

MACROCOSM

Perception, Election, Reality and Risk

Friday, September 5, 2008

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Bleak sentiment is way overblown -- but some real risks are getting closer and closer.

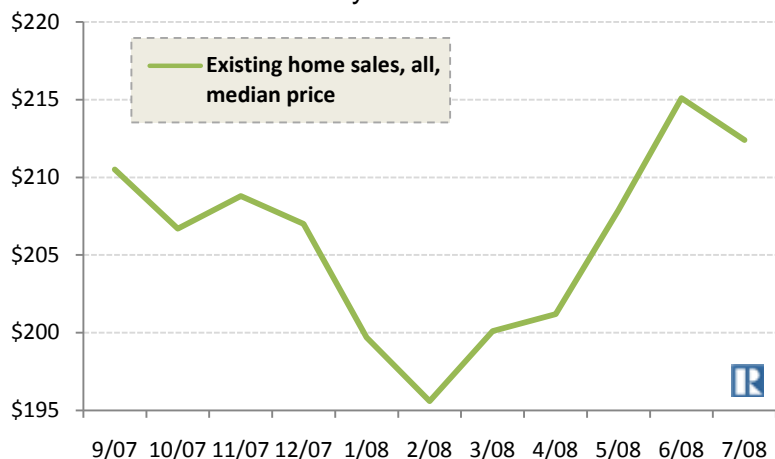
After a terrible day in the stock market and a bad jobs report this morning, and with the general mood of economic catastrophe deepening, we hesitate to stick our heads above the ramparts and say anything positive - but dare we shall. We can't add any value by simply echoing the exaggerated nightmare scenarios of a global recession and spiraling financial deleveraging that were being retailed again yesterday. Nor can we add any value by repeating the bleak and deceptive economic narrative emanating from last week's Democratic National Convention, a narrative that is already being repeated dutifully by the media. We want to make the case that when *sentiment* has swung as far in *one* direction as it has today, any deviation of actual *reality* in the *other* direction can open up profit opportunities for contrarians. In that spirit, let's look at some of the reasons why things are considerably better than sentiment currently reflects. But at the same time we'll also look at what we think are some real risks in play now.

Update to strategic view

US MACRO: The typical housing, credit and recession fears that dominate sentiment are exaggerated. But there are two real risks -- anti-growth policy under an Obama administration, and renewed denial of inflation pressures.

US STOCKS: Stocks are getting ridiculously cheap again, and probably don't have much downside risk from these levels. But upside potential is being eroded by renewed denial of inflation pressures, and the approaching risk of anti-growth policy under an Obama administration. That said, the emergence of Sarah Palin could be a political game-changer.

[\[see Investment Strategy Dashboard\]](#)



Sentiment obsesses on the decline in the housing market, and takes it as established fact that it is a self-reinforcing cascade that is sucking down the financial system and the rest of the economy. But the facts don't support that. In GDP terms, housing has been in very sharp decline now for two and a half years, yet in all that time there has been only one quarter of negative real

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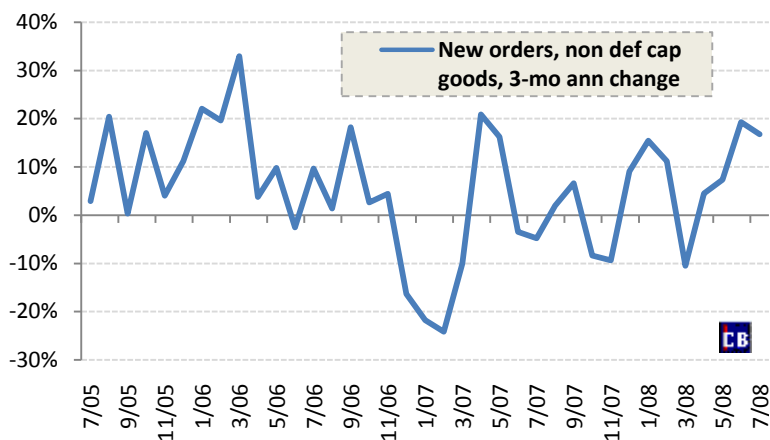
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GDP growth -- the fourth quarter of 2007 -- and if housing itself were removed from the calculation, that quarter would be positive. And based on the National Association of Realtors' index, the median price of an existing home appears to have bottomed in February and is now 8.6% higher. Based on the Census Bureau's index, even the median price of a new home, despite massive inventory overhang, is higher -- 1.3% above the apparent bottom last December.

