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MARKET CALLS

Great… Now What?

Friday, August 21, 2009

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A round-up of our strategic views now that the global economy has hit bottom.

US MACRO The consensus has caught up to our early view that the economy hit bottom in the second quarter. We caught the turn pretty much in real time by noting reversals in two infallible recession-end indicators: jobless claims (see "Stress Test for T-Bonds" May 8, 2009), and S&P 500 consensus forward earnings (see "The Case for Ambivalence" June 12, 2009). Since then more and more macro data has fallen into place, confirmed by the broad repair in markets for risky assets. Using the technique of econometrician Edward Leamer -- which models the decision function of the NBER in dating business cycles -- even if unemployment, payroll jobs and industrial production do no better than stabilize at their current levels, that would be sufficient by December to declare an end to the recession, with the trough back-dated to May. Any improvement in the input variables would accelerate the timing of the declaration, but the trough is locked in at May.

Granting that the bottom is in, we don't expect a smooth or rapid recovery. If that puts us in the center of the consensus, then so be it. The data simply doesn't support the pessimists who cling to the seemingly seductive narrative of consumer retrenchment (see "Still Waiting for that 'New Era'" July 31, 2009). But neither does it support the optimists who think, just because

Update to strategic view

US MACRO: The recession ended in May, but recovery will be slow and uneven.
US STOCKS: They don't want to go down, but after an historic run, it's not worth playing for the upside at this point.
US FINANCIAL STOCKS: The banking crisis is officially over, but now the game is picking the least rotten apples in the barrel.
US RESOURCE STOCKS: The best play on coming inflation and commodity bottlenecks. In need of correction or consolidation, which should be aggressively bought.
GOLD, OIL, COMMODITIES: Hanging on the outcome of the Fed's dangerous balancing act between the lingering threat of deflation and the future threat of inflation.
US BONDS: Long-term a great bear bet, as risk aversion subsides and inflation risk comes to the fore, and now the risk of Fed intervention is gone. Short-term, still a parking place in a slow recovery.
HIGH YIELD BONDS: The easy money is gone, with Depression-level spreads narrowed to merely recessionary levels. But still a good play in an environment of gradual recovery.
FED FUNDS: On hold indefinitely, with the balance sheet continuing to swell.
US DOLLAR: With all the world's central banks roughly equally easy, there's no particular threat to the dollar even as inflation risks rise.

[see Investment Strategy Dashboard]

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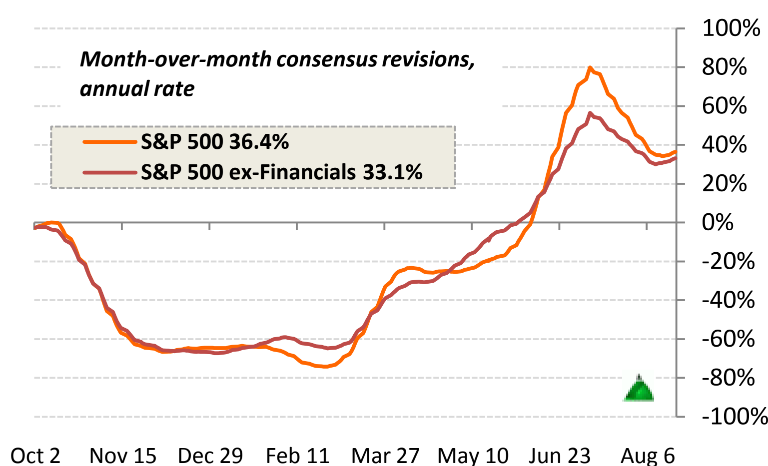
the banking crisis is over, that Humpty Dumpty has been put back together again (see "The Square Root of Recovery" July 2, 2009).

US STOCKS Stocks have borne out our oft-repeated gut instinct that they just don't want to go down. Yet our head continues to tell us, after a rally of speed and magnitude not seen since the recovery from the bottom of the Great Depression when stocks started from much lower levels, that it's probably not worth playing for much upside until there has been some form of correction or consolidation. The key event drivers of the second leg up from the brief June-July correction have been the unraveling of the Obamacare initiative (see "Health Care Deform" July 16, 2009) and the best earnings season in more than two years (see "Surprise, Surprise" July 23, 2009). For both, the news is out. It may seem like a dumb question to ask on a day when the S&P 500 is making new recovery highs, but what do we do for an encore?

