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MACROCOSM

New Year, Same Old Recession

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Let's review the baseline: how we got here, where we are, where we are going.

Update to strategic view
US MACRO: We're in a recession, not a depression and not a "new era." The key downside driver, "death by rescue" in the financial sector, has been reversed. And the key precondition for recovery, the rebirth of risk taking, is already beginning to materialize. **US STOCKS:** Earnings continue to fall, but stocks still have room to run, once they digest their gains from the November lows, before they equilibrate with a still very wide equity risk premium.
[see Investment Strategy Dashboard]

THE DRIVER OF THE CREDIT CRISIS HAS REVERSED Financial firm failures began with over-leveraged commitments to poorly structured assets. They were accelerated into cascading systemic panic by *ad hoc* and dubiously legal interventions by the Fed, the Treasury and the FDIC, the only common thread to which was the disincentive to hold or invest in equity, and the incentive to mount speculative attacks (see "Death by Rescue" November 17, 2008"). Beginning with the Capital Purchase Program executed under TARP in mid-October, the government's strategy abruptly transformed into one of protection and nurturance of equity capital (see "At Last: A Bail-out That's a Bail-out" October 14, 2008). The rescue of Citigroup and the nomination of Tim Geithner as Treasury secretary in late November demonstrated the sustainable commitment to this new strategy (see "Another Rescue, A New Rescue Ranger" November 24, 2008), and marked a provisional bottom in the equity markets. In mid-December the Fed's commitment to effectively abandon targeting short-term rates above zero "for some time," and to continue to expand its already enormous balance sheet with new asset-support programs, was further confirmation (see "'Some Time' A Great Notion" December 17, 2008). The key takeaway: the chaotic force that unleashed the global panic in markets and threw the global economy into sharp recession has been quelled -- now we have to deal with its aftermath.

RISK SPREADS BEGIN TO HEAL With the panic of late summer having claimed the most vulnerable victims, and the government now credibly committed to supporting the survivors at all costs, market indices of risk aversion have pulled back from the extraordinary levels seen in October and November. Examples include the OIS-LIBOR spread, the TED spread, high yield bond spreads, and the VIX index of equity option implied volatility (see "Signs of Life" December 30, 2008). These risk spreads remain at high levels, by historic standards. But they are no longer at pathological levels that effectively lock down credit markets, levels at which lenders

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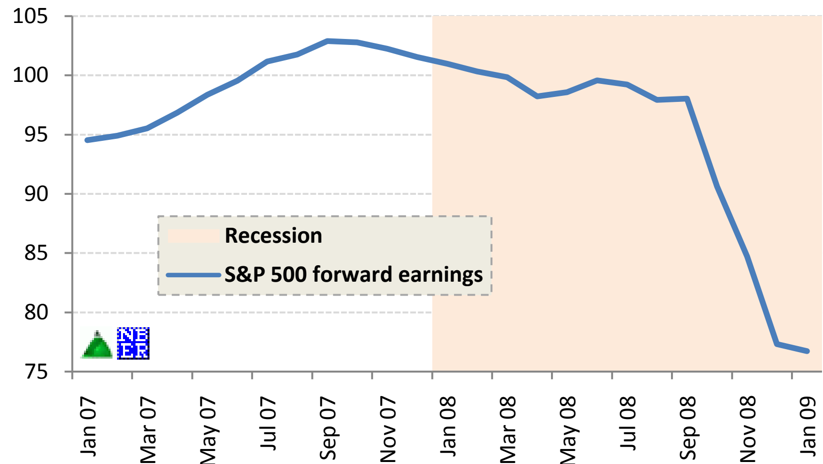
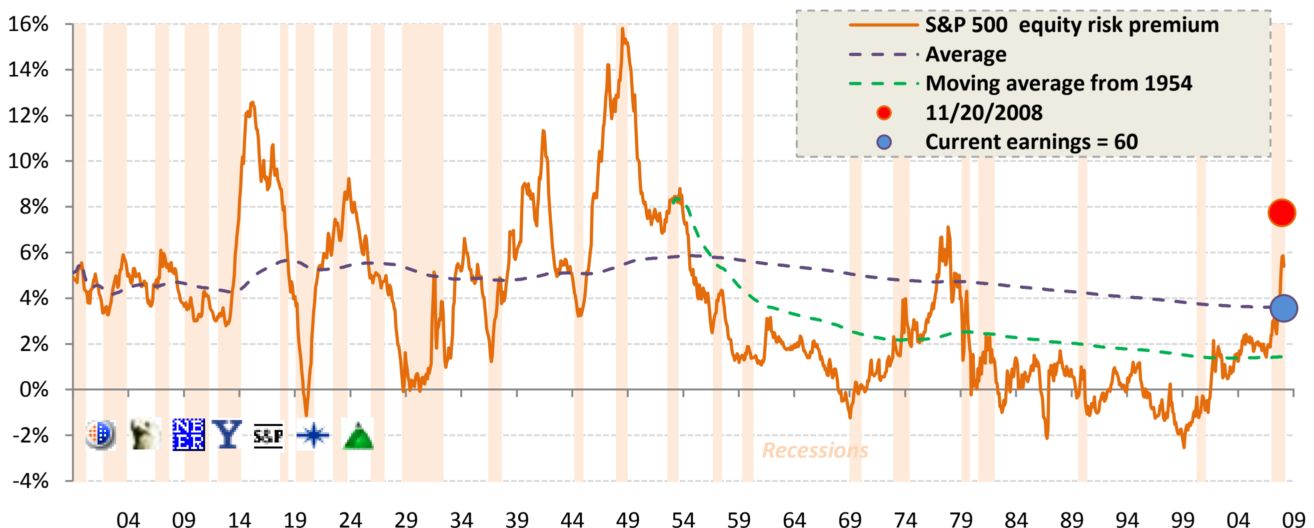
are afraid to lend and borrowers can't afford to borrow. As spreads ease, a virtuous cycle in which renewed access to credit itself further reduces credit risk has a chance to take root. There's some evidence that it's starting. Aggregate bank lending growth is still anemic, but last week marked the third largest increase on record in commercial paper outstanding -- and virtually none of it was taken up by the Fed's Commercial Paper Financing Facility.

