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Sell On *Good* News

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Donald Luskin

Correction is inevitable, but our instinct is that there will be a better moment to sell.

We've been worrying all month that gold should be ready for a correction after its stellar run (see "Pushing On a Golden String" October 1, 2010). Stocks have taken on board to high probability of a strong rebuke to anti-growth politics in the mid-term election. And the whole "risk-on" complex has benefited from the prospect of some version of "QE2" now a virtual certainty (see "Risk-On Hearts QE2" October 14, 2010). In short, we're at or near a classic "sell on the news" correction. We don't want to split hairs, but our instinct is that yesterday's big drop was just a pause to refresh, and that the ideal "sell on the news" moment is still ahead of us -- a logical candidate being the first week in November, with back-to-back mid-term elections and the FOMC meeting. Note that our focus here is primarily on sentiment and valuation -- the absorption by the market of evolving good news. We are not particularly worried about bad news. The narratives that drove yesterday's big drop don't change that. They're just the latest examples of our "no exit" theme, the idea that there will be endless aftershocks in the wake of a world-historical credit crisis, always followed by endless applications of remedial liquidity to fix them (see, most recently, "'No Exit' Cuts Both Ways" August 12, 2010).

CHINA RAISES INTEREST RATES It was a "surprise," according to numerous reports, but why? It's just another in a long line of fine-tuning operations this year in the direction of removing excessive ease from an economy that doesn't need it. Each such operation has elicited a similar response from markets -- a recoil in fear that "China is taking away the punchbowl" or "China is going to burst its bubble" (see, for example, "PIIGS, Panic and Jobs" February 5, 2010).

- With Chinese consumer inflation running at 3.5% year-on-year (an update is due tomorrow), the deposit rate, raised yesterday to 2.25%, still offers a negative real return for savers. It's probably the right thing for the Fed to intentionally punish savers with negative real rates, given that the US economy acts like the Fed is too tight (again, see "Risk-On Hearts QE2"). But China has no such rationale, with GDP growth running about as high as the US unemployment rate. The Fed is *cutting* rates with QE2 because it is too *tight*, and China is *raising* rates because it is too *loose* -- both are good news.

Update to strategic view

US STOCKS, GOLD: After stellar moves for stocks and gold, a pause was inevitable, and yesterday's big drop on what we see as not very bad news proves it. But serious corrections start with good news, not trivially bad news. Perhaps we are splitting hairs, but we think there will be modestly higher highs before a serious correction sets in. We're inclined to wait to "sell on the news" closer to the back-to-back mid-term elections and FOMC meeting.

US FINANCIAL STOCKS: For anyone not already convinced by the financial sector's status as worst-performer in the rally since the July bottom, the spectacle of Bank of America effectively suing itself should prove that banks will never be growth stories again.

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BANK OF AMERICA AND FORECLOSUREGATE Another non-surprise -- that more sins of the mortgage bubble should come to light and have to be atoned for. Admittedly, the irony runs thick and deep with this particular one. The Fed put billions at risk to save Bank of America in January 2009 (see "Passengers Survive, But Plane Sinks" January 16, 2009), yet now it is suing Bank of America to make it take back billions in mortgages alleged to have been improperly serviced, acquired by the Fed through the rescue of AIG four months before the rescue of Bank of America (see "AIG: Rescue or Bag Run?" September 17, 2008). A fellow plaintiff in the suit against Bank of America is Blackrock, which is 34% owned by Bank of America, and which itself owns 5% of Bank of America through index funds it manages for fiduciary clients.

- But cutting through all those tangled webs, this is the same basic story-line as the SEC's charges in January against Goldman Sachs (see "Goldman Sucks" April 19, 2010). It's one of the two reasons we are so bearish on the banking sector -- there's going to be "no exit" from very large-scale litigation risk. Based on what we know now, we're not worried that this is going to break Bank of America or any other similarly situated bank, and therefore become a *systemic* risk, any more than it broke Goldman. This is about getting a big settlement, which is why the plaintiffs seem to be trying their case in the media. It's an earnings event, not an existential threat.
- The second and more fundamental reason we're so bearish on the banking sector is that in our post-bubble world, banks have virtually no growth model (see "Subprime Lending Was Their Best Idea" June 4, 2008). Sure, financials were the best-performing sector in the S&P 500 from the March 2009 bottom -- coming back from zero will do that. But they're not starting from zero any more. So with all their legacy liabilities and the absence of a compelling future, they've been the *worst*-performing S&P sector in the second leg of the present bull market from July 2010.