There is obviously tremendous continued stress in global debt markets. But while sentiment holds that banks are utterly paralyzed by capital constraints and risk aversion, aggregate equity capital of US banks, in total, is now greater than it was a year ago before the credit crisis began. US bank credit and commercial paper, in aggregate, are now growing at a three-month annual rate of about 4%.

We take special note of signs that despite the continuing credit market upheaval, business investment has gathered considerable strength in recent months. New orders for core capital goods -- non-defense, ex-aircraft -- were up 2.5% last month, and are now growing at a three-month annualized rate of 17%, highest since early last year. This is one of the more forward-looking indicators in the official statistical arsenal. Such indications of strength in capital investment suggest a degree of confidence in the economic outlook that bodes well for growth going forward.



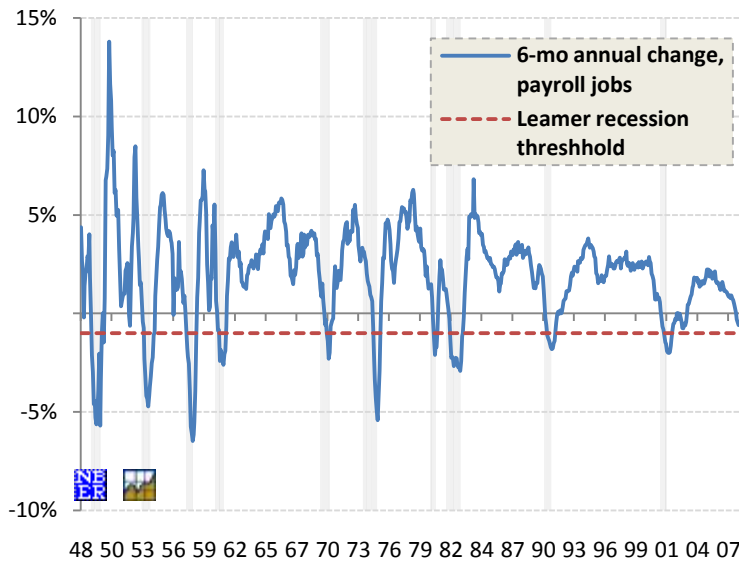
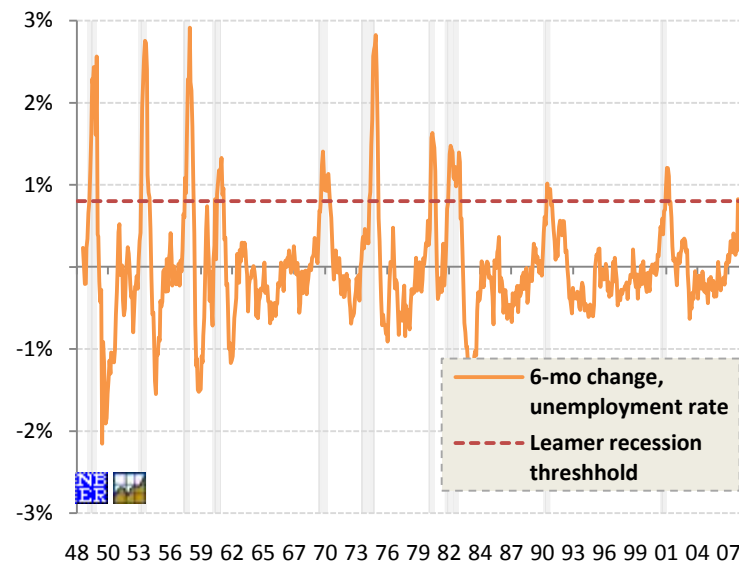
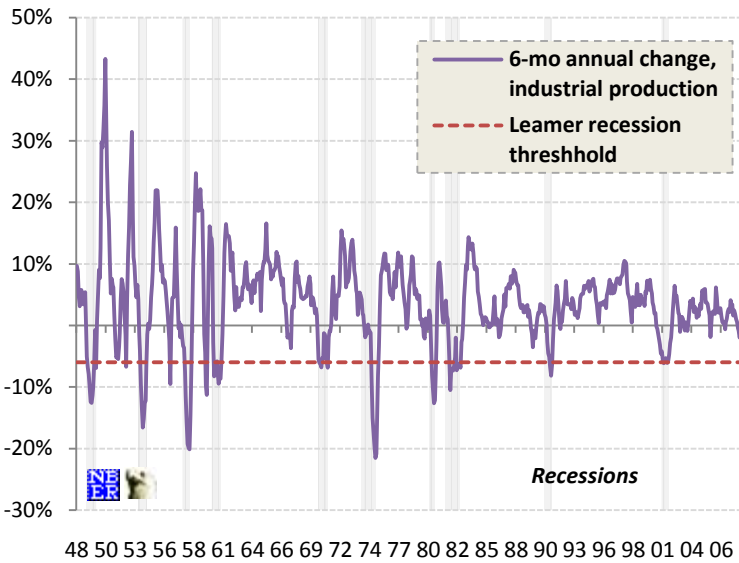
Certainly, it's not the stuff of which recessions are made.