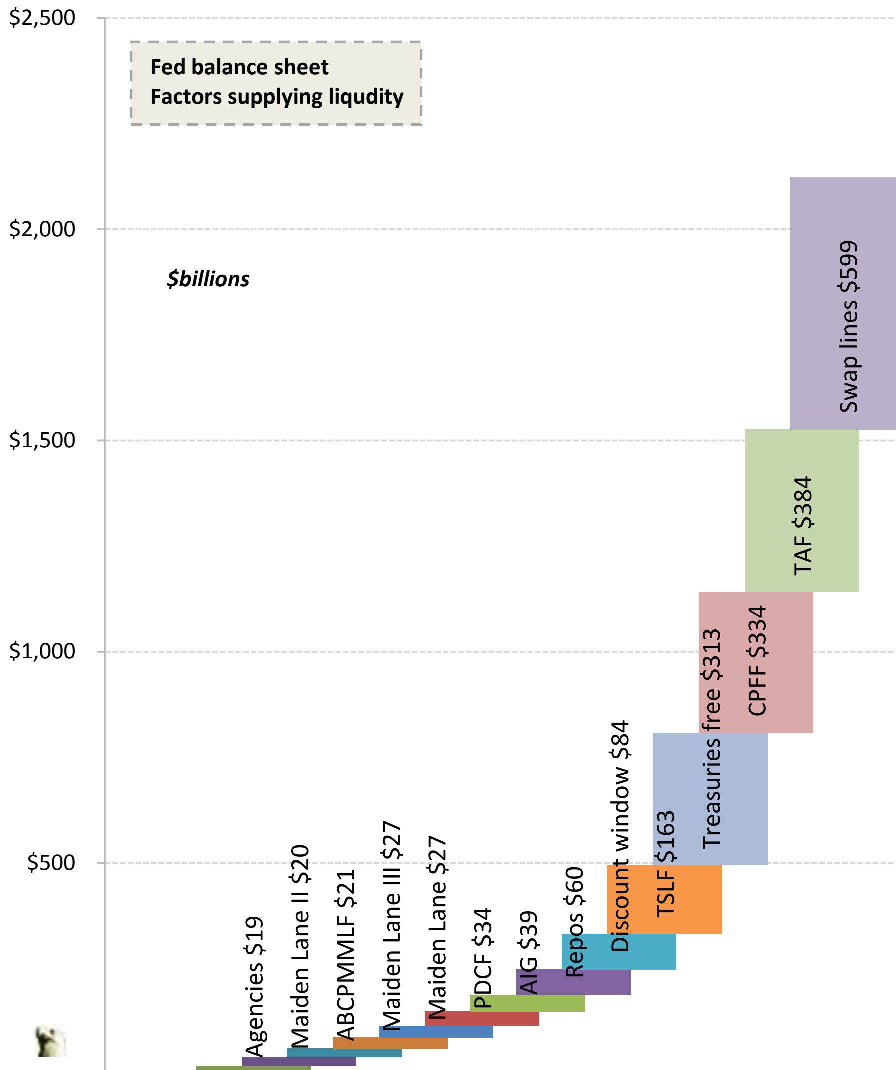
THE EQUITY RISK PREMIUM HEALS AS EARNINGS FALL At the provisional bottom in equities on November 20, the equity risk premium -- the difference between the forward earnings yield of the S&P 500 and the yield of long-term Treasuries -- made highs not seen since early 1953 (see "At Least They're Cheap" November 20, 2008). The calculation depends critically on consensus forward earnings, and it is suspect to the extent that earnings estimates can be expected to be revised downward. But in the context of the extremes of late November, such concerns are secondary. Indeed, since the November bottom, forward earnings have in fact fallen more than 11%, a remarkable drop in just seven weeks -- yet over the same short period, stocks have rallied as much as 24%, by some simple definitions a whole bull market. These two developments have worked in tandem to lower the equity risk premium from November's extreme level, though it still remains at very high levels by historical standards. Looking ahead, the pace of downward earnings revisions is now slowing, but we see no sign yet that it is reversing. But with the equity risk premium as high as it still is, stocks still have room to rise, once they've digested their gains from November, before they've equilibrated with forward earnings.





