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MACROCOSM

A Major Upgrade to our Strategic Outlook

Thursday, September 12, 2013

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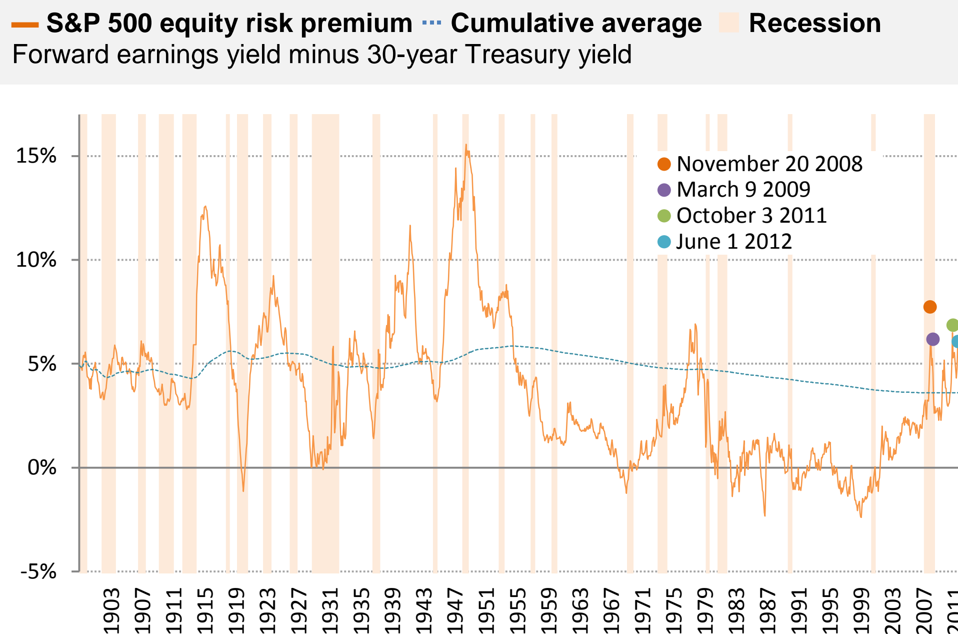
After four years of the Not So Great Expansion, growth acceleration is finally possible.

As we expected, the Syria crisis -- or, more accurately, President Obama's personal self-made "red line" crisis -- seems to have abated without implicating global systemic risks (see "A Little Distant Gunfire" August 29, 2013). It cements the theme we've been developing all year, that this will be the first year in seven without imminent threat of global systemic failure (see, earliest, "Oh What a Relief It Is" January 23, 2013). Just as we saw with the Cypriot banking crisis in March (see "On the Cypriot Depositor Bail-in" March 17, 2013) and the announcement of Fed tapering in May (see "Escape from Taperphobia" July 8, 2013), *events that in recent years would have triggered financial contagion are now digested by global markets as isolated events*.

- The maturation of this theme is causing us to fundamentally rethink the strategic outlook that has guided us through the aftermath of the Great Recession.
- We never bought into the conventional "new normal" notions. But ever since the end of the Great Recession, with our own very



Source: Various, TrendMacro calculations

Update to strategic view

US MACRO: The resolution of Obama's Syria crisis is yet another example of the fulfillment of our theme for 2013 -- the withdrawal from the world of the constant threat of imminent systemic failure. That threat has been the primary cause of slow growth in the Not So Great Recession, and now with its removal the economy is free to grow more rapidly as individuals and firms are liberated to take entrepreneurial risk. The growth acceleration could be sharp, given the present depth of the output gap. There is no sign at this moment that an acceleration is imminent -- but from here, evidence of it as it arrives should be taken very seriously. Longer term, a boost can come from political developments pointing toward liberalization of US hydrocarbons production, leading to a drop in energy prices that have contributed to inferior growth.

US STOCKS, US BONDS, EUROPE STOCKS, EUROPE BONDS, OIL: Developed equity markets are approximately fully priced for a world free from…

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different theory of causation, we've said correctly that the economy was stuck in what we've called "the Not So Great Expansion." Primary within our causal reasoning was the overhanging threat of systemic failure. But that factor has evaporated now. Indeed, some of the other causal factors we've focused on, which we will review toward the end of this report, are changing for the better, too.

