Trend Macro

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MACROCOSM

Surprise, Surprise

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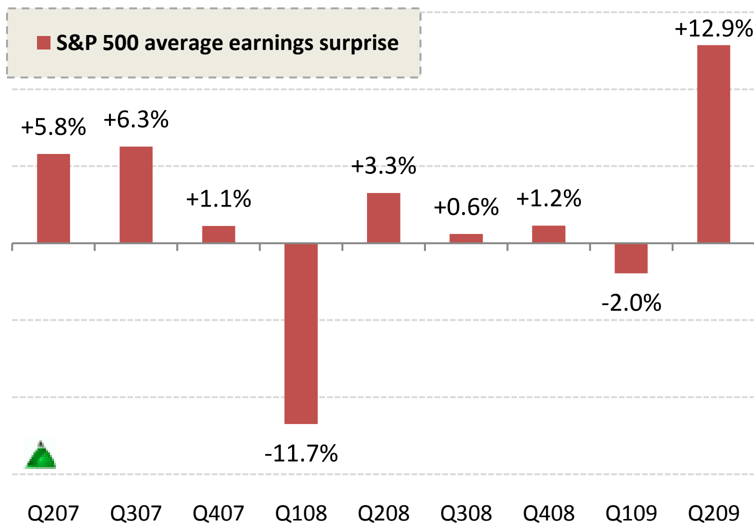
Earnings surprises, and a surprise crack-up of Obamacare, carry stocks to new highs.

Update to strategic view
US STOCKS: Stocks have moved to new recovery highs on the crack-up of the Obama administration's health care "reform," and at the same time a strong earnings season. On both counts the good news is out, and much further upside would be due mostly to just momentum. **US FINANCIAL STOCKS:** Financials have contributed nothing on net to this earnings season, with spectacular positives being perfectly erased by equally spectacular negatives. Other than picking the winning needles in a losing haystack, we continue to see the sector writ large as dead money.
[see Investment Strategy Dashboard]

We're not surprised to see stocks rallying to new recovery highs, having said that the correction from the June top was nothing more than a correction (see "A Deflationary Correction" July 9, 2009). But we *are* surprised that the correction didn't run longer and deeper. We had been looking for an entry point at the bottom of the correction, and we have to admit we missed it. This sudden rally is the result of the confluence of two factors -- an earnings season dominated by strong positive surprises, and the apparent crack-up of the Obama administration's health care "reform" initiative in the wake of the over-reaching plan to finance it with a surtax on wage, dividend and capital gains income (see "Health Care Deform" July 16, 2009). The latter is key, because it signals that what once seemed to be a runaway train of anti-growth "change" has been brought back to within the orderly parameters of deliberative democracy. This both lowers the likelihood of anti-growth impacts, and -- by simply slowing the pace of "change," even without lowering its likelihood -- helps the destabilized economy to find its footing with fewer perturbations.



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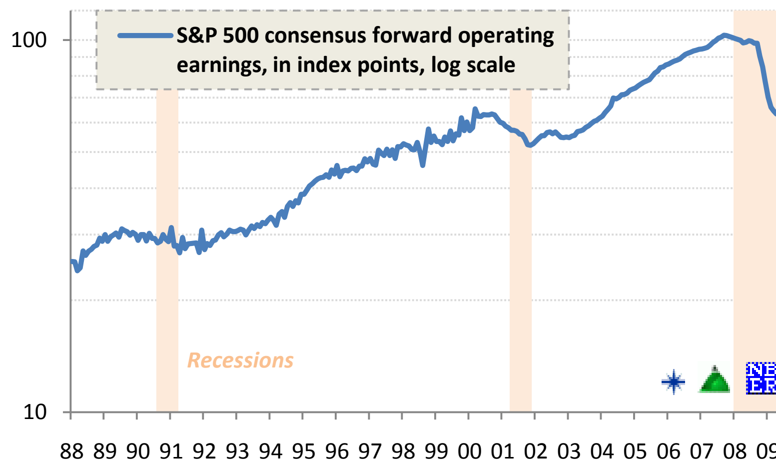
At the same time, earnings season has been very strong so far, about a third of the way through the reporting cycle. On an unweighted basis, the average surprise has been positive by 12.9%, making this by far the best earnings season in two years. Year-ahead forward earnings have been rising for almost two months now, so this strong surprise factor is occurring against a difficult backdrop of already rising expectations. And as forward earnings continue to rise, their recovery from a 21-month decline continues to sound a very strong recession-end signal.



The distribution of earnings surprises has not been monolithic. On a dollar-weighted basis, in which greater weight is given to larger companies with larger earnings, the positive surprise factor is 10.5% -- which indicates that more positive surprises have come from the smaller companies that make a smaller contribution to overall earnings in the economy. In fact, more than half the total dollar value of net positive surprises is explained by just three companies -- Wells Fargo, JPMorgan and General Electric.

But this shouldn't be taken to indicate that financials have been the backbone of this earnings season. The sectors that have driven this season's net positive results have been technology, industrials and basic materials. While Wells, JPMorgan, General Electric (which, for this analysis, we count as a financial firm), Bank of America and Goldman Sachs have all contributed very large positive surprises, Citigroup stands as the single worst negative surprise, followed by Morgan Stanley and Zions Bancorp. Overall, the financial sector (even including General Electric) has contributed no positive surprise at all, with its negatives perfectly erasing its positives. This comports perfectly with our view that the financial sector, once it absorbed the happy news that it was not going to zero, is basically dead money. The only way to play it is by identifying the few survivors that have a chance of resurrecting some kind of earnings growth model in the aftermath of the credit crisis (see "All's Not Wells" April 13, 2009).

Recommended reading
The Road Ahead for the Fed John Ciorciari and John B. Taylor, editors Hoover Institution Press, 2009
[Recommended Reading home]

It's also significant that so far, on net, revenue surprises have been precisely nil. So this earnings season has been all about the bottom line, not the top line. This is problematic, as a company can't cost-cut its way to greatness. And neither can an economy, as one company's cost-cutting is another company's lost sales. It may be great for measured productivity, but in the end sustainable bottom line growth has to start with top line growth -- and this economy, now almost surely technically coming out of recession but barely in recovery, just isn't generating that so far.

For the moment it would seem that the good news is out. On Obamacare, it will continue to be debated, but Congress won't actively consider it again until after the August recess. And given that it has had be delayed in this way, it's highly unlikely now that it will ever be enacted at full strength. As to earnings, the stock market gets the message, and we don't see why stocks ought to move a lot higher as more of the same comes out over the coming weeks. Many clients tell us they think stocks could surge here, as those who missed the March bottom come in out of

desperation -- that's certainly possible, and such forces can be powerful even if they are brief. So we continue to see upside for stocks (and remain quite sure that the March bottom was *the* bottom), but we think we're closer to the top of the trading range now than we are to the bottom.

BOTTOM LINE: Stocks have moved to new recovery highs on the crack-up of the Obama administration's health care "reform," and at the same time a strong earnings season. On both counts the good news is out, and much further upside would be due mostly to just momentum. Financials have contributed nothing on net to this earnings season, with spectacular positives being perfectly erased by equally spectacular negatives. Other than picking the winning needles in a losing haystack, we continue to see the sector writ large as dead money.