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INTELLECTUAL AMMUNITION

# The Case for Ambivalence

Friday, June 12, 2009

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### Where do we go from here, now that we're not going to zero?

| **Update to strategic view** |
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| **US MACRO, US STOCKS:** Depression is off the table, and the recession is likely over. But there are no precedents to guide us in assessing the shape of recovery. From first principles, we argue that the side-effects of the heroic treatments that averted crisis will mute recovery. The March bottom probably marks the birth of a new bull market in stocks. But it's never been tested. As ambivalence about recovery mounts, it will soon be time to trade this "tradable rally." |
| [see Investment Strategy Dashboard] |

We're gratified by our near-perfectly timed call for a "tradable rally" in stocks in early March (see "Quantum of No Solace" March 10, 2009). The S&P 500 is up about 40% since then -- with our "best idea" materials stocks leading the way, up more than 56%, behind only the back-from-death financial sector. We continue to believe that the March lows will mark the bear market bottom, as evidence accumulates that the recession is in the process of troughing and turning around (see, most recently, "On the May Jobs Report" June 5, 2009). Our trader's gut keeps telling us stocks don't want to go down. But we continue to be haunted by the question: where do we go from here, now that we're not going to zero? Should we be thinking about trading this "tradable rally"?


Stocks have been stalled for the last nine trading sessions in a 1.5% trading range. The S&P 500 has been only timidly pushing up against the downtrend line from the May 2008

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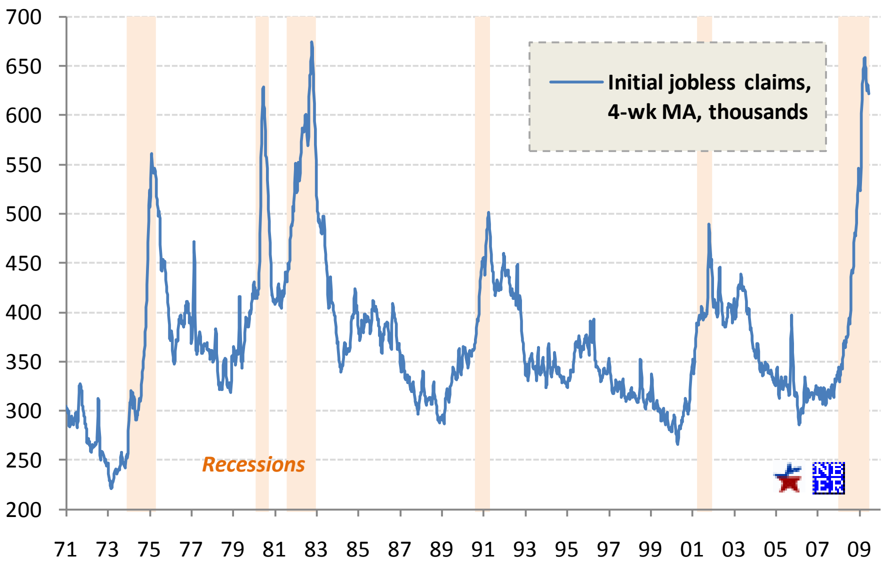
top, which defines the accelerated phase of the bear market (see the chart on the previous page). We don't wish to over-indulge in technical analysis, but such things do have symbolic value. It's worth noting that while as of yesterday stocks have broken above that trend, but it feels more like a whimper than a bang. It's as much because the trendline itself is declining as it is because stocks are rallying. Stocks seem to be narrating a story of ambivalence, one with which we have a lot of sympathy.

We certainly don't see any evidence-based rationale for the V-shaped recovery some analysts are calling for. The depth and suddenness of the recession does not in and of itself mandate a symmetrical rebound -- we could argue just the opposite, once some of the obvious rate-of-change arithmetic has played out from a low base. But neither do we see any rationale for a renewed cycle of decline, which some of the pessimistic analysts celebrated for "getting it right" are now calling for. The global financial system has been stabilized -- though at a price, to be sure (see "The Stress Tests' Hidden Mickey" May 4, 2009) -- and the data simply don't bear out these analysts' predictions for a secular consumer retrenchment or a wholesale correction of "global imbalances" (see "It's an Old New Era" May 1, 2009).

