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

MACROCOSM

Quantum of No Solace

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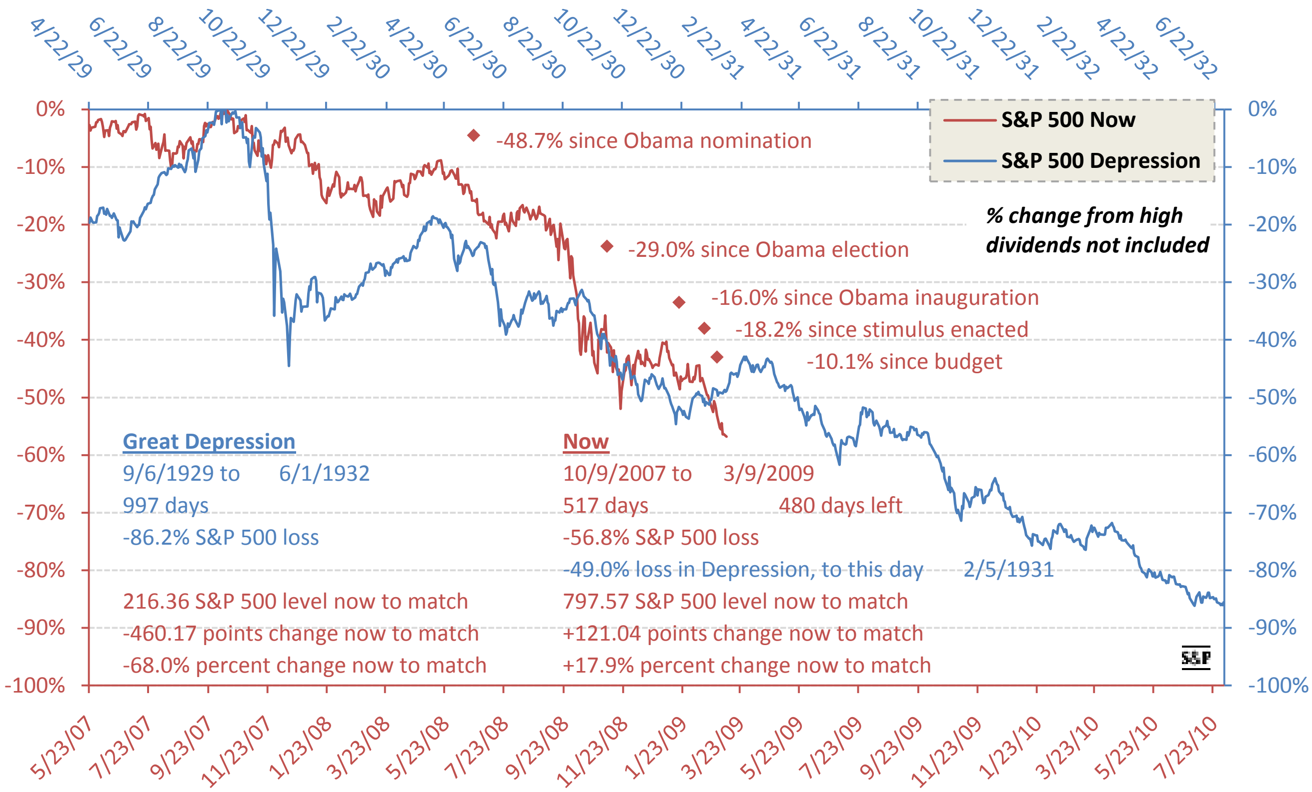
Donald Luskin

The equity risk premium has gone up because the amount of risk has gone up.

