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

MACROCOSM

Wolf in the Fold

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Donald Luskin

Meet the "change" trading range -- a go-nowhere market just like the 1960s-1970s.

Update to strategic view
US STOCKS: Stocks are finding the range in which they are likely to be confined throughout the Obama years. For the near term, the rally from the March lows continues to run out of steam as the risk of anti-growth policy comes back to the forefront. **US FINANCIAL STOCKS:** With the "stress tests" behind us, the risk of catastrophic government intervention is now low, and the sector is no longer priced to reflect any significant go-to-zero risk. Sector-wide valuations are now less attractive than they were pre-crisis, even assuming a significant earnings rebound. Individual superstars excepted, we are neutral on the sector at best.
[see Investment Strategy Dashboard]

The "tradable rally" we called for at the bottom in early March (see "Quantum of No Solace" March 10, 2009) continues to lose steam. The S&P 500 is still up 30.5% from the lows -- but that's well of the rally peak a week ago Friday, when stocks were up 37.4%. We remain confident that the March lows at 666 on the S&P 500 represent a durable bottom, but continue to believe that this rally's most energetic phase is over -- stocks are now up only 3.9% since we first said that (see "Stress Test Stress" April 21, 2009). Our trader's gut is telling us that it doesn't really feel like stocks want to go down much. That said, the rally is running out of steam because the theme responsible for the rally in the first place -- the resistance against intense and immediate anti-growth policy risk -- is itself running out of steam. Policy risk is back.

It's not as intense as it was in March, when an indigestible amount of "change" was being force-fed to an already destabilized economy in the name of emergency. When the S&P 500 fell 15% after President Obama's inauguration, it became clear that the runaway train of "change" was driving that emergency to the edge of chaos (see "Number of the Beast" March 18, 2009). It would appear that the political establishment got the message, and decided to pull back from the edge. Stocks began to recover as, one by one, some of the signature "change" initiatives that looked like sure things in March came off the table. Mortgage "cramdown," unionization "card check" and the cap-and-trade carbon tax all got shelved in the Senate. At the same time, the administration backed away from the worst of its anti-business and anti-bank rhetoric, and the Treasury revealed a toxic asset plan of extraordinary generosity (see "Geithner Gets a Do-Over" March 24, 2009), and carried out its "stress tests" with deftness (see "The Stress Tests' Hidden Mickey" May 4, 2009).