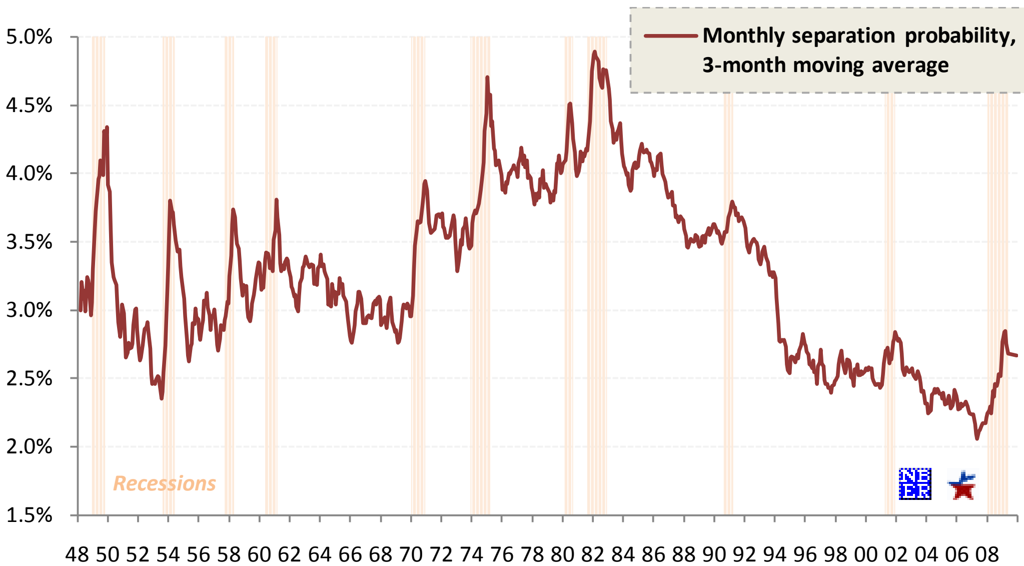
We agree with Ben Bernanke about "green shoots." But we also agree with Thomas Jefferson when he said, "There is not a sprig of grass that shoots uninteresting to me." The various signs of economic recovery are very real, but at the same time many of them are "interesting" to a fault -- they are wrapped in contradictions and complexities that make them difficult to confidently interpret. Indeed, some could even be coming on *too strong* -- such as rapidly rising oil prices and real interest rates -- suggesting a recovery that in an important sense is about to get in its own way (see "Green Overshoots" May 29, 2009). And from first principles, we can argue that we'll have to pay a price in the form of lower growth for the heroic fiscal and monetary emergency treatments that kept the global economy from a new Great Depression.

What we can say with confidence is that the Great Depression scenario of three months ago has been averted. That's terrific, and it's been sufficient to drive a rally big enough to be a bull market in its own right. But the reality is that the uniqueness of the near-death experience we've just come through -- if you accept what amounts to a prediction that we have indeed come through it -- makes predictions impossible, as we have no clear precedents to work from. When you're making history, it's hard to learn from history.

