TrendMacro

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

MACROCOSM

# So Much For The "V"

Friday, May 21, 2010

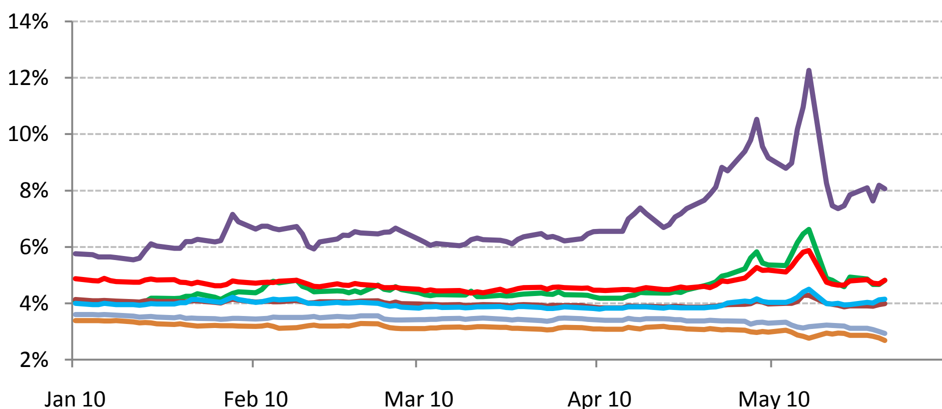
**Donald Luskin**

**An "expansionless recovery" in a world of "no exit" from government stimulus.**

The long-awaited correction in stocks is well underway, and the consensus for a "V-shaped recovery" has all but vanished overnight. There are multiple event triggers in play, economic and political, and we'll talk about them all in a moment. But the prime cause is that the "V-shaped recovery" consensus was incorrect to begin with -- as we've been saying for months (see, most recently, "On the April Jobs Report" May 7, 2010). The stock market's correction is *literally* a correction, a correction of that error. At the root, the error is that what we are experiencing is not a normal *business* cycle, but rather a normal *credit* cycle. They are two very different things.

Obviously the drama in Europe has been the trigger for the sudden shift in sentiment. But the real issue isn't Europe itself, and whether it has the capacity and the will to save its banks by absorbing the credit risks of its weaker nations. With smaller deficits overall as a percentage of GDP than the US, it has the capacity. And despite the lack of federal institutions, it is finding the will (see "Europe Gets *le TARP*" May 10, 2010). Markets apparently don't disagree -- sovereign yields across Europe, the weak and the strong, are all lower than two weeks ago (please see the chart below).

**10-year European government bond yields:**
**— Greece — Portugal — Ireland — Spain — Italy — France — Germany**




Source: Reuters

**Update to strategic view**

**US STOCKS:** At last a real correction, as investors get that the upside is limited in an "expansionless recovery." But in a world of "no exit," and with rising forward earnings quickly driving the equity risk premium back into attractive value territory, we wait for an entry point to buy the dip.

**FED FUNDS:** With reported inflation looking more like deflation, and with fear gripping global markets, the Fed is more firmly than ever stuck at a zero funds rate. From here, we wouldn't even be surprised by new asset purchases.

**GOLD:** Dragged from last week's all-time global highs along with all other risky assets, gold has nevertheless shown excellent relative strength. Once again -- in our volatile world, it goes up the most, and down the least. As the authorities soothe troubled markets with more and more promises of liquidity, it won't be long till gold makes it back to new higher highs.

[Strategy Dashboard home]

Copyright 2010 Trend Macrolytics LLC. All rights reserved. This document is not to be forwarded to individuals or organizations not authorized by Trend Macrolytics LLC to receive it. For information purposes only; not to be deemed to be recommendations for buying or selling specific securities or to constitute personalized investment advice. Derived from sources deemed to be reliable, but no warranty is made as to accuracy.

