Trend Macrolytics, LLC
Donald Luskin, Chief Investment Officer
Thomas Demas, Managing Director
Lorcan Roche Kelly, Chief Europe Strategist
John Clinton, Principal

MACROCOSM

Europe Fails, US Stocks Flail

Tuesday, October 4, 2011

Donald Luskin and Lorcan Roche Kelly

The stench of systemic risk from Europe drives stocks to generational value levels.

Update to strategic view

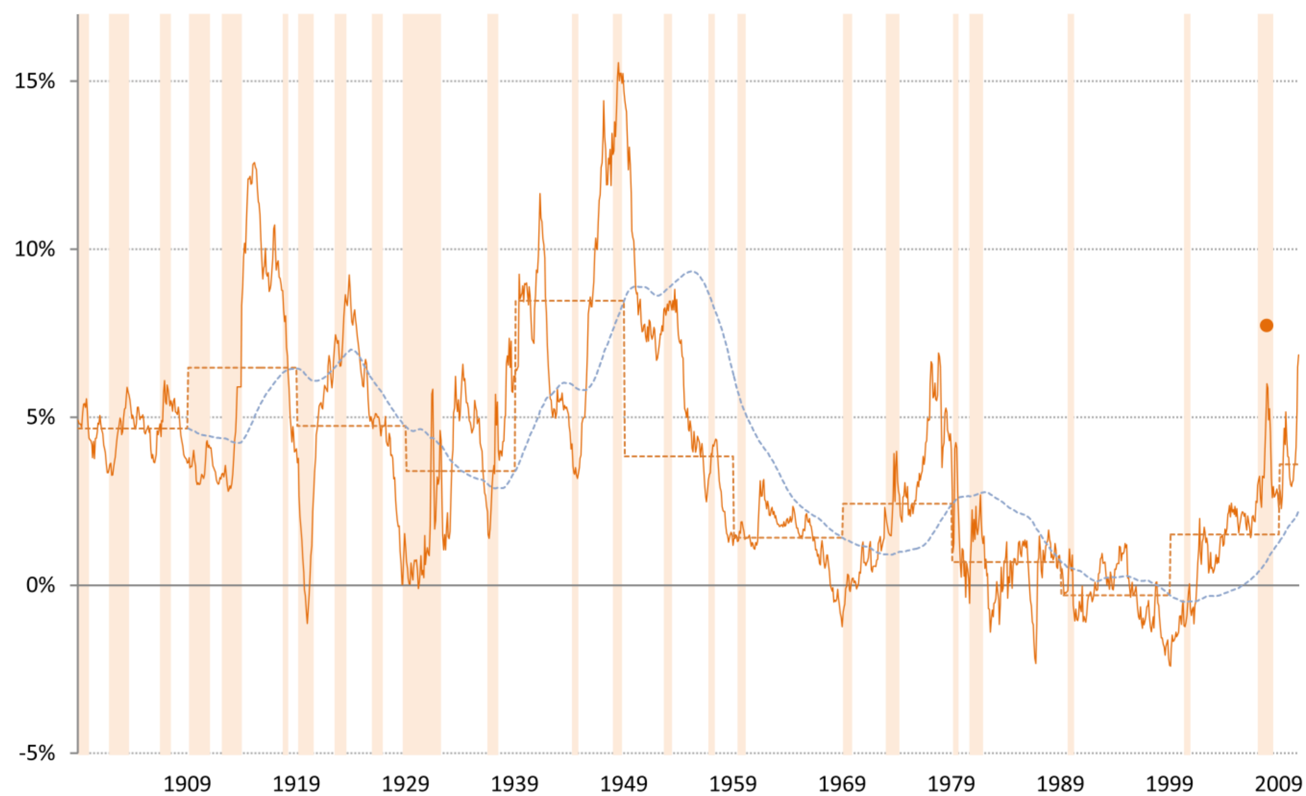
US STOCKS: As the crisis in Europe gets increasingly opaque and drawn-out, panic is spreading world-wide. US stock valuations are at generational lows…

[continued on next page]