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

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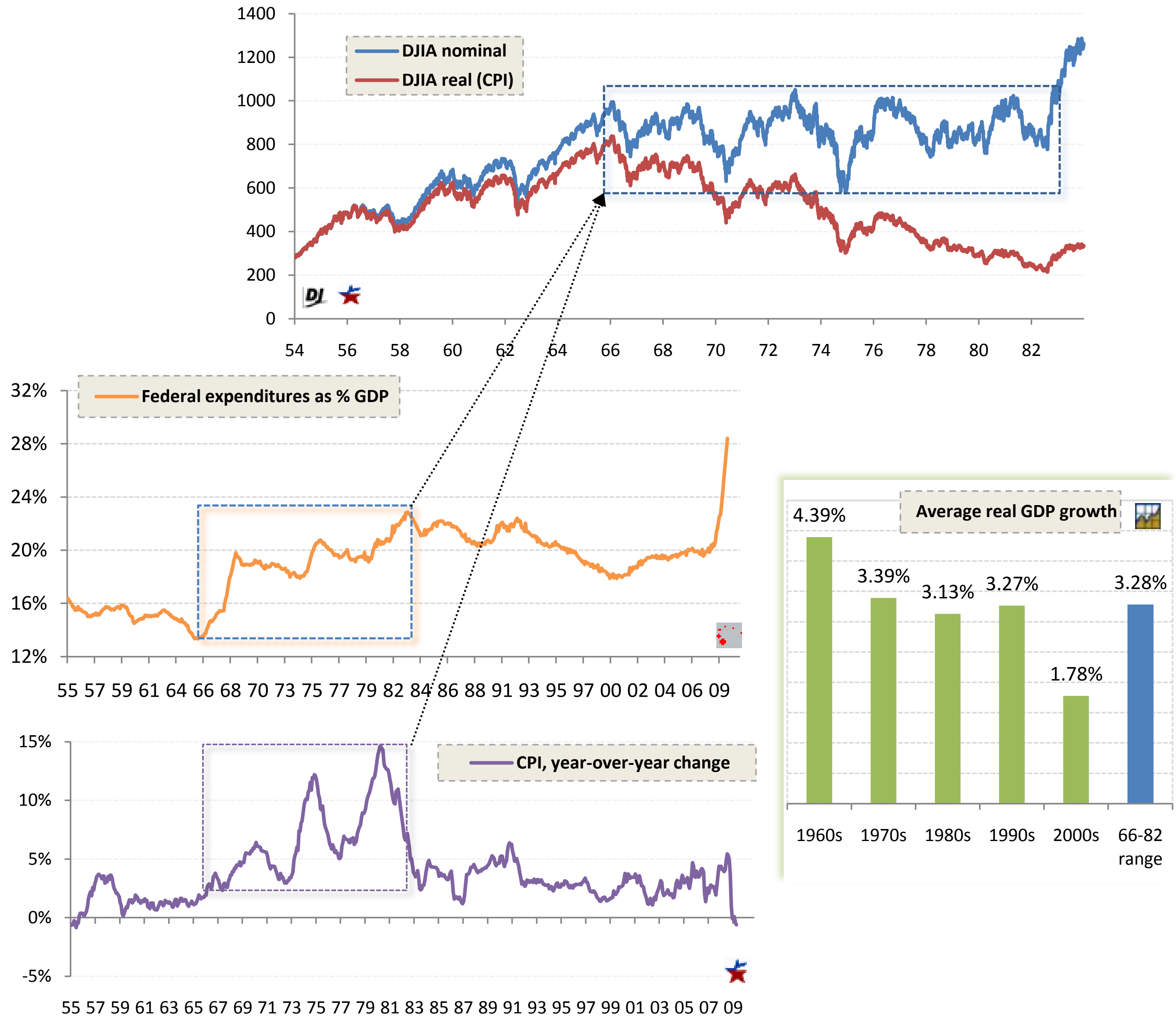
But now that a good measure of confidence has been restored, with the S&P 500 about 10% higher than it was on inauguration day, the political establishment is moving back toward the edge of chaos. The stock market rally faded last week as, late on the previous Friday, dissident Chrysler bondholders acceded to an administration reorganization plan -- citing irresistible political pressure -- that would appear to strip them of their legal rights in bankruptcy, awarding a controlling interest in the company to the United Auto Workers union. Under similar pressure, the health care industry presented a letter to the Obama administration promising to slash costs, signaling it would rather collaborate with, rather than fight, the prospect of nationalized medical insurance being enacted under filibuster-proof "budget reconciliation." The Treasury announced a new regulatory regime for OTC derivative securities, and leaked its intention to impose rules governing the structure of compensation in the financial sector. FDIC Commissioner Sheila Bair blurted in a Bloomberg TV interview that some bank CEOs would be replaced, and the head of the Justice Department's antitrust division Christine Varney announced that "too big to fail is a failure of antitrust enforcement." It was a busy week for "change" -- on top of the previous week's White House announcement of a sweeping plan to raise corporate taxes by changing the treatment of overseas income.

We are reminded of the old saying that the definition of *democracy* is "a dozen wolves and six sheep voting on what's for lunch." In early March, it appears the wolves realized that they were down to just two sheep. Wisely, the wolves recognized that their own survival required them to stop lunching for a while. Now the sheep have had time to repopulate. A couple weeks ago it even seemed that they had discovered that the definition of *liberty* is "a well-armed sheep," with a few Chrysler bondholders talking tough about insisting on their legal rights. But the wolves remain in the majority, and absent the threat of extinction they can start eating again. So even the better-armed GM bondholders are being subjected to intense political pressure to abandon their legal claims. It is clear that the wolves' optimal strategy is to keep the sheep within an optimal population range, bounded on the bottom by the threat of outright extinction and on the top by the wolves' need to eat. For stocks, that's the trading range we think we're stuck in. We feel confident that we've explored the bottom of it, but are less sure where the top is.

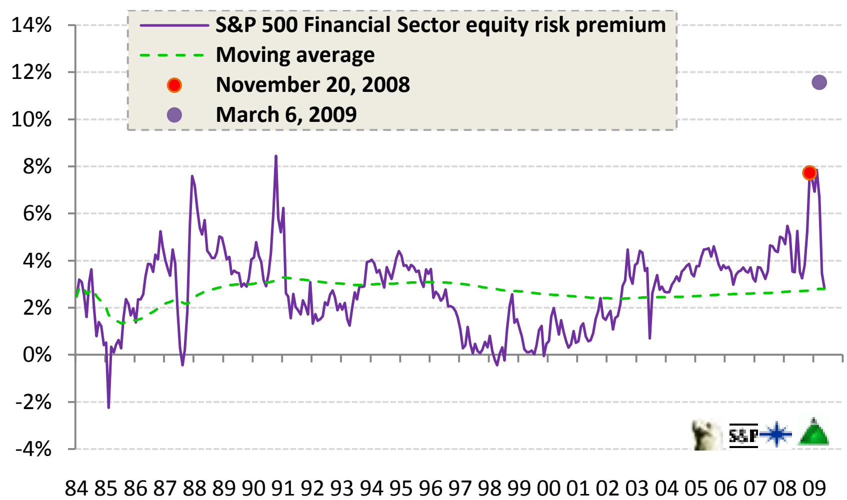
We think this trading range will have similar properties to the one that contained stocks for more than sixteen years from February 1966 to October 1982, when stocks were bounded between about 575 and 1050 on the Dow Jones Industrial Average. As the charts on the following page show, that period coincided perfectly with the vast expansion of federal power begun under the Great Society program of Lyndon Johnson, in which federal outlays grew from 12% of Gross Domestic Product to more than 22%. Growth of similar magnitude has been underway already for several years under the Bush administration, and is now virtually locked in under the plans of the Obama administration. Setting aside the ill effects of government exerting so much interference in the private economy, the sheer cost of it is staggering. The White House's 2010 budget predicts that federal debt held by the public will rise above 70% of GDP in 2010 -- from less than 40% in 2008! -- *and stay there forever*. And even that is based on *very* rosy assumptions for economic growth.