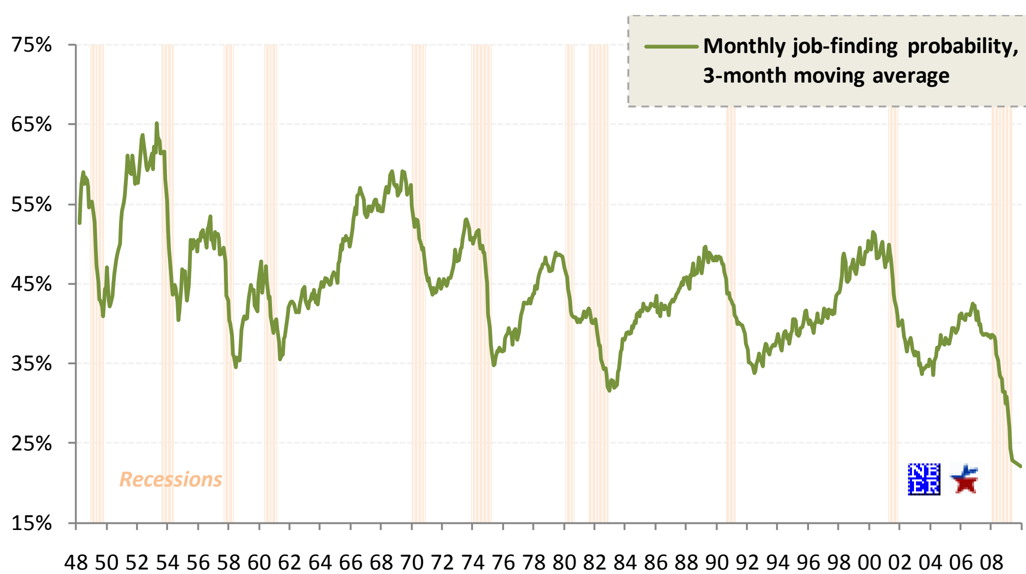



For example, how are we to think about the US labor market? Using it as a macroeconomic indicator, we can feel pretty confident. We've already pointed out several times that the April peak in new unemployment claims likely marks the trough of the recession, as it has in every recession since 1975 (see, first, "Stress Test for T-Bonds" May 8, 2009). Yesterday's drop in new claims added confirmation that April was indeed the peak (see the chart at left).

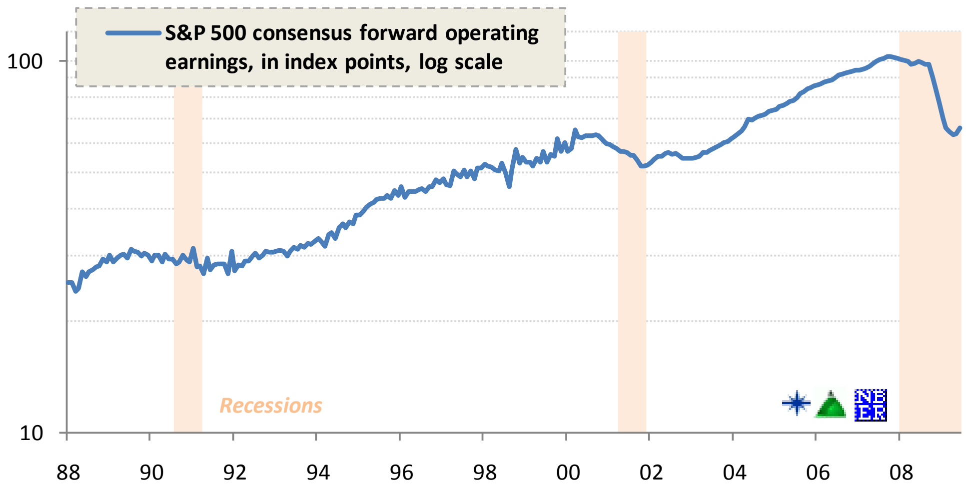
But in other dimensions, the unemployment situation is a lot harder to read. Even granting a recession trough, the data offer nothing but uncertainty about whether the coming recovery will be jobless or jobful. That's not a trivial distinction for the stock market. Recall that the last recession ended officially in November 2001, but was jobless for more than a year. Stocks didn't turn up until 2003, at about the same time that the recovery became jobful.




Look at the "unemployment inflow rate," shown in the chart at left. This is the percentage probability that an employed worker will become separated from his employer in a given month. Before recession onset, at the peak of the last expansion, it fell to an all-time low of just 2%. It is quite low *now* by historic standards, at 2.6% -- exactly its average value for the second half of the 1990s, a period considered to be a very strong labor market. At its worst at 3.0% last December, it was roughly tied with its peak in the 2001 recession -- a level that, by all earlier standards, would have meant an excellent level of job security. But one problem with this is that it leaves very little room for improvement. Recall that after the 2001 recession and its similar low peak in the monthly separation probability, it took 39 months to attain the previous expansion's level of payroll jobs -- making that the most jobless post-war recovery.




