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

MACROCOSM

From Correction to Test to Bear Market

Thursday, July 10, 2008
Donald Luskin

We're not scared by bears on the cover of *Barron's*. We're scared that Bernanke will blow it.

We predicted a correction in early May, near the top of the rebound in stocks from the March lows (see "The Next Thing to Worry About" May 8, 2008). But that "correction" became a test of the lows (see "Fail-Safe" July 2, 2008). Stocks failed that test. And now, for what it's worth, we're in an "official" bear market, with the S&P 500 off more than 20% from the October 2007 all-time high. Now the equity risk premium (the difference between the forward earnings yield of the S&P 500 and the 30-year Treasury yield) is wider than it was in the March 17 panic -- and it got there *the right way*: the Treasury yield has risen, but forward earnings have risen more. So, with white knuckles, we stand by our call last week that further downside here is probably pretty limited, and that the "sensible thing to do is to buy weakness" (again, see "Fail-Safe").

But we are highly alert to the *indirect* risks in the present panic about Fannie Mae and Freddie Mac. Yes, it confirms our view that there is nothing to be gained by bottom-fishing in the financial sector (see "Subprime Lending Was Their Best Idea" June 4, 2008). But substantively, as a catalyst for a broad panic, it strikes us as a reiteration of an already very well-known fact -- that there are lots of mortgage defaults. That said, real or imagined, to the extent that it acts to delay the Fed's urgently required move back toward a more normal level of interest rates -- thus weakening the dollar and feeding the frenzy in energy prices -- it could have very dire consequences (see "Bernanke's Test" July 3, 2008), and our neutral stance on the "inflation plays" would have to be reconsidered (see "Inflation Inflection" March 25, 2008).

Update to strategic view

US STOCKS: The value case for stocks is extraordinary, so we continue to believe that further downside will be quite limited, and that the sensible thing to do is to buy weakness for the near term.
US FINANCIAL STOCKS: When the present Fannie/Freddie panic abates, there will no doubt be a spectacular speculative opportunity in bottom-fishing in the financials. But we caution against anything but speculation, continuing to see this as a fundamentally broken sector.
GOLD, COMMODITIES, OIL, US DOLLAR, US RESOURCE STOCKS: Time has just about run out on the Fed's commitment to normalize interest rates. We're not there quite yet, but we are close to changing our view that the worst-case inflation scenario has been avoided, and instead going on high inflation alert. We would then expect to see a new leg up in inflation plays, and down for the dollar.

[see Investment Strategy Dashboard]

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

Copyright 2008 Trend Macrolytics LLC. All rights reserved. This document is not to be forwarded to individuals or organizations not authorized by Trend Macrolytics LLC to receive it. For information purposes only; not to be deemed to be recommendations for buying or selling specific securities or to constitute personalized investment advice. Derived from sources deemed to be reliable, but no warranty is made as to accuracy.

All the terrible things that can happen from here are pretty well known. There is, after all, a growling bear on the cover of *Barron's* this week. And a Zogby poll today announced that 66% of US likely voters think we are in a world-wide recession right now, or about to enter one. But please indulge us for a moment in considering some the less negative elements in play (we can hardly say "more positive" at this point).

- The idea of an "official" bear market has no meaning -- or at least no forward-looking meaning. The fact that stocks are off 20%, or any other arbitrary amount, does not necessitate that they must fall further.
- This bear market has become "official" as the result of the performance of a single sector -- the financials. Without the financial sector -- which is off 45.9% from the October 2007 peak in stocks -- the S&P 500 is off 14.1%, not 20.5%.
- The same is true for the slump in S&P 500 forward earnings. Without the financial sector, S&P 500 forward earnings (that is, earnings forecasted for 12 months from now) are at all time highs. And it's not just energy. Five out of ten S&P 500 sectors -- consumer staples, energy, health care, information technology and materials -- are at or within basis points of all-time high forward earnings.
- The bulk of the macroeconomic evidence continues to fail to confirm recession. With near certainty, the second quarter will show positive real GDP growth. The unemployment rate, at 5.5%, is at the average level in *expansions*.
- While there is great stress in credit markets to be sure, banks continue to lend to qualified borrowers. Obviously mortgage lending is off. But all other forms of commercial and consumer bank credit -- including home equity loans -- are expanding, while typically in recessions they contract. The corporate default rate remains at an ultra-low 2%.

All these things are so because we entered the present period of housing and credit retrenchment with real interest rates low by historical standards. Unlike all financial panics and economic adjustments of the past, this one was not caused by tight money. That's the good news. But the bad news is that the usual policy approach of easy money not only won't work now as it has in the past, but will be especially costly in terms of inflation. The Fed now has the *right* tools for dealing with the financial system's specific needs for liquidity. And at this moment the economy is still highly resilient, and capable of pulling out of the present slowdown if the Fed will only use those *right* tools, and stop using the *wrong* tool -- an inflation-stoking negative real funds rate. With the Freddie/Fannie panic bringing all the fears of last March back to the surface, we stand now on the verge of the great risk that the Fed will continue to apply the *wrong* tool.

BOTTOM LINE: The value case for stocks is extraordinary, so we continue to believe that further downside will be quite limited, and that the sensible thing to do is to buy weakness for the near term. When the present Fannie/Freddie panic abates, there will no doubt be a spectacular speculative opportunity in bottom-fishing in the financials. But we caution against anything but speculation, continuing to see this as a fundamentally broken sector. Time has just about run out on the Fed's commitment to normalize interest rates. We're not there quite yet, but we are close to changing our view that the worst-case inflation scenario has been avoided, and instead going on high inflation alert. We would then expect to see a new leg up in inflation plays, and down for the dollar.