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MACROCOSM

All Cross, No Current

Friday, August 1, 2008

Donald Luskin

Stocks are cheap near-term amidst a jumble of conflicting data, news and politics.

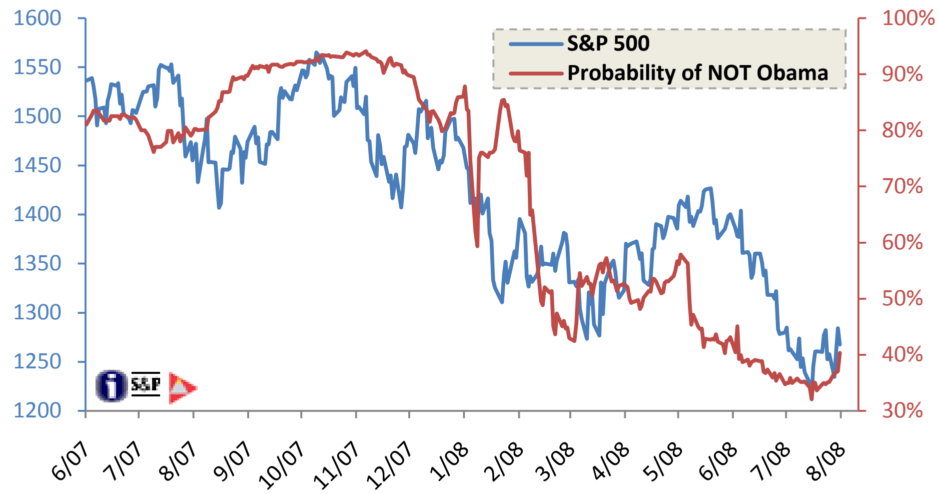
Update to strategic view

US STOCKS: In the near term, the good news is that undervaluation is stretched to the breaking point, capitulation is in the air, and the anti-growth consequences of an Obama landslide has moderated. Longer term, political risk is still a sword of Damocles.

[see Investment Strategy Dashboard]

CREDIT CRISIS: FROM TRAGEDY TO FARCE

Question: Why did the Wall Street coyote chew his own leg off? Answer: To keep the next shoe from dropping. And so it was with Merrill Lynch, with its announcement Monday that it was selling a $30 billion face value portfolio of CDO's to Lone Star Funds, thus supposedly eradicating subprime mortgage exposure from its books. In reality, because Merrill made a $5 billion non-recourse loan to Lone Star for the $6.7 billion deal, Merrill's downside exposure was reduced only by the $1.7 billion down payment -- while its upside potential was reduced to zero. Thus at enormous opportunity cost, Merrill has accomplished virtually nothing. It's worrisome to see so graphically how difficult it is for banks to shed their subprime exposure, but it's encouraging to see an act so desperately stupid that it can only be interpreted as the kind of capitulation that occurs when things have gotten as bad as they are going to get.



AN OBAMA CORRECTION

Stocks hit all-time highs last October, at the same time as the Intrade online political futures contracts on Barack Obama for president made all-time lows (implying, at their worst, a 94% probability he would *not* be elected). By the end of October, the Obama contracts began to rally, and stocks began to decline. The March interim low for stocks was made within days of an interim high for the