Leaders in Europe continue to dither, offering no clear next step toward a comprehensive resolution to their debt crisis, while mounting panic ramifies from their creaky banking system to world credit markets. Against this backdrop, the S&P 500 equity risk premium -- the expected return for taking equity risk as opposed to Treasury risk -- has risen far beyond where it stood at the very bottom on March 9, 2009, and almost back to its generational peak on November 20, 2008 (see the chart below). Other than that, the only comparable is October 1978, and before that March 1955. We've been saying since early August that this is where you buy

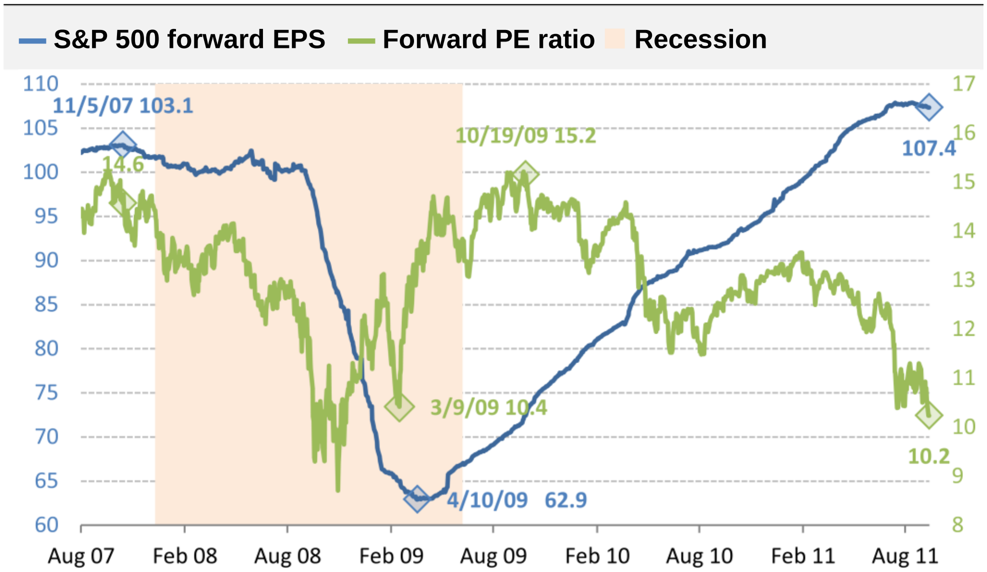
S&P 500 equity risk premium --- 10-yr moving avg --- Decade avg • 11/20/08 max Recession

Forward earnings yield minus 30-year Treasury yield



Source: Various, TrendMacro calculations 'em, not where you sell 'em (see "Downgrade: At Least the News is Out" August 8, 2011). Apparently we were early, or perhaps just plain wrong. But now, *unless the panic emanating from Europe turns into an actual global credit hard-stop, as the Lehman failure did in September 2008, then stocks are crazy cheap.*

- Yes, this extreme level of the equity risk premium says as much that Treasury bonds are expensive as it does that stocks are cheap. *But setting Treasury yields aside entirely, the forward PE ratio for the S&P 500 is lower now than it was on March 9, 2009* (see the chart below).



Source: Bloomberg

- Yes, forward earnings have been flat during the third quarter, and have turned slightly lower over the last month (see the chart above). In the past, this has been a reliable recession indicator. *So there's a case to be made that this is a "value trap."*
- Fair enough. But unless we really do face a replay of post-Lehman 2008, we don't think a recession starting here would likely be very deep or very long-lived. The losses *already borne* by stocks are probably close to adequate to absorb the earnings hit from that, as they proved to be ahead of the 1990 recession (see "Infectious Fear" September 22, 2011).

Macroeconomic data have been anomalously strong. Third quarter real US GDP is likely to be reported in the high 2's, maybe even the low 3's -- the best so far this year. Nevertheless, the evidence is all around us that fault lines emanating from Europe -- and Europe's painful slowness to address them -- are beginning to undermine US and world growth.