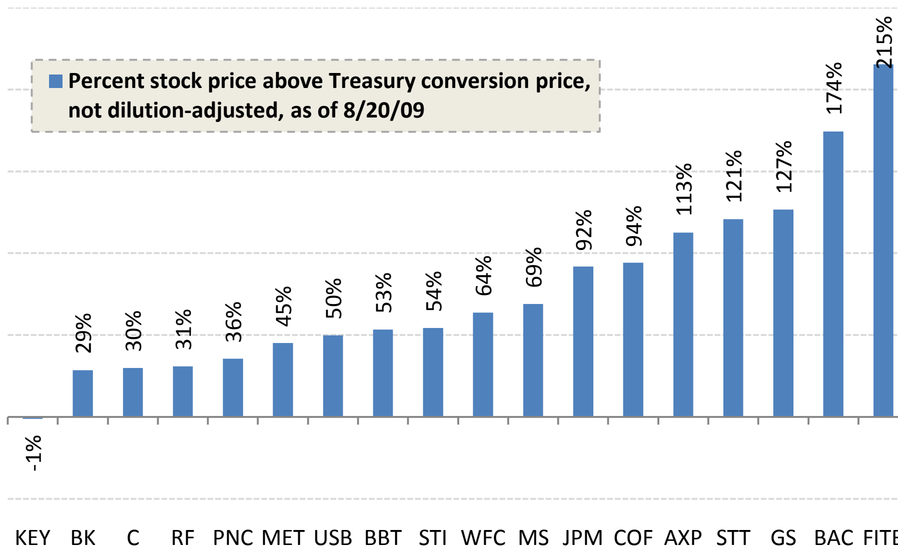


The best case for the upside in the near-term is the technical one we hear many clients make -- that the "pain trade" is now a scramble to cover shorts, and to try to make up for missing the bottom. But we generally find that such momentum arguments don't prevail for long. More sustainable macro-strategic arguments don't offer a lot of hope, at least not if you agree with our view that the recovery from a second quarter recession trough will be sluggish and halting. And while it's all to the good that consensus forward earnings continue to improve daily -- with the month-over-month revisions now running at a 36% annual rate -- valuation arguments only support about 10% more upside over the next year.

- The S&P 500 is now 35.6% off the all-time highs of October 2007. Consensus forward earnings are off 32.3%. So the forward price-earnings ratio isn't much more attractive today, at 14.5, than it was at all time highs, at 15.2.
- The bottoms-up cap-weighted price target for the S&P 500, based on an analyst consensus that is typically biased to the upside, only implies a 9.6% upside for stocks overall.
- Our equity risk premium model, based on the difference between the forward earnings yield of the S&P 500 and the yield of 30-year Treasuries, gives the most optimistic result -- but only given assumptions which may not be realistic. The ERP is quite high now by the standards of the bull market era post-1984, and if it were to revert to the average of that bygone era, then all else equal stocks would rise 45.5%. But if the ERP reverts to its average of 1966 to 1982 -- the era of big-government and high inflation that we think best analogizes our current environment (see "Wolf in the Fold" May 18, 2009) -- then stocks would rise only 11.3%. Even more pessimistic, if the average reverts to that of the entire sweep of history from 1900 to the present, then stocks would fall 11.9%.

US FINANCIAL STOCKS The crisis in the banking sector is over. It is now the avowed policy of the United States government that in the event of any future banking Titanic, there will be lifeboats with enough seats for everyone. The hard proof that this policy has been sufficient to stem the crisis is that, of the 18 publicly traded banks subjected to the Treasury's "stress test," all but one is trading substantially above the backstop level at which the Treasury stands