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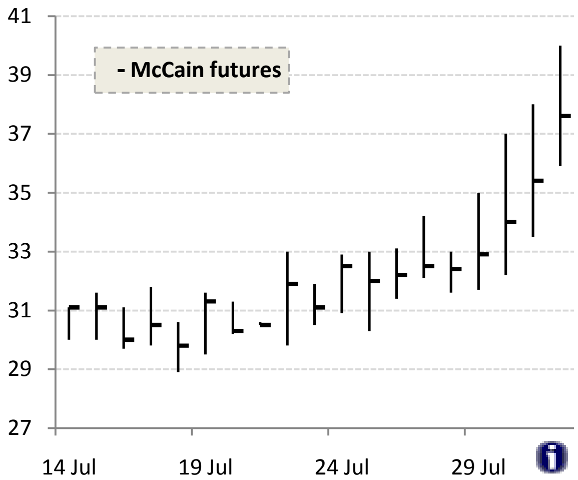
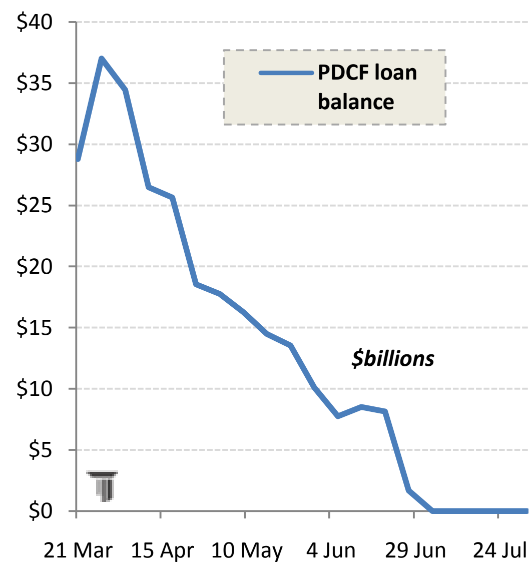
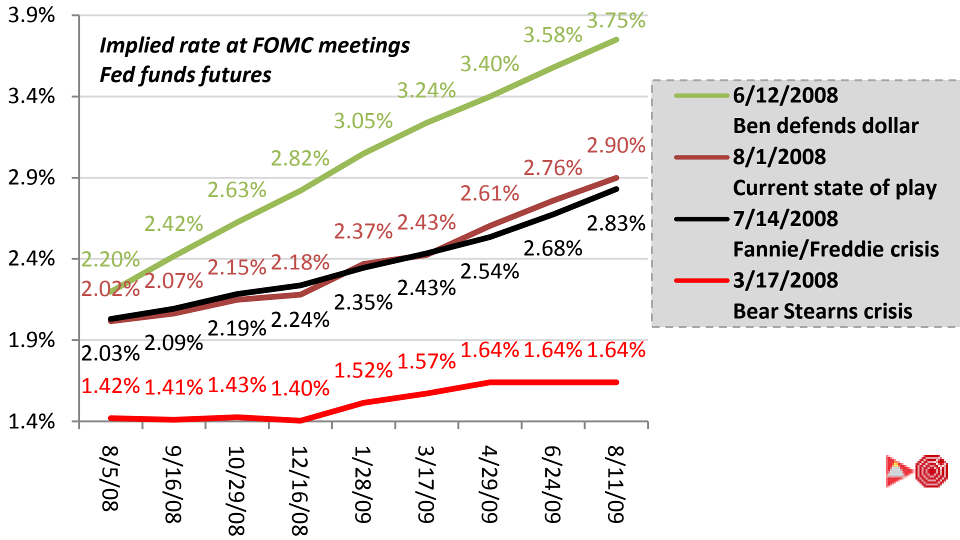


Obama futures, and stocks rallied for two months while the Obama futures fell. In May, the Obama contracts rallied back to their March highs, we pointed out that stocks were becoming increasingly sensitive to the anti-growth policy risks of an Obama presidency, and we warned -- not aggressively enough, as it turned out -- of a coming correction (see "The Next Thing to Worry About" May 8, 2008). Stocks fell sharply soon after that, and made a provisional bottom two weeks ago within a day of the Obama futures making all-time highs (implying, at their best, only a 32% probability he will *not* be elected). As stocks have struggled to recover since then, the Obama futures have declined (today implying as much as a 40% chance he will *not* be elected). As you would expect, over the same time the McCain for president futures have rallied commensurably (at their worst, reflecting a 29% probability he *will* be elected, and today reflecting as much as a 40% probability). There are surely other things than the November election driving stock prices, but the connection is nevertheless striking. And it's quite clear that, whatever Obama's virtues as a man may be, the stock market has concluded, correctly we believe, that his economic agenda will be bad for growth. For the moment, the opportunity for the market to consider that an Obama landslide is not inevitable is a catalyst for a relief rally. But longer term, Obama is a sword of Damocles hanging over the stock market.