- So finally we are able to be optimistic about an acceleration of growth that could begin to close the immense output gaps seen in the US and most other economies.
- *This is not to say we think that a growth acceleration is imminent (although it may be) -- rather, it is to say that now it is no longer ruled out from first principles. It is is now inevitable, and merely a matter of time.*
- We are emboldened not just by events falling into line with our theme of systemic risk abatement, but by the fact that markets world-wide have to a large extent completed a return to normalcy. Equity valuations, sovereign yields, and the spreads between them have for the most part returned to normal risk premia from what had been historic peaks (see "Data Insights: Global Equity Risk Premia" September 9, 2013). For what it's worth, in the US the equity risk premium has returned to its average since 1900 (please see the chart on the previous page).

The imminent threat of systemic failure has undermined the very foundation of what makes growth possible -- risk-taking by individuals and firms.

- Growth comes from productivity gains, and productivity gains come from investment in physical, intellectual and human capital -- and such investment is always an act of voluntary risk-taking.
- Individuals and firms have "risk budgets" -- a maximum amount of risk they are willing to take. When the threat of global systemic failure exogenously forces risk-taking upon individuals and firms, they have no budget left over for additional risk-taking of their own choosing.
- It is those voluntarily chosen risks -- acts of entrepreneurship, whether to dare to found a new company, to market a new technology, or just to dare to walk into the boss's office with a suggestion for how to do old things new ways -- that make growth possible. Such risks have not been taken for the last six years, so the economy has barely grown.
- In the crisis years, most risk-taking has been by government actors, or by the private sector in response to government programs designed to elicit particular types of risk-taking. But top-down risk decisions are rarely efficient or effective, often only politically motivated, and not diversified enough to embrace all the good ideas that the human race is capable of generating, nor winnow out the losers.
- So now, with the threat of systemic failure reduced to normal levels, private risk budgets are restored, and bottom-up acts of entrepreneurship are sure to follow.

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…systemic risk. Developed bond markets have normalized considerably, but yields have further to rise. When and if the expected acceleration of growth arrives, what has been a value case in markets will shift to a growth case, with another leg higher in equities and in bond yields.

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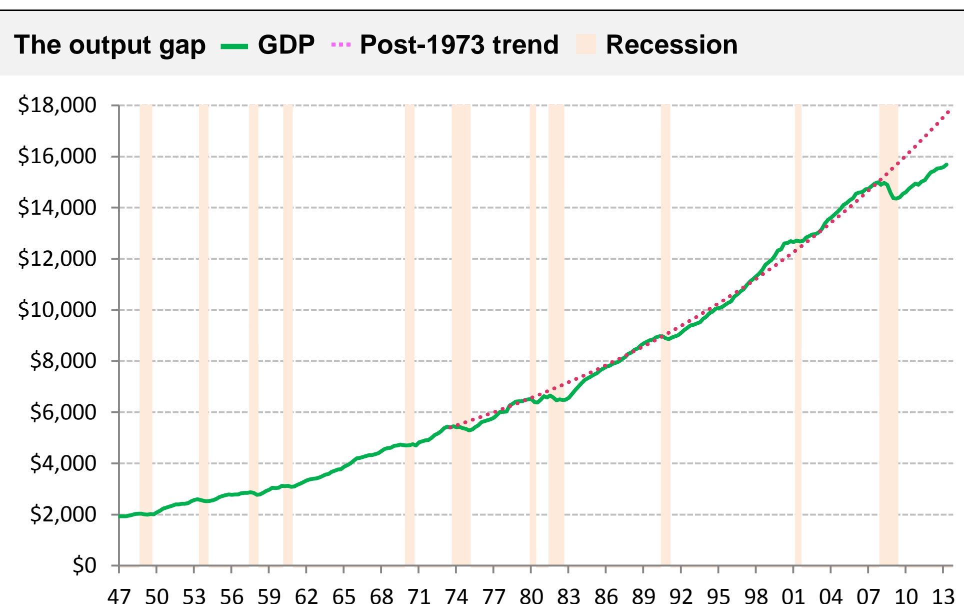
But if this is so, we must repeat the question we asked last month (see "No Guns this August" August 19, 2013): *if entrepreneural risk-taking is now possible again, then where's the growth?*

- That's a perfectly good tactical question, and indeed we're not seeing the growth yet. But that question distracts from a broader and more important strategic paradigm-shift.
- Until now, operating from our thought-model of a Not So Great Recession dogged by continuing systemic threats, whenever bits of good economic data showed up, we had to dismiss them as false alarms -- and we've been absolutely right to do so every time.
- *But from here -- we will be expecting data that indicate accelerating growth. When and if that data arrive we will give them full credence.*
- When growth accelerates, the pace could be surprisingly brisk. The depth of the Great Recession and the poor growth in the Not So Great Expansion have left an enormous output gap (please see the chart below) -- a vast reservoir of physical and human capacity ready to be deployed with no delay and little cost.