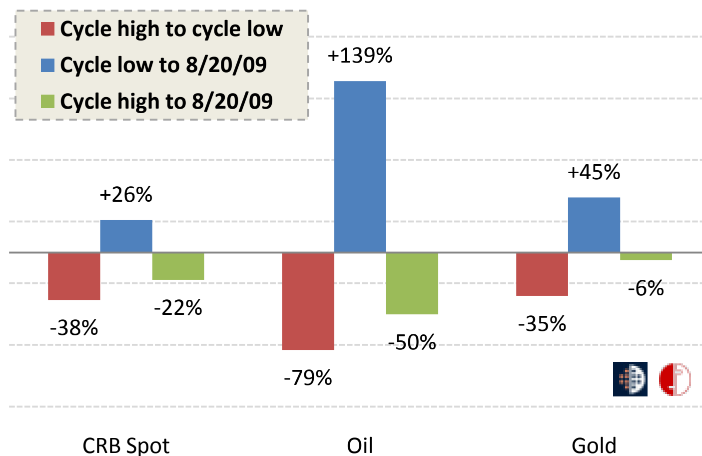
ready to buy mandatory convertible preferred stock (see "The Stress Tests' Hidden Mickey" May 4, 2009). This is especially remarkable considering the dilution that has occurred over the last several months of recapitalization by these companies.



Up 130% from the March lows, financials have been the best-performing S&P 500 sector, and many believe they have much further to go. We disagree. At best, it should be possible to identify the least rotten apples in the barrel, the ones who can draw some competitive advantage from the sector's ruination. But for one and all, the reality is that the leverage, the proprietary risk-taking and the high fees that drove earnings over the last cycle are simply gone without a trace. Today's forward PE multiple for the sector is 15.1, well above the norm of the last quarter century of only 11.1. Why pay that when, after the recovery from near-death is complete, we have no idea where the growth in E is going to come from?

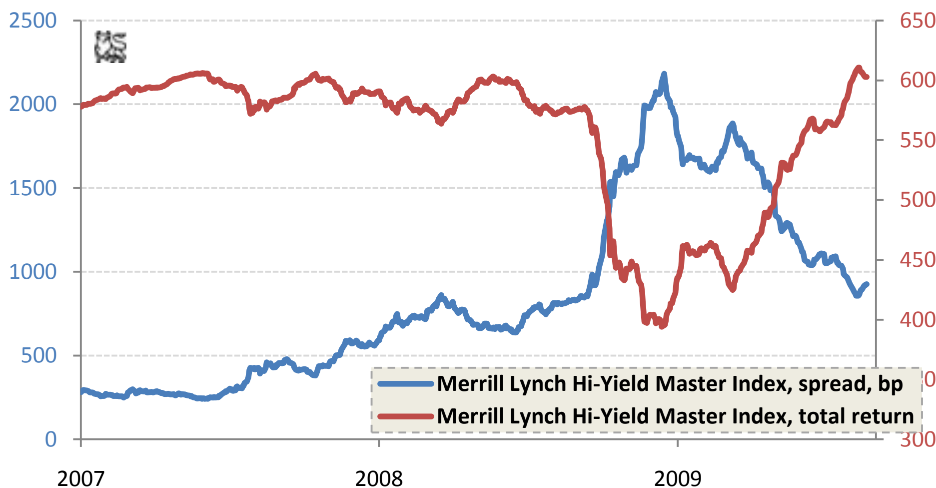
US RESOURCE STOCKS Our favorite sector, basic materials, has been the second best performing in the S&P 500 since the bottom, up 63%. We continue to favor the sector long-term as the best play on inflation in the equity market, and as the beneficiary of additional pricing power arising from commodity production bottlenecks as global demand recovers. But at the moment, it is the second least undervalued sector in the S&P 500, exceeded in that distinction only by (you guessed it) financials. The sector is in need of some correction and consolidation, which should be aggressively bought.

GOLD, OIL, COMMODITIES The combination of speculative purging, deflation expectations, fear of global contraction and recoil from risk-taking pushed gold, oil and commodities in general to panic lows, and it's no surprise to see them all have sharp reversals. But it's useful to observe the specific cycle dynamics of each, revealing the respective roles of inflation and growth expectations. The CRB Spot Index sets the baseline, showing a strong percentage gain off a larger percentage drop, leaving this indicator of basic industrial commodities (excluding gold and oil) off 22% from cycle highs -- all roughly symbolizing the state of global growth. Oil's spectacular 139% gain from its January lows doesn't correlate with any known