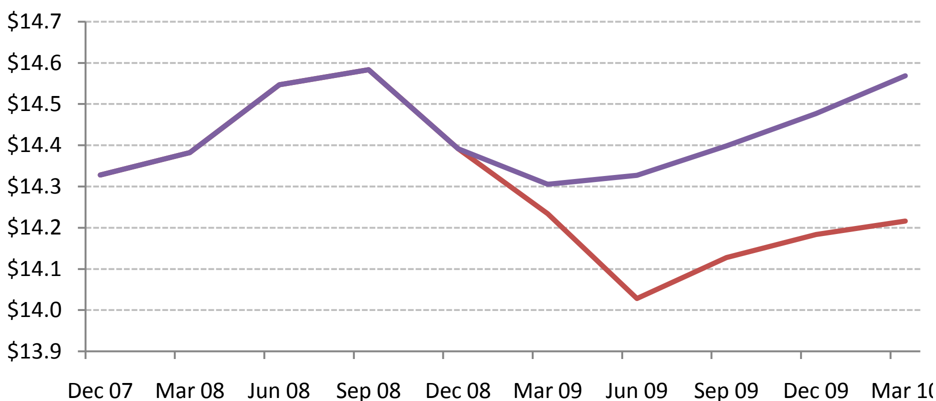
Even Greek debt has pulled back from the brink, and German yields are lower than US yields. The real issue is that Europe's agonies have made it unmistakable that the governing macroeconomic dynamic in play is not that of a transient *business* cycle, but rather a lingering *credit* cycle. Business cycles are earthquakes. Credit cycles are earthquakes with aftershocks. Europe is an aftershock, so this must be a credit cycle.

None of us have any experience of having lived through a *credit* cycle, at least not in the US. So it's easy to mistake what we've just been through as a *business* cycle, and to think that betting against a "V-shaped recovery" now would be tantamount to the hubris of saying "this time is different." But that presumes typical *business* cycle patterns. If this is a *credit* cycle, then to expect a swift and robust expansion back to trend, and for stocks to quickly surpass their previous highs as they always have, would be to say "this time is different."

The twentieth century US experience with credit cycles is instructive, though quite remote in time. After the Great Depression it took eight years for real GDP to recover to new highs, and 25 years for stocks to do so. But perhaps that's too extreme an example to feel relevant. So consider the far less cataclysmic credit crisis of 1907. It took real GDP five years to make a new high, and it took stocks ten years. In both cases, the intervening years were not entirely unsatisfactory -- they just weren't the kind of rapid and robust expansions contemplated in the "V-shaped recovery" consensus.

It's all in the data. The reality is that the unemployment rate has never really come down, and now has been rising for the last two months ("On the April Jobs Report" May 7, 2010). The reality is that if you take away the transfer payments, tax rebates and spending in the February 2009 stimulus bill, final sales have hardly recovered at all (please see the chart below). Does that mean we're still in recession? No, but we'd rather not use the lingo of *business* cycles to describe this *credit* cycle. If we must use it, then what we have here is an "expansionless recovery."

**— Final sales (GDP ex-inventories) — Without stimulus**
Nominal; includes only American Reinvestment and Recovery Act




Source: Bureau of Economic Analysis, TrendMacro calculations


**Contact TrendMacro**

On the web at
www.trendmacro.com

Donald Luskin
Menlo Park CA
650 429 2112
don@trendmacro.com

Thomas Demas
Charlotte NC
704 552 3625
tdemas@trendmacro.com

[About us]

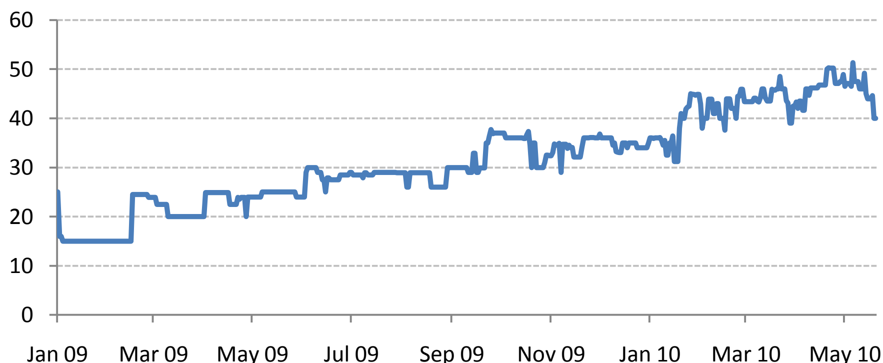
## The election and financial regulation

At the same time that Europe has raised consciousness about economic realities that were present all along, Tuesday's elections and yesterday's Senate passage of draconian financial regulation legislation has reminded markets that the US is not free from significant anti-growth political risks.

