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The Enemy of the Good

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Donald Luskin

It doesn't require a perfect economy to justify substantial stock market gains in 2011.

Visiting clients this week and explaining our positive shift on the economy and the stock market (see "Stock Outlook: Differences Make a Difference" November 10, 2010), we've been surprised by both the near-unanimity of the disbelief we've encountered and the intensity of the pushback we've received. It's not bearishness, it's the deep conviction that in the face of so many lingering economic challenges, no improvement is possible. We see that as a form of letting the perfect be the enemy of the good. We don't have to solve all the world's problems -- we just have to ameliorate one or two of them. Most economic and market transformations happen at the margin, in tiny steps. The big phase-shifts are memorable, but they are quite rare. As we've said before, differences make a difference.

This is especially true when the economy is operating at far below capacity as it is today. Think about it in terms of employment. If the economy was operating at literally full capacity, every worker would already be employed, and nothing could create an additional job. Today, far below capacity, with so many workers unemployed, even the smallest positive development can create new jobs. Yet the fact that there are so many workers unemployed now is generally viewed not as a source of potential growth, but as a cause for despondency. It's ironic, then, that so many investors have such deep convictions about the growth potential of China and India, precisely because those nations have such deep pools of potential new workers -- in other words, that they are operating so far below capacity.

What got the US economy so far below capacity was a world-historical systemic global credit crisis. We don't doubt that the deep damage from this event, and its aftershocks, have made it uniquely difficult for growth to recover, and will continue to do so. We can't do anything about that except let time go by -- so don't expect "the perfect" anytime soon. But there have also been unforced errors that have retarded recovery, and two of those are starting to be successfully fixed. They're enough to make us now expect "the good."

- With QE2 the Fed is beginning to redress the error of having been too tight for two years (see, for example, "How to Ease, Not When to Tighten" June 23, 2010). Most clients we've talked to about QE2 strongly disapprove of it, seeing it as both useless and dangerous.

Update to strategic view

US STOCKS: The post-election post-FOMC correction isn't getting much traction. Stocks could exceed our 1217 price target for 2010. And we reiterate our expectation for a 25% to 30% rally by year-end 2011.

US MACRO: We're getting lots of pushback on our upgraded forecast for 2011 real growth, but we're also starting to see signs that the consensus is going to move slowly toward us. The more growth improves, the lower the risk of the exogenous systemic shocks that now make optimism feel so impossible.

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But if the Fed has indeed been too tight, then QE2 will be quite useful, and *not* doing it would be dangerous.

- We know what economies look like when central banks are too tight. They have intractable high levels of long-term unemployment, deflation or unusually low levels of inflation, stagnant growth, and frozen bank lending markets. In other words, they look just like the US economy looks today. And we know what happens when central banks stop being too tight. Those problems start going away.
- A special externality of QE2 is that its conspicuous boldness has opened up solution-space for other central banks -- who have been too tight to an even greater degree than the Fed -- to move in the direction of ease. The European Central Bank is a critical case in point. It is suicide for a central bank in an economy with both an unsustainable debt overhang *and* undercapitalized banks to run a monetary policy that even hints of deflation. With Eurozone headline inflation running at 1.9%, against an official target of 2.0%, full-blown deflation is not the issue. But given the risks Europe faces, and with core inflation at only 1.1%, surely errors from the headline target should be on the upside, not the downside. One of the drivers of yesterday's strong stock market rally was the report that ECB president Jean-Claude Trichet would likely step back from expected plans to accelerate the exit strategy from its main refinancing operations in today's press conference. Indeed he did, but it's disappointing there was no overt gesture toward ease. On the other hand, his evasiveness in response to questions about the ECB's bond purchases should probably be interpreted as a sign that this controversial program will be expanded.
- The other critical element in play in our improved outlook is the political backdrop, although "political" doesn't quite capture what we mean. We aren't talking simply about the fact that Republicans are going to control the House of Representatives in January.
- The November election was only a symbol, an affirmation of the critical underlying reality that the US electorate has, after only a two-year dalliance with anti-growth policy, rejected it in favor of a move back toward pro-growth policy (see "The Pendulum Swings Back" November 2, 2010).
- There is concrete evidence that this is a fundamental realignment of the electorate's demands, not just a transient partisan electoral phenomenon. The movement to extend the Bush-era tax rates for "the rich" began not with Tea Party Republicans in the election campaign, but with Democrats -- well before the campaign got fully underway (see "Good Week for Growth" July 26, 2010).
- Prosaically, it's a positive that economic policy will likely stabilize under gridlock, giving capital a stable rule-set to operate under. It's a pro-growth positive that the Bush-era tax rates will likely get fully extended. Another positive would if the job-killing Federal long-term unemployment benefits will be allowed to roll off. Both are in the cards now. But the critically important underlying positive is that in the same year that saw the enactment of Obamacare and Dodd/Frank, these things are even possible, and both thanks primarily to Democrats.

