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MACROCOSM

A Little Distant Gunfire

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Donald Luskin

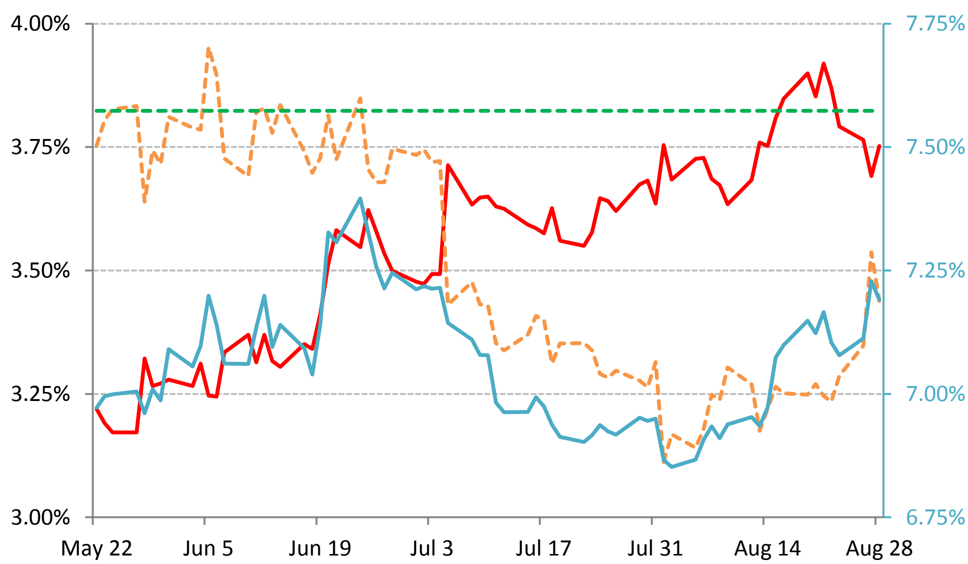
The summer without systemic risk is over. But we don't think the bad old days are back.

We commented last week on the how calm markets have become in the substantial absence, for the first summer in six years, of imminent systemic risk (see "No Guns this August" August 19, 2013). This week a whiff of such risk has re-appeared -- with Treasury yields pulling back, stock prices making new correction lows and, consequently, the equity risk premium moving back toward its crisis-era mean (please see the chart below).

The whiff of risk has been wafted upon three distinct narratives: a possible US military intervention in Syria, the prospect of brinksmanship over the debt ceiling and the continuing resolution, and a growing sense of panic in emerging markets. With respect for clients on vacation or working reduced schedules, we'll cover each of these three large topics briefly.

SYRIA It's hard for us to see any objective good reason for Bashar al-Assad to have dared to use poison gas on his opponents. For that matter, other than pride about Assad crossing a "red line" delineated *ad hoc* over a year ago, or shame about not "doing something," it's hard to see what is to

30-year Treasury yield — Equity risk premium --- Crisis-era mean
Right axis: S&P 500 fwd earnings yield



Source: Bloomberg, TrendMacro calculations

Update to strategic view

US MACRO, US STOCKS, OIL: We expect a western intervention in Syria, if any, will be minimal and mostly symbolic, and think a commensurable reaction from the Arab states that does not suggest a non-linearity or enduring increase in oil prices. We expect lots of posturing as the continuing resolution and debt ceiling now must get negotiated at the same time, but predict the GOP will pull back from the brink with no serious threat of government shutdown or debt default. US stocks have no value cushion here, and without a growth acceleration there's not a lot of upside when the present fears subside.

EMERGING MARKET MACRO, EMERGING MARKET STOCKS: The declines in emerging markets -- most intense among those that have performed the best -- are only the latest installment in a decline of over two years, possibly fueled by tapering fears. We think emerging markets stocks will continue to languish, but do not expect a credit non-linearity.

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be gained by the United States and other western nations responding with some kind of military strike.