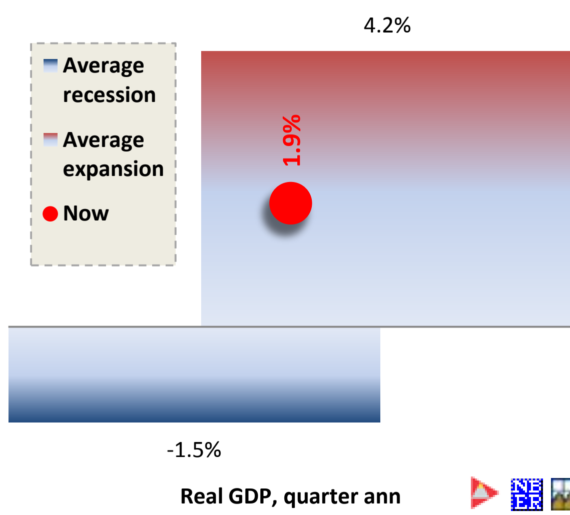
THE FED RE-UPS It's a positive development that the Fed has announced it will extend the Term Securities Lending Facility and the Primary Dealer Credit Facility into January 2009, and create a new TSLF option program. With respect to the PDCF, we're not sure how the Board of Governors managed to convince their general counsel to make the necessary finding under Federal Reserve Act section 13.3 that market conditions are sufficiently exigent, and that no other source of lending is available, when presently the value of PDCF loans outstanding is precisely zero. So our fears that PDCF would go away as originally scheduled in September have been allayed -- and just as important, PDCF extension has been achieved, however temporarily, without any new broker/dealer regulation as a *quid pro quo* (see "Subprime Lending Was Their Best Idea" June 4, 2008). Some observers have noted that the extension of TSLF and PDCF make is less likely that the Fed will raise the funds rate this year, as the FOMC is likely to believe that if conditions are exigent enough to justify extension they are exigent enough to command a 2% funds rate. Possibly, but on the other hand extension gives the Fed a policy option for dealing with the ongoing credit crisis *other than* maintaining a low -- and inflationary -- funds rate. That is to say, *without* extension a low funds rate would have likely been seen as indispensible, inflation or no inflation -- but *with* extension there are choices, and indeed better choices.



Nevertheless, futures markets show that expectations for rate hikes remain nearly as depressed as they were two weeks ago at the depths of the Fannie/Freddie crisis, with not even one hike fully priced for this calendar year (see ["Stocks are Cheap, But the Fed's Asleep"]() July 15, 2008). This makes quite mysterious the sharp pullback in inflation-sensitive markets such as gold, commodities and forex since the Fannie/Freddie crisis. The present expectations environment isn't as dangerously inflationary as the one that obtained in mid-March during the Bear Stearns crisis. But without a return to the more hawkish expectations environment that obtained in mid-June, when Ben Bernanke was [explicitly talking]() about the Fed's critical role in preserving the foreign exchange value of the dollar, a very serious inflation risk remains. It's possible that the pullback in inflation-sensitive markets has been, to a large extent, in sympathy with the drop in the crude oil price over the same period. After the Bear Stearns crisis, when most inflation-sensitive markets retreated from all-time highs, oil alone went on to make new highs as tensions with Iran intensified. Now those tensions have relaxed, with the Bush administration having signaled several diplomatic initiatives that make military intervention less likely, and oil has fallen dramatically from the highs. As the oil price establishes a new equilibrium, unless the Fed expectations environment improves, it's likely that inflation-sensitive markets will move back up. But perhaps we should take those markets at face value, and believe that they are signaling that a worst-case inflation scenario will be avoided, regardless of what the rate expectations markets are saying. For now, the truest statement is that the inflation picture remains mired in indecision (see ["Indecision and Inflation"]() July 22, 2008).