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Recommended Reading

There's No Escaping Hauser's Law
W. Kurt Hauser
The Wall Street Journal
November 26, 2010

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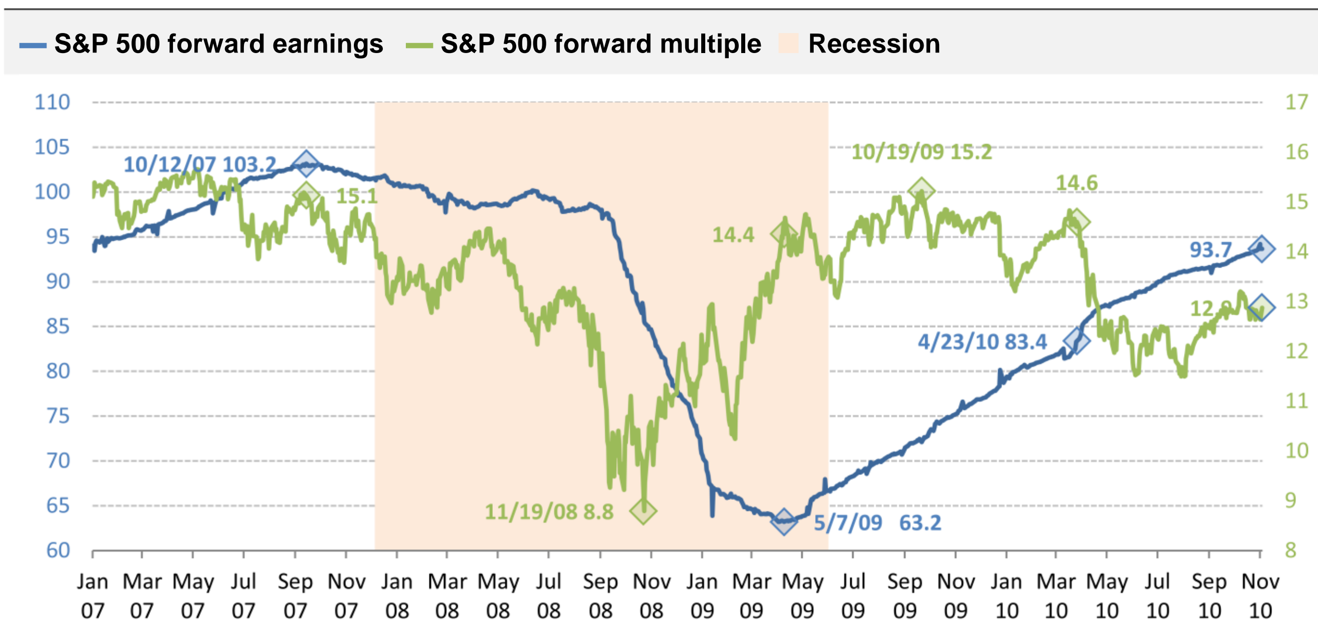
What do these things mean quantitatively for the economy and the stock market?

