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MACROCOSM

2013: The Year of Living Not Dangerously

Tuesday, December 31, 2013

Donald Luskin

Lower equity risk premia -- check! Faster global growth -- not yet, but coming in 2014.

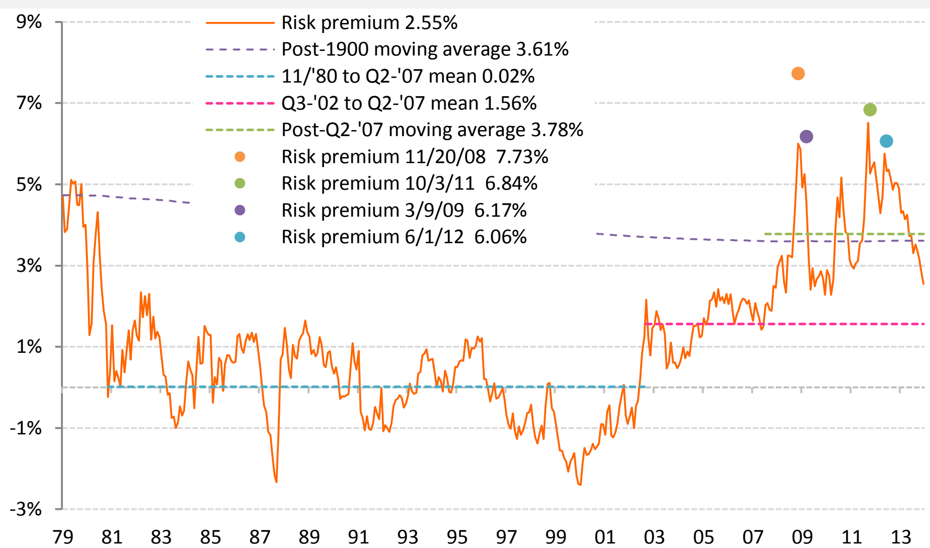
2013 ends very much in the spirit of the dominant theme we've been gradually developing for most of the year -- *that this would be the first year in seven without the threat of imminent financial contagion* (see, early on, "The Crisis Score is Four for Four" March 4, 2013)*. Markets have responded with shrinking equity risk premia, and economies will respond with accelerating growth* (see, most comprehensively, "A Major Upgrade to our Strategic Outlook" September 12, 2013).

- *We expect this theme to continue and accelerate in 2014.*
- This report will review and offer an outlook for this and other major themes we developed over the past year.

THE END OF THE ERA OF CONTAGION The world's resiliency to shocks has been battle-tested in 2013. Consider these three events:

- The Cypriot government needs a bail-out and the major banks collapse. Euro area authorities rescue the government, but decline

S&P 500 equity risk premium
Forward earnings yield minus 30-year Treasury



Source: Various, TrendMacro calculations

Update to strategic view

US, EUROPE, ASIA AND EM MACRO: 2013 was the first year in seven in which the world has not faced global financial contagion. That has been tested with multiple serious shock events from the Cypriot bank collapse to the US government shutdown and default scare. The result has been and will continue to be a tightening of equity risk premia, and will soon turn into an acceleration in economic growth. The US regulatory environment will improve along with the GOP's prospects for the mid-term elections.

US STOCKS, US BONDS, US FED: For 2014 our modal forecast for US stocks is a gain of 18%. For bonds, we expect the 10-year yield to finish 2014 at 3.5% to 3.75%, with Fed LSAPs completely terminated.

ASIA STOCKS, EUROPE STOCKS, EUROPE BONDS: Japanese stocks will be strong thanks to reflationary monetary policy, but without the "third arrow of Abenomics" they won't repeat this year's moon-shot. Peripheral euro area stocks and bonds will be top performers.

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to bail out bank depositors or senior bond holders -- the first such application of market discipline since Lehman (see "On the Cypriot Depositor Bail-in" March 17, 2013).