Update to strategic view
Please see the top of the following page

We noted two weeks ago that stocks had fallen from all-time highs nearly as far as they had in the bear market in the Great Depression, over the same number of days (see "Obama: '…today does mark the beginning of the end.'" February 20, 2009). Now, things have gotten even worse. Off 56.8%, the S&P 500 has now fallen more *so far* than in any *complete* bear market since 1900 -- except for the 1929-1932 one, in which the final tally was a loss of 86.2%. And now 517 days from the October 2007 highs, the S&P 500 would have to *rally* about 121 points, or 17.9%, just to match the 49.0% loss in the Great Depression bear market the same number of days from the September 1929 highs (see the chart below).



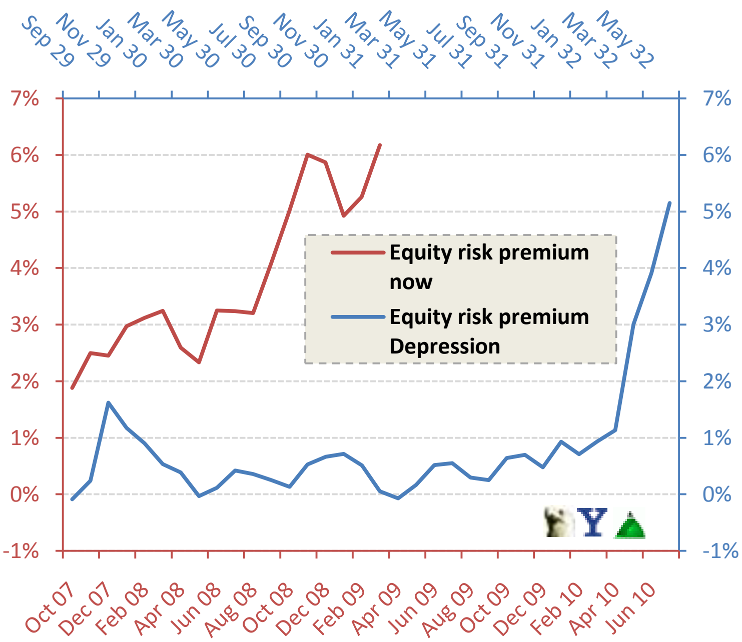
http://www.trendmacro.com
don@trendmacro.com
dgitlitz@trendmacro.com
tdemas@trendmacro.com

Offices:
Menlo Park CA
Parsippany NJ
Charlotte NC

Phone:
650 429 2112
973 335 5079
704 552 3625

As stocks have fallen to new bear market lows, the equity risk premium -- the difference between the forward earnings yield of the S&P 500 and the income yield of 30-year Treasuries -- has risen to panic levels. In fact, it's higher now than it was at the very bottom of the bear market in 1932 (see the chart below). But there's more than panic involved. It's not just that investors are less willing to take risk, it's their entirely rational judgment that *there is now a greater quantum of risk to take*.

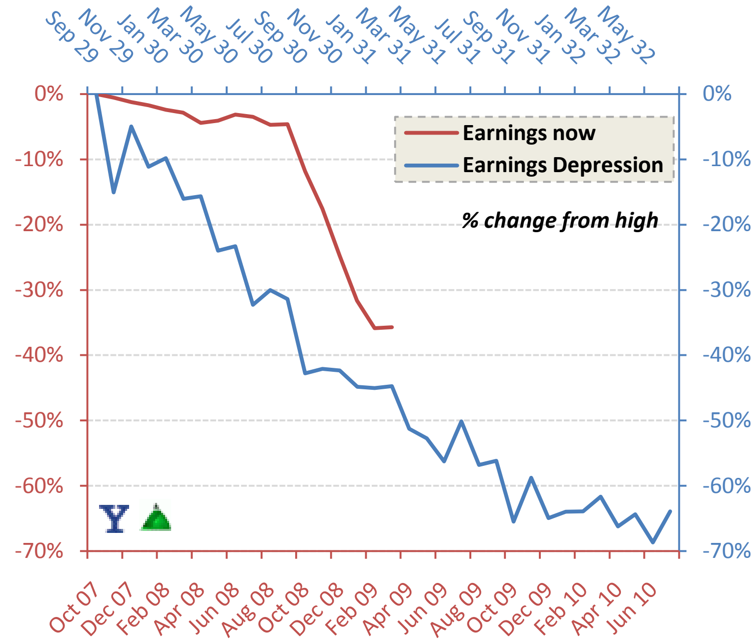
Update to strategic view
US STOCKS: The equity risk premium has risen as stocks have made new lows. Volatile sentiment is in play, and valuations have far overshot current conditions -- so at least a tradable rally is probably nearby. But more deeply, it is a rational response to an increase in the amount of risk investors must now shoulder, in a political environment of rampant "change." Until that stabilizes, the longer-term outlook is discouraging. **GOLD:** As expected, gold has pulled back after touching $1000 two weeks ago. It's unlikely to stay for long in its sharp uptrend from the November lows, but its successful test of $900 last week as stocks made new lows demonstrates the durability of the Fed's reflationary agenda. We continue to expect new highs.
[see Investment Strategy Dashboard]



