Trend Macrolytics, LLC
Donald Luskin, Chief Investment Officer
David Gitlitz, Chief Economist
Thomas Demas, Managing Director

MACROCOSM

Throwing the Baby Out with the Kitchen Sink

Wednesday, January 16, 2008
Donald Luskin

Even great news is taken as proof that we're heading into recession, or already there.

Thinking about catalysts that could turn around the bitterly negative sentiment that has gripped equity markets for months now, favorites would be a distressed banking giant announcing a "kitchen sink" earnings report, a dividend cut and a massive capital infusion. Citigroup gave us all three catalysts yesterday, all at the same time, but all that was catalyzed was more negativity. The buzz was that Citi's $14.5 billion in new capital was such a large amount, it could only be a signal that there are more negative earnings surprises to come. That's tragically ironic, because we believe it's a powerfully *positive* sign that so many troubled lenders have been able to raise so much new capital from private and public markets -- it means that plentiful global liquidity is there to keep the financial sector functioning (see "Rescue Rangers" December 10, 2007). But it seems that the markets are in the grip of an irremediably negative mindset in which all incoming information -- good, bad, indifferent, and even downright wrong -- is interpreted as confirming a pre-existing belief that the US is headed inevitably toward a serious recession, or is already in one.

Update to strategic view

US STOCKS: Stocks are challenging the lows of 2007, ignoring the manifest evidence of healing in the financial sector and keying off even the most spurious evidence of impending recession. We interpret this behavior as panic, not as evidence that the economy is weakening more than we expect. Panic makes timing difficult, but with the risk premium relative to Treasuries at all-time highs, we reiterate our call that stocks present a major buying opportunity here.

[see Investment Strategy Dashboard]

Today, Intel's slightly disappointing revenues and guidance announced after the close yesterday are being stretched to fit the Procrustean bed of the recession mindset. Never mind that the company's chief financial officer said explicitly that "We didn't see signs of slowing" in the US economy. Intel's lower guidance was based not on actual evidence, but rather on the company's interpretation that, as the CFO put it, "macro-economic indicators that are out there would say to be a little bit cautious." Such a statement is not evidence of recession, only *expectations*. But that's not how the stock market is taking it today.

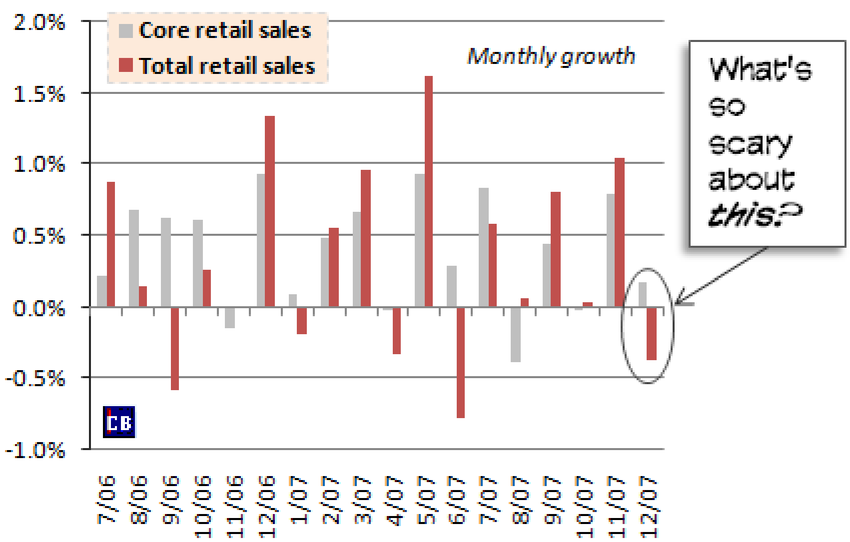
Look at the way yesterday's report of December retail sales was treated by the market. The 0.4% drop in total sales, and the small 0.2% gain in core sales, were generally interpreted as proof positive that consumer spending is already in recession. But look at the chart on the following page. There's nothing especially negative or out of the ordinary about December's sales numbers -- nothing that one doesn't expect to see with regularity in this and every other

http://www.trendmacro.com
don@trendmacro.com
dgitlitz@trendmacro.com
tdemas@trendmacro.com