- Fed chair Ben Bernanke definitively foreshadows tapering Large-Scale Asset Purchases (LSAPs), and in response, the weakest of the emerging markets experience intense currency, interest rate and equity market pressures (see "A Little Distant Gunfire" August 29, 2013).
- The US government is shut down for 17 days, and the possibility of a default is so real that the short end of the Treasury curve inverts (see "On the Pending Government Shutdown" September 30, 2013).
- Any one of these shocks, had it occurred a year or two earlier, would have ignited a fresh bout of global "risk-off" driven by fear of financial contagion. *But in 2013, the effects were limited to the scope of each event itself -- no contagion*.

SHRINKING EQUITY RISK PREMIA With growing confidence that the global economy is free from systemic risks that drive financial contagion, equity risk premia throughout the developed economies have fallen below their crisis era means (see "Data Insights: Global Equity Risk Premia" December 30, 2013).

- On the negative side, this means that stocks no longer present the once-in-a-generation value proposition that they did at several points during the crisis era (please see the chart on the previous page).
- On the positive side, a lower equity risk premium symbolizes a smaller cost of entrepreneurial risk, which can be expected to accelerate the sluggish economic and earnings growth that has characterized the Not So Great Expansion following the Great Recession.
- *We think the market has further to go in its recognition that the world has become a less risky and more growth-friendly place* (see "Regime Change for Equities" November 26, 2013)*. That implies that the expected mean equity risk premium in 2014 should be lower than the crisis-era mean. If we assume the 2014 mean will be that which obtained from mid-2002 to mid-2007 -- a mean established during a disappointing expansion and bull market, hardly the exuberant environment of the prior decades -- then, all else equal, stocks are still undervalued by 18%.*
- *We will use a gain of 18%, without dividends, as our modal S&P 500 target for 2014. We expect similar gains for most developed markets*.
- We are not deterred in this by the fact that now the S&P 500 has shown a positive total return for five years in a row. Such a streak is not unusual -- it has happened, over the last century or so, about 20% of the time. Among such streaks, about three quarters of them went on to a sixth positive year, with an average return (including both positive and negative years) of about 13%.

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GOLD: Gold can be an inflation hedge at these levels, following its 40% correction. But the drivers of a strong bull case have all fallen away.

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[About us]

Recommended Reading

What to Do When ObamaCare Unravels
John H. Cochrane
Wall Street Journal
December 26, 2013

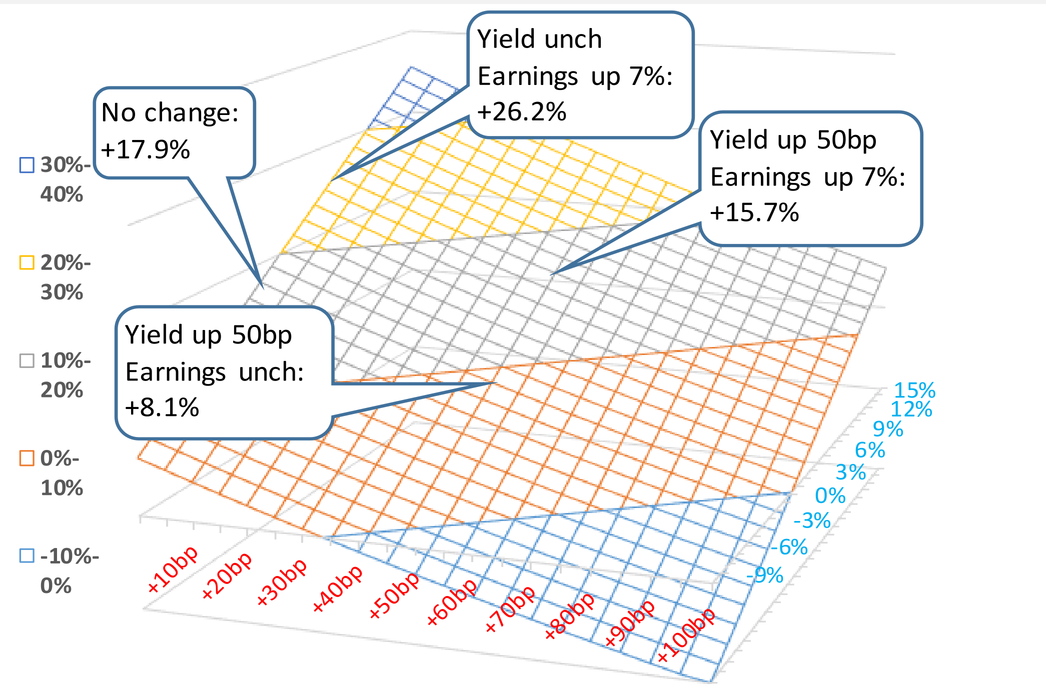
Behind Mexico's Oil Revolution
Daniel Yergin
Wall Street Journal
December 18, 2013

