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

MARKET CALLS

Stock Outlook: Differences Make a Difference

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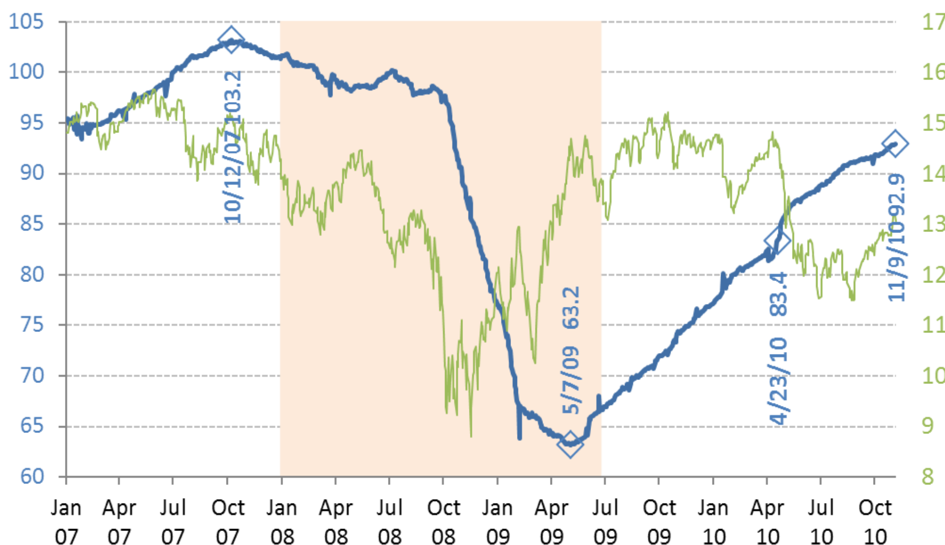
Donald Luskin

Upgrading our view on stocks and the economy, with no crazily optimistic assumptions.

As we suspected (see "Sell on the Leak?" October 27, 2010) it was too "obvious" to sell on all of last week's good news. Maybe we'll get a little correction now that a week has passed, a delayed reaction. But this report is more about the intermediate-term future, for which we think the prospects have improved considerably. If a correction comes now -- complete with a scary "double top" at 1225 on the S&P 500 chart -- it will be an opportunity to buy the dip.

Stocks have now reached the price target we set at mid-year when we called the bottom of the correction -- that is, they've reclaimed the level of the April highs (see "Betting Against a 'Double Dip'" June 30, 2010). Looking ahead, we think it would not be a stretch for stocks to gain more than 25% over the coming 12 months. To see why we say that, consider some of the differences between now and last April, the last time stocks were at this level (please see the chart below).

S&P 500: —Consensus forward earnings —Forward multiple Recession



Source: Zacks, NBER, TrendMacro calculations

Update to strategic view

US STOCKS: Stocks have reached our price target for this year -- recapturing the highs of April. But forward earnings are higher, multiples are lower, and the economy is poised to improve. We think stocks could gain more than 25% in the coming 12 months without making any crazily optimistic assumptions.

US MACRO: Political stabilization and the Fed moving away from being too tight remove two critical barriers to growth. This is where the "expansionless recovery" can become an actual recovery, even if probably a weak one. Post-crisis risks and hangovers could keep the economy from getting back to trend for a long time, but we think we are upshifting to a higher growth path.

[Strategy Dashboard home]

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- While market capitalization is the same, cap-weighted consensus forward earnings are 11.5% higher -- they've grown from 83.4 at the top in April to 92.9 now, in S&P 500 point terms.
- So stocks are a better value, with the forward multiple having fallen from 14.6 in April to 13.1 now.
- Long-term interest rates are lower -- the 30-year Treasury yield was 4.67% in April, and it's 4.25% now. With a lower discount rate at which equities are valued, by rights the forward multiple should be higher than it was in April, not lower.
- With earnings season behind us, the upgrade rate of forward earnings has accelerated to about 10%, as we predicted it would (see "Sell On *Good* News" October 20, 2010). If this rate can further accelerate just a little bit -- which we think it can -- then the S&P 500 will be back to peak forward earnings of 103.2 twelve months from now.
- Peak forward earnings were achieved in early October 2007, within days of when the S&P 500 made its all-time high at 1565.15. So if we can reclaim peak earnings, then it's feasible we can reclaim peak stock prices.
- This would require *also* reclaiming the forward multiple that prevailed in October 2007 -- on the day of the top, it was 15.2. That's not an especially heroic number that should be unusually difficult to get to. In fact, we were already there a year ago, and flirted with it several times up to the recovery high in April 2010, so we know for sure such a multiple is still possible in our post-crisis world.
- Put all that together, and you've got a 27.9% gain in the S&P 500, not including dividends -- *all without any crazily optimistic assumptions*.

