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Triple Play? No Way!

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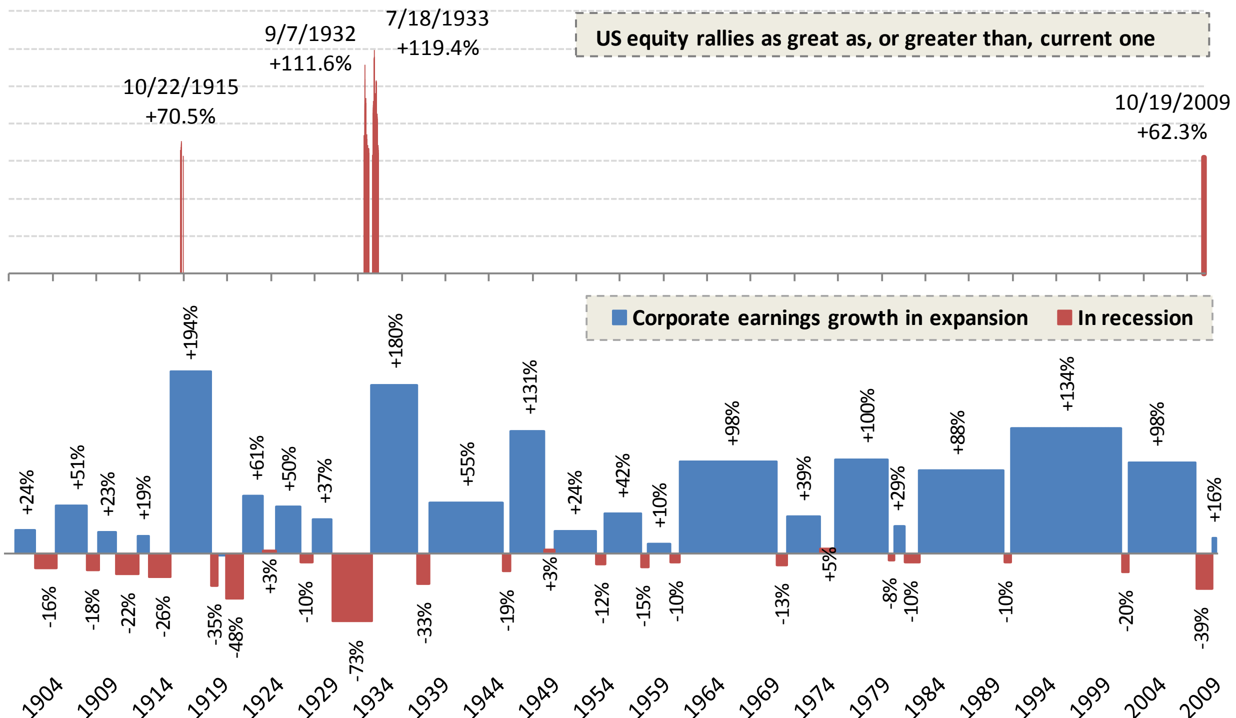
Stocks see an impossible earnings triple -- but gold sees inevitable inflation.

Update to strategic view
US STOCKS, GOLD: Gold has pulled ahead of stocks in the correction of the last two weeks, and we think its relative strength will continue. Inflation we can be certain of -- but its power to reflate corporate earnings can't possibly live up to the enormous expectations impounded in stock prices.
[see Investment Strategy Dashboard]

Is a stock market correction finally upon us? If so, it's about time (see "Monster Rally" August 31, 2009). Stocks were up 62.2% from the March bottom in just 224 days, at the high-water mark on October 19. There have only been three rallies in history more powerful than that -- all at the onset of business cycle expansions during which *corporate earnings nearly tripled* (see the chart below). Does anyone



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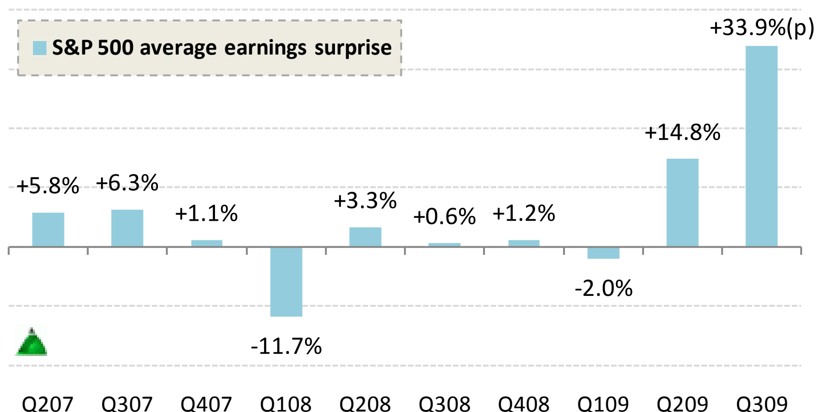

seriously expect an earnings triple in this new expansion that is only questionably getting itself started, even with massive government stimulus (see "On Q3 GDP" October 29, 2009)? That would take earnings to twice the previous high in October 2007. Yes, this earnings season has been the best in years, with the average S&P 500 company beating by 33.9% (see the chart above). But it hasn't been *that* great. And the much-touted renaissance in top-line growth hasn't materialized at all -- no beat there.