Source: BEA, NBER, TrendMacro calculations

This upshift in our strategic outlook doesn't immediately impact our market views.

- Under our theory of the Not So Great Expansion, in the face of various systemic threats over the last several years, we were able to identify superlative moments of generational undervaluation in equities (please see again the chart on the previous page and, for example, "Europe Fails, US Stocks Flail" October 4, 2011).
- And we have understood all along that the 14-month back-up in global sovereign yields was not about central bank behavior, but about the obsolescence of safe-haven assets in what has become a less risky world (see, for example, "US Fixed Income Strategy: The Fed Irrelevancy Hypothesis" July 2, 2013).

- *But now, with markets having returned to normalcy, there is no longer any strong valuation-driven case for equities, nor against bonds. From here, superior equity performance will only be driven by a growth case.*
- The evidence so far does not sufficiently support a growth case. There are encouraging signs that we now take seriously, such as last week's excellent ISM reports (see "Data Insights: Global PMI" September 5, 2013). And we're not especially discouraged by last week's jobs numbers -- they were completely in-line with our expectations, and are a lagging indicator anyway (see "On the August Jobs Report" September 6, 2013).
- We would like to see substantive improvement in forward-looking indicators such as new orders for non-defense capital goods ex-aircraft (see "Data Insights: A Few of our Favorite Things" August 26, 2013) -- and most important the S&P 500 forward earnings upgrade rate, which still is quite low.
- *But absent some event that restores the threat of global systemic failure, our expectations are now realigned so as to anticipate the eventual arrival of more encouraging evidence.*

We think the particular way in which the Syria crisis seems to have been resolved reduces one possible source of systemic risk -- brinksmanship in the negotiation to raise or suspend the statutory debt ceiling, which could lead catastrophically to a US Treasury default (again, see "A Little Distant Gunfire").

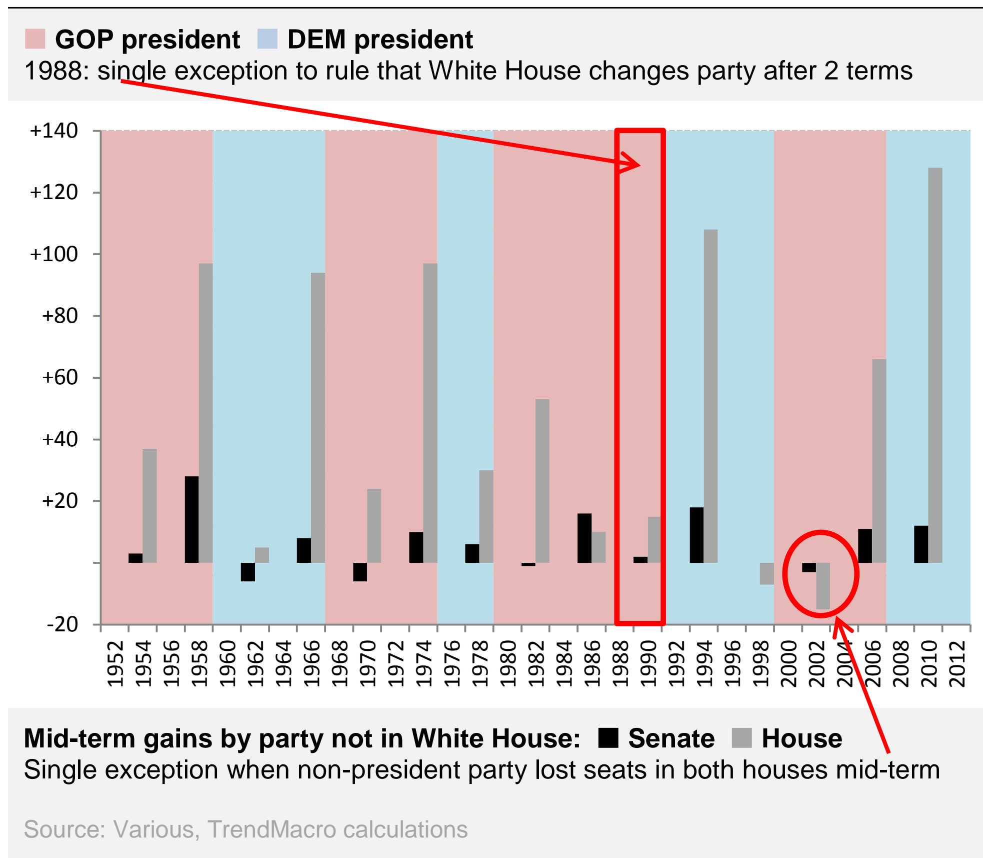
- Had Obama been humiliated by a repudiation in congress by his own party over Syria force authority, it may have undermined his prestige to the point where House Speaker John Boehner (R-OH) would have dared to try to blackmail him into spending reductions. There would be no telling how a weakened Obama would have behaved in the face of that challenge to his authority.
- But as it played out, it seems that Obama will be able to avoid a congressional vote, and emerge from the Syria affair with his dignity sufficiently intact to discourage Boehner from taking unwise chances.