[Reading home]

RISING BOND YIELDS, AND THE FED The 10-year US Treasury yield is ending the year at the low end of our expected range of 3% to 3.25%.

- We think this year's back-up in yields was not caused by the prospect of the Fed's tapering its LSAPs (see "US Fixed Income Strategy: The Fed Irrelevancy Hypothesis" July 2, 2013).
- Instead, the more than doubling of the 10-year yield from its all-time low in July 2012 was due to the cessation of the risk of contagion, and the prospects for better global growth. Indeed, these same factors were what made it possible for the Fed to decide to taper. We had these factors in mind -- along with Bernanke's institutional concerns about the viability of Janet Yellen's leadership -- when we made the out-of-consensus prediction that tapering would be announced at the December FOMC (see "Yellen and Screamin' at the Fed" December 5, 2013).
- *We expect yields to continue to rise in 2014, as markets further internalize the reality that the world is a less risky and more growth-friendly place. Our target for the 10-year at year-end 2014 is 3.5% to 3.75%.*
- Higher yields mean less gain for equities at a given equity risk premium. But the higher yields we expect should be easily offset by higher forward earnings -- which means that even with the expectation of higher Treasury yields, stocks are significantly undervalued (please see the chart below, and again, "Regime Change for Equities").
- As to the Fed, we would highlight that the surprise initiation of tapering at the December FOMC (see "On the December FOMC"

Change in S&P 500 market cap at post-Q3'02 mean equity risk premium
— Increase in 30-year Treasury yield — Change in forward earnings



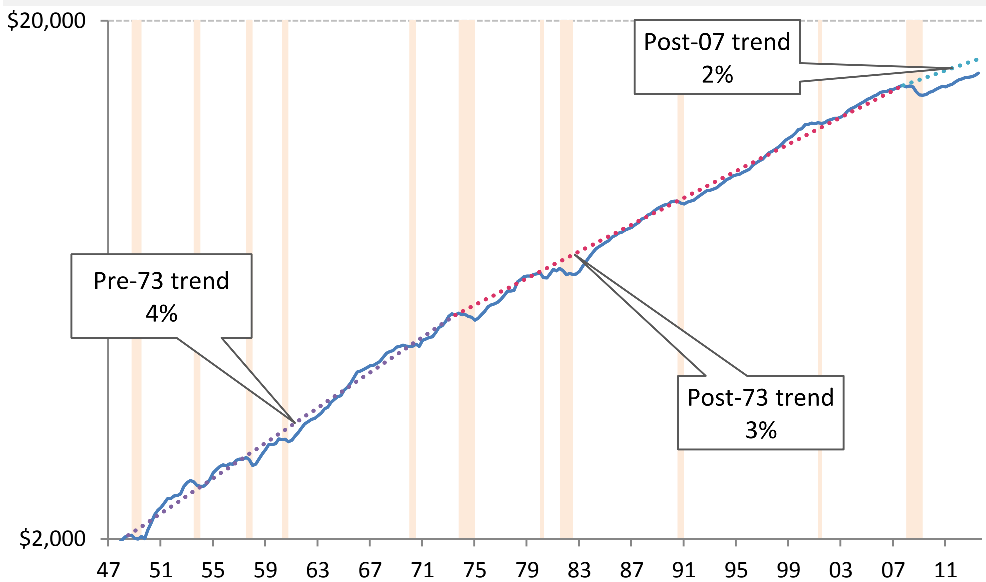
Source: Various, TrendMacro calculations

December 18, 2013) is a critical element in our theme of the end of contagion.

