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MACROCOSM

Betting Against a "Double Dip"

Wednesday, June 30, 2010
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It feels like the end of the world. But liquidity is plentiful and stocks are very cheap.

Just ten weeks ago it was supposed to be a "V-shaped recovery." Now it's a "double dip recession." We didn't believe it then, and we don't believe it now. We're sticking with our long-standing call for an "expansionless recovery." It's a tough tide to fight at the moment. Nearly overwhelming are the bearish narratives of "imminent" cataclysms: a China slowdown, a European banking meltdown, a global turn to fiscal austerity, deflation, a recession signal from the ECRI leading economic indicators, even an Israel/US attack on Iran. And we have Paul Krugman proclaiming "The Third Depression" -- but actually, we find that one to be encouraging.

Seriously, what we find encouraging is the fact that while stocks are *finally* correcting an historic bull move, bottoms-up forward earnings continue to be upgraded. From the April top, stocks are down 14.5% and consensus forward earnings are up 5.9%. Combined with the 30-year Treasury yield below 4%, that elevates the equity risk premium and makes stocks the best value proposition they've been since late March, 2009 (please see the chart below). We've been calling for a correction for a long time, and we've finally gotten one. We think it's a correction, not a new bear market,

S&P 500 equity risk premium
Forward earnings yield minus 30-year Treasury yield

Source: Zacks, Federal Reserve, TrendMacro calculations

Update to strategic view

US STOCKS: Pessimism is peaking. With stocks 14.5% off the April highs while forward earnings have grown 5.9%, and with Treasury yields low, stocks are cheaper than they've been since March 2009. We're not saying the correction is over, but we still think it's just a correction. This would be a good place to take the first step toward buying the dip.

US MACRO: We stick by our guns for continued "expansionless recovery," despite a rising consensus for "double dip" recession.

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despite -- maybe even to some extent because of -- the multiplicity and depth of the bearish narratives out there. Throughout the correction we've been agnostic about whether the precise bottom has been reached, and we still are (the 79.9% move from the March 2009 bottom deserves some serious correction). And we're not especially enthusiastic about how much upside there is -- the April highs may stand for the rest of the year. But we still think this is a buyable dip, and would use this moment of intense pessimism to at least take a bite.

We also find it very encouraging that gold has moved to new all-time highs over the last week or so, and then remained rock-steady, while pessimism has mounted and stocks have corrected. Ben Bernanke would say this reflects "uncertainty and anxiety in financial markets." We don't agree. We think it reflects the market's appraisal that we do not face an imminent deflation and a new round of forced deleveraging, but rather a continued flow of liquidity that will support our ongoing "expansionless recovery." Remember, we think the conventional wisdom is wrong to think of a high gold price as reflecting fear and panic. In 2008 after the Lehman failure, gold fell along with everything else during the ensuing panic. A rising gold price signals rising liquidity. Right now, it's the best news out there.

We don't want to come off here as taking the role of the bullish "answer man" who has an easy story to refute all the bearish narratives. There's some truth in all of them, and some can't be answered. If it's true, as rumored, that there's an imminent attack on Iran in the works, then all bets are off. But rumors like that are evolutionarily successful as thought contagions precisely because they are as unanswerable as they are unaccountable. And besides, they excite not only fear, but greed and status ambitions too, as one imagines betting successfully on such a "black swan." But for most of the other narratives, we don't deny that they are real, but we think they are old news, and probably not enough to tip the world into a "double dip."

- China slowdown? If it's true -- and whatever it even means in an economy with so much potential that is nevertheless growing rapidly, though less rapidly than some hoped -- then it's nothing that Chinese stocks haven't been expecting for many months. The Chinese stock market did worse than the US in the 2008-2009 bear market, and has recovered less in the 2009-2010 bull market. We keep telling clients that while China's long-term growth prospects are self-evidently superlative given its untapped reservoir of human potential, in the near-term its export-driven model can't deliver maximum performance when its customer nations are in an "expansionless recovery."
- European banking meltdown? It's an ongoing risk, even given May's massive rescue commitment (see "Europe Gets *le TARP*" May 10, 2010). We warned then that while sufficiently large, the commitment was too vaguely structured to restore confidence without a series of tests. In the absence of information, and given the value of a Franco-German guarantee on lesser-quality debt, Mr. Market -- that is, the market construed as a goal-seeking self-organizing complex system -- will probe to activate that guarantee

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[About us]

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Kartik Athreya
Federal Reserve Bank of Richmond
June 17, 2010

Resolution of Banking Crises: The Good, the Bad, and the Ugly
Luc Laeven and Fabian Valencia
IMF Working Paper 10/146
June 1, 2010

