MACROCOSM

The Case for Ambivalence, Volume Two

Monday, December 14, 2009

Donald Luskin

We stick with our call for a sluggish recovery -- there's no evidence for anything else.

Update to strategic view
US STOCKS, US MACRO: The new wave of economic optimism is exaggerated, but even if accurate, the reality can't live up to the impossible growth expectations impounded in stock prices. We see limited upside, and still expect correction and consolidation.
[see Investment Strategy Dashboard]

With the Dubai World debt crisis resolved by Abu Dhabi's intervention this morning, we'll get a chance to see what kind of upside stocks are capable of at this point. We suspect not much. The S&P 500 hasn't been able to close above the recovery high established just before the Dubai matter emerged over the Thanksgiving holiday (see "On the Dubai Debt Crisis" November 27, 2009). But stocks had actually stalled out two weeks earlier, with the bellwether financial sector having topped out a month before that. Overall, stocks have now spent a month in a tight range of high-level consolidation. It hasn't been the sharp correction we've been looking for, but at least it's been a rest. That, and the removal of the Dubai cloud -- which threatened *both* another round of credit contagion *and* the specter of sovereign default -- could set stocks up for new recovery highs. But if it happens at all, we doubt it will be much of a move, and our base case for stocks remains one of correction and consolidation.

Remember, since the March bottom, stocks have mounted a rally the likes of which have been seen only twice before in the 123-year history of daily US stock prices -- and those times, it was at the onset of business cycle expansions in which corporate earnings nearly tripled (see "Triple Play? No Way!" November 3, 2009). Admittedly, we're seeing a marked shift in the consensus -- or at least the *average* of diverse opinions -- toward not only certainty that the US economy is out of recession, but also toward the expectation we are also now on the threshold of a significant growth phase. We certainly agree that the recession is over, as we've been saying since we saw the first "green shoots" in May (see "Green Overshoots" May 29, 2009). But we continue to believe that recovery will not be especially vigorous (see "The Case for Ambivalence" June 12, 2009) -- and certainly not vigorous enough to satisfy the expectations implied in an historic stock market rally that has yet to experience a significant correction.

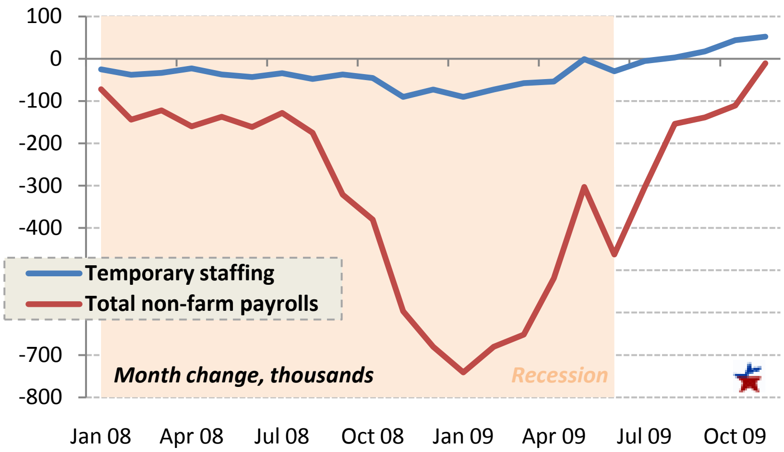
Being habitual optimists trapped in a world of pessimism, it's not a natural act for us to make the bear case. But that's not actually what we're doing -- we're opposing what we see as an

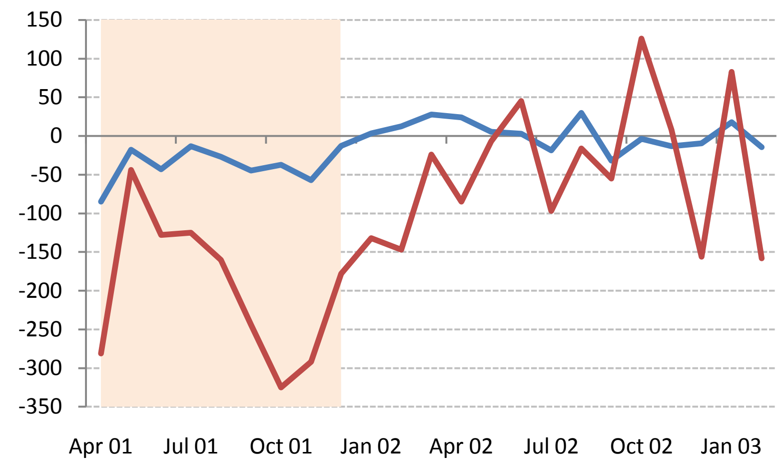
http://www.trendmacro.com
don@trendmacro.com
dgitlitz@trendmacro.com
tdemas@trendmacro.com