Recall that our strongest call for a correction in the over-extended stock market came the very day that Scott Brown was elected to the Senate in a special Massachussetts election (see "A Scott Heard 'Round the World?" January 19, 2010). Yes, we celebrated his surprise election as a move toward partisan gridlock that could further slow what had been a runaway train of anti-growth policy initiatives (see "2009's Economic Chart of the Year" December 28, 2009). But we warned that populist Republicans are as dangerous for growth as populist Democrats (see "Republicans and the Populist Temptation" February 9, 2010). Indeed Brown himself was the swing vote who made it possible for the Senate to pass last night Chris Dodd's (D-CT) regulatory blank check drawn against the US banking system (see "Goldman Sucks" April 19, 2010). This was a flip-flop: Brown had voted *against* it Wednesday, calling it "a flawed bill." Now, the political futures contracts traded online at Intrade now show a 60% probability of enactment of a bill including the "Volcker rule," which we think would be a profound structural setback to credit market efficiency.

The elections Tuesday are an even greater disappointment for those saw Brown as the poster-boy for a GOP resurgence in the November congressional elections. Most significant, the GOP failed to win the closely watched race for the seat of the late John Murtha (D-PA). It would have been the linear extension of Brown's upset capture of Ted Kennedy's Senate seat in January, but it didn't happen. The GOP is making the best of it, noting that the winning Democrat ran on an anti-Obama platform, and claiming that the elections overall show an anti-incumbent bias. But the political futures show the probability of a GOP House takeover in November down to about 42%. It was 45% before Tuesday's election, got as high as 51% in early May, and was at 50% a month ago, the very day the S&P 500 made its recovery highs (please see the chart below).

**GOP 2010 House majority futures contracts**



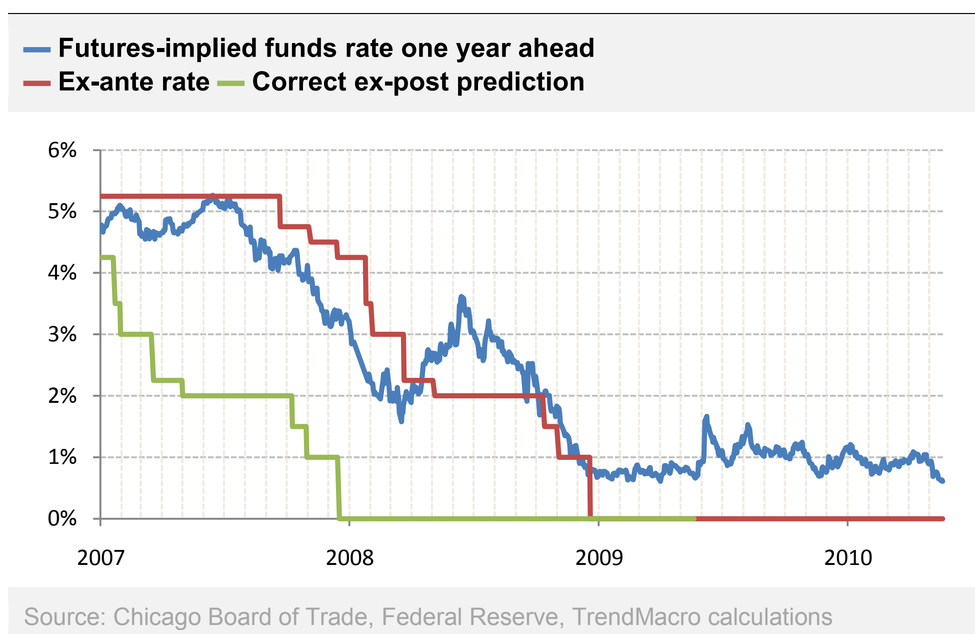

Source: Intrade

## Now, on the plus side

For all these risks and disappointments, we don't want to be misunderstood as being excessively bearish on stocks or pessimistic on the economy. We don't accept the false choice of "V-shaped recovery" on the one hand, or "double dip" on the other. Instead we embrace the less intuitive idea of the "expansionless recovery." But in some sense none of that matters, because our key action-driver remains the idea of "no exit," a state of the world in which fiscal and monetary authorities are willing and able to throw an infinite amount of money at the global economy (see, most recently, "Gold at New Global Highs" May 13, 2010). In such a world, you buy every dip and you don't waste money paying up for quality. The upside may be limited, but at least the downside has been ruled out by fiat.