Whether or not the economy is in recession is not just a matter of opinion, at least not if the word "recession" is granted to have intrinsic and important meaning. We think it does have such meaning, and we think the economy today does not fall within it.

The National Bureau of Economic Research, the organization that officially determines the beginning and ending dates of recessions for the history books, has no formula for making its determinations. But it has a set of fairly objective [guidelines](#). In a new NBER Working Paper ([click here to download it from our client resource collection](#)), Edward Leamer of the UCLA Anderson School of Management shows that the guidelines can be transformed into formula that designates recessions. It amounts to a Taylor Rule for business cycle dating, but Leamer's formula is far better at explaining recessions than the Taylor Rule is at explaining the fed funds rate. Leamer's formula, though quite simple, perfectly identifies all ten official post-war recessions, with no false negatives and no false positives. It pinpoints most peak and trough dates perfectly, missing a few by only a single month. The formula's only large miss is that it dates the November 1973 recession onset to September 1974.

What's so important about Leamer's work is that it provides a precise meaning of the word "recession," derived from experience. That meaning encompasses just three straightforward criteria. Every post-war recession has satisfied all three; they have never all been satisfied during an expansion.

- Industrial production declines over six months at or above a 6% annual rate; and



- Payroll employment declines over six months at or above a 1% annual rate; and
- The unemployment rate rises over six months by at least 0.8%.

Today, only one of the three criteria is satisfied, and that one only as of this morning with the news of a jump in the unemployment rate. Leamer writes, "things have to get much worse to pass the recession threshold." The unemployment rate has met Leamer's criterion, up 1.2% (though it should be noted that this was due as much to an increase in the size in the labor force as it was to a decrease in the number of jobs). Payrolls and industrial production are far from their thresholds, down at annual rates of only 0.6% and 1.3%, respectively. To get some context on just how far we are now from truly recessionary levels, consider that on average over the last ten recessions the six-month increase in the unemployment rate gets as high as 1.9%; and the annual six-month fall in payroll jobs and industrial production gets as low as -3.5% and -12.5%, respectively.

This puts the widespread consensus that we are either in recession now, or heading immediately into one, at variance with history. As Leamer remarks on that disjunction, "The episode that we are currently experiencing has been marked by an unusually large number of very vocal recession pronouncements. That, by itself, provides statistical evidence that we are not in a recession."

Today's deeply entrenched negative sentiment is itself internally contradictory in one important regard. There is a striking disconnect between peoples' perceptions of their own economic health and the country's. According to a recent analysis of opinion polling by the American Enterprise Institute, 76% of Americans

are optimistic about their personal economic situations, but only 18% are optimistic about the national economy. Clearly, the bleak overall outlook is not being informed by personal experience -- it is then surely the result of external influence, and that influence is very likely the political message of a presidential candidate running on a platform of "change," and a media establishment so fascinated with him that it repeats his messages to the public both uncritically and endlessly.