Offices:
Menlo Park CA
Parsippany NJ
Charlotte NC

Phone:
650 429 2112
973 335 5079
704 552 3625

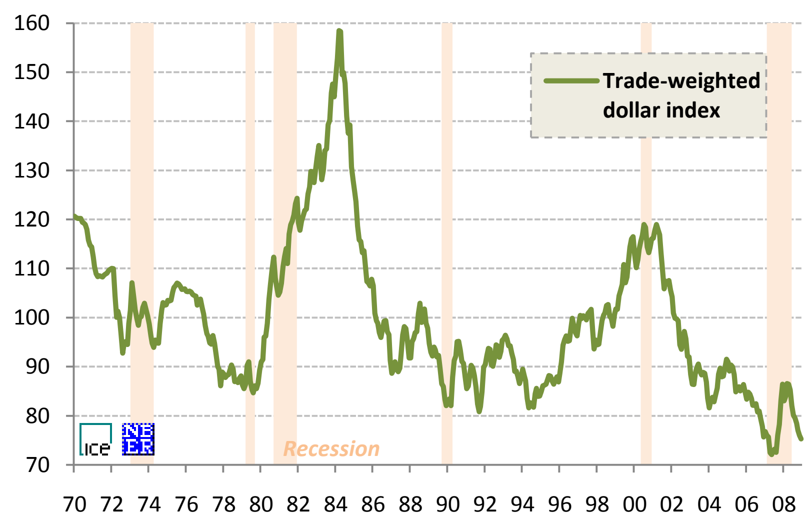
unrealistically strong-bull case, and making the case for caution and patience. So let us respond to some of the evidence recently cited by those who are shifting to the strong-bull case.



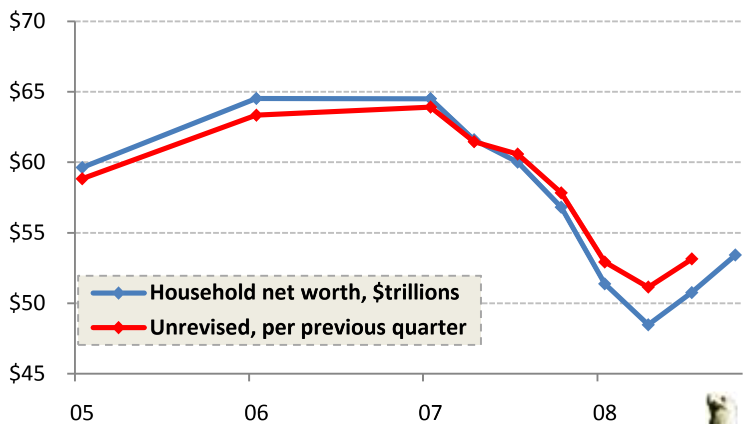


A number of economists have cited the recent surge in temporary employment -- four back-to-back months of positive growth, with 52,400 temp jobs added in November -- as a sign that strong payroll job growth will resume in the first quarter of 2010. We simply don't see the case for that based on historical experience. The data on temporary employment only goes back far enough to include three recessions, including the most recent one. In the 1990-91 recession, temporary employment hardly varied at all. In the 2001 recession, it gave a false signal about overall job growth. Then as now, temporary job growth went positive first, and closely coincided with the technical end of recession (see the charts at left). But then, after four back-to-back months of growth just as we've seen now, temp jobs fell into the negative again -- and then spent a year oscillating around the zero-growth line, just as overall payroll jobs ended up doing in that "jobless recovery."

