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INTELLECTUAL AMMUNITION

TrendMacro's Best Long Term Charts

Thursday, November 12, 2009

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Deep historical context on today's unique market and economic conditions.

A client recently asked us to show him our favorite long-term charts -- and this is what we came up with.

Going back in some cases over 100 years, we can better put today's market and today's economy in context. We see that in some ways today is nearly unique -- for example, we are experiencing one of the very best equity rallies in recorded history. In other ways, for all the turbulence of the last two years, nothing seems to have changed -- for example, the US consumer is showing no less propensity to consume.

Looking back a long ways we can see relationships that have come unstuck -- for example, between the fed funds rate and the dollar gold price. Other relationships have reverted to long-term norms -- for example, the equity risk premium has risen to the higher levels seen in most of the last century other than the heady 1980s and 1990s.

For each chart we offer a brief explanation of the methodology involved, followed by an investible conclusion linking the long-term perspective provided by the chart to our current strategic views.

Update to strategic view

GOLD: With the Fed targeting the unemployment rate, which will likely stay high for the foreseeable future, there is no constraint on how far the dollar gold price can rise.
US BONDS, FED FUNDS: Today's low long-term Treasury yields are not a believable market signal that there is no future inflation risk. They reflect the power of the "carry trade," driven by the Fed's credible commitment to keep short rates extremely low for an "extended period," a policy aimed at deliberate reflation.
US STOCKS: Stocks are appropriately celebrating the reliquefaction of the economy after a brush with deflationary depression. But the prospects for expansion don't begin to justify further equity gains without substantial correction and consolidation. We are several years into a new regime of higher average risk aversion than seen in the last 25 years, characterized by lower equity valuations relative to bond valuations.
US MACRO: As recovery struggles ahead, there is so far no evidence in the data that the US consumer has entered a new secular period of retrenchment. The US economy's ability to generate new jobs has diminished, even well before the onset of recession. Until unemployment can be reduced, recovery will be sub-par.

[see Investment Strategy Dashboard]

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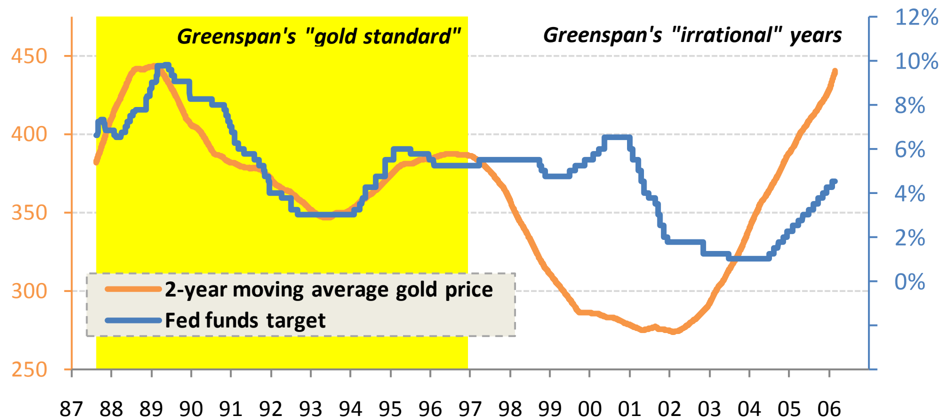
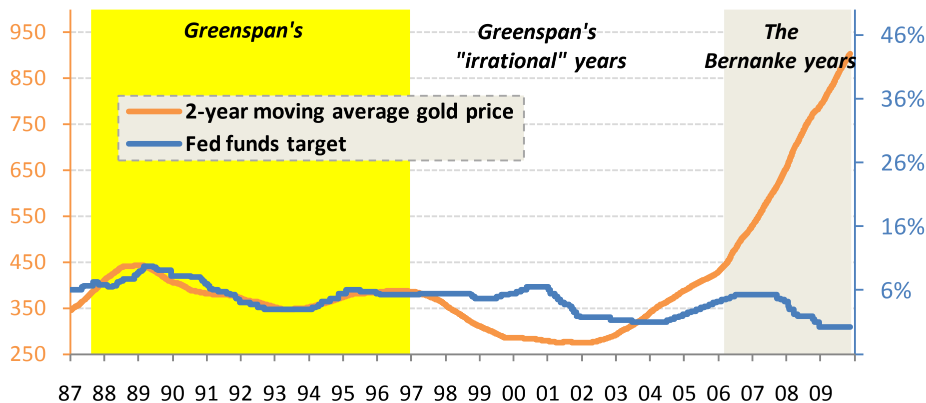
Alan Greenspan's "gold standard"

From his appointment as Fed chairman in August 1987 through the time of his "irrational exuberance" speech in December 1996, Alan Greenspan appears to have been following a monetary rule based on gold. During that period the fed funds target was adjusted to perfectly track the 2-year moving average gold price, which had the property of stabilizing inflation as well as the dollar price of gold. The rule was abandoned after the famous speech, and an era of global monetary turbulence followed.