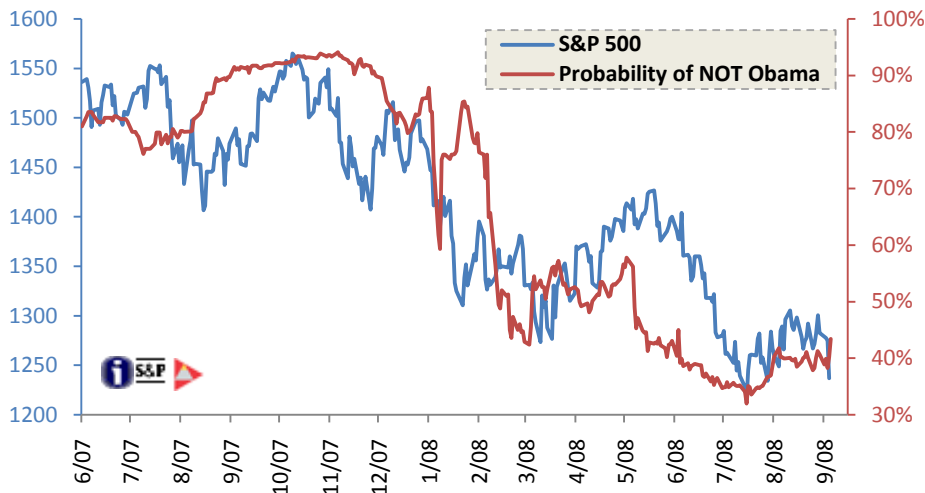
A major theme of the Democrats is the supposed decline of living standards under George W. Bush, with various party figures citing claims that current real income is lower than it was some 30 years ago. That is simply false -- it's higher now than it was just 11 years ago. The most recent data from the Census Bureau, out last week, showed median real household income last year of \$50,233, up 1.3% from 2006. That's below the peak of \$50,641 in 1999. But 1999 was, in an important sense, a fluke -- it was the peak of the tech bubble, an unsustainable boom that temporarily swelled employment and inflated compensation. A fairer comparison would be to 1997, before the tech frenzy went hyperbolic. Median real household income has risen by \$2,600, or about 5.5%, from 1997 to 2007 -- a decade that included the bursting of the tech bubble and the reversal of its associated compensation distortions.

In our view, the real risks ahead to the economy are not the ones that sentiment is being influenced to focus on. Instead, one major risk we see is the possibility of that influence succeeding (see ["The Next Thing to Worry About"](#) May 8, 2008). Specifically, the electorate may well succumb in November to a belief that a vote for a return to economic interventionism on the vast scale proposed by Barack Obama will be the antidote to the bleak economic picture painted by his campaign and the media. Will the public be persuaded that times are hard enough to validate such a choice, which in our view what would amount to "change" for change's sake, despite the fact that Obama's policies are certain to lead to slower growth? If the polling data mentioned earlier are correct, then a foundation of positive sentiment hasn't been entirely extinguished. Obama could yet face a real challenge in his bid to win election on the promise of activist government to heal what he claims is a critically wounded economy, as the electorate comes to understand that there's a price to be paid for such activism -- that is, more central control and more taxes.

At the moment, we see the election as pretty much a toss-up, with Obama favored. The McCain campaign's bold choice of Sarah Palin for vice president is potentially a game-changer. With Palin, McCain has found someone of sufficient charm, charisma and fascinating background to compete with Obama's cult of personality. The Democrats' attacks on Palin only make her more of a celebrity. Thanks in part to the controversy about her qualifications and her family, her convention speech Wednesday night was watched by only a million fewer viewers than Obama's historic acceptance speech the previous week, despite being televised on only six networks rather than ten. Selecting her makes McCain look bold and innovative, and makes Obama's choice of Joe Biden instead of Hillary Clinton seem unduly risk-averse -- especially for a candidate who advertises himself as an agent of "change." It creates an opportunity for McCain's competing economic vision to be taken seriously -- indeed, to be heard at all.