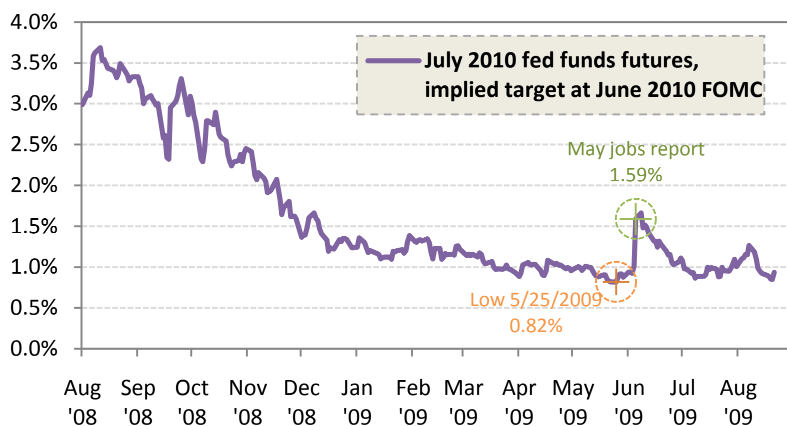


specific demand phenomenon, and can be explained simply by the extremity of its 79% fall from last year's highs -- and it still leaves oil off 50% from those highs. Gold tells a unique story. Having fallen less than commodities overall, it has since rallied more -- and now stands just 6% off all-time highs. We believe the gold price is driven almost entirely by inflation expectations, so this symbolizes the recovery from the intense transient deflation of late last year, and the lingering risk of a sharp inflation ahead. Given the Fed's extreme monetary stimulus, we continue to marvel that the gold price isn't at new all-time highs as we speak. We believe this reflects the residual risk that the Fed may make a deflationary error here before it makes, ultimately, an inflationary one -- a risk sharpened by the fact that the Fed has stopped explicitly talking about deflation risk in public statements (see "Can Inflation Plays Do Without Deflation?" June 25, 2009). We discuss the inflation outlook further in the section below on the fed funds rate, but the headline is that we expect the Fed ultimately to err on the side of inflation, which will boost all commodity prices and propel gold to new all-time highs.

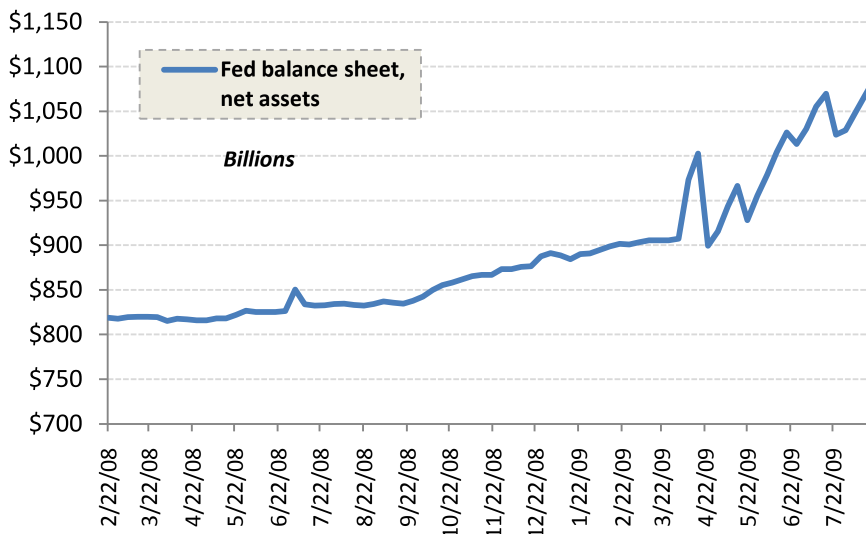
US BONDS Ultimately, as safe-haven demand evaporates while the federal government's large and growing funding needs continue -- and as inflation expectations sharpen -- we expect a significant rise in long-term Treasury yields. That said, the worst case has been ameliorated with the Fed's discontinuation of its program to buy long-term Treasuries (see "On the August FOMC" August 12, 2009), thus backing out of an outright debt monetization scheme that the FOMC now unanimously regards as having been a mistake from the beginning (see "The Fed's Bond Boo-Boo" July 24, 2009). This takes off the table the risk of a "reflexive" spiral of defending bond yields against speculative attack, inevitably ending in a blow-out like the Bank of England's abandonment of the sterling peg in 1992 (see "No, Mr. Bond, I Expect You to Die" May 22, 2009). For bond bears, that takes the fat tail out of the upside out, but at the same time it eliminates the risk of a sudden Fed intervention that would, at least for a brief while, catastrophically punish short-side speculators. Our major concern for short positions in long term Treasuries is simply that, for the near horizon over which we expect only sluggish growth, yields here are not entirely irrational -- they could be sustained for quite a while yet, before the inevitable break, and in the meantime the steep yield curve makes shorting very expensive.