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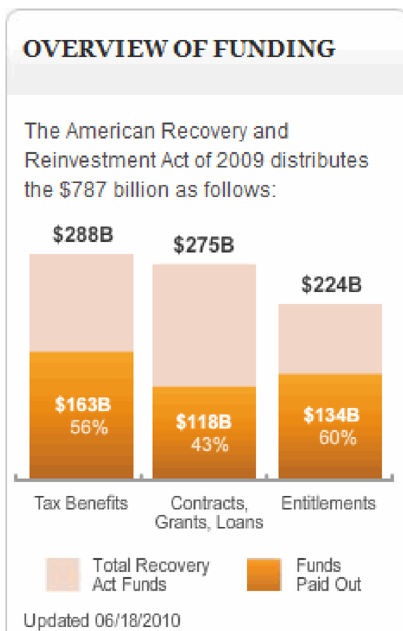
by fomenting crisis. But the underlying reality is that the guarantee is there, and we do not doubt that it will be activated as necessary.

- In the meantime, stress tests (yes, of dubious quality -- more counterproductive vagueness) are being done. And the ECB seems to be successfully managing the long-term refinancing operations (LTRO) associated with the expiration of €442 billion in one-year loans to 1,100 member banks, despite agitated news stories portraying various elements of the process as system failures. We are especially unalarmed by the so-called "failed auction" this week of 7-day term deposits to sterilize the ECB's purchase of Greek government debt. That the ECB was able to raise only €32 billion of the desired €55 billion without exceeding the maximum allowable interest rate of 1% would seem to indicate illiquidity -- a desire by member banks to husband short-term funds during this week's LTRO. But in an important sense this is self-correcting -- it forces the ECB to leave €23 billion of their Greek bond portfolio unsterilized, which has the effect of creating whatever liquidity the market implicitly demanded by failing to bid for the term deposits. We surmise that the policy of sterilizing the bond purchases was a sop to the hawkish minority on the Governing Council to begin with -- so the failed auction, and its effective monetization of €23 billion of debt, may have been not a failure at all, but rather a welcome development to the dovish majority.
- A global turn to austerity starting in Europe? We'll believe it when we see it. And it might be a good thing anyway. From the get-go, we've never bought into the idea that "stimulus" spending here or anywhere else in the world has created enough benefits to overcome its perverse incentives against labor and investment. So if Europe wants to try some fiscal discipline for a change, we're not going to say it will produce worse results than the "expansionless recovery" we've seen so far. And if it's spending you like, in the US, half of last year's $787 billion American Recovery and Reinvestment Act currently remains to be spent -- and there's an election coming up (please see the chart at left).

ARRA spending

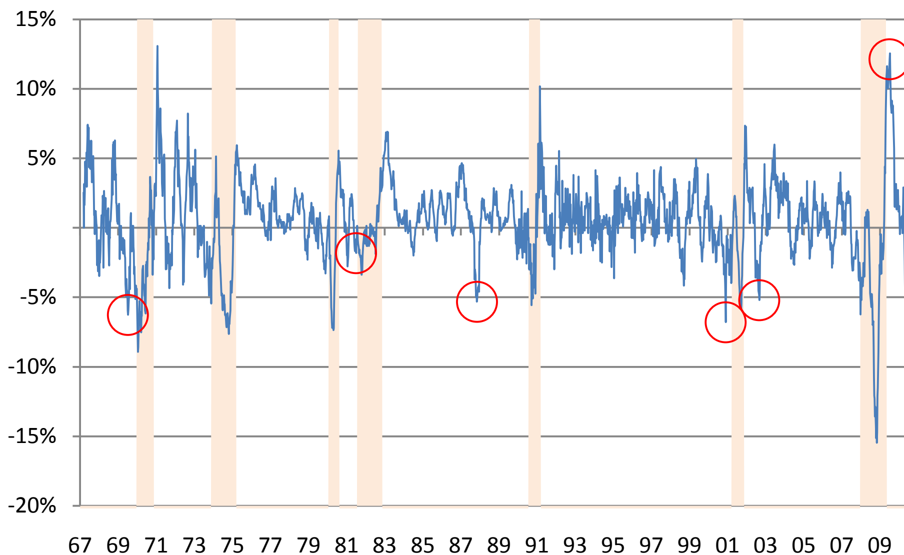


Source: recovery.gov

- ECRI index of leading economic indicators? It's presented by the bears as drop-dead objective proof that recession is upon us. It has a decent track record -- and it's no surprise to see it picking up on the self-evident slowing of macro data over the last couple months. But it shouldn't be taken uncritically as a perfect binary indicator of the false choice between "expansion" and "recession," particular in the wake of credit crises. We keep urging clients to realize that the world doesn't really

organize itself into such neat black-and-white categories. But the ECRI index hasn't been a flawless predictor of even that false choice (please see the chart below). It was early in predicting the 1970 and 2001 recessions. It failed to predict the severe 1981-1982 recession. And it falsely predicted a recession in 1987 and 2002. We would even argue that it was wrong in moving to near all-time highs a year ago after the worst of the 2008-2009 recession, signaling a strong recovery that never materialized. There are other recession indicators that we prefer, which have better track records -- the growth of consensus forward earnings, and Edward Leamer's three-factor model. Neither is predicting recession.