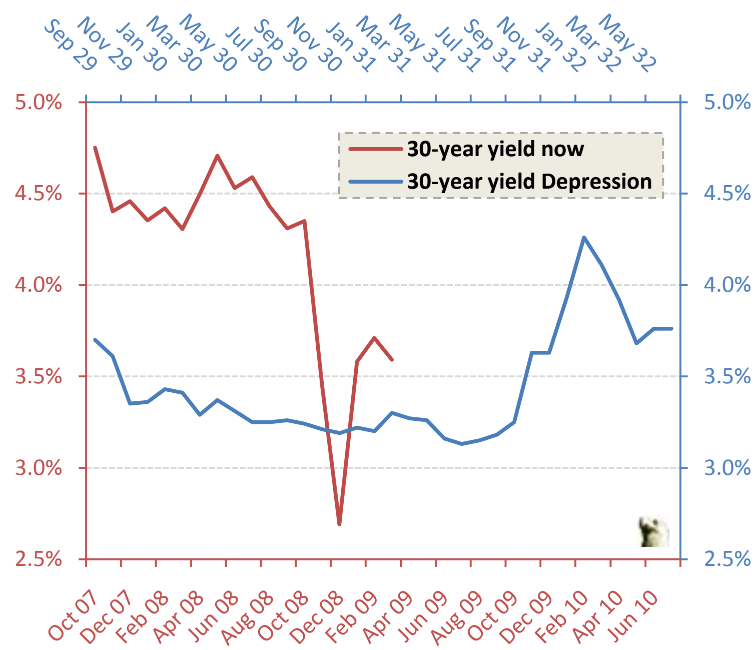
It's not just the "unknown unknowns" about banks (see "Unknown Unknowns" January 30, 2009) -- though that, and uncertainty about the government's possible interventions in them, is an important contributing factor (see "Citi's Common Misconception" March 2, 2009). What's in play now is an even more fundamental and long-range risk: uncertainty about the rules of the game that will obtain under Barack Obama's destabilizing agenda of "change," being imposed at a time when the economy urgently needs, instead, to be stabilized.

Even in the best of times, *investors should rightly fear the sudden and wholesale imposition of the broad agenda of intervention in the economy now underway at the White House and in the Congress*. The roll-off off the present low tax rates on capital and labor income and estates, capping of deductions and elimination of favorable income characterizations for high earners, heavy re-regulation of financial services and securitization, judicial modification of mortgages, limits on executive compensation, imposition of carbon taxes, curtailment of domestic oil and gas production and refining, the substantial nationalization of health care, and elimination of secret ballot for union elections -- these are *all* actively in play. The only threat not obviously right in the center of the radar is protectionism, but it's nevertheless in play, too -- any "stimulus" or "bail-out" that involves government subsidies for particular domestic economic activities is protectionist on the face of it, and risks drawing a protectionist response from other nations.