- Eurogroup chairman Jean-Claude Juncker announced yesterday that the sixth of eight tranches of the 2010 Greek bailout -- due this week -- will be held over until November. He stated that Greece has sufficient funding until then, an opinion echoed by Greek

[continued from page 1]

…with the S&P 500 equity risk premium nearly at its 2008 peak, and the forward PE ratio lower than on the day of the bottom in March, 2009. Unless the panic emanating from Europe turns into an actual global credit hard-stop, as the Lehman failure did in September 2008, then stocks are crazy cheap. From this starting point, any clarity from Europe -- especially if it involves the inevitable default of Greece -- will be an upside catalyst.

EUROPE MACRO: The ratification of the EFSF is tying the hands of Euro area policy makers. Until it is finalized, they can only hint at how it will really work, and they cannot be clear about next steps for Greece.

ECB: The only place in Europe where any real decisions will be taken this week is the ECB. Expect a 25 bp cut and an extension of term liquidity operations.

[Strategy Dashboard home]

finance minister Evangelos Venizelos today, although this runs in the face of previous reports saying Greece would run out of cash in two weeks.

- That was the only concrete information that came out of the closely watched conference, other than the confirmation of Jörg Asmussen as replacement for Jürgen Stark on the ECB governing council.
- The elephant in the room that stopped them from announcing any major policy direction was the ongoing approval process for the expanded and more powerful European Financial Stability Facility (EFSF) moving through 17 national parliaments. So far, 15 of the 17 Euro area member states have passed the necessary legislation, with only the Netherlands and Slovakia still to vote.
- The Eurogroup must be aware of political sensitivities ahead of full ratification of the new EFSF (see "On the German Court EFSF Decision" September 7, 2011). So, we only got hints of how it will actually be deployed, and what may be next for Greece.
- Juncker, EFSF CEO Klaus Regling, and European Commissioner for monetary affairs Olli Rehn all emphasized the need to maximize the effectiveness of the new EFSF when it is ratified. But they were all very careful not to use the word "leverage." Their reticence speaks volumes -- telling us that leverage will indeed end up being used.
- While a conclusion to the Finnish demands for collateral was announced, considering the perilous state of Greek finances, it is certain that the bailout as originally announced is now dead in the water. Though Juncker, Regling and Rehn insisted that Greece would not default, they openly discussed "technical revisions" to the private sector involvement (PSI) element of the second Greek bailout. So we expect there will be an attempt to control the coming Greek default through increased voluntary loss-taking (see "Whatever It Takes", July 22, 2011).

Thus the Euro area is now in a holding pattern, waiting for the EFSF legislation to be passed. Then there will be the necessary firepower to take action on Greece. So the meeting of Euro area leaders on October 18 will be the first time -- presuming the EFSF has been approved by then -- that we will be able to hear what the real plans for Greece are, and how they will be implemented.

Thursday sees the last ECB monetary policy meeting under the presidency of Jean-Claude Trichet. Markets last week were looking for a 50 bp rate cut in rates, but the latest Euro area inflation flash estimate at 3% -- up from 2.5% last month -- has cut those expectations in half (see the chart on the following page). Under normal circumstances, we would expect no rate cut at all given this inflation surprise. But these are not normal circumstances. Not only are markets under sever duress, but Trichet surely knows (see "Too Few Good Men" September 9, 2011) that the ECB's catastrophic error of raising rates earlier this year (see "EUicide" April 7, 2011) contributed much to the present crisis. So he will probably