- *Indeed, the unprecedented size of the Fed's balance sheet, and what seemed like no end in sight for its continuing growth -- coupled with a new Fed chair of dubious leadership abilities -- was shaping up as the last great systemic risk faced by the global economy. The initiation of tapering puts the Fed on a path toward decommissioning that risk.*
- *We think that Bernanke has handed Yellen a credible* fait accomplis*, and that tapering will continue at a "measured" pace through 2014, concluding asset purchases entirely by year-end.*

GROWTH Even assuming a slower-than-historical trend for real growth in the US economy -- and most of the other economies in the developed world -- there remains significant room for very strong acceleration beginning in 2014. The so-called "output gap" remains today as wide as it was at the depths of the Great Recession. To be sure, that is testimony to the strong headwinds we have faced -- but at the same time, it's a measure of the opportunity remaining in what is still by no means a mature business cycle (please see the chart below).

Real GDP SAAR, USD billions, log scale **Recession**



Source: BEA, TrendMacro calculations

- Twice-revised real US GDP growth for Q3 at 4.1% is a delightful surprise in the rear-view mirror, but we don't see that as conclusive evidence for our thesis. *Our expectations are just that -- expectations for 2014 and beyond -- based on our belief that freedom from global contagion and lower equity risk premia will unleash the trickle-up entrepreneurship which, we believe, is truly responsible for almost all growth.*
- *We will be looking first for signs from favorite forward-looking growth indicators* (see "Data Insights: A Few of our Favorite

Things" December 24, 2013) -- ***and we really haven't seen those signs yet.***

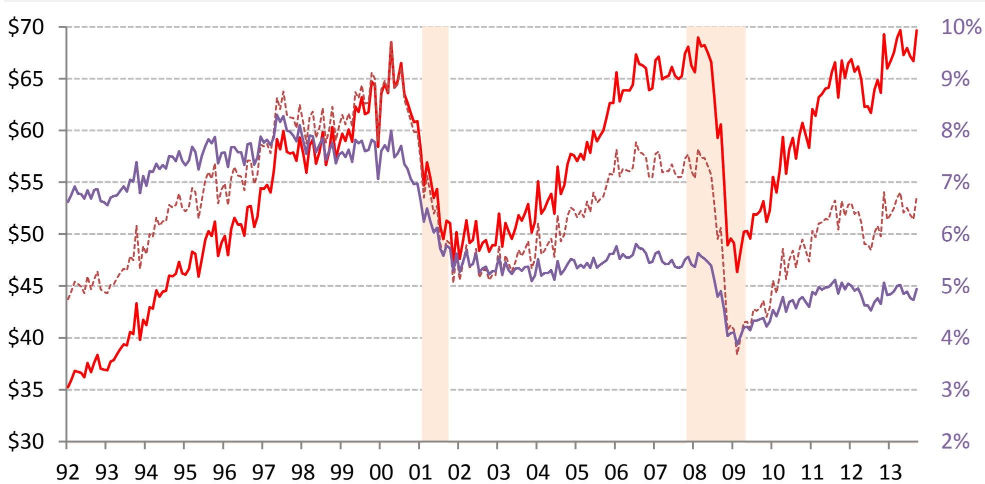
- One favorite is the upgrade rate in consensus forward earnings for the S&P 500. It hasn't changed much over 2013, from end to end -- but it has recovered from the very anemic rates we saw over the summer (please see the chart below). Rates above 10% year-on-year will be *very* encouraging (just to demonstrate what is possible, presently in Japan, where growth is igniting much more vigorously than in any other developed market, the forward earnings upgrade rate is almost 26%).

