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The Case for Ambivalence, Volume Three

Thursday, March 4, 2010

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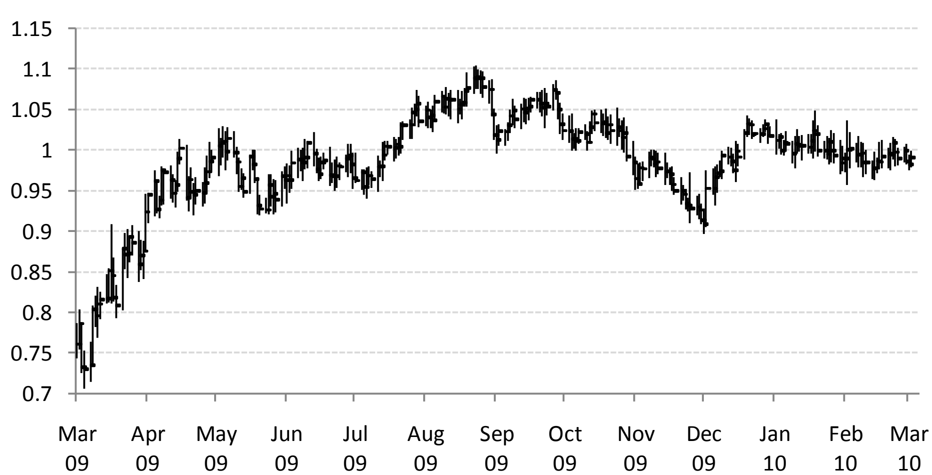
Data continues to confirm that we're only in a recovery, not a real expansion.

With the sovereign debt crisis in Europe somewhat pacified for the moment, and with the anti-business lynch mob in Washington crowded out of the news cycle by the health care end-game, the correction in global risk-assets that began mid-January has turned into a mere consolidation. We continue to feel that it's in the nature of the beast for the record move from the March 2009 lows to get more of a correction. But corrections can be carried out in two substitutable dimensions -- price and time -- and what isn't corrected in price can eventually be corrected by the passage of time. We're experiencing the latter, it seems. While US stocks made recovery highs on January 19 after an historic 70% rally in just 316 days, today we're really no higher than we were last mid-November.

The stock market's resistance to a serious price correction speaks well of the prospects for continued economic growth. But there is another view that troubles us, and contributes to keeping us sticking with the expectation that recovery will be slow and grudging -- *stocks priced in gold*, rather than dollars (please see the chart below). The number of ounces of gold that can be bought with a unit of the S&P 500 is a proxy for the *real* value of the

S&P 500 priced in ounces of gold



Source: Reuters, TrendMacro calculation

Update to strategic view

US MACRO: With GDP growth dominated by inventories, weak income growth supported by transfer payments, and continuing bank credit contraction, we still look for only continued recovery in 2010, not robust expansion.

US STOCKS: Instead of a severe correction, stocks are sweating out a broad consolidation, giving expected earnings time to catch up to price. But until overall growth kicks into higher gear, we don't expect significant further gains from stocks, and would not be surprised short-term by further consolidation.

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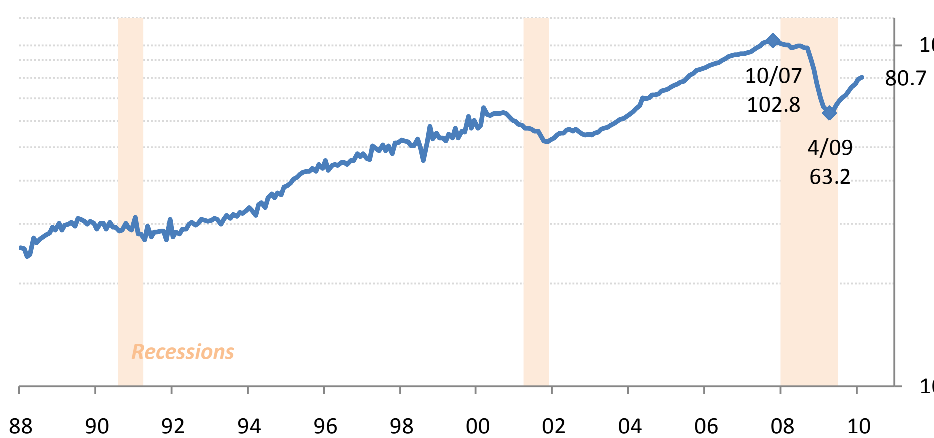
stock market, and as such, can be a rough indicator of the extent to which stocks are signaling sustainable growth as opposed to just inflation-inducing government stimulus. It has been declining since last August, after a 56.4% run from the March 2009 panic bottom. From there, it corrected 23.2% -- the kind of serious price correction we haven't seen in stocks denominated in dollars. As of this writing, it stands 10.4% below the August highs. It's no higher today than it was in April, 2009.

