TrendMacro

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The Panic Abates -- But Now What?

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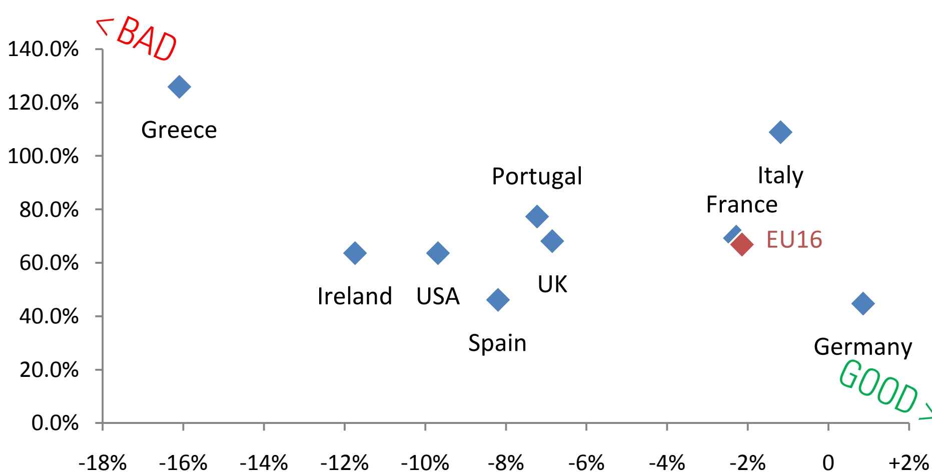
Euro-panic isn't the end of the world. But the world we face isn't the one we expected.

With word today from China that it is *not* about to withdraw support for battered euro-denominated credits (following word yesterday that it *was*), the stench of panic is off the markets. That may be enough to end the correction in equities -- but we've never thought the Europe panic was much more than an excuse for an overdue correction anyway. And in a world of "no exit" from global stimulus and bail-outs, it's only a question of *when* to buy the dip, not *if*. But even assuming Tuesday's intra-day low marks the correction's bottom, that doesn't necessarily mean that US equities will easily surpass their April highs and resume the momentum that lifted them 80% from the March 2009 lows. In a nutshell, we continue to see this correction as only a correction, not the beginning of a new bear market or signaling a double-dip recession (see "On the April Jobs Report" May 7, 2010). That said, we think the economy is in an "expansionless recovery," and that 2010 will end up delivering only average equity returns ("So Much For The 'V'" May 21, 2010).

First to Europe. The chart below visualizes the point we've been making all along about the crisis in PIIGS debt: Europe, if conceived as a federal

Vertical: **Debt as fraction of GDP** Horizontal: **"Death spiral coefficient"**



Source: Eurostat, OMB, HM Treasury, TrendMacro calculations

Update to strategic view

US STOCKS: The stench of panic is off. While remaining agnostic about whether the lows have been seen already, we reiterate that this is only a correction, not a new bear market. That said, with exuberance for a non-existent "V-shaped recovery" deflated, at best we expect stocks to have difficulty exceeding the April highs.

US MACRO: Evidence continues to refute the "V-shaped recovery" scenario. The economy is not in a normal business cycle, but rather a credit cycle, and it will take longer to recover from it.

GOLD: Just because the panic is off doesn't mean gold has to fall. It's liquidity-sensitive, not panic sensitive. In a world of "no exit," the liquidity will keep on coming, and the gold price should keep working higher.

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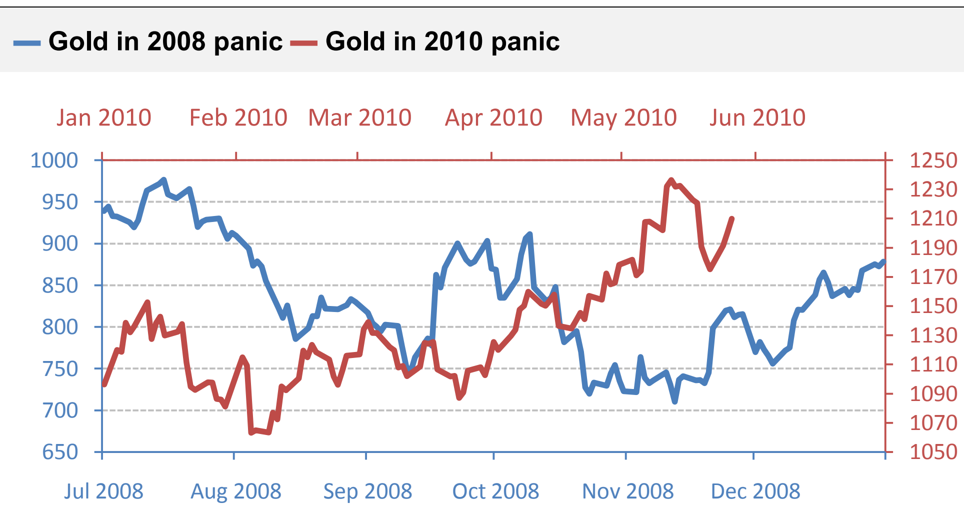
whole, definitely has the capacity to successfully subsidize its lesser credits (and thus save its over-extended banks). In terms of debt as a fraction of GDP, and in terms of what we call the "death spiral coefficient" -- the sum of deficit as a fraction of GDP, funding cost changes and GDP growth -- Europe *collectively* meets the treaty-driven fiscal standards for European Union, even if some of its individual nations do not. In fact, *collectively* it is in better shape than the US. The only issue -- and it's a non-trivial one -- is whether Europe can improvise *de facto* federal institutions to implement the necessary subsidy in the absence of *de jure* ones.