S&P 500 consensus forward EPS, YOY upgrade rate
Bottom up, cap-weighted

Source: Bloomberg, TrendMacro calculations

- Another favorite is new orders for non-defense capital goods ex-aircraft (please see the chart below). Since we believe all growth comes from capital investment, this is an indicator of the pre-cursor of the precursor of growth. Near all-time highs in nominal terms, it is still well below the levels of the prior two business cycle expansions when adjusted for inflation or seen as a share of GDP.

New orders for non-defense capital goods ex-aircraft USD billions
Inflation-adjusted **%GDP** **Recession**



Source: Census Bureau, TrendMacro calculations

POLITICS AND POLICY As we discuss our more optimistic growth outlook with clients, we are often asked why we are not more concerned by the negative impact on consumer behavior from the Affordable Care Act, or on credit conditions from Dodd-Frank.

- We definitely do share these concerns. Our outlook would be more optimistic without them. They are very real sand in the gears.
- But our thesis for a growth acceleration is based on something of an entirely different order. *We see the cessation of global systemic risk being a non-linear change in the state of the world, a quantum leap to a new higher level of potential. What's a little sand in the gears compared to that?*

Moreover, we can clearly see a political path leading to the amelioration, and perhaps even the outright reversal, of the anti-growth trends symbolized so well by ObamaCare and Dodd-Frank.

- Our seemingly absurd out-of-consensus call that the Republican Party would emerge from October's government shutdown with enhanced prospects for the 2014 mid-term (see "On the Shutdown and Debt Limit Deal" October 17, 2013) is already beginning to be vindicated. Two months after Republicans universally vilified, the most recent CNN generic congressional poll shows the GOP with a 49% to 44% lead over the Democrats.
- *A strong GOP showing in 2014 will not only put in place a legislative mechanism for amelioration or reversal of anti-growth policies -- more important, it will reflect a change in the center of gravity in the electorate away from such policies.*
- *The most significant consequence will be the liberation of new energy extraction technologies, which offer the very real possibility of bringing to an end the present era of the highest inflation-adjusted oil prices in history* (again, see "A Major Upgrade to our Strategic Outlook").
- Nearer term, the resurgence of the GOP bodes well for a less risky US sovereign credit environment. With the GOP now unified in opposition to the increasingly unpopular ObamaCare, the party now seeks to demonstrate its qualifications as an alternative, that is, its capacity to govern. Thus we see the bipartisan budget compromise developed by Representative Paul Ryan (R-WI) and Senator Patty Murray (D-WA), which eliminates the risk of government shutdown for two years. *The debate upcoming in the first quarter over raising the debt ceiling may be somewhat more contentious, but we strongly doubt there will be a replay of October's default brinksmanship. This, too, becomes another factor contributing to the durable elimination of global systemic risk.*

EUROPE We think that the era of global contagion ended on July 26, 2012, when ECB President Mario Draghi assured the world in a London speech that the ECB would do "whatever it takes" to preserve the euro currency (see "On Draghi in London" July 26, 2012). That set the entire world on the road to durable recovery -- but the impact in the euro area was especially strong.

- We've said all through 2013 -- and before -- that a great way to exploit recovery from crisis in the euro area was to buy German stocks and Spanish sovereign bonds (see, most recently, "SpanDax" July 12, 2013). That proved to be a home run in 2013.
- German stocks were the only equity market to outperform the S&P 500 in dollar terms in 2013, 31.0% versus 29.1% (through yesterday).
- Spanish 10-year bonds were the best-performing major sovereigns in the world in 2013, with a total return in dollar terms of 18.9%, versus a loss of 5.5% for US Treasuries (through yesterday).
- Spain's equity market was the second-best performing in the euro area in 2013, up 26.8% in dollar terms.
- *Looking to 2014, Spanish bonds -- and bonds of other peripheral euro area nations that faced debt crises -- are starting the year with sufficiently high risk premia so that we can expect continued outperformance of US Treasuries, although nothing like 2013's moon-shot.*
- *Spanish stocks -- and stocks of other euro area peripheral nations that have been beaten down while they undergo fundamental supply-side economic reforms -- are poised for excellent performance in 2014 as an accelerating global expansion improves their operating environment.*
- The key for Europe is the continuation of the drive to structural supply-side reforms and closer federal integration that began in the crucible of the debt and banking crises of 2010-2012. Spain, for example, is conspicuously doing the right things -- 2014 will bring in significant scalebacks in Spain's unsustainably generous government pension system. On the other hand, France is moving in the opposite direction, with its high court having just approved a controversial "millionaires tax."

