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MACROCOSM

No Guns this August

Monday, August 19, 2013

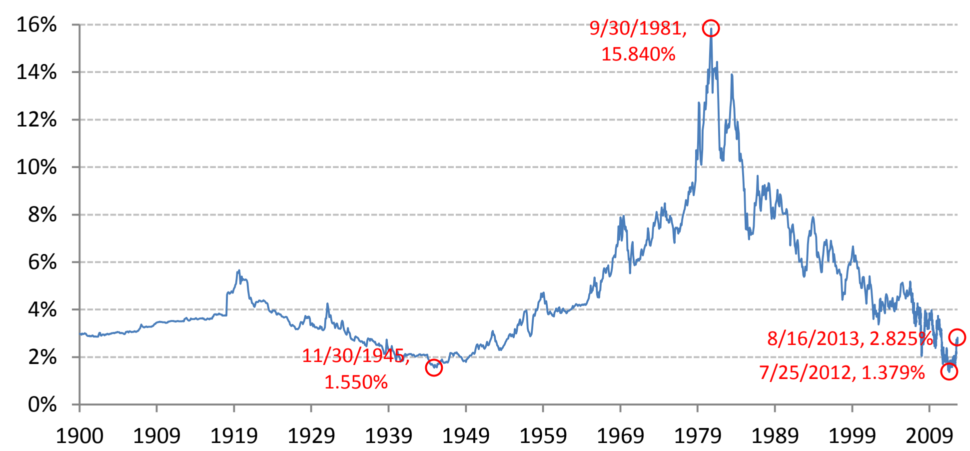
Donald Luskin

Free from systemic risk, markets are about at normal. So when will normal growth return?

It feels like it's the quietest August we can remember. At least it's the first one in seven years in which we and our clients have not had to be on some kind of crisis-watch. It fits in perfectly with our theme for 2013 -- the return of relative normality for markets set free at last from the risk of an imminent global systemic event (see, among many this year, "Oh What a Relief It Is" January 23, 2013). With that in mind, and with respect for clients on vacation or working reduced schedules, this report will be in the manner of a brief update.

- As we have expected, Treasury yields are heading back toward normal levels, from the lowest levels in history about a year ago (see "US Fixed Income Strategy: The Fed Irrelevancy Hypothesis" July 2, 2013). We think this move will continue.
- The 10-year has ended a multi-generational round-trip market cycle spanning 67 years -- 36 years from the prior low in 1945 to the all-time top in 1981, and then 31 years from the top to last year's all-time low (please see the chart below).
- A complete return to normality for Treasury yields now, given inflation, would bring the 10-year to about 3.5%.
- All else equal, that doesn't help growth prospects or equity valuations. But all else is not equal -- at least it shouldn't be.

US Treasury 10-year yield Monthly to mid-2007, then daily



Source: Various, TrendMacro calculations

Update to strategic view

US BONDS, US STOCKS, US MACRO: In the quietest August in seven years, bond yields continue to move back to normal levels. Equity valuations are already there. But growth hasn't accelerated at all -- we're now finishing up the most lackluster earnings season in more than four years. Free now from the imminent risk of a global systemic event, private sector risk-taking should come back to life, producing faster growth rates. But there's no evidence for it yet. For now, we expect bond yields to move somewhat higher, and equities to consolidate or correct.

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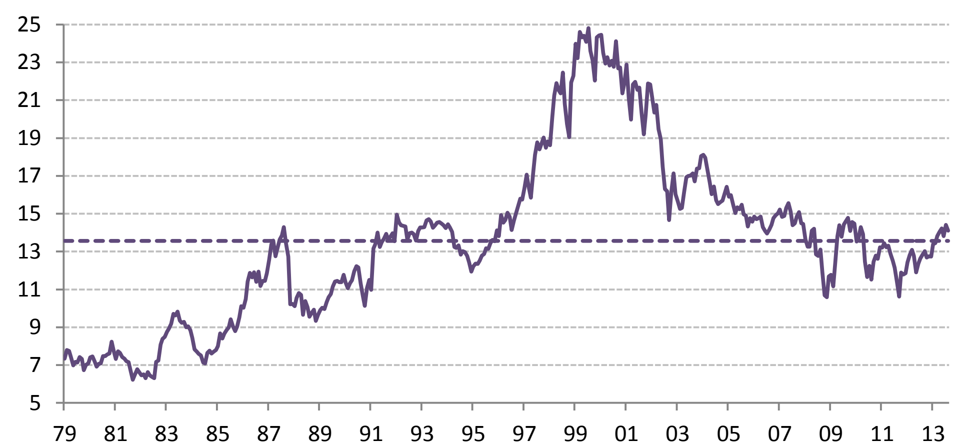
- Yields -- and by extension, the cost of credit -- are *not exogenous*. They are *endogenous* -- they are a function of the risks and opportunities in the environment.
- *So given that there is no evidence of dangerously rising inflation expectations, we should see the normalization to higher yields as organic evidence of health, not a threat.*
- Equities have returned to normal valuations, too. The S&P 500 forward PE multiple, at 14.1, is about at its mean of the last 40 years, in fact slightly above it (please see the chart below). Another sign of health.