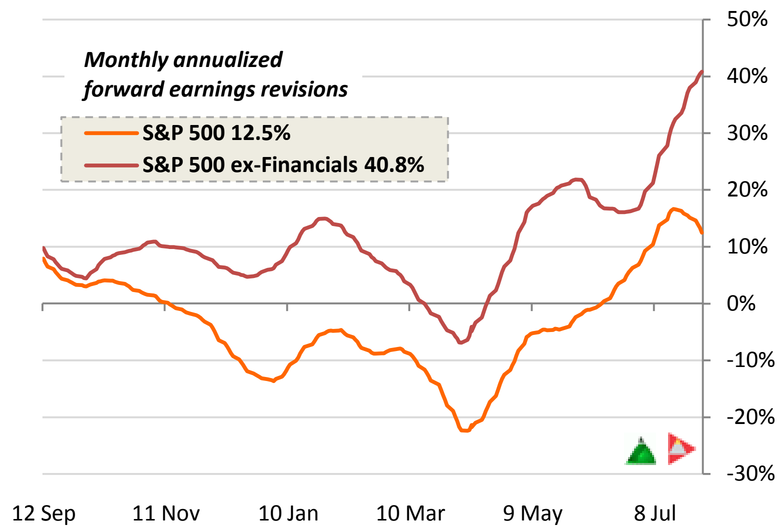
DATA MUDDLE Yesterday's second quarter GDP report is difficult to interpret and contextualize. On the face of it, real GDP at 1.9% simply does not qualify as recessionary -- and neither does the -0.2% growth, to which the fourth quarter of 2007 was revised. Over history, real GDP growth has averaged -1.5% during recessions. But the second quarter doesn't really qualify as expansionary either, with 4.2% the historical average in expansions. It's right in the middle. That said, it's likely that real GDP was distorted upward by a peculiarity of the way the Bureau of Economic Analysis handles inflation adjustments and imports. Imports subtract from GDP computationally, so sharply rising import prices driven by soaring energy



prices ironically acted to reduce the inflation adjustment in the second quarter. *Nominal* GDP, which is not affected by this perverse adjustment, came in for the quarter at a seemingly weak 3.0% (the historical average in recessions is 2.7%). But without an extremely large decline in inventories, it would have been 5.0%. And without another sharp drop in residential investment, it would have been 5.9%. We're not trying to make excuses, but 3.0% nominal GDP growth just doesn't make sense in light of the vast majority of macro data that just isn't that weak. This morning's report of a 51,000 payroll jobs decline doesn't do it -- the historical average in recessions, adjusted for the size of today's labor force is 275,000. The ISM manufacturing index came in this morning at 50 -- the average in recessions is 42. Orders for non-defense capital goods ex-aircraft grew at an 18.9% annual rate in the second quarter -- the average in recessions is -22%. And the unemployment rate is just 5.7% -- just above the 5.5% historical average during *expansions*.

A BLOW-OUT EARNINGS SEASON

The most striking good news in this economy is forward earnings. Without financials, S&P 500 consensus forward earnings are virtually at all time highs (this remains true even if the energy sector is excluded). Month over month, they are growing at an astonishing annual rate of 40.8%. Even including financials, a sector for which forward earnings are collapsing, the annual monthly growth rate is 12.8% -- a faster pace than the historical average for expansions of 9.8%. Five of the ten S&P 500 sectors -- consumer staples, energy, health care, information technology and materials -- are at or just basis points away from all-time highs. With forward earnings this strong, the equity risk premium is enormously elevated -- at levels not seen since 1980, even though long-term Treasury yields have risen considerably over the last several months. With the reward for bearing equity risk this great, we don't see a lot of downside potential for stocks here.



BOTTOM LINE: In the near term, the good news is that undervaluation is stretched to the breaking point, capitulation is in the air, and the anti-growth consequences of an Obama landslide has moderated. Longer term, political risk is still a sword of Damocles.