Note that as the present stock market correction has unfolded, expectations for the Fed funds rate one year ahead have fallen below the 61 bp all-time low achieved at the worst of the banking crisis in 2009 (see the chart below). As of early Friday morning, expectations are for a 56 bp funds rate one year ahead. With a mere 10% correction in stocks, what we've long predicted (see, most recently, "On the April FOMC" April 28, 2010) is now commonly accepted: the Fed is on hold at a zero funds rate for what amounts to forever. All the more so with this week's April Consumer Price Index data showing the lowest year-on-year core inflation rate in 47 years. That means the Fed faces no binding constraint against keeping the funds rate at zero in order to stimulate the expansionless recovery. Indeed, a core inflation rate so low represents the threat of *deflation*, not inflation. At this point it wouldn't surprise us if the anti-deflationist Bernanke Fed were to announce new asset purchases as a means of combating deflation with the funds rate stuck at the zero-bound.

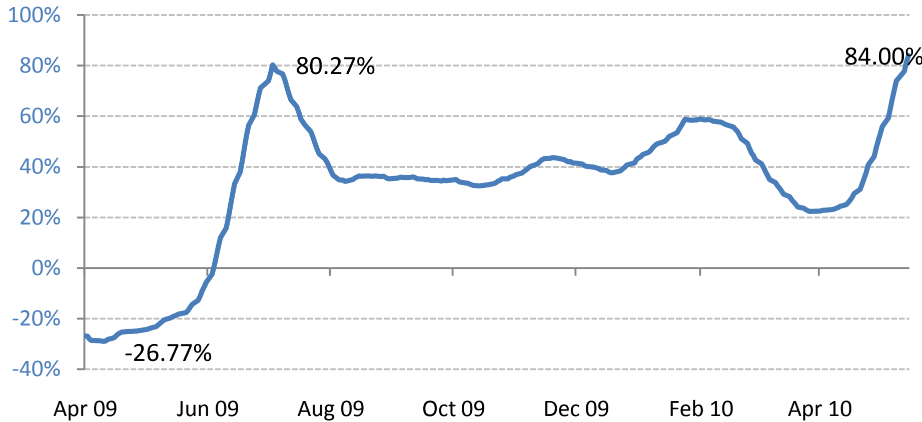
At the same time, stocks have suddenly become an interesting value proposition. They were constrained just a month ago by bumping up against peak forward multiples at about 15 (that is, the multiples seen at




Source: Chicago Board of Trade, Federal Reserve, TrendMacro calculations

the peak in October 2007). The first 10%-plus correction since the March 2009 bottom has occurred at the same time as a surge in forward earnings upgrades. In fact, the S&P 500's annualized monthly upgrade rate has now surpassed its high last June, an astonishing 80%-plus rate that we thought we couldn't possibly ever see again (please see the chart below).

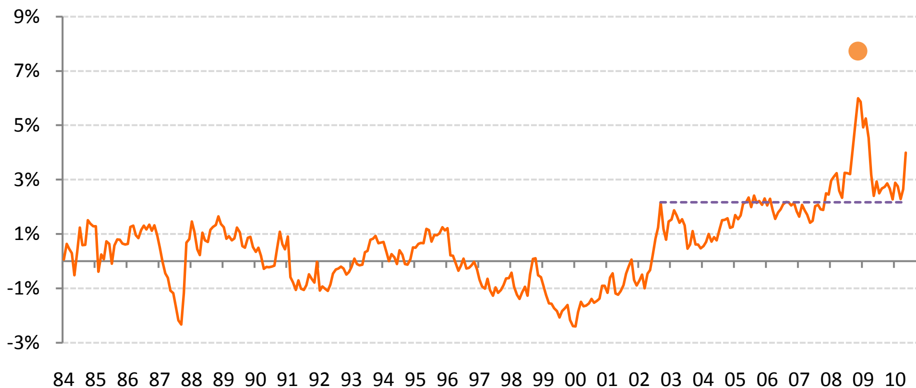
**S&P 500 annualized monthly forward earnings upgrade rate**