Let's not mince words for the sake of a false appearance of political comity -- this is about investing success, not politics, anyway: *we believe that every one of these initiatives is bad for growth and bad for equity returns.* But even analysts with very different convictions than ours on that score would agree that they will, at the least, create winners and losers. Even given only that, the sheer number and scope of them, all being rushed into law in the name of "emergency" and under a supposed mandate for "change," is destabilizing. It seems to us that, right now, the world can't tolerate much more destabilizing. At this moment, *that's* the crux of the matter.

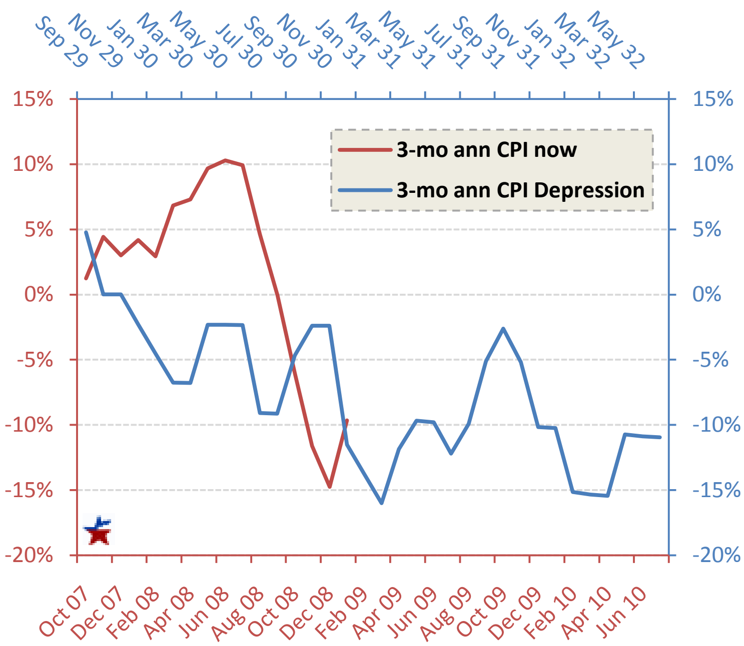


It was bad enough when all these initiatives were just campaign rhetoric. Stocks have fallen 58.6% since the *highs* of October 2007, within days of the *lows* in the probability that Obama would be the next president, as expressed in the political futures market at Intrade (see "Bearack Obama" October 31, 2008). They've fallen 48.7% since Obama's nomination, 29.0% since his election, and 16.0% since his inauguration (see the chart on the first page). Obama cannot be blamed for all that, and we have tried to be as hopeful as possible about him. We had speculated that a charismatic leader could restore confidence (see "The Upside of Obamanation" May 22, 2008), and we noted gladly that he had populated his economic team with relative centrists (see "Brace for Another TARP Debate" December 3, 2008). But now, as Obama's true agenda has evolved post-inauguration from campaign rhetoric to actual legislative and budget initiatives -- being rushed into law all at once, because as Rahm Emanuel said, "Never allow a crisis to go to waste" -- stocks have continued to trade lower and lower. Stocks have fallen 18.2% since Obama signed the so-called "stimulus" bill, and 10.1% since he unveiled his budget. We wish him well, but we regret our earlier hopefulness about him.