JAPAN Our call to buy Japanese stocks and short the yen (see, first, "On Kuroda and Iwata at the BOJ" February 25, 2013, and reiterated, "Japan: At Long Last a Correction" May 31, 2013) was a major winner. In dollar terms, Japanese stocks tied the excellent performance of US stocks. But in yen terms -- that is, from the standpoint of a US investor, being long Japanese stocks and short the yen -- returned a stellar 56.7%.

- That said, we have been disappointed that the so-called "third arrow of Abenomics" -- fundamental supply-side reforms -- have been implemented so far only timidly and in diluted form (see "Time for Abe to Show Us the Money" September 30, 2013).
- We are still positive on Japan -- but with less than our initial conviction. The "first arrow" -- aggressive reversal of 18 years of deflationary monetary policy -- has been itself sufficient to set in motion a most impressive economic and earnings recovery. But we don't expect for 2014 the kind of world-beating performance we saw in 2013 unless the "third arrow" is loosed.

GOLD Throughout the 2000's gold was a deep conviction trade for us. But at this point we find ourselves losing interest in it. Having corrected more than 40% from its all-time high above $1900 in September 2011, it feels to us like it could be accumulated here as an inflation hedge. But we don't really see a strong upside case.

- Gold's great bull market from 2001 to 2011 corresponded perfectly with two coterminous geopolitical events -- the war on terror from the 9-11 terrorist attacks to the assassination of Osama bin Laden, and the rise of China as a super-power and the dominant foreign holder of US Treasury securities. The former built a geopolitical risk premium into all strategic commodities, and the latter created a vast floodtide of dollar liquidity with unknown inflationary consequences (see "Gold and Commodities: Breaking Bad" April 15, 2013).
- Gold's rise was further powered by massive injections of liquidity from the world's central banks in the wake of the global financial crisis of 2008-2009, and the credit shocks in its aftermath. This liquidity raised legitimate fears of currency debasement (see "Gold is the Strongest Currency" May 6, 2010).
- *But all of those factors underlying gold's bull market have subsided. The war on terror is over. China's great growth phase is over, and it has stopped adding to its Treasury positions. And with the exception of Japan, the world's major central banks have either stopped or begun decelerating LSAPs.*
- It's certainly possible that there could be an inflationary surprise ahead. At the Fed, Janet Yellen's policy predilections certainly tilt in that direction (see "Inflation in Fashion" October 29, 2013). But as a basis for a bull case for gold -- at least at this point, when Yellen's actual policy path is still unknown -- that's nothing compared to the powerful once-in-a-generation drivers in place from 2001-2011.

Bottom line

2013 was the first year in seven in which the world has not faced global financial contagion. That has been tested with multiple serious shock events from the Cypriot bank collapse to the US government shutdown and default scare. The result has been and will continue to be a tightening of equity risk premia, and will soon turn into an acceleration in economic growth. The US regulatory environment will improve along with the GOP's prospects for the mid-term elections. For 2014 our modal forecast for US stocks is a gain of 18%. For bonds, we expect the 10-year yield to finish 2014 at 3.5% to 3.75%, with Fed LSAPs completely terminated. Japanese stocks will be strong thanks to reflationary monetary policy, but without the "third arrow of Abenomics" they won't repeat this year's moon-shot. Peripheral euro area stocks and bonds will be top performers. Gold can be an inflation hedge at these levels, following its 40% correction. But the drivers of a strong bull case have all fallen away.