We'll go further. This latest embarrassment for Obama is integrally related to the theme of reduced systemic risk.

- In 2009 and 2010 when Obama enjoyed strong popular support and had a Democrat-controlled congress, the enactment of large-scale anti-growth policy initiatives such as Obamacare and Dodd Frank arguably rose to the level where we'd want to classify them as systemic blows.
- The threat of more such blows was substantively withdrawn in 2010 when the Democrats lost control of the House of Representatives, and one-party rule was replaced by gridlock (see "The Pendulum Swings Back" November 2, 2010).

- The threat is even more remote now that Obama has, like all lame duck presidents before him, contracted a severe case of second term-itis.

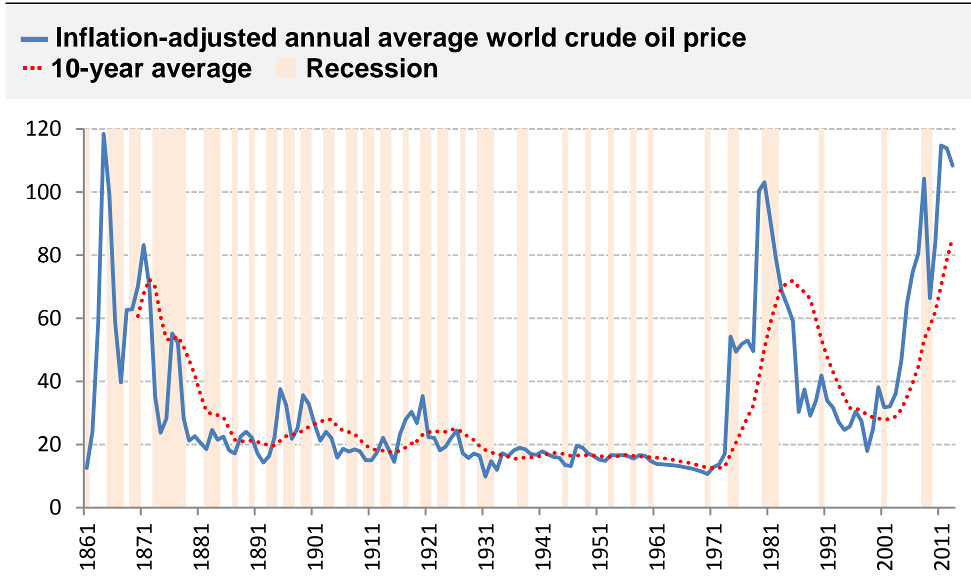
We'll go further still. With Obama a damaged lame duck, there is no reason to think that the durable patterns of electoral history will not operate here to the favor of the GOP -- congressional gains in the 2014 mid-term election, and taking back the White House in 2016 (please see the chart below, and "TrendMacro's Election Model" September 28, 2012).



- We are aware that we run the risk here of seeming to be politically biased (we've never made a secret of where our sympathies lie).
- But our view on this goes beyond a general conviction that the GOP economic agenda -- as flawed as it is, and as allied as it is to a regrettable non-economic agenda -- is better for growth.
- In this case we are focusing on just one key element, which interacts substantively with our causal theory of the Not So Great Expansion, and also to the prospect for accelerating growth looking forward.