To see how far we have come off Greenspan's rule today, the chart below extends to the present. To get back to Greenspan's original relationship, either gold would have to fall back to about $300, or the funds rate would have to rise to about 43%.

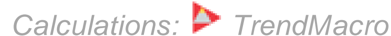


BOTTOM LINE: With the Fed targeting the unemployment rate, which will likely stay high for the foreseeable future, there is no constraint on how far the dollar gold price can rise.

Sources:

Gold price: Reuters

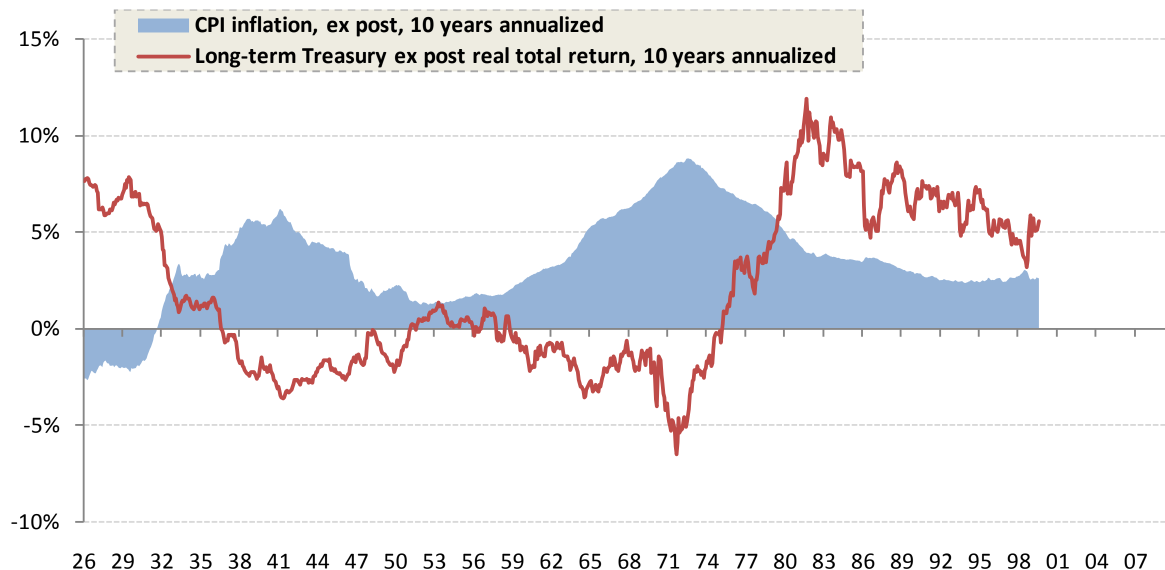
Fed funds rate: Federal Reserve



Calculations: TrendMacro

Bonds are a terrible inflation predictor

The Treasury market has consistently underestimated inflation, deflation, disinflation and reflation. The chart below compares ex-post CPI inflation with real total returns to long-term Treasuries, as though looking forward with perfect foresight from each point in time. The more critical it was that bonds got it right, the more they got it wrong. They totally missed the inflations of the late 1930s and the 1970s (resulting in persistent *negative* real returns), and the disinflation of the 1980s-1990s (resulting in persistent *excess* real returns).