We think the scenario we've just sketched can play out even if we continue to be muddled in an "expansionless recovery" in the aftermath of a world-historical credit crisis.

- Already, since the bottom in May 2009, S&P 500 forward earnings have recovered 47%, while nominal GDP has recovered just 5.0%.
- Such operating leverage is typical in the early phase of an expansion. With nothing better than an "expansionless recovery" so far, we can expect the early phase to be drawn out over more quarters than usual. So there should still be enough operating leverage in corporate America to keep earnings growing robustly even if background economic growth is tepid.

That said, we're coming to think that economic growth going forward will be better than tepid. We'll know more in a month or two, but from here we think that the "expansionless recovery" will transform over the coming year into an *actual* recovery. Let's not split hairs right now about how *strong* an expansion it will be -- let's just focus on the qualitative shift from "expansionless recovery" to expansion.

Contact TrendMacro

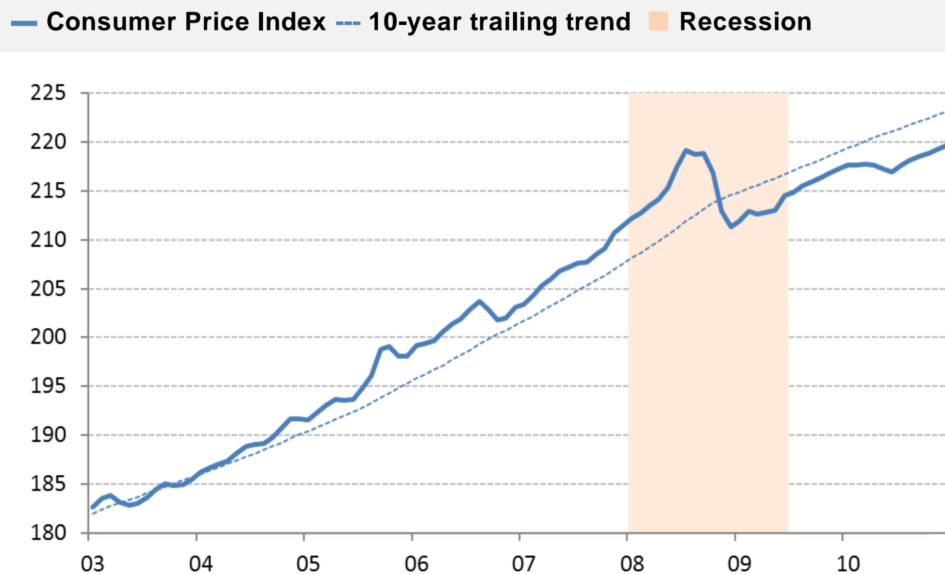
On the web at
www.trendmacro.com

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

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

[About us]

- We have already said that we think last week's mid-term elections were a fundamental turning point, a signal that further anti-growth policy would be rejected by the electorate, and that pro-growth policy would be demanded (see "The Pendulum Swings Back" November 2, 2010).
- We expected the Obama administration to "tack to the center" in the aftermath -- so that GOP control of a single chamber of Congress can make a real difference to policy. That has already begun to happen in very visible and significant ways, including President Obama saying the day after the election that he would "absolutely" be willing to compromise on extending the Bush-era tax rates, and then writing an op-ed for the *New York Times* on Saturday advocating free-trade agreements.
- Even if these developments do not lead quickly to true pro-growth policies, they represent the stabilization of a political process that had been so unpredictable as to crush business and consumer confidence. If nothing else, a restoration of some degree of certainty that the political process will not yield an ever-shifting economic playing field should be a strong impetus at the margin for growth.
- We have been calling for more easing by the Fed for six months (see "So Much For The 'V'" May 21, 2010), arguing that the Fed has been too tight even at the zero-bound on the fed funds rate (see "How to Ease, Not When to Tighten" June 23, 2010). Last week's announcement of "QE2" should relieve that condition -- that is, should reverse the lingering deflationary tendencies symbolized by the fact that the level of the Consumer Price Index remains today below its all-time high in July 2008, and far below trend (see the chart below, and "Risk-On Hearts QE2" October 14, 2010).