ECRI index of leading economic indicators ○ False signals
Weekly, 13-week change

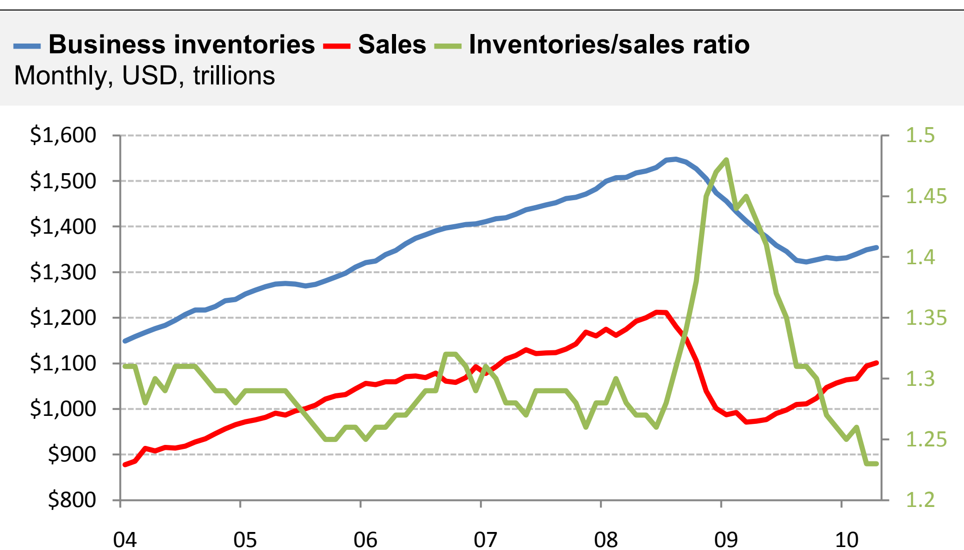


Source: ECRI, TrendMacro calculations

- Finally, deflation? We see it in all the official statistics, but we don't see it in the future -- and either does the gold price. We remain staunchly convinced that the Bernanke Fed's unwavering priority is the avoidance of monetary deflation, which Bernanke believes caused the Great Depression of the 1930s. The more apparent evidence of deflation, the more the Fed will fight it with inflation. Now, as official price statistics continue to flash deflation, with the funds rate at the zero bound now for a year and a half, the only possible move is for the Fed to make additional asset purchases for its balance sheet (see "On the June FOMC" June 23, 2010). A speech Monday by Fed governor Kevin Warsh has been portrayed as designed to discipline such speculation, with Warsh saying "any judgment to expand the balance sheet further should be subject to strict scrutiny." But who would disagree with that? In our view, even mentioning the idea of expanding the balance sheet -- when prior to this all the public discussion has been about how to reduce it --

suggests that it’s a live possibility, and thus more validates our speculations than quashes them.

Our baseline scenario continues to be "expansionless recovery." We see the world as having undergone a horrific credit cycle, not a typical business cycle. We think the risk of further global credit collapse has been successfully ruled out by massive intervention. From here, the economy rebuilds from the ashes -- slowly, haltingly. So much was liquidated last year -- so many jobs, so much debt -- that we don't see enough room on the downside for anything we'd want to call a "recession." Inventories illustrate this view very nicely (please see the chart below). Sales have been growing at pre-recession rates for a year now, but inventories have hardly grown at all. Thus the inventory/sales ratio has been at all-time lows for the last two months. On the one hand, this reflects the shattered confidence that retards growth coming out of a credit bust. But on the other hand, with the inventory/sales ratio already at all-time lows, it would take a major shock to sales for inventories not to be seen as irreducibly lean. It's an asymmetrical position -- any improvement in confidence should trigger an inventory rebuild, but only a major blow to confidence could trigger any liquidation at this point. It's not easy to get a recession out of that situation.



Source: Census Bureau

Bottom line

Pessimism is peaking. With stocks 14.5% off the April highs while forward earnings have grown 5.9%, and with Treasury yields low, stocks are cheaper than they've been since March 2009. We're not saying the correction is over, but we still think it's just a correction. This would be a good place to take the first step toward buying the dip. We stick by our guns for continued "expansionless recovery," despite a rising consensus for "double dip" recession.