Stocks priced in gold would seem to be saying that a depression was averted and that the recession is over -- but so far, what follows is mere recovery rather than robust expansion. That sounds about right to us. We remain highly confident that the recession is indeed over. Its causes -- a global banking crisis, severe monetary deflation, and a US political crisis -- have been remediated. But even setting aside the damage sustained in the crisis itself, the side effects of the remediation -- measured both in residual debt and risks concerning the timing and nature of the unwind of various forms of stimulus -- are lingering and costly.

We think this view is borne out in the data. The first green shoots we observed in real time last April -- the fall in initial jobless claims and the turnaround in consensus S&P 500 forward earnings, the two most reliable recession-end indicators -- have only improved in the fullness of time. Expected earnings, especially, have been remarkable. Already up 28% from April's lows, they are still being revised higher every day at a 40% month-over-month annual rate (please see the chart below). More recently we have been encouraged by seeing the first quarter since recession onset in which fixed investment made a positive contribution to GDP. We were cheered by yesterday's non-manufacturing ISM, which until now has lagged its manufacturing counterpart, and *finally* gave a good reading on growth in the sector of the economy where all the jobs are.

S&P 500 consensus forward earnings
In index points, log scale



Source: Thompson, Zacks, TrendMacro calculations

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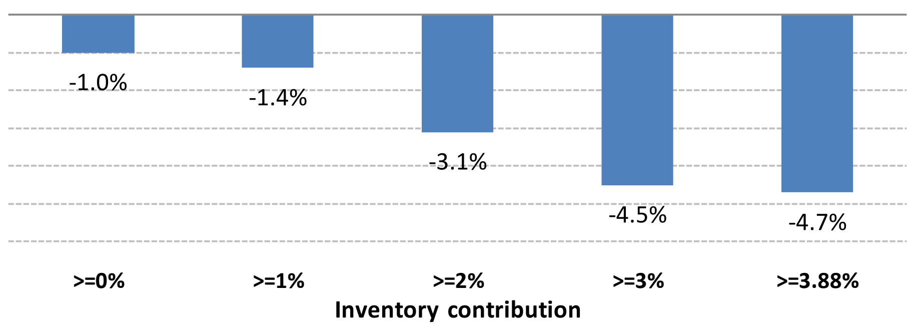
But none of that points to robust expansion, and there are important datapoints that indicate stagnation. For example, last quarter's GDP, even after an upward revision to 5.9% real growth at an annual rate, was dominated by a 3.88% contribution from private inventories. By definition, inventories are a zero-sum game -- production in one quarter is production

Median change in following-quarter real GDP, based on current quarter's contribution from change in private inventories
Q1 1947 to Q4 2009, annual rate