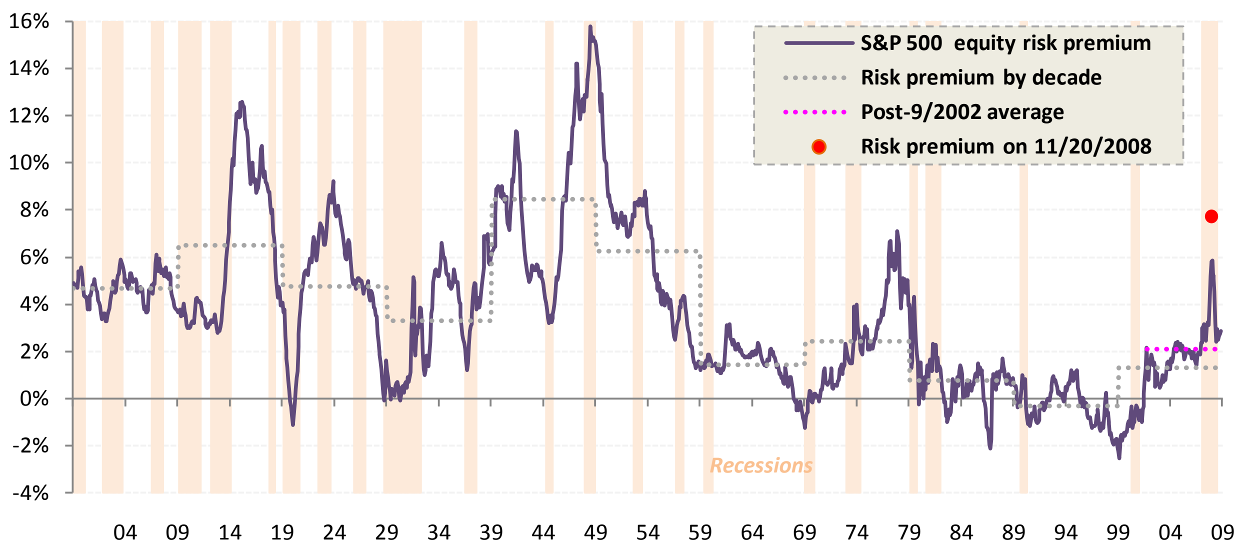


BOTTOM LINE: Today's low long-term Treasury yields are not a believable market signal that there is no future inflation risk. They reflect the power of the "carry trade," driven by the Fed's credible commitment to keep short rates extremely low for an "extended period," a policy aimed at deliberate reflation.

Sources:
Bond total return: Ibbotson "Stocks Bonds Bills and Inflation"
Inflation: Bureau of Labor Statistics
Calculations: TrendMacro

Regime changes in the long-term equity risk premium

The equity risk premium can be estimated by observing the difference between the forward earnings yield of the S&P 500 and the income yield of the 30-year Treasury. The ERP is mean-reverting locally, which means that successful tactical asset allocation strategies can be built around betting against extremes in either direction. But it is not mean-reverting globally, which is to say that the mean is not stationary. The chart below shows the monthly ERP since 1900, with decade-by-decade means. As these means shift, they reveal regime changes in risk aversion. The pink dotted line at the far right shows the mean since the fourth quarter of 2002, when it seems there was a lasting regime change toward higher risk aversion -- or, equivalently, when investors suddenly began to appraise a greater quantum of risk to be averse to. That was the quarter following the Worldcom scandal, and it contained the Joint Resolution on Iraq war powers, and the Fed's shift away from inflation-fighting to deflation-fighting.