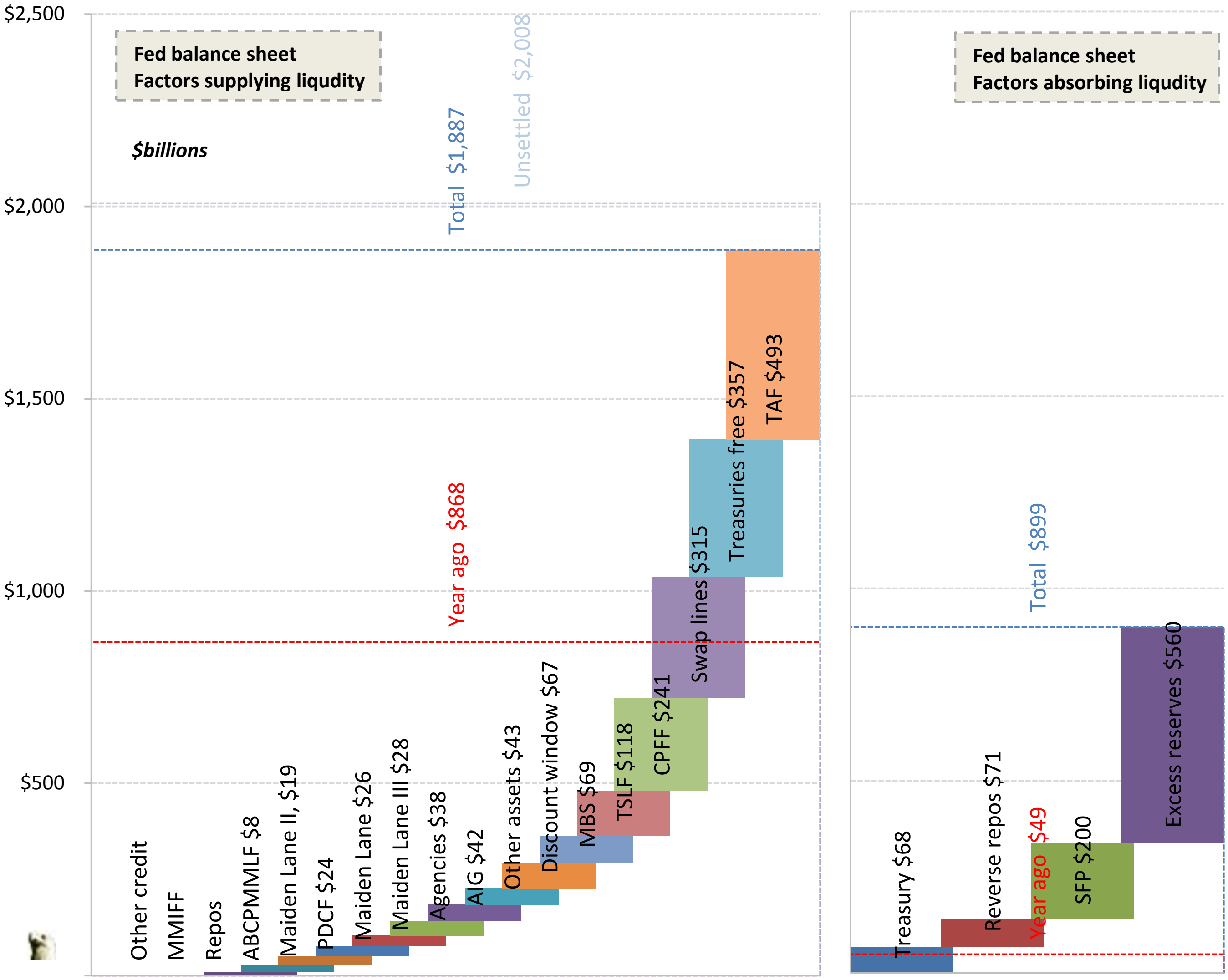
Today's extremely high equity risk premium can't be explained by the usual factors. It's not that forward earnings have fallen -- they *have*, by almost 36% from cycle highs. But the equity risk premium has expanded so much because stocks have fallen *more*, by almost 59%. By contrast, in the Great Depression, at this stage in the bear market, earnings and stocks had fallen by about the same amount -- 45% and 49%, respectively (see the chart above). And it's not that interest rates are so low. They're *higher* now than they were at this stage in the Great Depression -- and when they were briefly lower last December, the equity risk premium was *lower* than it is now (see the chart at left).