Contact TrendMacro

On the web at
trendmacro.com

Follow us on Twitter at
twitter.com/TweetMacro

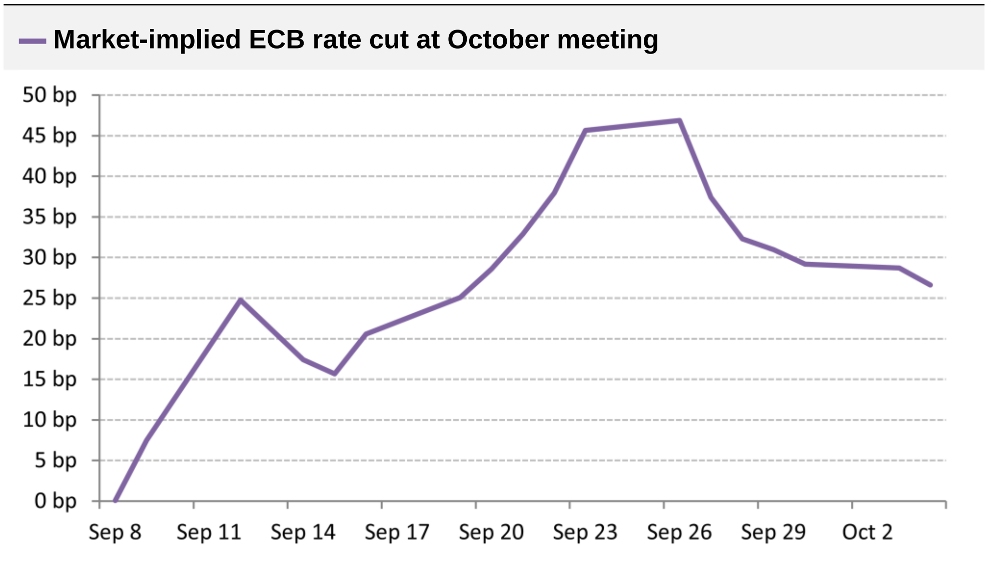
Donald Luskin
Menlo Park CA
650 429 2112
don@trendmacro.com

Thomas Demas
Charlotte NC
704 552 3625
tdemas@trendmacro.com

Lorcan Roche Kelly
Sixmilebridge Ireland
212 537 9067
lorcan@trendmacro.com

John Clinton
Charlotte NC
704 552 3629
jclinton@trendmacro.com

[About us]



Source: Credit Suisse

cut rates by 25 bp -- perhaps rationalizing to himself that this will allow his successor, Italian Mario Draghi, the luxury of not having to cut rates at his first meeting in November.

- Market rumors are pointing to more ECB movement on liquidity operations, with resumption of one year long-term refinancing operations (LTRO). These were effectively used during the height of the financial crisis, and it would make sense to re-introduce them in the current climate.
- Meanwhile, as eureaucrats dither, we must endure the spectacle of the proposed break-up of Dexia, the Franco-Belgian lender. While it is news to nobody that Dexia is a basket case, it is worthy of note that this bank passed the Europe-wide stress tests published on July 15. This echoes the July 2010 stress tests, where Allied Irish Bank passed, only to be nationalized to avoid failure a few months later. The European Banking Authority's stress tests are worse than useless -- they are a bad joke, seriously undermining confidence.
- And in the emerging markets -- deprived of funding from European banks now assuming a defensive crouch -- the sharp drop in the price of copper and the drying up of new bond issuance indicate a growing regional credit crunch.
- On the home front, Bank of America's web site goes down, and rumors swirl that this is the New Economy equivalent of chaining the doors. And an airline that has deserved to be bankrupt for years is now cited as a victim of a recession that isn't even here yet.

These are authentic negatives -- and the waiting is the worst. We welcome clarity, even if it hurts. We especially welcome the inevitable default of Greece. It will give Europe the opportunity to prove that it is robust to contagion. The removal of that key uncertainty will be a major upside catalyst.

- While we wait, corrosive worry will undermine growth, and markets will flail. The very fact that they are flailing so painfully exerts a countervailing demand effect on Europe's leadership to move matters forward.

Bottom line

As the crisis in Europe gets increasingly opaque and drawn-out, panic is spreading world-wide. US stock valuations are at generational lows with the S&P 500 equity risk premium nearly at its 2008 peak, and the forward PE ratio lower than on the day of the bottom in March, 2009. Unless the panic emanating from Europe turns into an actual global credit hard-stop, as the Lehman failure did in September 2008, then stocks are crazy cheap. From this starting point, any clarity from Europe -- especially if it involves the inevitable default of Greece -- will be an upside catalyst. The ratification of the EFSF is tying the hands of Euro area policy makers. Until it is finalized, they can only hint at how it will really work, and they cannot be clear about next steps for Greece. The only place in Europe where any real decisions will be taken this week is the ECB. Expect a 25 bp cut and an extension of term liquidity operations.