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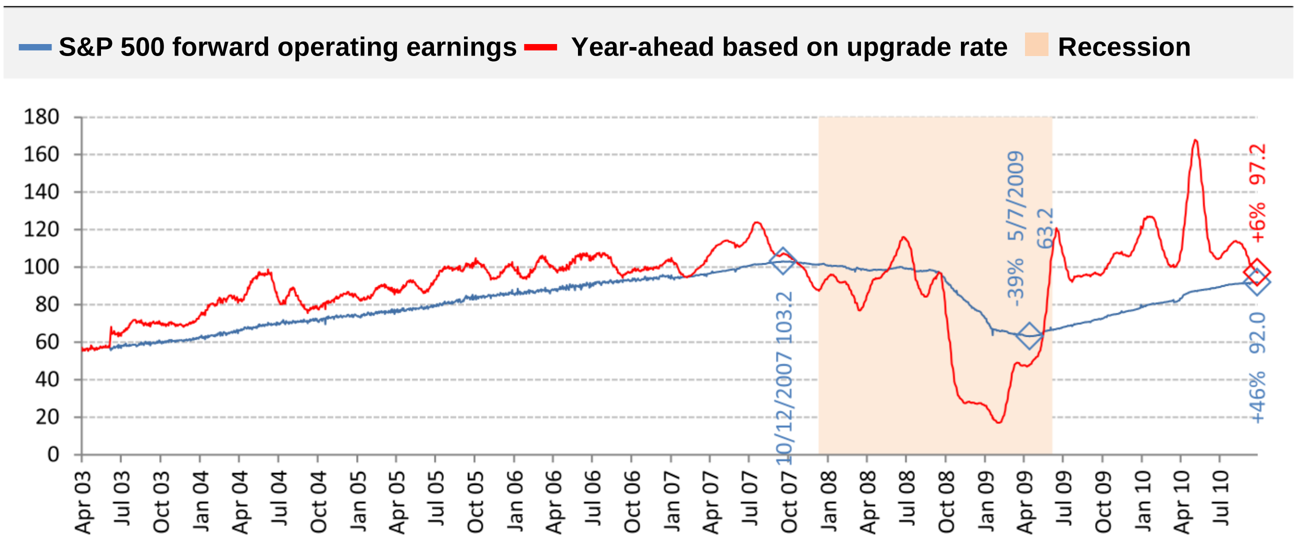
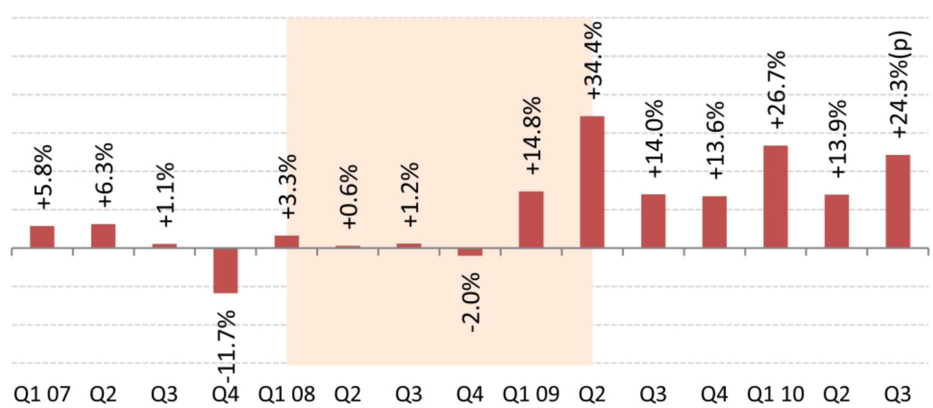


Source: Zacks, TrendMacro calculations

EARNINGS SEASON BLUES The forward earnings upgrade rate has fallen to its lowest level since the end of the recession, just 6% at an annual rate (please see the chart below). That means after two years of wild oscillations to both record lows and record highs, it has converged for the moment on what is just about the long-term historical average annual operating earnings growth rate.

- In some sense this moderation is to be expected, given that S&P 500 forward operating earnings now at 92.0 have already been upgraded 46% from their May 2009 lows. But in this slow-motion "expansionless recovery," we are still in early-cycle, and there could be a lot more operating leverage to be harvested over the coming year even with modest background economic growth.
- It sounds insane after a downbeat day like yesterday, but the upgrade rate would only have to double to an eminently reasonable 12% over the coming 12 months for S&P 500 forward earnings to get all the way back to the October 2007 high-water mark of 103.2.
- Yesterday's earnings season narrative focused on disappointing elements in Apple and IBM's reports, but so far, with 55 of 429 S&P 500 stocks reporting, this earnings season has objectively been perfectly good. As of yesterday, only one has missed the consensus. With the unweighted average surprise at 24.3% it's in the top three earnings season in almost four years (please see the chart below).

S&P 500 earnings surprise **Recession**
Unweighted average, companies reporting quarter-end, (p) = preliminary



Source: Zacks, TrendMacro calculations

Bottom line

After stellar moves for stocks and gold, at least a pause is inevitable, and yesterday's big drop on what we see as not very bad news proves it. But serious corrections start with good news, not trivially bad news. Perhaps we are splitting hairs, but we think there will be modestly higher highs before a serious correction sets in. We're inclined to wait to "sell on the news" closer to the back-to-back mid-term elections and FOMC meeting. For anyone not already convinced by the financial sector's status as worst-performer in the rally since the July bottom, the spectacle of Bank of America effectively suing itself should prove that banks will never be growth stories again.