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

MACROCOSM

No Game-Changer

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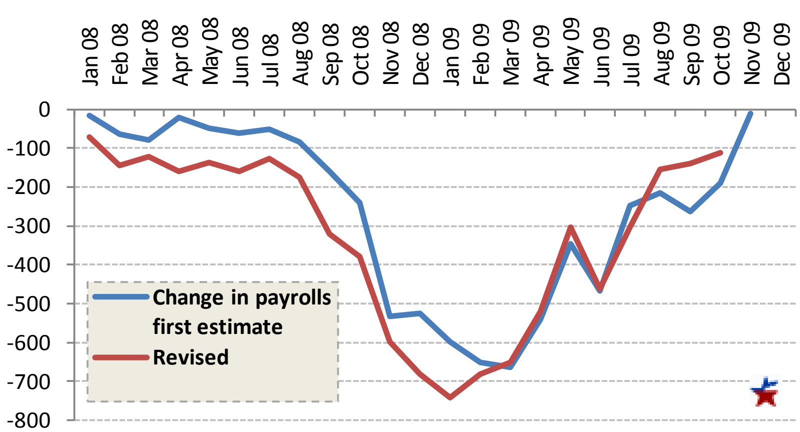
Donald Luskin

Markets and the Fed have quite correctly shrugged off last week's upside jobs surprise.

As we expected, Friday's upside surprise in jobs hasn't proven to be much of a game-changer (see "On the November Jobs Report" December 4, 2009). At least not for the Fed. Yesterday in separate speeches chair Ben Bernanke and New York Fed president William Dudley both reaffirmed the commitment to an "extended period" of extremely low interest rates. There's no mystery now about next week's FOMC meeting -- those critical two words will remain in the policy statement. As of this writing Tuesday mid-day, expectations reflected in futures markets for the fed funds rate one year ahead are back right where they were before the jobs news was announced.

Update to strategic view
FED FUNDS: Last week's upside surprise in jobs won't move the Fed off its commitment to an "extended period" of extremely low rates at next week's FOMC meeting. **STOCKS:** A strong November jobs report couldn't break over-extended stocks to new recovery highs. We still expect consolidation and correction. **GOLD, US RESOURCE STOCKS, US DOLLAR:** The strong November jobs report has buoyed the dollar, and induced a related sharp drop in gold. Nothing has changed in the prospect for continued excess liquidity, so we see these as speculative reactions in over-extended markets.
[see Investment Strategy Dashboard]

Stocks apparently don't see the game having changed, either. We said that there would be a "brief breakthrough" to new recovery highs (again, see "On the November Jobs Report"), and that's indeed what there was -- but there's been no new closing high above the high-water mark on November 25, and as of this writing stocks are lower than before the jobs news was announced. That's because the jobs data didn't really tell us much about the economy that we didn't already know. Yes, the net loss in payroll jobs was less than expected -- and there was an alluring statistical oddity that for the first time in the recession revisions have turned positive (see the chart at left). But



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

these should be game-changers only for extreme pessimists who haven't yet conceded that the recession is formally over. At the same time, the historic rally in stocks is already discounting a super-V recovery the likes of which haven't been seen since the war boom of 1915 and the turnaround from the Great Depression bottom in 1933. In both those expansions, corporate earnings almost tripled -- and we realistically *aren't* going to see that happen *now* (see "Triple Play? No Way!" November 3, 2009).

We've been saying since May that the recession is over (see "Green Overshoots" May 29, 2009). Friday's drop in the unemployment rate below 10% -- to 9.99%, actually -- means the second of the three essential recession-end variables has now fallen into place. The turnaround in industrial production was the first, in July. The only remaining one is the rate of change of payroll jobs. Assuming no revisions, if there is a net gain of 59,000 or more jobs *next* month -- or even net losses *two months out* -- then the end of recession is a virtual certainty, with the official NBER trough probably to be set at May or June. These variables make up the business cycle model of UCLA's Edward Leamer, which has near-perfectly determined the timing of every post-war recession and expansion. The point of belaboring these details is to give grounding to the idea that Friday's employment data significantly swings the probabilities away from the strong bear case. Yet at the same time, the bull case, even the mild one we've been making since July (see "The Square Root of Recovery" July 2, 2009) isn't quite fully locked in yet, but it seems inevitable.

The biggest effects from Friday's jobs data have been in the dollar and in gold. Both have been one-way momentum trades of late, driven in part by the most pessimistic macro expectations. We've seen one analysis estimating that the speculative gold holdings of Paulson and Co. are greater than the gold reserves of many nations -- at about 110 metric tonnes, they're about equivalent to the reserves of Australia and Brazil combined. So it's no surprise to see a sharp correction, especially on the heels of data that challenges the most pessimistic premises. But for us, it's never been about pessimism -- quite the contrary. We've seen the dollar's drop as mostly explained by global recovery, the result of the disgorgement of clearing balances hoarded at the height of the credit crisis in a headlong flight for liquidity -- and for what it's worth, we know Treasury secretary Tim Geithner sees it the same way (see "Geithner and the Dollar: That's Not My Job" October 15, 2009). Gold's rise, too, has been the product of recovery, as inflation expectations replace deflation expectations, and as it becomes clear that the Fed will stay extremely accommodative even as the economy begins to grow again (see, among many others, "Ben Boldly Goes" March 19, 2009).

As our long-standing "best idea" investment, we've been delighted to see gold become the only equity asset class to make new all-time highs -- but we have a special duty to be alert to game-changers, and disciplined about when enough is enough. We don't see any game-changers here. Admittedly, at its all-time high of $1226.10 last week, gold had already come close to the informal price target of $1300 that we set for it last summer, back when it was at about $940 (see "Can Inflation Plays Do Without Deflation?" June 25, 2009). We think that target is still likely to be met, and if and when it is, we'll re-evaluate if nothing has forced us to do so sooner. We would buy dips here, seeing gold as having far more potential than stocks (among stocks, we favor the basic materials sector). We think it speaks volumes that in this sharp correction off all-time highs, gold hasn't closed below the panic *lows* we saw in reaction to the Dubai World debt crisis (see "On the Dubai Debt Crisis" November 27, 2009) -- while stocks haven't been able to close above their pre-Dubai *high*.

BOTTOM LINE: Last week's upside surprise in jobs won't move the Fed off its commitment to an "extended period" of extremely low rates at next week's FOMC meeting. A strong November jobs report couldn't break over-extended stocks to new recovery highs. We still expect consolidation and correction. The strong November jobs report has buoyed the dollar, and induced a related sharp drop in gold. Nothing has changed in the prospect for continued excess liquidity, so we see these as speculative reactions in over-extended markets.