Those sixteen years from 1966 to 1982 were a period of very high inflation, too, as also shown on the charts on the following page. Inflation worked together with the expansion of government's control of the economy to keep stocks bound in a trading range. Inflation is corrosive even to nominal stock prices because the capital gains tax is not inflation-indexed -- the higher the inflation rate, the higher the effective capital gains tax rate. But the damage is



even more visible in *real* stock prices. *They* were not in a trading range during those years, but rather in a ferocious bear market. On a real basis, stocks didn't re-attain their 1966 values until 1995. Like federal outlays, inflation has been rising already for several years -- it would be clearer on the chart above if it were not for the sudden deflation triggered by the credit panic in the second half of 2008 (see "Deflation Takes Center Stage" November 19, 2008). As the panic eases, we think inflation will rise to levels that may well rival those of the 1970s.

It is worth drawing the distinction here between equity performance and economic growth. As the rightmost chart above shows, the 3.28% average real GDP growth during the sixteen years of the stock market trading range was *higher* than the average growth in the 1980s and the 1990s, decades in which stocks performed spectacularly. As a matter of first principles, we hesitate to draw from this evidence any assurance that growth will continue at the same level regardless of inflation



or government interference. But it's easy to see why, from first principles, the returns to capital would be impaired under such conditions.

Consider, as an example, the policy-driven trading range the financial sector may now be starting to establish. The sector has rebounded remarkably from early March, when investors were pricing -- incorrectly, we said (see "Citi's Common Misconception" March 2, 2009) -- the substantive risk that the sector could go to zero. That risk is understood now -- correctly -- to be gone, with the government interventions that nearly destroyed the sector last year (see "Death by Rescue" November 17, 2008) finally having drawn an effective safety net under it. But how much further can the sector rally, when the price of that safety net will be a future of intense regulation and government micro-management, to the point of the largest banks being relegated to the status of public utilities? With that in mind, it seems that investors have gone in just two months from overestimating the worst outcome to overestimating the best. The S&P 500 financial sector's equity risk premium -- near record highs in November, and then far beyond them in March -- has now narrowed back to its long-term average, as though the sector held no special risk anymore for which investors need compensation. It's even narrower than before the banking crisis began -- in other words, the sector earnings are more expensive now than they were before the wheels came off. Individual superstar banks with unique competitive positions may break away from the pack from here, but at these prices, how much higher can a soon-to-be utility sector go?

To be clear, we do think that the economy has very likely hit bottom, and is poised to work toward recovery. Risk spreads of all kinds have collapsed to levels that are still quite elevated, but are consistent now with recession bottoms, not incipient Great Depressions (see "Sorting Out the Spreads" April 27, 2009). Even the macro data is starting to turn, the most notable example being a potential peak in new jobless claims -- an event associated perfectly with every official recession trough since 1975. Our concern is that, just two months ago, stocks were being panicked to new lows by a runaway train of "change" in the name of emergency. That train was derailed, and the emergency immediately receded. In the process we learned that the wolves -- to return to our earlier metaphor -- however hungry they may be, are not suicidal. And there is no longer an emergency to justify "change." That's all to the good -- in fact, it's *very* good, considering the alternative. But now "change" is back, precisely *because* the emergency has receded -- now the wolves can feed again, without risking the extinction of the sheep. It seems the higher stocks go, the more the political establishment will feel emboldened to pursue more "change." Thus rallies have become self-limiting. Welcome to the "change" trading range.

BOTTOM LINE: Stocks are finding the range in which they are likely to be confined throughout the Obama years. For the near term, the rally from the March lows continues to run out of steam as the risk of anti-growth policy comes back to the forefront. With the "stress tests" behind us, the risk of catastrophic government intervention is now low, and the sector is no longer priced to reflect any significant go-to-zero risk. Sector-wide valuations are now less attractive than they were pre-crisis, even assuming a significant earnings rebound. Individual superstars excepted, we are neutral on the sector at best.