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

MARKET CALLS

Monster Rally

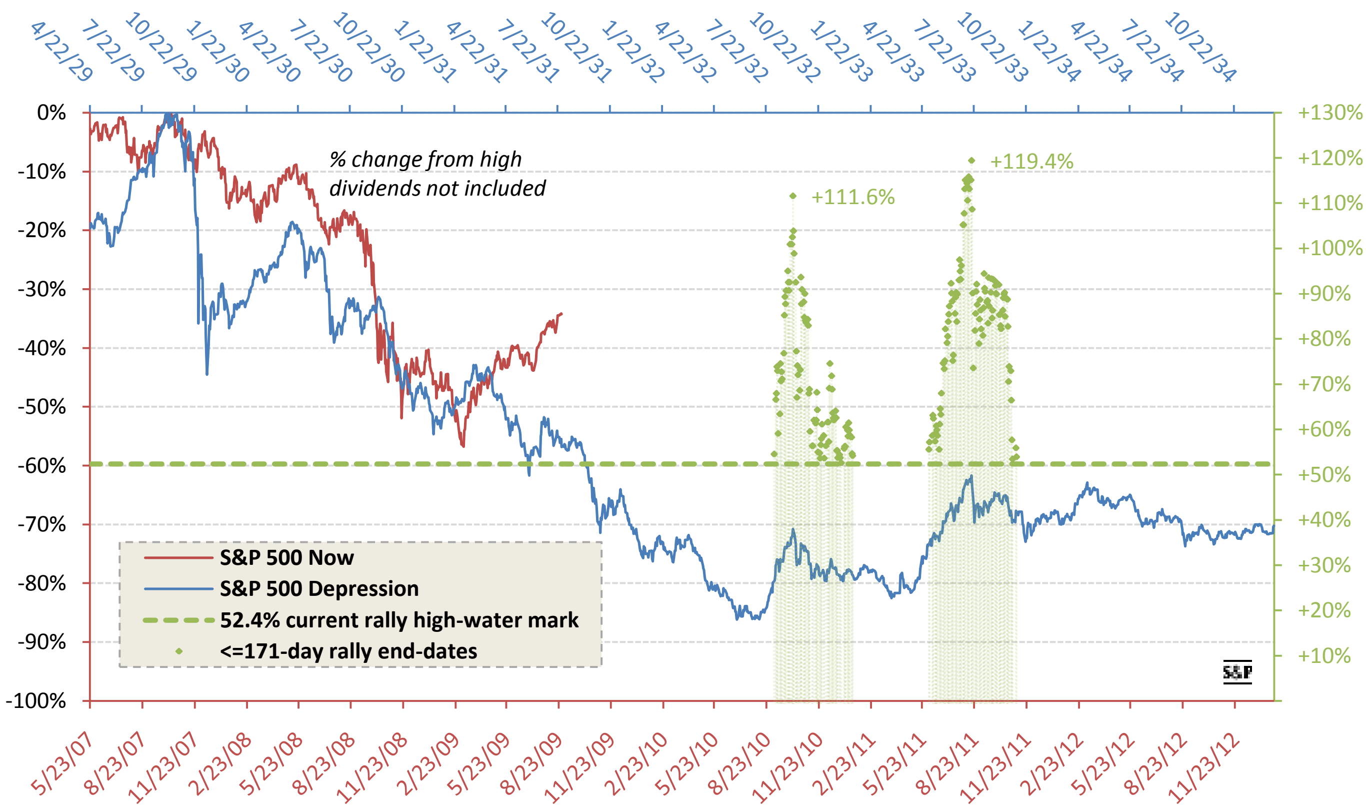
Monday, August 31, 2009

Donald Luskin

Stocks will have to obey Stein's Law: "If something cannot go on forever, it will stop."

Update to strategic view
US STOCKS: Clearly, stocks don't want to go down. But the event-flow that triggered a profound turnaround in expectations in March is unlikely to produce enough future surprises to sustain more fireworks on the upside. We continue to look for consolidation and correction.
[see Investment Strategy Dashboard]

The more stocks rally, the more we detect it becoming something of a consensus among our clients that they are going to rally *much* further. Ultimately we're skeptical -- but we're sympathetic, too. We called the bottom to the day (see "Quantum of No Solace" March 10, 2009), and ever since then we've acknowledged over and over the obvious fact that stocks just don't feel like they want to go



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

down. You know the drill: on the few days when stocks don't open higher and stay higher, they open lower and then miraculously recover by the close. And no wonder, really, in light of the miraculous recovery in the strategic backdrop that has occurred since the bottom in March -- the technical end of the recession (see "Stress Test for T-Bonds" May 8, 2009, and "The Case for Ambivalence" June 12), the Fed's definitive blow against monetary deflation (see "Ben Boldly Goes" March 19, 2009), the effective intervention to halt the global banking crisis (see "The Stress Tests' Hidden Mickey" May 4, 2009), the arrest of the Obama administration's runaway train of anti-growth policy initiatives (see "Wolf in the Fold" May 18, 2009), and the first really good earnings season in two years (see "Surprise, Surprise" July 23, 2009).