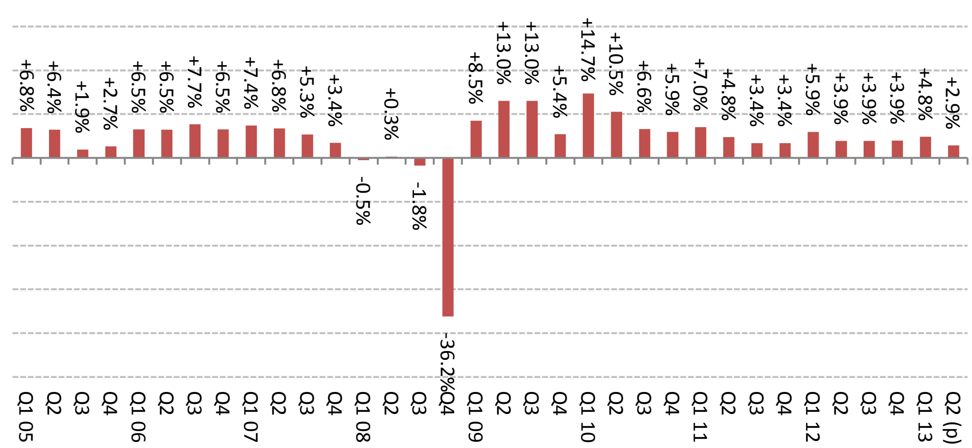
— S&P 500 forward price-earnings ratio --- Average



Source: Various, TrendMacro calculations

- The problem is that these signs of health and normality reflected in markets are not being reflected in actual economic activity.
- Consider the current earnings season. With 444 of S&P 500 companies reporting, the dollar-weighted average earnings surprise so far has been only +2.9%, the least impressive in over four years (please see the chart below).

Earnings surprise Dollar-weighted, by calendar quarter reported



Source: Bloomberg, TrendMacro calculations

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- With downbeat reports like last week's from Cisco and Walmart, *forward* earnings aren't growing any faster now than the sluggish pace we've seen now for more than two years.
- From the bottom in October 2011, the S&P 500 has rallied as much as 55.5% (exluding dividends). But forward earnings have been upgraded by only 9.5%. All the gain has been in "P", not "E".
- Where is the "E" going to come from when, with the exception of last month's upside surprises in US Purchasing Manager Indices (please see "Data Insights: Global PMI" August 15, 2013), we don't see the slightest improvement in macroeconomic data?
- We have always taken it as an axiom of our brand of supply-side economics that growth is the product of risk-taking, and risk-taking is enabled when the environment is stable. The environment is stable now, after a long period of instability. *But where's the risk-taking? Where's the growth?*
- In theory, it should emerge at any moment. Will that moment be tomorrow, or a year from tomorrow? We see no point in being early.
- In the meantime, markets are about normal, and they will stay about normal.
- From that position -- a position of necessity driven more by noise than by signal -- we're inclined to think that bond yields will move somewhat higher and that stocks will continue to consolidate or correct.

Bottom line

In the quietest August in seven years, bond yields continue to move back to normal levels. Equity valuations are already there. But growth hasn't accelerated at all -- we're now finishing up the most lackluster earnings season in more than four years. Free now from the imminent risk of a global systemic event, private sector risk-taking should come back to life, producing faster growth rates. But there's no evidence for it yet. For now, we expect bond yields to move somewhat higher, and equities to consolidate or correct.