Given all that, the usual explanation for an elevated equity risk premium would be sentiment -- or more specifically, risk aversion -- which is assumed to be aberrant at extremes, and thus mean-reverting. But *that* implicitly assumes away the question of the *amount of risk* that there is to be averse to, or at least assumes that it, too, is mean-reverting. We are arguing that, now, for the equity risk premium to return substantially to more normal levels -- and for a commensurable recovery in stock prices -- we would not just require a change in sentiment, as usual, but also a *reduction in the quantum of actual risk* in the investment environment. One could say that such a reduction is nearly inevitable, as even the worst unknowns today will eventually become knowns. With sentiment as negative as it is, even based on a realistic appraisal of how much is unknown, there's a very good chance that any shred of good news, any little decrease in uncertainty, could trigger a tradable rally commencing almost immediately. But that would likely prove to be only a short-term affair. If Obama's "change" agenda resolves from unknown to known by actually being enacted, then that would mean the ongoing presence of tax and regulatory strictures that would make robust recovery impossible (see "We Can Build on This -- But How High?" February 27, 2009). So for stocks to recover in a lasting and important way, not only do the unknowns have to resolve into knowns, they also have to prove to some large extent to have been false alarms -- that is, they must not actually happen.

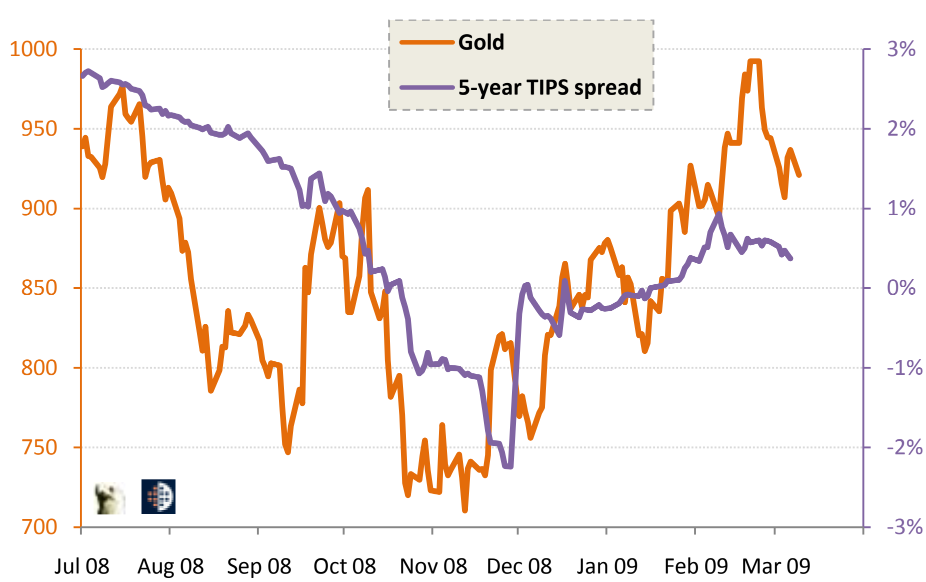


And while we wait for all this to play out, remember that extreme uncertainty expresses itself in economic activity of all kinds, not just stock prices. Most critically, risk-aversion plays out as an increase in the demand for money as a safe-haven store of value -- that is, monetary velocity collapses. As money demand increases, unless the Federal Reserve accommodates it by commensurably increasing the supply, the necessary result is monetary deflation. As we've pointed out many times in the last several months, that is probably the single most serious risk the economy faces (see "Deflation Takes Center Stage" November 19, 2008). In the Great Depression, the Fed met an increase in money demand with a *decrease* in the money supply, and the resulting sustained monetary deflation sliced the economy between two scissors blades -- it simultaneously eroded asset values, and increased the real burden of debt repayment. Today, at about -10%, the CPI deflation rate is nearly identical to what it was at this stage in the Great Depression (see the chart at left). If, going forward, extreme risk aversion or a sustained high quantum of risk itself leads to deflation being sustained at these levels -- as it was sustained then -- we have a very bleak several years ahead of us.