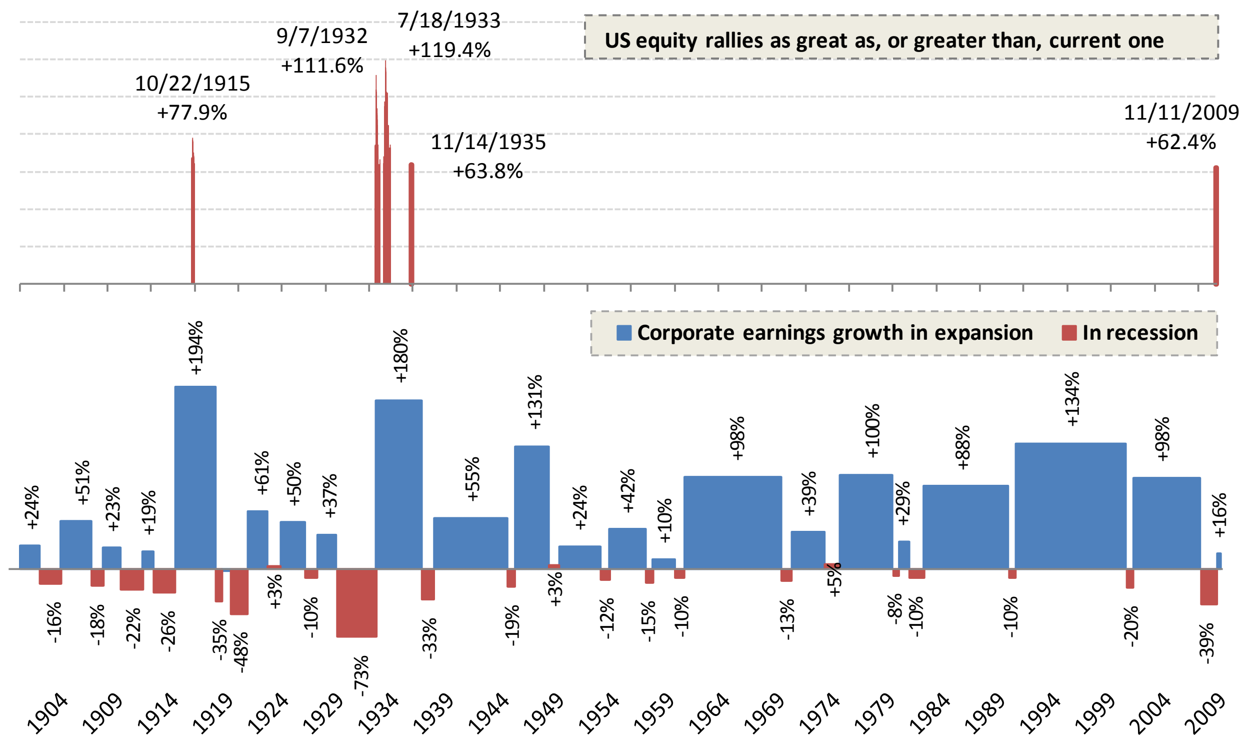


BOTTOM LINE: We are several years into a new regime of higher average risk aversion than seen in the last 25 years, characterized by lower equity valuations relative to bond valuations.

Sources:
Equity prices: Standard and Poor's
Earnings: Yale/Shiller, Standard and Poor's, Thompson, Zacks
Bond yields: Federal Reserve
Recessions: National Bureau of Economic Research
Calculations: TrendMacro

The biggest stock market rallies in history

Considering the combination of net gains and the time period in which they were achieved, the stock market rally from the March lows -- with a 62.4% gain in 247 days -- has been among the best in history. The only better rallies were in 1915, 1932, 1933, and 1935. In those cases, the rallies coincided with the onset of new business cycle expansions in which corporate earnings nearly tripled. In 1915, the US was emerging as the granary and the armory for the world, as all the other developed nations entered the Great War. In the early 1930s, the US experienced enormous percentage growth off the low base established in 1932 at the depth of the Great Depression. We can point to no similar conditions today that would set the stage for such tremendous earnings growth -- which causes us to conclude that the present rally is not sustainable without substantial correction or consolidation.

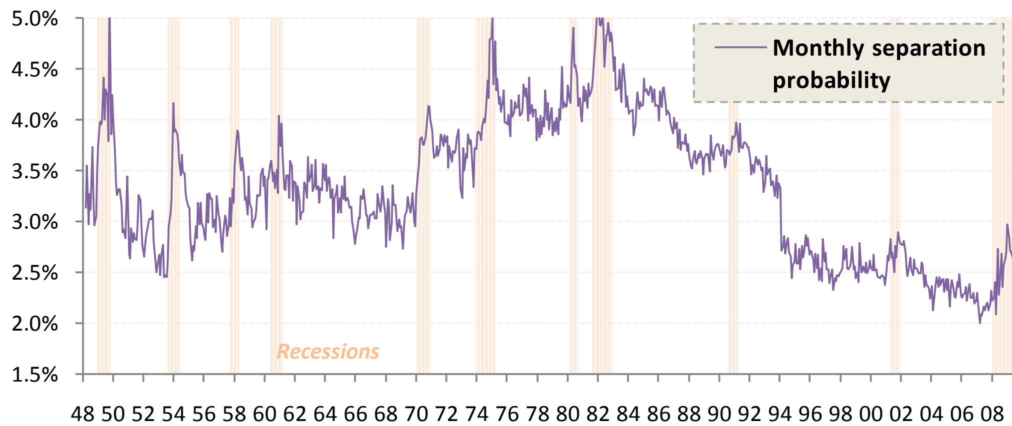


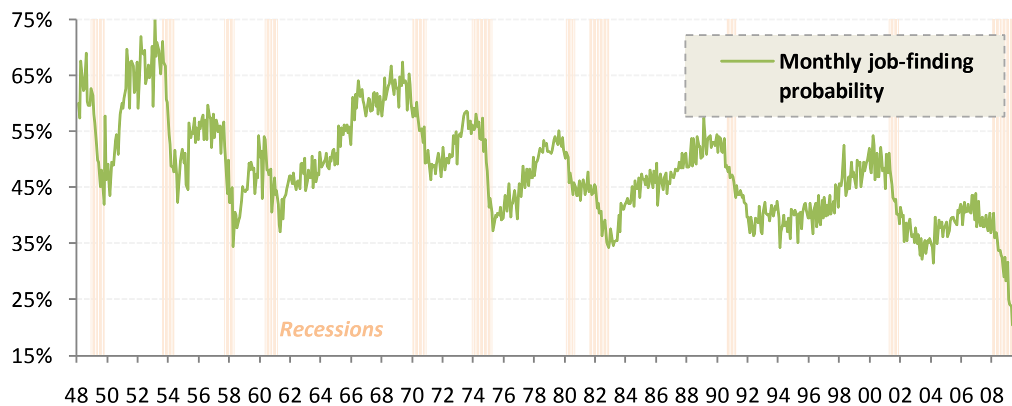
BOTTOM LINE: Stocks are appropriately celebrating the reliquefaction of the economy after a brush with deflationary depression. But the prospects for expansion don't begin to justify further equity gains without substantial correction and consolidation.