But at some point enough is enough. Every bit of that good news represented a fundamental upside surprise -- a profound reversal of prevailing expectations. But now it's all out, and it seems highly improbable to us that the event-flow going forward can have anywhere near as much salience. Yes, we were too early when we first began looking for a correction -- we made that call on June 12, when stocks had rallied by 40.6% (again, see "The Case for Ambivalence"). At their high-water mark last week the rally had extended to 52.4%, so obviously we have left the last fifth of this monster rally on the table. But the higher stocks move, the less inclined we are to expect they could move higher still.

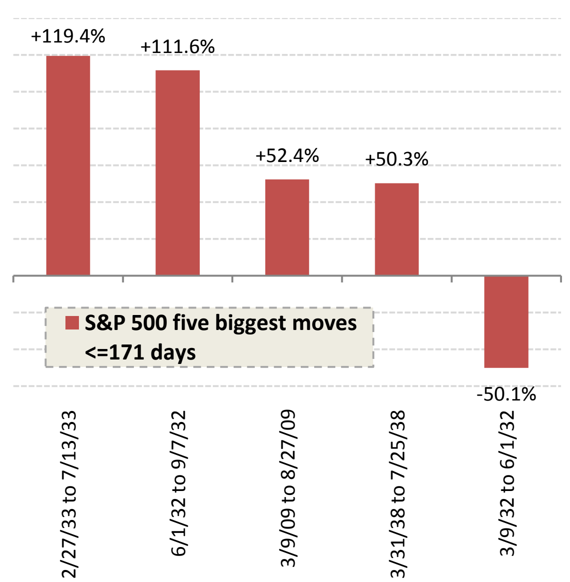
We hear over and over a sentiment argument that there is a "pain trade" driving stocks up, as investors left on the sidelines scramble to get in and not be left behind. That might be true (it is impossible to objectively validate or refute such conjectures). But even if it is, those who expect an uninterrupted continuation of this rally need to come to terms with how very nearly unprecedented it is in the combination of its speed and magnitude. Playing the percentages, it is always a dangerous thing to expect that the unprecedented can continue. As Herbert Stein's Law puts it, "if something cannot go on forever, it will stop."

The high-water mark for stocks last Thursday, a gain of 52.4% in 171 days, is the third largest move, up or down, ever made by the modern post-1928 stock market over that number of days, or less. The two greater moves were both on the upside, and both occurred off the bottom of the bear market of the Great Depression (see the chart on the previous page). Both those moves, at their respective high-water marks, greatly exceeded the present rally -- the first crested with stocks up 111.6% in September

And incidentally…

Conventional wisdom has it that the stock market is more volatile on the downside than on the upside. It's true that since 1928, the average down day (at -0.8%) is of greater absolute magnitude than the average up day (at +0.7%). And the single worst down day (October 19 1987, at -20.4%) was of greater absolute magnitude than the single best up day (October 30 1929, at +12.5%). Over time, stocks have shown a positive net return because there have been about 12% more up days than down days.

But… the most *intense intermediate-term runs* for stocks have been on the *upside*. The present rally, with a high-water mark last Thursday at +52.4% in 171 days has been exceeded twice before, and almost matched once before -- and all four rallies are of greater absolute magnitude than the worst downside run within the same number of days. That distinction goes to the final collapse in the Great Depression, a drop of 50.1% in just 84 days from March 9 1932 to the all-time bottom for stocks on June 1 1932.



1932, and the other up 119.4% in July 1933. So there's nothing in precedent that says stocks *can't* rally more than they just have. But those two times in the Depression are the *only* modern precedents. And they occurred against a backdrop of changing expectations far more profound that those in play now.