One element that has given us confidence in our "no exit" theme throughout the panic -- the idea you should always buy the dip because there will always be a bail-out -- has been gold. True, many observers have cited gold's rise to new global highs (see "Gold at New Global Highs" May 13, 2010) as evidence of panic and a harbinger of disaster to come. But we don't see gold primarily as a *panic-driven asset*, but rather as a *liquidity-driven asset*. This is a critical conceptual distinction, one usually missed by conventional analyses of gold (such as Nouriel Roubini's last December, when he said gold was in a bubble). When we see gold rising, it tells us that monetary liquidity is plentiful. And in a financial crisis, plentiful liquidity is the *sine qua non* of survival. Yes, plentiful liquidity usually leads to inflation, and can indicate loss of confidence in currencies. Nevertheless, in a panic, *a rising gold price is a very good thing.*

Consider the opposite (please see the chart below). In the summer of 2008, a growing liquidity shortage became a global crisis with the collapse of Lehman Brothers in mid-September. That set off a panic far worse than the present Europe panic -- yet the gold price didn't rise, it fell by 22%. That's because, until mid-November, it wasn't at all certain that the central banks of the world were going to act decisively enough to replenish liquidity. They ultimately did so, and gold recovered -- but not fully until the Fed pulled out all the liquidity stops in March, 2009 (see "Ben Boldly Goes" March 19, 2009). This time around gold fell only 10% while the Europe crisis brewed up early in the year, before it was clear that the Europe's



Source: Reuters

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Lauren Cohen, Joshua Coval and Christopher Malloy
Harvard Business School
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Calling Recessions in Real Time
James D. Hamilton
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largest nations could or would supply the liquidity needed to weather the storm (see "PIIGS, Panic and Jobs" February 5, 2010). Now that the ECB and the European Commission have signaled that they can and will (see first "Greece Gets TARPed" April 12, 2010; and then "Europe Gets *le TARP*" May 10), gold has rallied to new highs in every major currency.

Note that today, with panic abating and the euro rallying, the gold price is steady. To us, this is gold signaling that liquidity to weather the storm is in place. If gold were merely panic-sensitive, the price would have collapsed today. This signals an extremely critical -- and very positive -- distinction between the financial market panic of 2008 and the situation today.

The Europe panic, even if we imagine that it has entirely passed now, has forced investors to look more critically at the macro situation. Hopes for a "V-shaped recovery" so prevalent a month ago have been smashed, and less than stellar incoming macro data confirms that whether the glass is half-full or half-empty, it sure isn't all-full. Investors are still struggling to get the new message. This morning Q1-2010 gross domestic product was revised *downward* from 3.2% to 3.0%, with the consensus having expected an *upward* revision to 3.3%. Even 3.3% isn't enough to justify the "V-shaped recovery" scenario at this stage in the cycle, considering the extraordinary fiscal and monetary support the economy is getting.

For us the most telling is yesterday's April durable goods report. Shipments of capital goods ex-aircraft grew, and that's the statistic that ends up as the capital spending component of GDP. But if April's growth is indicative of Q2, it implies about 10% sequential quarterly growth (annualized). That's *okay*, but it's down from the 14.7% growth rate we saw in Q1, and utterly inadequate considering that capital spending is coming from the lowest level in history in terms of fraction of GDP. From that low base, it ought to be surging, but it's not. In fact, yesterday's report showed *new orders* for capital goods -- and you have to have *orders today* before you can have *shipments tomorrow* -- actually fell in April by 2.4% month-over-month (not annualized).

We urge clients to realign their expectations. We are not experiencing a normal expansion because this has not been an ordinary business cycle. This has been a credit cycle -- which puts us in uncharted territory in terms of US experience during our lifetimes. Today's "expansionless recovery" is typical of the aftermath of credit cycles -- slower and more painful than the typical aftermath of business cycles. We have been blessed with an historic bull market from the panic lows in March 2009. Let's not get greedy by extrapolating that into an infinite future when the facts just don't support it.

Bottom line

The stench of panic is off. While remaining agnostic about whether the lows have been seen already, we reiterate that this is only a correction, not a new bear market. That said, with exuberance for a non-existent "V-shaped recovery" deflated, at best we expect stocks to have difficulty

exceeding the April highs. Evidence continues to refute the "V-shaped recovery" scenario. The economy is not in a normal business cycle, but rather a credit cycle, and it will take longer to recover from it. Just because the panic is off doesn't mean gold has to fall. It's liquidity-sensitive, not panic sensitive. In a world of "no exit," the liquidity will keep on coming, and the gold price should keep working higher.