Offices:
Menlo Park CA
Parsippany NJ
Charlotte NC

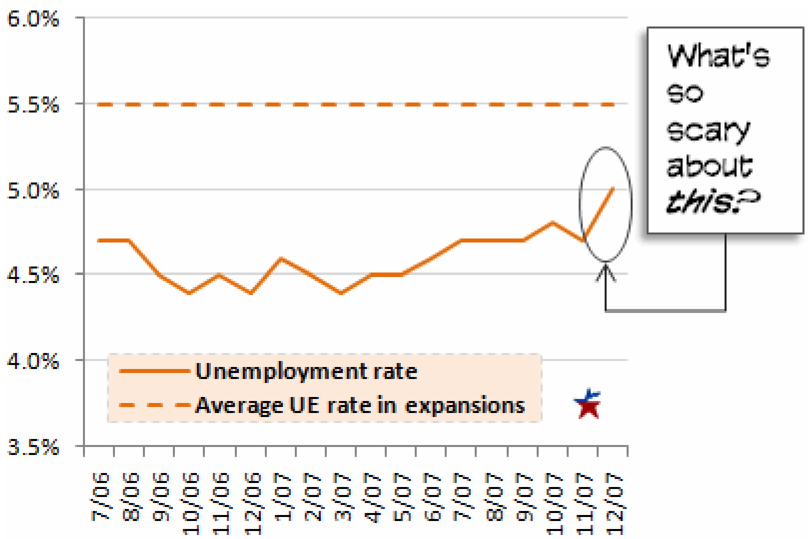
Phone:
650 429 2112
973 335 5079
704 552 3625

economic expansion. But if you already expect recession, these numbers fit right into your prejudices.



And look at the reaction to last week's jobs report, in which the unemployment rate ticked up to 5%. That's well below the 5.5% rate that is the average for post-war *expansions*. Yet based on this, Merrill Lynch's perennially bearish David Rosenberg told clients, in a highly publicized research report that a recession "has arrived." He noted that the unemployment rate is up 60 bp from its lows last year, and argued that a half-point rise from the "from cycle lows" has historically predicted the onset of recession "100% of the time." Drop-dead proof, it would seem.

But in fact, Rosenberg has distorted the historical record to use new data as evidence for a theory he held before the data even arrived. Rosenberg's interpretation of upticks in the unemployment rate can't be used to predict recessions in real time, because one never knows



without benefit of hindsight whether or not a particular uptick is "from cycle lows," or is just a transient anomaly. There have been several examples of upticks of a half-point or more that did *not* lead to recession -- for example the one that occurred in a single month in February 1986 (the next recession was not until 54 months later). Rosenberg also claimed that aggregate hours worked have declined for both of the last two quarters, and said that this has "always been associated with recession." But he's flat wrong about the data -- last week's jobs report showed that aggregate hours worked have *grown* over both of the last two quarters, not declined. But for a market hungry for confirmation of its pre-existing negative sentiment, Rosenberg's story is, as newspaper reprters say, "too good to fact-check."

In a similar vein, there have been several press accounts warning investors about how poorly stocks perform during recessions -- the implication being that, with recession inevitable or already underway, one ought to dump stocks. For example, a column by veteran market columnist Dan Dorfman claimed that "recessions, as you might expect, can be devastating to the stock market, with the S&P 500 in one instance -- between March and November 2001 --

falling more than 49%." Like Rosenberg, Dorfman is flat wrong about the data. In fact, the total return for the S&P 500 from March to November 2001 -- the span of the most recent recession, was a loss of only 0.9%. Even at the worst moment of the recession, the week after the terrorist attacks of September 11, the total return of the S&P 500 was a loss of 16.2%, less than a third of the loss Dorfman cited.