Source: Bureau of Labor Statistics, TrendMacro calculations

- It is a near-universal reaction among clients that QE2 can't possibly work. It is being criticized within the Fed itself -- for example in quite

sensible comments by Governor Kevin Warsh on Monday, cautioning that it is no silver bullet, and that it won't last forever.

- It is being derided by politicians overseas. And there is what amounts to a revulsion about it on the political right at home, as exemplified by remarks by Sarah Palin, and by Ron Paul's statement that "the Fed will self-destruct." The right is in the ascendency, and in fact Paul is going to be chairman of the House Financial Services Subcommittee on Monetary Policy. But we think it's naïve to expect that such criticisms, however strident, would ever be enough to sink QE2.
- All this encourages us, because it means that *markets will fail to immediately price this transcendently important development* -- that our central bank is moving away from being too tight. When central banks that have been too tight stop being too tight, stunted economies start to grow.

To shift to a more positive outlook on the economy does not require that we imagine all the well-known problems besetting the world have gone away.

- All the stories about excessive debt overhangs, currency depreciation, emerging market bubbles, US state finances and so on are as true as they ever were. But economic growth can upshift, and asset prices can move higher, without having any of these problems solved. All that is required is improvement at the margin. Differences make a difference.
- Wild-card risk still exists. We know from history that in the aftermath of a systemic credit crisis, there are always unpredictable aftershocks. A year ago we did not predict that the crisis in European peripheral sovereign debt would be such an aftershock, and we have no idea what the next one will be, or if there will even be a next one.
- But this year the European response to the debt crisis has demonstrated the validity of our notion of "no exit" -- the idea that the world's authorities will not permit any potential systemic crises to get out of hand, that whatever it takes there will never be "another Lehman."
- The crisis in European debt has by no means gone away -- indeed, sovereign yields for peripheral nations are back to their May crisis highs. As we expected, "Mr. Market" is probing to find out the exact terms of the highly ambiguous European Financial Stability Facility (see "Europe Gropes toward Stress-Tests" July 12, 2010). Yet the panic atmosphere that prevailed in May, the last time that they were at these levels, is absent. Euro LIBOR/OIS spreads -- an indicator of funding stress in the European banking system -- are near the lows of the year. So while there are still very real issues with a number of countries, serious systemic risk seems to be off the table.
- Our expectation is that if new systemic risks do arise -- and again, we have no idea what they will be -- the "no exit" doctrine will continue to prevail. Our outlook could be more optimistic if we had more confidence that there would be no such risks. But we don't

require perfection just to tune our outlook a bit toward the optimistic in response to what we see as important positives.

We think the sentiment environment supports our changing views.

- As we talk to investors about this, we find it to be generally regarded as somewhat unbelievable that the economy could improve at all -- and that stocks could rise 25% or more without substantial economic improvement. This encourages us.
- There are still super-bears out there, but virtually no super-bulls, or really anything more than mildly bullish agnostics. Such agnosticism is exactly the position we've encouraged all year, first resisting the highly bullish sentiment in the first quarter (see "The Case for Ambivalence, Volume Three" March 4, 2010), and then resisting the highly bearish sentiment in the second quarter (again, see "Betting Against a 'Double Dip'"). This has been just the right position to take, and it has been difficult at times.
- In April, the last time stocks were at this level, after an historic 79.9% rally in 410 days, all the chatter was about a "pain trade" stampeding investors into stocks who had not participated from the March 2009 bottom. But then, how much pain was there really, with memories of the bottom so fresh, providing a bullet-proof argument of prudence for non-participants? If we're right and stocks start moving significantly higher, that excuse won't wash -- we could see an even more painful "pain trade."

Bottom line

Stocks have reached our price target for this year -- recapturing the highs of April. But forward earnings are higher, multiples are lower, and the economy is poised to improve. We think stocks could gain more than 25% in the coming 12 months without making any crazily optimistic assumptions. Political stabilization and the Fed moving away from being too tight remove two critical barriers to growth. This is where the "expansionless recovery" can become an actual recovery, even if probably a weak one. Post-crisis risks and hangovers could keep the economy from getting back to trend for a long time, but we think we are upshifting to a higher growth path.