We have argued that the death of Osama bin Laden, by ending the war on terror and opening the door to US military withdrawal from combat involvement on Middle East soil, effectively withdrew the "terrorism tax" on oil and other strategic commodities (see "The bin Laden Commodities Crash" May 6, 2011; and "Gold and Commodities: Breaking Bad" April 15, 2013). *New mucking about in the region only raises the specter of the "terrorism tax" coming back in some form, and for no good purpose.*

- The Arab League, which suspended Syria as a member in 2011, has condemned the gas attacks as a "heinous crime," has stopped short of endorsing a western intervention.
- Pride and a legitimate concern for regional self-determination make it unlikely that the west will ever get a riskless go-ahead. In 2011 the Arab League called for a western-enforced no-fly zone in Libya, and then weeks later vehemently protested western bombing when it was violated.
- Today the League's stance on Syria is less permissive than it was on Libya, so its protests would likely be more forceful.
- That said, our most-likely scenario has to be that western intervention will be as minimal and symbolic as possible -- considering that it would have no true security purpose anyway. Arab reaction would be similarly symbolic and minimal.
- So we don't expect a non-linearity or an enduring hike in oil prices.

WASHINGTON BUDGET BRINKSMANSHIP It was a relief to learn last week that the continuing resolution required by September 30 would be agreed with no threat of a government shutdown. House Speaker John Boehner (R-OH) informed his caucus that it was his intention to quickly pass a bill to fund the government for three months -- retaining the sequesters, but not de-funding Obamacare. *But then on Monday in a speech in Idaho, Boehner promised "a whale of a fight" over lifting the debt ceiling in exchange for long-term spending cuts -- an entirely separate issue from the continuing resolution, and one that implicates not just a government shutdown but a debt default.*

- The very next day, Tuesday, Treasury Secretary Jack Lew (D-C) sent a letter to Boehner warning that the debt ceiling will be breached in "the middle of October." That's about a month earlier than had been previously expected.
- The timing of Lew's letter suggests it was a response to Boehner's speech. The battle is joined.
- And the deadline Lew has put forward, as a practical matter of negotiations, intertwines the debt ceiling and the continuing resolution, concentrating two risk-events into a single point in time.
- *We think the GOP recognizes that it holds a losing hand here -- and that if it handles it gracefully it stands to win a larger game.*
- That larger game emerges from the logic of our election model, which correctly predicted the last presidential election within four

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[About us]

Recommended Reading

What Is Economics Good For?
Alex Rosenberg and Tyler Curtain
New York Times
August 24, 2013

Global aspects of unconventional monetary policies
Charles Bean
Panel remarks at the Federal Reserve Bank of Kansas City Economic Policy Symposium, Jackson Hole
August 24, 2013

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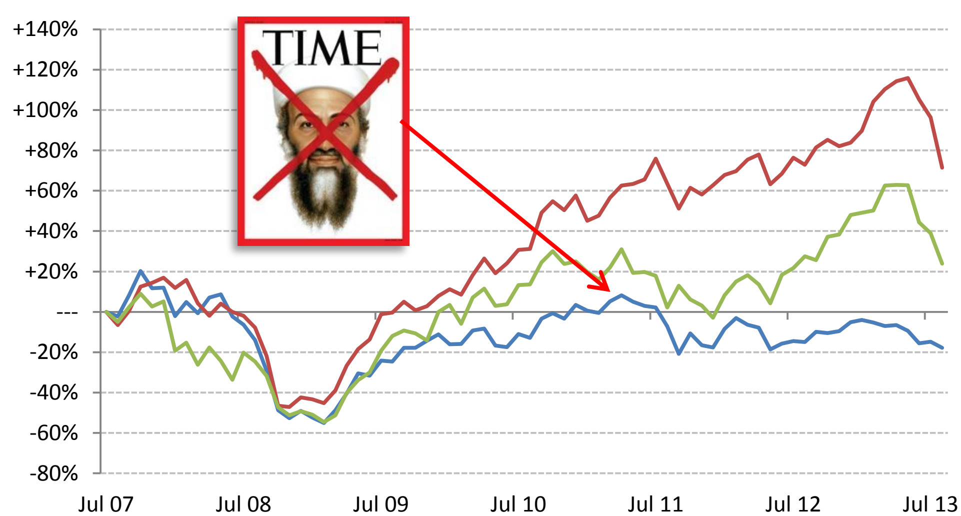
electoral college votes (see "TrendMacro's Election Model" September 28, 2012; and "On the 2012 Election" November 7, 2012). The seemingly immutable historical patterns underlying the model call for GOP mid-term gains in the Senate and the House, and for the GOP to recapture the presidency in 2016.