Be that as it may, forward earnings are now up 16% from their cycle low. What in April were just green shoots are now green saplings, to be sure. But a triple? 184% to go, for that. And where forwards are now *already* implies an heroic 51% growth rate over actuals. It's not like we're in 1932 and 1933, when stocks had two back-to-back rallies bigger than the present one. We're not coming out of a Great Depression in which stocks had fallen 86% and earnings had fallen 73% -- a low base off which an earnings triple wasn't actually that hard (even with that triple, *it took until 1947* for earnings to get back to their 1929 peak). And it's not like 1915, when stocks had a rally very much like the present one in magnitude and duration. Then earnings were driven by a war boom when, before the US took sides in the Great War, it acted as the granary and the armory for all combatants.

And if stocks can't rally much further for now on earnings, they're probably not going to do it based on multiples. At the high-water mark on October 19, the S&P 500 forward multiple had already come all the way back to 15.2, *precisely* where it was at the bull market peak in October 2007. The point is: *how much better can it get, without at least the passage of time?* And for stocks, the passage of time is a correction. We called the March bottom to the day (see "Quantum of No Solace" March 10, 2009), and we saw the beginning of the second leg up in early July (see "Health Care Deform" July 16, 2009) -- and as we've said all along, even as we expected a big correction that so far hasn't really come, stocks just don't feel like they want to go down. They still don't, to us. But neither do they feel so much like they want to go up anymore. Even if we don't get the scary downside test we expect and think we deserve, at least some form of extensive consolidation is inevitable.

Recommended reading
Paulson's Gift Pietro Veronesi and Luigi Zingales, October, 2009 The Constitutionalization of Money James M. Buchanan May 12, 2009
[Recommended Reading home]

Gold, on the other hand, feels like it wants to go up -- and we may well be embarking on a period in which gold consistently outperforms stocks. Stocks overtook gold as the second leg of the rally started in July, but in the correction of the last two weeks, gold has retaken the front position. With gold as a symbol of inflation -- the present value of the future consumer price level -- and stocks as the symbol of growth -- the present value of future earnings -- the renewed dominance of gold might be the symbol of our reaching the limits of how much monetary stimulus can promote growth.

To see this most clearly, consider the S&P 500 priced not in dollars, but in ounces of gold (that is, the number of ounces of gold one unit of the S&P 500 will buy -- with the S&P at 1042 and

gold at $1058, it will buy a little less than one ounce). In this time of deliberate reflation when both stocks and gold are rising, *growth* in the S&P priced in gold can be at least casually thought of as a monetary stimulus "multiplier," akin to the spending "multiplier" Keynesian economists look for in government spending programs -- in other words, the improvement in expected growth above and beyond the increase in expected inflation. The good news is that since the March bottom, through yesterday, the monetary stimulus multiplier is on net positive. Stocks priced in gold have rallied 34%. The difference between that and the 54% nominal gain in stocks over the same period is pure inflation. And that's the bad news: the multiplier is positive, but it's less than one. A unit of inflation has bought less than a unit of growth.

Seen from the longer-term perspective (see the chart at left), the multiplier is very negative and, unfortunately, greater than one. Since the top in October 2007, stocks have lost 53.6% priced in gold, compared to 33.4% in nominal terms. This means not only that *the real value of expected growth is today less than half what it was two years ago*. It is also a reminder that first and foremost, inflation got us into this mess -- years of excessive and oscillating Fed policy that gave rise to a various bubbles, the bursting of which triggered a synchronized global near-depression (see "The Maestro's Golden Years" September 11, 2009). Yet now we're counting on inflation to get us out of it, as well as relying on it to be a universal antidote to anti-growth developments in other policy domains -- such as financial re-regulation (see "Promise Keepers" October 27, 2009). The performance of stocks since the March bottom shows that monetary stimulus can surely drive a recovery from catastrophic deflation, and that's enough to produce some growth -- at least growth against the low base of fire-sale levels marked when deflation fears were at their worst. But if the 1970s taught us anything, it's that you can't inflate your way to greatness -- certainly not the earnings triple that stocks seem to expect. We think stocks will continue to lose ground priced in gold as we learn that difficult lesson all over again.

BOTTOM LINE: Gold has pulled ahead of stocks in the correction of the last two weeks, and we think its relative strength will continue. Inflation we can be certain of -- but its power to reflate corporate earnings can't possibly live up to the enormous expectations impounded in stock prices.