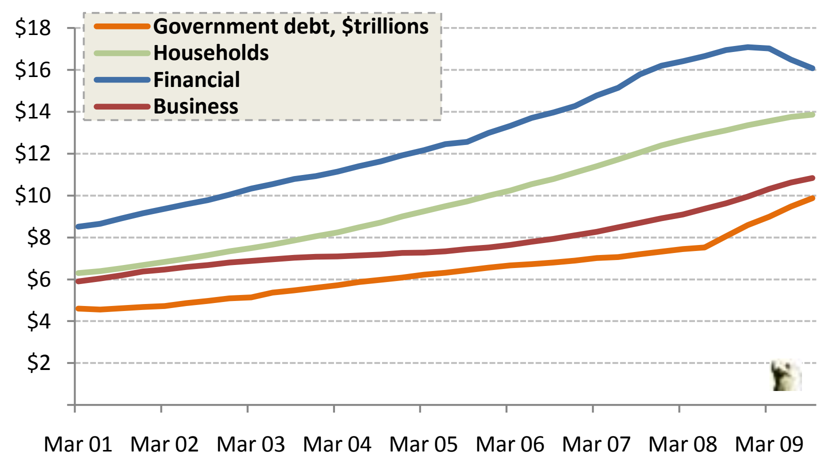
We don't see the recent rally in the US dollar on foreign exchange markets as a harbinger of accelerating economic strength. We think it has nothing to do with economic growth at all -- look at the chart at right, in which we defy you to discern a reliable connection between business cycles and the dollar. Rather, the dollar is an indicator of global economic uncertainty, a safe-haven play. The dollar made its cycle highs at the peak of economic anxiety this spring, topping on March 9, the very day the S&P 500 bottomed.

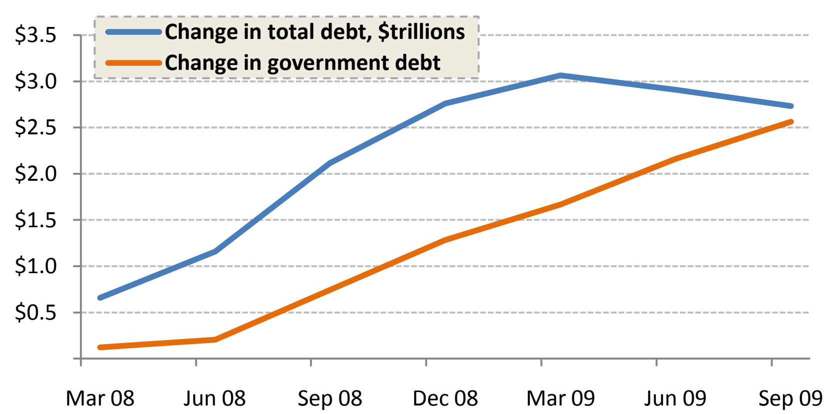


Conversely, the dollar's current rally launched from a low made on November 25, the very day of the recovery high in the S&P 500 -- and the day before global credit fears were set in motion by the Dubai debt crisis.

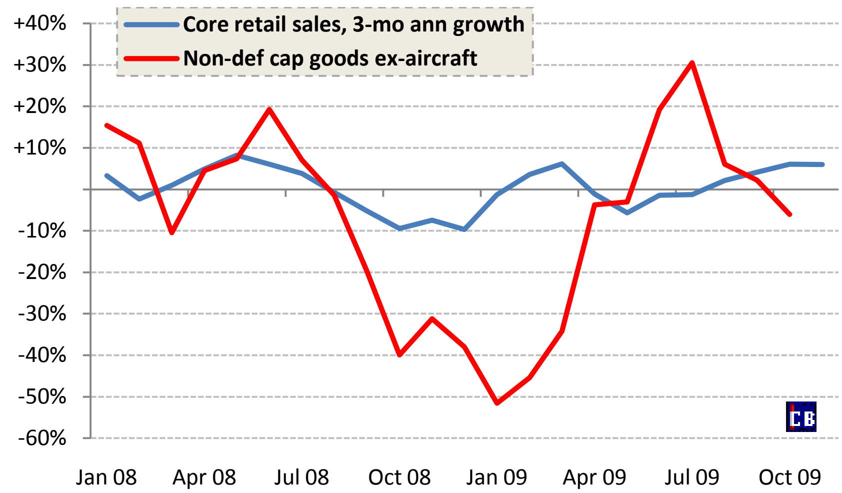


Much has been made of the strong Q3 09 improvement in the US household balance sheet reported last week in the Fed's quarterly [Flow of Funds data](). Assets grew by $2.6 trillion to $67.8 trillion, and liabilities fell by $12 billion to $14.0 trillion -- thus net worth grew by $2.7 trillion to $53.4 trillion. This is manifestly good, but it is hardly news. We didn't need a quarterly data-dump from the Fed to tell us, two and a half months after the fact, that asset markets appreciated strongly in Q3. What *is* news is the revisions to last quarter's report, which move lower Q2's household net worth by $2.4 trillion (almost all in housing) -- so Q3's uptick does little more than make up for Q2's downward revision (see the chart above). What's assumed to be good here is that rising net worth will trigger wealth effects that will support consumption and investment. It will do so if households have short memories, and focus mostly on the asset appreciation from the bottom in Q1. But if they have longer memories, and judge changes in wealth versus its level, say, two years ago, then those same wealth effects won't be so salutary.