As of this writing, with two months to go till the election, Obama is favored in the political futures contracts traded online at Intrade. This morning the Obama futures have traded especially volatily, fluctuating between 54.5% and 60%. That's down from 62% about a week ago, and down as much as about 5.5% overnight, apparently on the news of a CBS poll showing Obama and McCain tied. So it appears that Palin has definitely had an effect. We note that stocks made their *lows* this year on July 15, the same day that the Obama futures traded at their all-time *highs* in the mid-60's. Remember, within days of the all-time *lows* for the Obama futures last October, stocks made all-time *highs*. It's not too much a stretch for us to conclude that stocks

would strongly prefer to not have Obama elected president. They've gained ground -- not very impressively -- right along with McCain, since mid-July. Perhaps yesterday's equity rout had something to do with the failure of the probabilities to have adjusted very much in the aftermath of Palin's seemingly high-impact speech on Wednesday night. It's possible that things will look different in the next several days, with the Obama contract having traded sharply lower this

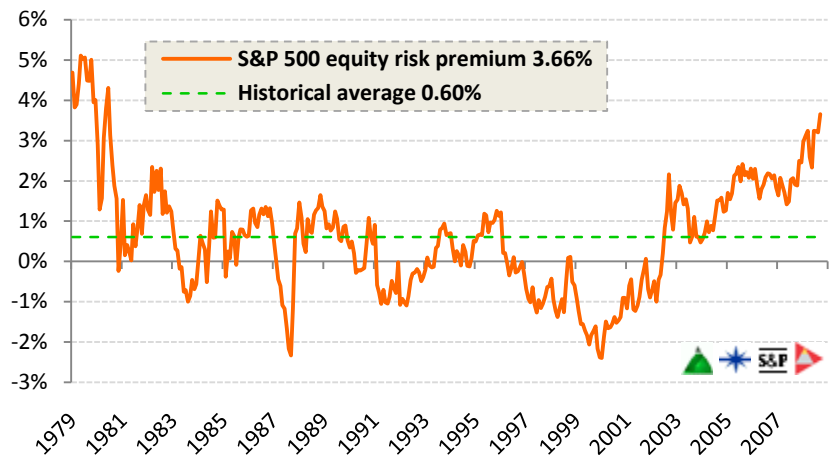


morning, and the McCain contract having touched new all-time highs. If McCain does manage to make headway here, it would help stocks mount another attempt to revive.

The other risk we see is, for the moment, being discounted or ignored in the election debate, and by the media or the Wall Street consensus -- inflation.

The release of July personal income and consumption last week helped underscore the point. Nominal personal consumption expenditures were up 0.2%. After adjustment for inflation, however, real expenditures were down 0.4%. The headline PCE deflator was up 0.6% for the month, and has jumped 4.5% in the last year, the most in 17 years. Core PCE prices, the Fed's favored indicator, rose 0.3% for the second consecutive month, and are now rising at a three-month annualized rate of 2.8%, versus the Fed's preferred ceiling of 2%. For now, policymakers remain complacent, telling themselves that this is a short-lived spurt of commodity-driven price pressure, sure to reverse with the slowing economy and the drop in oil prices. Today's jobs report will only strengthen that view -- as reflected in fed funds futures, which in the report's immediate aftermath priced for a small probability of rate cuts by year-end. And the European Central Bank and the Bank of England haven't helped matters by tightening the terms or scheduling the phase-out, respectively, of their special liquidity facilities. Anything that diminishes the impact of such facilities only puts more pressure on maintaining low and inflationary policy rates.

It's more art than science to try to scaling the opportunity presented here by sentiment so bleak and so exaggerated, when at the same time we see very real risks. Our position over the last several months has been that stocks in the near-term were bargain priced, with an equity risk premium more attractive than any seen since 1980. But we worried that the long-term



risks of unchecked inflation and anti-growth policy in an Obama administration made stocks unattractive longer term. Now with each passing day, the near-term is running out, and the long-

term is getting closer and closer. We do know that the equity risk premium is extremely generous, so any upside bet is, at least, highly asymmetrical -- upside potential surely outweighs downside risk from here. But how much of that potential can actually be realized at this point is getting problematic.

BOTTOM LINE: The typical housing, credit and recession fears that dominate sentiment are exaggerated. But there are two real risks -- anti-growth policy under an Obama administration, and renewed denial of inflation pressures. Stocks are getting ridiculously cheap again, and probably don't have much downside risk from these levels. But upside potential is being eroded by renewed denial of inflation pressures, and the approaching risk of anti-growth policy under an Obama administration. That said, the emergence of Sarah Palin could be a political game-changer. ▶