish remarks yesterday (which, in fact, were far less bearish than most of the headlines suggested). No doubt those remarks played into yesterday's general fearfulness. But we caution investors to remember that Greenspan's record as a forecaster is spotty as best, his stellar reputation notwithstanding. His diagnosis in December 1996 that markets were experiencing "irrational exuberance" is surely the single worst financial forecast in history. Stocks fell for a couple days following those famous words, but then launched into the greatest bull market of modern times and -- even in the depths of bear market that followed -- never came back down to the levels that Greenspan had warned were too high.

EARNINGS DECELERATION Moving on now from what the conventional wisdom is afraid of, we'll turn to some factors that are of concern to us within our own analytic framework. The first is the deceleration in consensus forward S&P 500 earnings. Starting in October 2003, the S&P 500 began a period of uninterrupted year-over-year earnings growth above 10% (that's true whether you look at trailing earnings or forward earnings). We recall that in 2004 and 2005 investors were worried that such growth could not be sustained, and feared that the bull market in stocks that began in March 2003 would end when that run of earnings growth ended. This was often cited as an argument against our valuation model that showed stocks being historically cheap relative to bonds, depending as it does on forward earnings as an input. Now, that run of double-digit earnings growth has indeed ended (year-over-year growth in forward earnings will just miss 10% at month-end February). And yet we find that investors aren't talking about it -- in fact we hear frequently that stocks are deeply undervalued relative to bonds, based on earnings. That's part of the complacency that caused us to expect a correction in stocks.

But it's more than that. There's nothing wrong with year-over-year earnings growth just shy of 10%. The problem is that, in real-time terms, the dollar value of S&P 500 consensus forward earnings -- about $880 billion -- has just about stopped growing altogether. It's up less than one third of one percent over the last month. If that were to continue for a full year, then we'd be looking at actual earnings growth of less than 4% (and remember, forward earnings tend to err on the high side). We take this development very seriously, because both of the last two recessions were preceded, one year ahead, by declines in the dollar value of forward earnings (see "The Out-of-Consensus Consensus" June 26, 2006).

We are not comforted by the fact that, even though forward earnings themselves have almost stopped growing, they nevertheless are well about trailing earnings. With forward earnings at $880 billion and trailing earnings at $788 billion, implied growth is 11.7%. But the last time forward earnings themselves started to turn down was April 2000. That was an excellent sell signal for stocks, and a warning of the recession to come one year hence -- even though, at the time, implied growth versus trailing earnings was about the same as today's, at 10.8%.

There are two factors that cut against our worries about what seems to be happening in forward earnings. First, an actual decline has not occurred yet, and the deceleration we're seeing is quite gentle. In 2000, the decline that began in April was, from the very beginning, a sharp and definitive drop from the peak in March. We continue to expect that overall economic growth will surprise on the upside, and this could easily translate into a resumption of more rapid growth in forward earnings. Second, today's decline is to a meaningful extent an artifact of the earnings dynamics of the energy sector. Forward earnings in the energy sector have been declining every month since their peak in August. So just as we might argue that overall economic growth is robust by subtracting the negative influence of the housing sector, we can argue that overall S&P 500 earnings are robust by subtracting the energy sector. It's worth noting that this argument could not have been made in 2000 with respect to the technology sector -- the sector which, like energy in this latest cycle, contributed so disproportionately to overall earnings growth. In April 2000, when S&P 500



forward earnings fell sharply, technology sector forward earnings actually increased (in fact, they didn't top out until September 2000). Then the earnings problem was clearly systemic, while today it appears confined to a single sector. And that particular sector today, energy, is arguably somewhat parasitic -- to some extent, its earnings represent a tax on the earnings of all the other sectors that must consume energy. So we could mount the argument that, over time, a decline in energy earnings will translate into higher earnings everywhere else.

TAX HIKES A month ago we expressed concern that today's low tax rates on incomes, dividends, capital gains and estates are all set, under current law, to automatically expire after 2010, reverting then to their higher Clinton-era levels -- and this very tax year the income exclusion for the alternative minimum tax is set to revert to its 2001 levels (see "Tax Wars" January 22, 2007). With Democrats in control of congress, it is not clear what will prevent what amounts to a series of dramatic tax hikes which would surely cause tangible damage to the economy. This is a very serious risk for the long term, and an op-ed in yesterday's *Wall Street Journal* by our friend David Malpass of Bear Stearns making much the same point probably played into the negative tone of the day. With this kind of long-term uncertainty, it's never easy to assess how and when it will get factored into valuations. If the Bush administration or congressional Republicans were to announce a policy indicating acquiescence in these tax hikes, expectations would deteriorate immediately even though the actual effects may be several years in the future. We know of no such policy at this time, but with the AMT exclusion in play in the current budget negotiations, we can't rule out a nasty surprise.

THE FED AND INFLATION The conventional wisdom has believed for the better part of a year that the Fed is too tight, and fixed income markets have been priced to reflect expectations for rate cuts. Other than those expectations themselves, we see no evidence in markets to support the idea that the Fed is too tight. With commodity prices elevated, the dollar weak, and credit spreads narrow, we only see evidence to the contrary -- that liquidity is too abundant, that the Fed is too accommodative. We have often said that the biggest threat to growth, and to stocks, is that this accommodative stance will lead to a reacceleration of reported inflation, which will risk causing the Fed to raise interest rates to restrictive levels (see, for example, "Gold Versus Goldilocks" June 2, 2007). On the face of it, yesterday's sell-off is unlikely to have been driven by fears of a tighter Fed. Market expectations for Fed rate cuts rose dramatically yesterday, with futures markets now calling for a 70% chance of one cut as soon as June, and a nearly 100% chance of *two* cuts by year-end. If these expectations prove to be accurate, the our concerns about inflation would be exacerbated. But that was probably not on the market's collective mind yesterday. Large drops in gold and other commodities are not consistent with increasing inflation fears; only the large fall in the dollar on forex markets could arguably point in that direction.

BOTTOM LINE: We reject conventional explanations that would explain yesterday's sell-off -- housing and subprime issues, China slowing down, and general recession fears. We are on the alert for negative policy surprises with respect to trade and taxes. And we are concerned that forward earnings are sharply decelerating and may turn lower, and our long-term inflation worries remain in place. But absent a worsening of the issues that concern us, our stance at the moment is that yesterday's sell-off -- as severe as it was -- should be seen as part of a speculative correction, and not as the sign of a major inflection point. With the sudden expansion of the S&P 500 risk premium, valuation is off the table as a concern. But we're not prepared yet to suggest buying the correction, but we're on the alert for the right moment. We would be more aggressive in bargain-hunting in the inflation plays that we have favored -- gold, oil, commodities and the weak dollar. We see nothing in yesterday's action that suggests the cessation of inflation pressures, and much to suggest their intensification. TM