Source: S&P, Federal Reserve, Zacks, Thompson, TrendMacro calculations

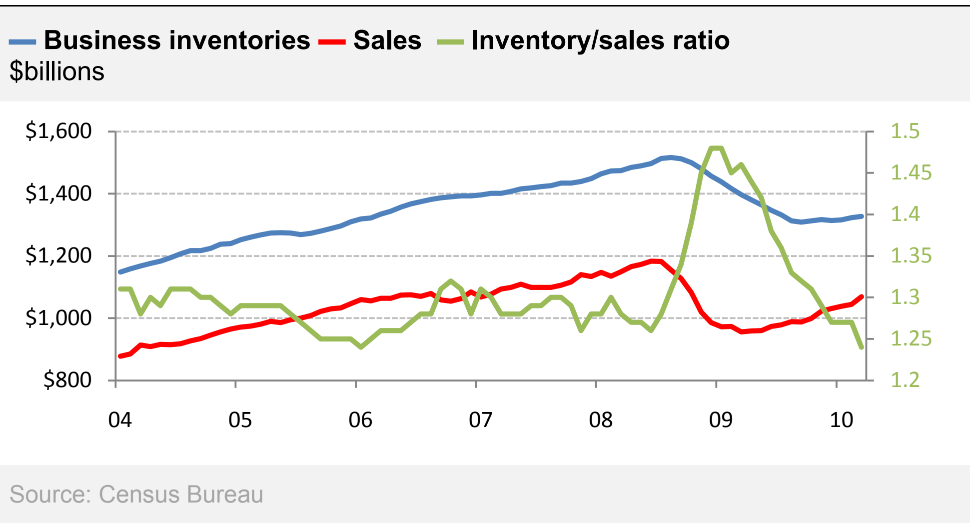
So forward multiples have quickly fallen toward the middle of the range at about 12. Further, with long-term Treasury yields having been driven lower in the Europe panic, the equity risk premium -- that is, the difference between the S&P 500 earnings yield and the 30-year Treasury yield -- has quickly moved away from what we see as merely average valuation in the post-2002 risk-tolerance regime, and back up toward levels that imply significant potential reward for bearing equity risk (please see the chart below).

**S&P 500 risk premium: forward earnings yield minus 30-yr Treasury**
**Post-Q302 average ● 11/20/2008 record high**




Source: S&P, Federal Reserve, Zacks, Thompson, TrendMacro calculations

In some small ways the economy itself is starting to get interesting, too. We're well aware of the string of recent disappointing datapoints, such as yesterday's unexpected jump in new jobless claims, and the first downturn in more than a year by the Leading Economic Index. But one particular disappointment encourages us a bit. Last week's business inventories data showed continued weak inventory-stocking in March. But this puts the inventories-to-sales ratio at an all-time low, which means that for the first time since recession-onset, there is *finally* a somewhat credible "inventory cycle" story to tell (please see the chart below).




We don't particularly believe in the so-called "inventory cycle" to begin with, the idea that inventories can kick-start a virtuous circle of growth. Instead, we see inventories as a necessary evil in service of a "sales cycle" -- that is, they lag, while sales lead. But if ever inventories were to be expected to play a role in future growth, it is now, with them so out of whack with sales. From here, unless sales collapse, inventories could make a three-quarters-in-a-row positive contribution to growth in Q2 2010.

## Bottom line

At last a real correction, as investors get that the upside is limited in an "expansionless recovery." But in a world of "no exit," and with rising forward earnings quickly driving the equity risk premium back into attractive value territory, we wait for an entry point to buy the dip. With reported inflation looking more like deflation, and with fear gripping global markets, the Fed is more firmly than ever stuck at a zero funds rate. From here, we wouldn't even be surprised by new asset purchases. Dragged from last week's all-time global highs along with all other risky assets, gold has nevertheless shown excellent relative strength. Once again -- in our volatile world, it goes up the most, and down the least. As the authorities soothe troubled markets with more and more promises of liquidity, it won't be long till gold makes it back to new higher highs.