Another problem is the "unemployment outflow rate," shown in the chart at right. This can be understood as the probability that a newly separated worker will be able to find a new job within a month. With the probability of separation quite low across the previous business cycle, it has been the probability of finding a new job that has been the driving dynamic of fluctuations in unemployment. In the current recession the job-finding probability has fallen sharply to historic lows, leaving the labor market in an unprecedented and paradoxical position. Job security is quite high, for those who have a job -- but for those who don't have a job, it's extremely and disproportionately difficult to get one. Here, to be sure, there is room for improvement. But cutting against that possibility is the very high proportion of the labor force involuntarily working part-time -- a near-record at almost 6%. As the economy recovers, it's likely that such workers will be given the opportunity to work longer hours, in preference to hiring new workers from among the entirely unemployed. The economy will benefit from the increase in hours worked, but it means that recovery will have to be quite substantial before it moves the needle much on the unemployment rate.




More ambiguities arise from S&P 500 consensus forward earnings. This is one of our favorite and most reliable macroeconomic indicators. By aggregating thousands of dispersed datapoints, no one of which is a macroeconomic forecast *per se*, it harnesses "the wisdom of crowds" to produce a macroeconomic forecast -- downturns reliably precede expansion peaks, and upturns reliably coincide with recession troughs. We now have an upturn. At 65.9, forward earnings have risen 4.3% from their low on May 7, at which point they had fallen 38.7% from their all-time high on October 12, 2007. We remember writing in October last year, when we were still underestimating the severity of the recession that would come in the wake of the summer's financial panic, that bearish expectations for 60.0 S&P 500 earnings were "overdone" (see ["How Bad An Earnings Hit?"]() October 23, 2008). True, as it turned out, but it was closer than we would have liked, with the bottom a month ago at 63.2. But the important thing now is that forward earnings have turned positive. There has never been a case over the last century in which, when falling earnings turned higher to this extent during a recession, the recession did not end almost immediately.

**Recommended reading**

["Jobless Recovery Redux?"]()
Mary Daly, Bart Hobijn and Joyce Kwok, FRBSF Economic Letter, June 5, 2009

["Why is Japan so heavily affected by the global economic crisis? An analysis based on the Asian international input-output tables"]()
Kyoji Fukao and Tangjun Yuan, VoxEU, June 8, 2009

[Epstein on the Rule of Law]()
Richard Epstein, Econtalk, June 1, 2009

[Recommended Reading home]

The turnaround in forward earnings is broad-based, touching all ten S&P 500 sectors except health care and industrials. The problem is that half the aggregate improvement from last month's bottom can be explained by a statistical artifact -- the removal of General Motors from the S&P 500 Index, and its replacement by DeVry. This eliminates a $12.9 billion forward loss from the aggregate, and replaces it with a $200 million gain. That indeed improves S&P 500 forward earnings by $13.1 billion, and raises no particular index valuation issues -- both before and after the change, investors are paying the index's market capitalization to get the index's earnings. But as a macroeconomic indicator, the $13.1 billion swing is simply an illusion. General Motors' losses *do not leave the economy*, they only leave the index.

Not only will General Motors' losses not leave the economy, they will undoubtedly be even greater now that the company is under government ownership. And this illustrates the greatest ambiguity of all about the coming recovery. The nationalization of GM has been one of many heroic emergency treatments that have kept the global economy from falling into a new Great Depression. Like many heroic emergency treatments, the bargain was to exchange the risk of immediate death for a long period of illness and debilitating side-effects. We'll never know what the world would have looked like if Fannie Mae, Freddie Mac, Citibank, Bank of America, Chrysler and General Motors had been allowed to die suddenly. We are about to learn what the world will look like instead as they remain sick for years, and the whole economy suffers the side-effects of increased regulation, taxation, inflation, government meddling -- and as the bond market, the dollar and commodities are experiencing now, uncertainties about the pace and extent of the withdrawal of the treatments (see "They Laughed When I Sat Down to Monetize" June 4, 2009).

**BOTTOM LINE:** Depression is off the table, and the recession is likely over. But there are no precedents to guide us in assessing the shape of recovery. From first principles, we argue that the side-effects of the heroic treatments that averted crisis will mute recovery. The March bottom probably marks the birth of a new bull market in stocks. But it's never been tested. As ambivalence about recovery mounts, it will soon be time to trade this "tradable rally."