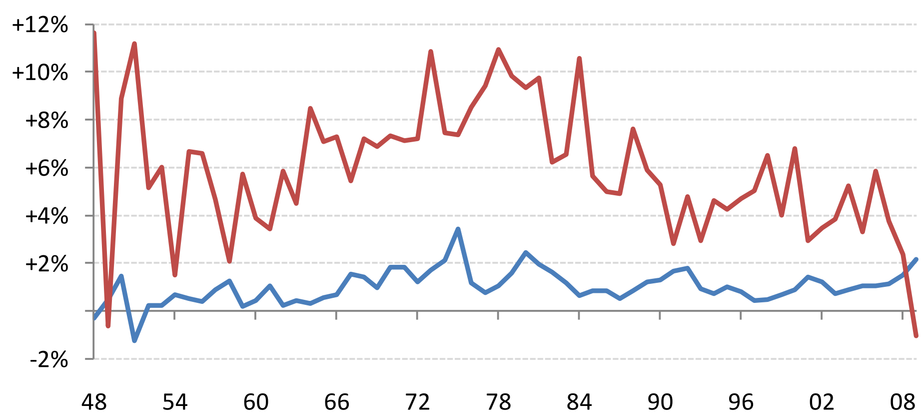


Source: Bureau of Economic Analysis, TrendMacro calculations

that doesn't happen in the following quarter. So historically, on average, quarters in which inventories make a dominant contribution to overall growth are followed by declines in overall growth the next quarter, with the magnitude of decline monotonically linked to the magnitude of the prior quarter's contribution (please see the chart above). Based on nothing but this pattern, we'd expect Q1 2010 real GDP to come in at about 2%.

We are also concerned by the extremely poor recovery in disposable personal income. More than all of 2009's 1.1% growth in nominal DPI came from transfer payments, something that hasn't been seen since 1949 (please see the chart below). Without those payments, all else equal, DPI

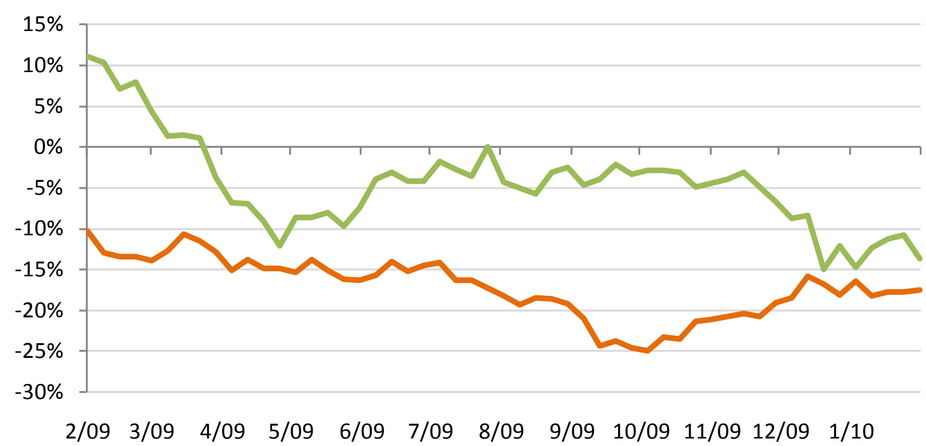
Disposable personal income:
— transfer payment contribution — everything else
Nominal, annual 1948 to 2009



Source: Bureau of Economic Analysis, TrendMacro calculations would have *fallen* by 1.1%. 2010 isn't off to a good start, either. In January, despite 0.1% growth in transfer payments -- and despite stabilization in the jobs market -- DPI nevertheless fell by 0.4%. So it has to remain an open question what would happen to income if these transfer payments were to stop growing, and we may get the answer sooner rather than later. A mere one-month extension of emergency unemployment benefits, impacting 400,000 unemployed workers here and now, barely passed the Senate this week.

Finally, we repeat the commonplace but important observation that bank credit continues to contract (please see the chart below). The rates of contraction in both consumer credit and commercial and industrial loans have abated from the lows of several months ago, but they are currently at levels associated with recession, not expansion. At least on the business side this is offset somewhat by the fact that large US companies in the

Growth in bank credit: — consumer — commercial and industrial
13-week annual change



Source: Federal Reserve, TrendMacro calculations

aggregate, both financial and non-financial, are sitting on record cash hoards. But most growth, or at least most employment, comes from small and new businesses, which are typically cash-poor. We don't expect that recovery can mature into expansion until the technology most critical to business formation and expansion -- credit -- comes fully back online.

Bottom line

With GDP growth dominated by inventories, weak income growth supported by transfer payments, and continuing bank credit contraction, we still look for only continued recovery in 2010, not robust expansion. Instead of a severe correction, stocks are sweating out a broad consolidation, giving expected earnings time to catch up to price. But until overall growth kicks into higher gear, we don't expect significant further gains from stocks, and would not be surprised short-term by further consolidation.