Fortunately, today we have a very activist central bank, led by a man who has deeply studied the institution's grave errors that played such a key role in creating the Great Depression. Since deflation suddenly set in, in the aftermath the banking crisis of last summer -- reversing dramatically from an *inflation* running on a 3-month annual basis at about 10%, the highest rate since 1982 -- the Fed has rapidly grown its balance sheet and the money supply (see the chart on the following page). The salutary results are only now, and just potentially, showing up in



lagging CPI statistics, with the most recent month's index reporting the first small uptick after six months of relentless decline.



Our best indicator of whether the Fed is winning the battle against the deflation borne of extreme risk aversion and the high quantum of risk is gold (see ["Why Isn't Gold at $1500?"]() December 10, 2008). In October, it appeared we were losing the battle. When money demand spiked following last summer's banking crisis and during the early days of TARP, gold fell from near $1000 to below $700 on an intraday basis, and TIPS spreads went negative at the same time (see the chart at the bottom of the previous page). TIPS spreads -- and stocks -- recovered from their lows late in November, with the rescue of Citigroup, but gold had bottomed more than a month earlier, on an intraday basis, indicating that even before that critical bank rescue the forces of deflation were being arrested. Now, while stocks have fallen to new lows and TIPS spreads have petered out just above zero, gold has made another run to $1000, indicating optimism that the Fed will continue to match its balance sheet against the deflationary threat.

But it's still touch and go, with deflation being both the ongoing *product* of uncertainty and its ongoing *cause*. We predicted two weeks ago, as a simple matter of technical dynamics, that gold would have to consolidate after touching $1000, and indeed it has (see "Stocks Test the Lows, Gold Tests the Highs" February 23, 2009). But more than technicals are at stake. We were worried last week when gold briefly traded below $900, down 10% in a matter of a few days, as stocks made new lows -- raising the specter that the Fed was falling behind the curve, that extreme risk aversion and the rising quantum of risk itself were increasing money demand faster than the Fed could or would meet it with supply. We're still worried. We recognize that the gold's sharp uptrend from the October intraday bottom, which even after the pullback of the last two weeks leaves it higher by 35%, is bound to be broken. But a sustained fall in the gold price now would indicate very serious deflation trouble, and would make our comparison to the Great Depression experience more than just an analytical exercise. Our expectation is that the Fed will keep adding assets to its balance sheet as necessary, with $1 trillion more now forecastable with the start-up of TALF in just two weeks (see "TALF -- The Fed Gets One Right" March 6, 2009). Ultimately, we worry that the Fed won't have an effective exit when the time inevitably comes to reduce its balance sheet (the only one we know about is the freeway exit in South Carolina just named for Chairman Bernanke). We don't look forward to the inflation implied by gold at $1000 and higher, but that is the outcome we expect and hope for, because deflation is far worse.

Recommended reading
Too Big Has Failed Thomas M. Hoenig Federal Reserve Bank of Kansas City, March 6, 2009 *The Financial Crisis and the Systemic Failure of Academic Economics* David Colander, Hans Föllmer et al. Dahlem Workshop, November 17, 2008
[Recommended Reading home]

BOTTOM LINE: The equity risk premium has risen as stocks have made new lows. Volatile sentiment is in play, and valuations have far overshot current conditions -- so at least a tradable rally is probably nearby. But more deeply, it is a rational response to an increase in the amount of risk investors must now shoulder, in a political environment of rampant "change." Until that stabilizes, the longer-term outlook is discouraging. As expected, gold has pulled back after touching $1000 two weeks ago. It's unlikely to stay for long in its sharp uptrend from the November lows, but its successful test of $900 last week as stocks made new lows demonstrates the durability of the Fed's reflationary agenda. We continue to expect new highs.