- So far all the historically determined patterns are repeating themselves, with the once seemingly invincible Obama now suffering from a classic case of second term-itis.
- All the GOP has to do now is keep quiet and let the patterns of history work their will. So far so good on that. Unlike the GOP's overreach in the second Clinton term, today's GOP is keeping relatively quiet on a flurry of seemingly exploitable Democratic fault lines -- Benghazi, the IRS, the NSA, and numerous sex scandals.
- Now, the GOP has to make enough noise about reining in spending and defunding Obamacare to establish its *bona fides* with its right wing. But leadership is not likely to be stupid enough to foment an embarrassing breach such as a debt crisis or government shutdown. Even if the extreme-right in the House won't co-operate, it will be a simple matter for Boehner to pass Senate-originated bills with Democratic support in the House, such as he did with the bill that ended the fiscal cliff crisis (see "Tax Hikes Have Consequences" January 2, 2013).

EMERGING MARKETS MELTDOWN Intense sell-offs in certain emerging markets -- Indonesia and Turkey, prominently -- have raised fears of some sort of contagion that could lead to a global credit event.

- It's essential to put recent price action in context. It is, in fact, nothing new or sudden. Emerging markets overall have been in correction and consolidation for more than two years. The ones that have performed the worst recently are the ones that had most

MSCI Emerging Markets Index **Turkey** **Indonesia**
Performance from July 31, 2007



Source: Bloomberg, TrendMacro calculations outperformed that bearish trend (please see the chart on the previous page).

- The post-recession top in the MSCI Emerging Market Index occurred the very day Osama bin Laden was killed, which ushered in a bear market in oil and commodities -- and signaled the end of China's great growth surge and savings binge (again, please see the chart on the previous page, "The bin Laden Commodities Crash" and "Gold and Commodities: Breaking Bad").
- The recent sharp breaks in what had been the outperforming emerging markets coincides with the onset of expectations that the Fed will taper is Large-Scale Asset Purchases. We have argued that LSAPs subsequent to 2009 haven't mattered, so tapering and ending them won't matter either (see, among many, "US Fixed Income Strategy: The Fed Irrelevancy Hypothesis" July 2, 2013). Emerging markets may be an exception to this view. *Tapering may signal to certain lenders, rightly or wrongly, that the Fed intends to tighten credit conditions -- a shift in expectations that would hit the most sensitive credit-driven capital projects, such as building more office towers in Istanbul.*
- Indeed, this seems to have been something of a theme at the Kansas City Fed's Jackson Hole conference last week (see, among others, "Global aspects of unconventional monetary policies" Charles Bean, panel remarks, August 24, 2013).
- We are not inclined to expect that recent intimations of panic present any substantive systemic global risks.
- But we think the default scenario here is that the emerging markets will continue to slow. They offer what seem to be the most attractive equity risk premia among world stock markets, but until we see accelerating global growth, they could likely be value-traps (see "Data Insights: Global Equity Risk Premia" August 21, 2013).

On the other hand, US stocks offer a merely average risk premium. So as the risks we have discussed here are processed, stocks have no value cushion to keep them from having to consolidate and correct. But when these risks pass, there is no particular reason why stocks should rally much unless growth accelerates.

Bottom line

We expect a western intervention in Syria, if any, will be minimal and mostly symbolic, and think a commensurable reaction from the Arab states that does not suggest a non-linearity or enduring increase in oil prices. We expect lots of posturing as the continuing resolution and debt ceiling now must get negotiated at the same time, but predict the GOP will pull back from the brink with no serious threat of government shutdown or debt default. US stocks have no value cushion here, and without a growth acceleration there's not a lot of upside when the present fears subside. The declines in emerging markets -- most intense among those that have performed the best -- are only the latest installment in a decline of over two years, possibly fueled by tapering fears. We think emerging markets stocks will continue to languish, but do not expect a credit non-linearity.