HIGH YIELD BONDS Considering that we've come through a credit crisis that began with risk premia at historic lows, it's a surprising fact that high-yield bonds have recovered back to pre-crisis levels. In fact, the Merrill Lynch High Yield Master Index made all-time highs two weeks ago, on a total return basis. We called the top in the high yield spread (see "It's a Recession -- Not the End of the World" November 21, 2008), when it was at levels indicative of depression, and it has now narrowed to levels indicative instead of recession. Believing that the recession has bottomed, we still see some opportunity in high yield debt, but clearly the easy money has already been made (okay, that wasn't really easy, was it?).



FED FUNDS We continue to expect that inflation will rise considerably in the wake of the Fed's aggressive monetary stimulus that did so much to rescue the economy from the brink of depression. We think the fed funds rate is on hold near zero indefinitely -- even with so many signs of recovery, the futures markets have the funds rate a year forward only a dozen basis points higher today than they forecasted at the trough three months ago. And the Fed's balance sheet continues to grow, with the level of net unfunded assets now at all-time highs, even as many of its emergency credit facilities are beginning to run off.



The Fed has the tools to withdraw that stimulus as the economy recovers, but is unlikely to have either the skill or the political will to use those tools. And it's a dangerous balancing act, because at the moment the threat of deflation -- which was so severe late last year that it briefly rivaled the deflation of the Great Depression -- cannot be said to have been entirely dispelled. Intermittent bouts of intensifying risk aversion such as we saw in late June (see "A Deflationary Correction" July 9, 2009) and again as recently as early this week -- in which we see falling stocks, falling bond yields, falling commodities prices, rising dollar, and widening credit spreads -- remind us that the deflationary demand for money has not dissipated with the first signs of economic recovery. Ben Bernanke's top policy priority is avoiding deflation, so we fully expect he will err on the side of inflation when the time comes to resolve the balancing act. It is too much to expect that, after a world-historical credit crisis, the Fed could emerge with price stability intact. For us, the only real question about inflation is: *when*?

US DOLLAR We understand the well-known case for why the dollar ought to fall, based on America's large and growing federal debt, and pending entitlements crisis. But remember, the dollar exchange rate versus any other particular currency is a joint function of the fundamentals on *both* sides of the trade. The recession we are emerging from is a global one, and all nations have had to spend and monetize their way out of it. The entitlements crisis is global too, with graying populations in the developed nations and the larger developing ones, too. So while the dollar has come off its highs associated with safe haven demand from the worst of the credit panic last year, we don't necessarily expect it to collapse back to pre-crisis lows.

BOTTOM LINE: The recession ended in May, but recovery will be slow and uneven. Stocks don't want to go down, but after an historic run, it's not worth playing for the upside at this point. The banking crisis is officially over, but now the game is picking the least rotten apples in the financial sector barrel. The basic materials sector is the best play on coming inflation and commodity bottlenecks, but in need of correction or consolidation, which should be aggressively bought. Gold, oil and commodities are hanging on the outcome of the Fed's dangerous balancing act between the lingering threat of deflation and the future threat of inflation. Long-term Treasuries are a great long-term bear bet, as risk aversion subsides and inflation risk comes to the fore, and now the risk of Fed intervention is gone. Short-term, still a parking place in a slow recovery. The easy money is gone in high yield bonds, with Depression-level spreads narrowed to merely recessionary levels. But still a good play in an environment of gradual recovery. The fed funds rate is on hold indefinitely, with the Fed balance sheet continuing to swell. With all the world's central banks roughly equally easy, there's no particular threat to the dollar even as inflation risks rise.

Recommended reading
"How Will Unemployment Fare Following the Recession?" Edward S. Knotek II and Stephen Terry *Economic Review*, Federal Reserve Bank of Kansas City, Third Quarter 2009
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