Sources:
Equity prices: Dow Jones, Standard and Poor's
Earnings: Yale/Shiller, Standard and Poor's, Thompson, Zacks
Recessions: National Bureau of Economic Research
Calculations: TrendMacro

Uniquely distressed labor market

Even before the recession, labor markets were exhibiting strange and disturbing behavior. While job losses were few, job creation was scare. So even though only a small number of workers became unemployed, those who did then found it impossible to become re-employed. The charts below show the probability that an employed worker will lose his job in any given month -- it has been the lowest in history, suggesting enormous job security. At the same time, the chart further below shows the probability that an unemployed person will get a job in a given month. That has fallen even faster. It is unknown why, even in the last expansion, the US economy seems to have become uniquely incapable of generating new jobs.



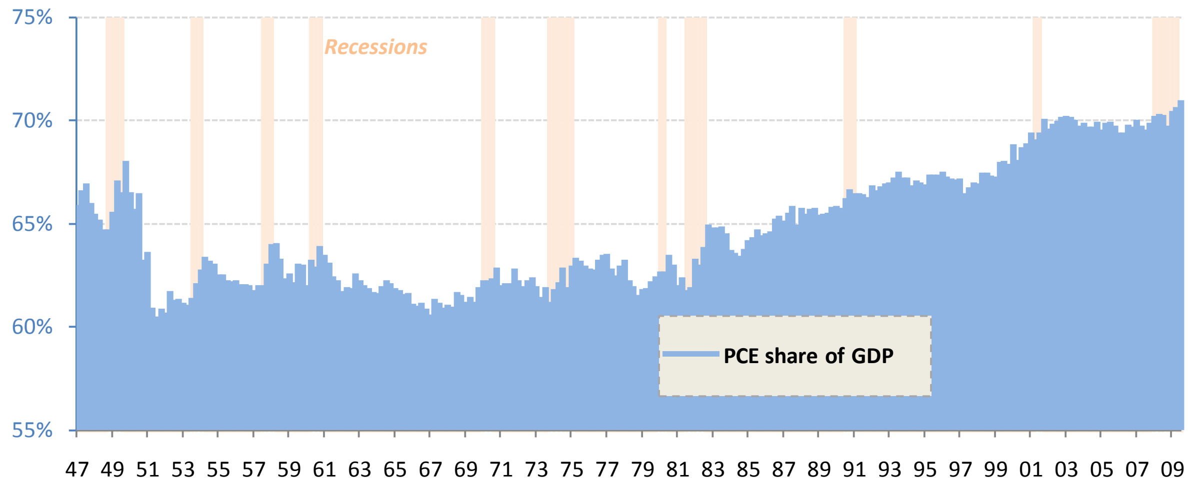


BOTTOM LINE: The US economy's ability to generate new jobs has diminished, even well before the onset of recession. Until unemployment can be reduced, recovery will be sub-par.

Sources:
Unemployment: Bureau of Labor Statistics
Recessions: National Bureau of Economic Research
Calculations: TrendMacro, after Shimer (2005)

No "new era" in personal consumption

The share of gross domestic product explained by personal consumption expenditures has been steadily growing. This has led many analysts to worry for much of the past decade that the US consumes too much, especially relative to the developing world. They have predicted a sharp correction of this "global imbalance," triggered by a recession that would teach the US consumer to spend less and save more -- commentators today call it the "new normal." But confounding their predictions, now that the worst recession since the Great Depression has hit, the consumption share of GDP has in fact risen to new all-time highs. It would appear that the US consumer has not reduced his propensity to consume his production whatsoever.



BOTTOM LINE: As recovery struggles ahead, there is so far no evidence in the data that the US consumer has entered a new secular period of retrenchment.

Sources:

Personal consumption expenditures, gross domestic product: Bureau of Economic Analysis

Recessions: National Bureau of Economic Research

Calculations: TrendMacro