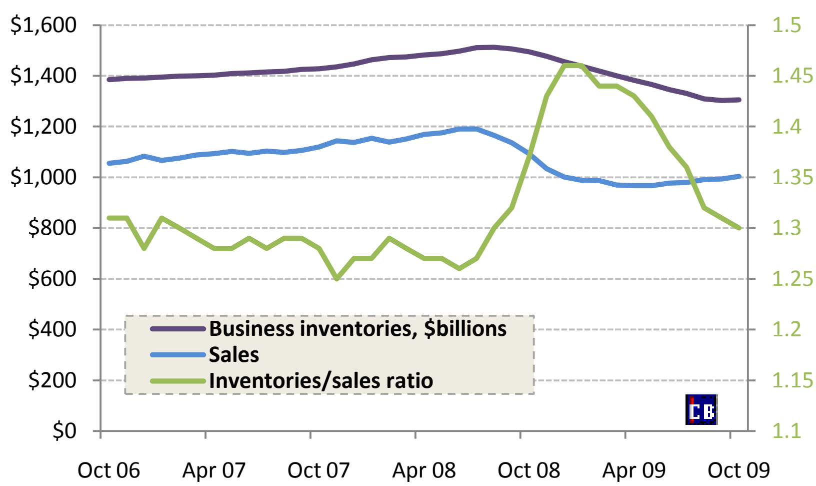




It should be noted that Q3's increase in household net worth came almost entirely from asset appreciation, and nearly not at all from debt reduction. Yes, that means the household balance sheet is stronger, but it offers no evidence of the "new normal" of deleveraging of supposedly over-indebted consumers that many economists forecasted even before the onset of recession (see ["On Q3 GDP"]() October 29, 2009). In fact, the Flow of Funds data reveals that nobody's been deleveraging except the financial sector, and it has managed only to reduce debt back to the $16 trillion level seen at the height of the previous expansion in Q4 07 (see the chart at right). *Total* debt is higher today than at recession onset by $2.7 trillion -- though it peaked, so far, at $3 trillion higher two quarters ago. We've never been especially debt-phobic, so the failure to reduce debt isn't in and of itself an issue for us -- but it ought to be an issue for strong-bulls who think a clean balance sheet means a platform for stronger growth. What concerns us is that almost the entire increase in debt since recession onset is explained by the explosion in government debt of $2.5 trillion, much of it on the Fed's balance sheet.



Getting the supposedly over-leveraged consumer spending again has never been the problem, anyway -- so don't take too much encouragement from the improvement in the household balance sheet, or from the string of strong retail sales numbers reported the last four months. As we've pointed out several times, this recession has been investment-driven, not consumer-driven -- the consumption share of GDP is now at all-time highs, and the fixed investment share is now at all-time lows (see ["Still Waiting for that 'New Era'"]() July 31, 2009). Note that while retail sales have steadily improved over the last four months, capital goods orders have weakened.



Finally, let's look at the implications of business inventories reported as having grown in October for the first time in 13 months. If this could be sustained through Q4, it would have a strong positive impact on GDP growth, perhaps as much as 3% -- even if this quarter's build were fairly small, simply because it would follow last quarter's strongly *negative* inventory growth. But that would say little about sustainable expansion, because a bounceback from depleted inventories is, by its very nature, not repeatable.

What's the outlook for even more inventory growth, then? The inventories/sales ratio certainly doesn't indicate the need for any further liquidation, but it's not an especially tight ratio either, so it doesn't indicate the need for further build (see the chart above). That would likely come only with an increase in sales, demanding a commensurate increase in inventories to maintain the present ratio. And therein lies the key concept in thinking about inventories: they don't drive growth, but rather they are driven by growth. So don't be fooled if we get an inventory-driven pop in Q4 GDP without a commensurate pop in final demand. Remember, we saw the same kind of head-fake in an illusorily strong Q1 2002, the first quarter after the 2001 recession, and what turned out to be the onset of a long period of sluggish and jobless growth before real expansion finally got underway more than a year later (see "A Green Eyeshade Recovery" January 9, 2002).

BOTTOM LINE: The new wave of economic optimism is exaggerated, but even if accurate, the reality can't live up to the impossible growth expectations impounded in stock prices. We see limited upside, and still expect correction and consolidation.