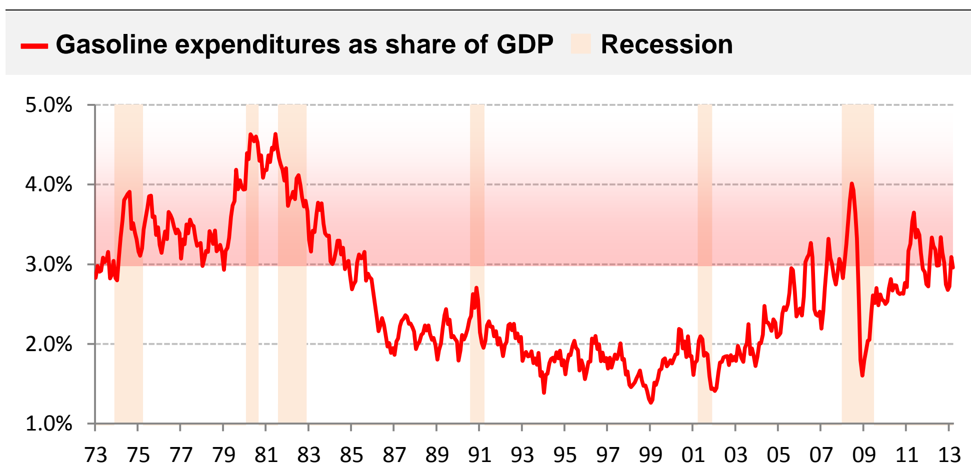
We believe that, in addition to the persistent threat of imminent systemic failure, the Not So Great Recession has been driven by historically high global oil prices. A Republican president and congress could change that by unchaining the revolution in unconventional hydrocarbon exploration and production.

- Inflation-adjusted oil prices have been higher than, and for as long as, in the energy-crisis years of the mid-1970s and early 1980s (please see the chart below).



Source: BP, BLS, NBER, Bloomberg, TrendMacro calculations

- This time high oil prices have not come as sudden highly visible geopolitical shocks, as they did before. But we think they contributed to the onset and the severity of the Great Recession, and continue to contribute to slow growth in the Not So Great Expansion (see "Oil Melts Up, Too" February 24, 2012).
- And yes, the US economy is not as energy-intensive as it was in the 1970s. But being less energy intensive is no virtue, at least not if your objective is economic growth. We'd be better off if we didn't have to consume resources trying to conserve resources.
- Be that as it may, the US economy is still energy-intensive enough so that, given today's high real prices, we are spending more than 3% of GDP in gasoline alone (please see the chart below).



Source: BEA, EIA, NBER TrendMacro calculations

- We regard 3% as the threshold above which energy prices really hurt -- and we've been there on-and-off for eight years now.
- The conventional demand-side concern here is that energy expenditures crowd out other forms of consumption. So they do, but the more trenchant supply-side analysis is that expensive energy inhibits expenditures on energy itself, blocking utilization of an absolutely critical factor of growth.

So in the immediate present, we are now on the lookout for signs of endogenous growth to emerge from the receding shadow of exogenous systemic risk. More remote, for the future, we can see a political path that could lead to engagement of growth-enabling energy resources, turning a critical scarcity into a critical abundance.

- We are well aware that much in the current environment is less than ideally conducive to growth. But it is an analytic mistake to let the perfect be the enemy of the good. Economic and market change happens at the margin. Differences make a difference. At the margin now, the differences are in the direction of goodness, and that's what counts.

We are delighted to be able to say, for the first time in six years, something more upbeat than "stocks are cheap."

Bottom line

The resolution of Obama's Syria crisis is yet another example of the fulfillment of our theme for 2013 -- the withdrawal from the world of the constant threat of imminent systemic failure. That threat has been the primary cause of slow growth in the Not So Great Recession, and now with its removal the economy is free to grow more rapidly as individuals and firms are liberated to take entrepreneurial risk. The growth acceleration could be sharp, given the present depth of the output gap. There is no sign at this moment that an acceleration is imminent -- but from here, evidence of it as it arrives should be taken very seriously. Longer term, a boost can come from political developments pointing toward liberalization of US hydrocarbons production, leading to a drop in energy prices that have contributed to inferior growth. Developed equity markets are approximately fully priced for a world free from systemic risk. Developed bond markets have normalized considerably, but yields have further to rise. When and if the expected acceleration of growth arrives, what has been a value case in markets will shift to a growth case, with another leg higher in equities and in bond yields.