IT'S A RECESSION, NOT A DEPRESSION, NOT A "NEW ERA" We are in a serious recession, but the widespread fears that we may be headed into a depression are unfounded. The conditions that created the Great Depression are entirely absent today. Then, the weakened economy was saddled with tax increases -- today, president-elect Obama has

abandoned his campaign promise to repeal the 2003 tax cuts, and has now included in his "stimulus" program a variety of personal and business tax breaks (many, admittedly, of dubious incentive effect). Then, the Smoot-Hawley Tariff Act collapsed the volume of cross-border trade -- today, the voices of protectionism in Congress are silent, and the G20 has affirmed "the critical importance of rejecting protectionism and not turning inward in times of financial uncertainty." Then, the government stood by passively while thousands of banks failed -- today, it is committed to sustaining systemically important banks at all costs (see "Brace for Another TARP Debate" December 3, 2008). Then, the Fed contracted the money stock by 28% from 1929 to 1932, triggering years of monetary deflation and debt liquidation -- today the Fed is growing the monetary base at an annual rate exceeding 900%, and it has committed to keep growing its already enormous balance sheet as a bulwark against deflation (see "Why Isn't Gold at $1500?" December 10, 2008). It's not a depression, nor is it a "new era." This is an unusual recession to be sure, if only because it is the first one in half a century not to have been catalyzed by prohibitively high real interest rates.



But we don't believe the evidence supports the theory advanced by some pessimistic analysts that we face a prolonged epoch of collapsing consumption and debt (see "Is This a 'New Era' Recession?" December 29, 2008).

WHERE DO WE GO FROM HERE? We're in a recession, and we face the task of getting out of it. As the level of systemic risk recedes while risk premia in markets remain high, attractive investment opportunities will continue to gradually coax even risk averse investors back into markets, and therein lies the catalyst for starting the virtuous cycle of investment that makes recovery possible. The process has already begun, so now perhaps the greatest risk is that the various forms of "stimulus" -- and inevitably regulation -- imposed by Congress and the new administration will be counterproductive in and of themselves, or will unleash severe unintended consequences. For example, while we're glad to see tax cuts emerge as a large part of the Democratic "stimulus" program, it was worrisome yesterday to see the controversial mortgage

"cramdown" revision to bankruptcy law endorsed by Citigroup, after months of having opposed it. That could be a sign that the weakened bank is now powerless to resist regulatory incursions that will ultimately make it weaker still, suggesting a *future* for US banks that looks a lot like the *present* for US automakers. This quarter we'll be watching the credit markets and the macro statistics, but the big developments are more likely to be the political ones.

BOTTOM LINE: We're in a recession, not a depression and not a "new era." The key downside driver, "death by rescue" in the financial sector, has been reversed. And the key precondition for recovery, the rebirth of risk taking, is already beginning to materialize. Earnings continue to fall, but stocks still have room to run before they equilibrate with a still very wide equity risk premium.