Dorfman was quoting -- or, rather, misquoting -- a December 2007 research report from Standard and Poor's. The 49% loss figure he cited was, in fact, the decline from top to bottom in the bear market that began long before that recession began, and ended long after that recession ended. Bear markets are indeed often associated with recessions (although not always) -- but they are not the same thing. And while it is possible to add real value by timing bear markets and bull markets -- and we have the track record to prove it -- it turns out that whether or not the economy is officially in recession, in and of itself, isn't a very valuable piece of knowledge in making market timing decisions.

- As hard as it may be to believe, over the last sixty years, the average annualized total return to the S&P 500 has been substantially identical for both recessions and expansions -- 12.1% in recessions, versus 12.7% in expansions. End-to-end, only one recession -- that of 1974-75 -- showed a meaningful negative return: 6.0% annualized, over 16 months.

- All that said, recessions have been *riskier* times for stocks -- the annualized monthly standard deviation of S&P 500 returns has averaged 17.0% in recessions and 13.4% in expansions. Using monthly data, the average draw-down for the S&P 500 during recessions has been 10.7%, while during expansions it was only 0.1%. But that doesn't mean one should automatically sell stocks at recession onset (assuming you knew when that was), in order to avoid an inevitable draw-down. The average recession has lasted ten months, and the average draw-down for *all* ten-month periods, recessions and expansions, has been 4.3%. So selling stocks because you know you're entering a recession only gives you a small advantage. And that advantage has not been universal: in the recessions of 1948-49 and 1960-61 the draw-downs were less than 1% -- staying out of stocks to avoid those small draw-downs would have caused you to miss gains of 15.2% and 20.3%, respectively.

Let's suppose, for a moment, that we are in fact in a recession already, and it began in December (we don't see how the data could possibly support dating recession onset any earlier than that). From the end of November through yesterday, the total return of the S&P 500 has been a loss of 6.5%. So we're already about two thirds of the way toward the average draw-down during a recession. So even granting that we are already in recession, there's no reason by virtue of historic norms to think that stock market losses necessarily have to get much worse than they already are -- despite what the scare stories in the press would have you believe.

We *don't* think the economy is in recession, nor do we expect it to go into recession anytime soon. The climate of fear we've been describing here is consistent with our expectation in November that we are entering into a sentiment-induced slowdown -- a "self-fulfilling prophecy" of economic weakness driven by cautious economic behavior in light of unjustified, but nevertheless widespread, anxiety (see "Fear Itself" November 16, 2007). Think of it as the lagged effect of the shock to sentiment imparted six months ago by the onset of the global credit crisis. It's taken most of those six months to set the global financial system aright, but the resumption of order in several key credit markets over the last couple weeks suggests strongly that it's been successfully accomplished. Now we must wait for the initial shock to sentiment to pass through the economy like a pig in a python, to be replaced in several months by the lagged effects of the healing process just now really taking hold. The risk is that the present fearinduced slowdown, and the atmosphere of anxiety that is creating it, will take on the dynamic of a vicious cycle, ultimately spiraling into actual recession. With so little tangible evidence of economic weakness so far, and with many key interest rates flirting with zero in real terms, we think the economy is strong enough and well enough lubricated to pretty much rule out that kind of seizing-up.

BOTTOM LINE: Stocks are challenging the lows of 2007, ignoring the manifest evidence of healing in the financial sector and keying off even the most spurious evidence of impending recession. Ought we to treat this as inferential evidence that the economy is weakening more than we expected? We admit that it's a tough call. We anticipated the stock market corrections from the highs last February and last July (see "Enough Good News for a Correction" February 16, 2007, and "Bill Gross Shoots, But Can't Hit" July 25, 2007), so we were in a good position to ride them out with confidence. But we were caught somewhat flat-footed by the correction from the October highs, and that leads us to question our own judgment more than we would anyway in the ordinary course of rigorous analysis. But in the end, we have to conclude that the balance of hard evidence is on the side of economic resilience, and that what evidence of weakness we see speaks only to a sentiment-induced slowdown. The panic we see in the stock market is an echo of the same fears fueling that slowdown. While such an unstable atmosphere makes timing difficult, with the risk premium relative to Treasuries at all-time highs, we reiterate our call that stocks present a major buying opportunity here.