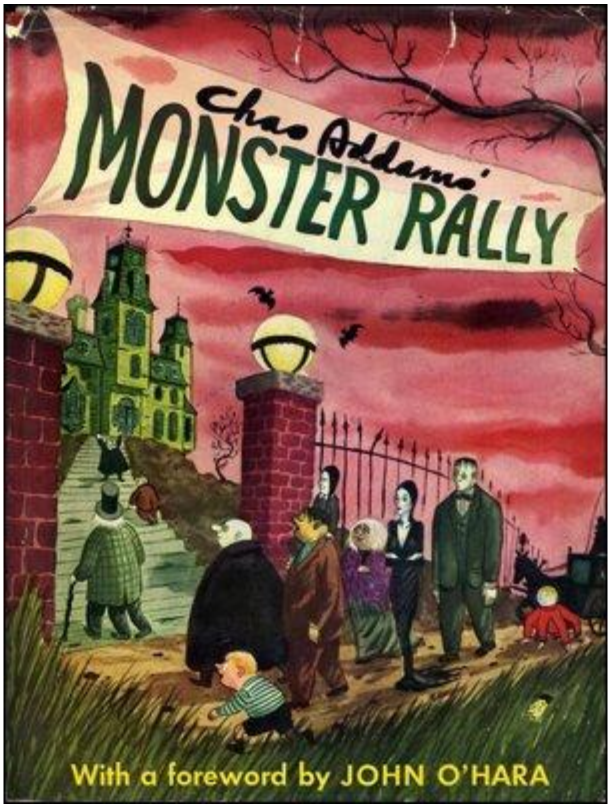
Today, after what the economy and the markets have just been through, it's hard to believe how vastly worse things were in 1932, before those two monster rallies:

- At the bottom in March 2009, stocks had lost 56.8% over 517 days. But on the day of the Depression bear market bottom on June 1, 1932, stocks had lost almost as much -- 50.1% -- over just the previous 84 days, the single most intense downside episode in modern stock market history (see the sidebar on the previous page). Cumulatively from the top in 1929, stocks at the bottom had lost 85.2%. That's such a huge decline that, even after the 111% 1932 rally *and* the 119% 1933 rally, stocks were still cumulatively off 62.3% from the 1929 top (still worse than the worst day of the recent bear market).

- The swing from peak valuation to trough valuation was much greater in the Depression than in the recent recession. Both the Depression bear market and the recent one ended with the forward price-earnings ratio of the S&P 500 at 10.3. But in the Depression, stocks had fallen from the lofty multiple of 28.2 at the bubbly 1929 top, while in the recent recession stocks fell from only a reasonable 15.2 at the 2007 top. Yet today, despite having fallen less, multiples have more fully recovered their peak than they did at the top of the 119% rally in 1933. At 14.7 today, stocks have made it back 96% of the way to their peak multiple -- in 1933, at the top of the second great rally, stocks had made it back to 25.6, 91% of their peak multiple. So how much more multiple expansion ought we to expect?

- Earnings fell from cycle peak to cycle trough an astonishing 73.3% in the Depression, the largest drop on record. In the recent recession, they fell 38.8%. From their cycle trough in the Depression, earnings did not recover to the level of their previous cycle peak for 15 years -- until December, 1947. Surely recovery will be more rapid in this cycle, but we disagree with the expectations for extremely rapid recovery we are hearing more and more frequently from clients. Today's forward multiple implies a year-over-year earnings growth rate of 26% -- though we're confident that we've seen the recession trough, it doesn't seem sensible to us to take for granted a growth rate greater than that. If for no other reason, bear in mind that since the top in 2007, the S&P 500 has lost 65 stocks -- 20 of them in the financial sector, a number of which have been virtually wiped out -- which, altogether, accounted for $72.3 billion in aggregate peak forward earnings. The 65 stocks that replaced them represent altogether $27.9 billion in peak forward earnings -- so a complete cyclical recovery will leave the S&P 500 more than $40 billion short. This looks even worse on a per-share basis, considering the massive dilution that has occurred in the banking sector.

- In the Depression, consumer prices showed year-over-year declines -- that is, monetary deflation -- for 45 months in a row, peaking at 10.7% in late 1932. From cycle peak to cycle trough, prices declined cumulatively 26.7%. In the recent recession, consumer prices have shown year-over-year declines for only eight months, at peak right now at 1.9%. From cycle peak to cycle trough, prices declined cumulatively only 2.7%. It is a great relief that the Fed has arrested the recent deflation. But that simply cannot compare to the electrifying transformation for the Depression economy that followed the cessation of its far deeper deflation and the prospect of reflation after the Emergency Banking Relief Act of March 1933.



We don't want to be mistaken as advocating the "bungee-cord theory" of the stock market, but it is the case that we should rationally expect a move in stocks to be proportionate to the size of a given transformation in the state of the world. We were concerned earlier this year that, if certain trends in place were to have stayed in place, there was the *possibility* that our recession might have become a new depression (see "Obama: '…today does mark the beginning of the end.'" February 20, 2009). But at the same time, we've consistently urged a realistic real-time appraisal of this economy as no more than a recession (see, among many, "It's a Recession -- Not the End of the World" November 21, 2008). It is in that spirit that we regard the monster rally in stocks from the March bottom. We're recovering from a recession. Why expect stocks to act as though we were recovering from a depression?

BOTTOM LINE: Clearly, stocks don't want to go down. But the event-flow that triggered a profound turnaround in expectations in March is unlikely to produce enough future surprises to sustain more fireworks on the upside. We continue to look for consolidation and correction.