- Real GDP has been growing at a 2.9% annual rate over the five quarters since the Great Recession's trough in Q2 2009. That happens to be exactly the economy's long-term trend growth rate (post the 1974 business cycle peak).
- So in some sense economic performance in this recovery has been precisely normal by modern standards. However, the first five quarters of an expansion typically exhibit growth rates well above trend, so this recovery is in fact quite sub-normal. It's the second-worst in the modern era, even though it follows the deepest recession. Deep recessions are strongly correlated with robust recoveries, so by historical norms, instead of a 2.9% annual rate, today's economy should have been growing at a 5.3% annual rate.
- We do not expect a return to such a robust rate based on what we know now -- and also out of respect for the very well-known threats that overhang the fragile post-crisis world. We are comfortable expecting real growth in 2011 to average something like 3.5%.
- We don't see this as an especially heroic call, although it does put us a full percentage point above the Blue Chip median of 2.5%. For all the pushback we're getting, since we first made this call three weeks ago, baby steps toward our forecast have already begun among mainstream economists. Yesterday Goldman's Jan Hatzius issued a report self-described as "a fundamental shift," upgrading his 2011 GDP forecast to 2.6%.
- For stocks, with our 2010 price target already in the bag (see "Betting Against a "Double Dip") June 30, 2010), we are now expecting something like a 30% gain over the coming 12 months. It sounds like a lot, but we see this as a baseline scenario based on very feasible assumptions.
- Consensus bottom-up cap-weighted 12-month forward operating



earnings for the S&P 500 are now 93.7. That's only 10% away from the all-time high of 103.2 notched in October 2007 (please see the chart at the bottom of the previous page).

- The cycle low was at 63.2 in May 2009, a 39% drop, the worst in 70 years. We've already recovered 48%, and given the still sup-par state of the economy, we think that residual operating leverage alone makes the 10% required to get back to all-time highs virtually a given. With the kind of backdrop economic improvement we are forecasting, *more* is possible.
- All that is required for stock prices to get back to all-time highs, too, is a return to the 15.1 forward multiple that obtained in October 2010. That's not an especially big multiple, and not even the cycle high. We've seen better than that about a year ago, and values near it for much of this calendar year.

As we discuss these things with skeptical clients, part of the pushback is always a review of the various potential systemic threats -- European sovereign debt, China hard-landing, double-dip in housing, funding crisis in a US state, dollar collapse, hyper-inflation, and so on. Some of these things we utterly rule out, but we we're not pretending we can sure that one of them won't. But we note that simply citing these things as risks isn't itself sufficient as an objection to a modestly improved 2011 outlook for the US.

Ironically, part of our more optimistic outlook is that the Republican political resurgence will lead to the fraying of the various safety nets we've enjoyed in the US over the last two years (see "Eyeing an Exit from 'No Exit'" November 18, 2010). We see that as removing a "collar" from the markets and the economy -- an implicit government put option that provides a floor on the downside, but also entails an implicit short call option that both finances the put and limits the upside. On the face of it, the removal of the collar makes the world a riskier place. But in another sense, the put option has been a source of moral hazard, and a magnet for speculative attack -- we have warned all along that this dynamic is very much active as a self-fulfilling prophecy in the European peripheral debt crisis (see "Europe Gropes toward Stress-Tests" July 12, 2010). So it may be that withdrawing the put actually reduces the likelihood of downside outcomes.

And with each passing day that one of the various systemic risks out there doesn't happen, we think the odds improve that none of them will. They are all potential aftershocks of the Great Recession, and thus all things that can be abated by the very upshift in growth that we are expecting. In that sense they don't thwart our forecast, but rather our forecast thwarts *them*.

Bottom line

The post-election post-FOMC correction isn't getting much traction. Stocks could exceed our 1217 price target for 2010. And we reiterate our expectation for a 25% to 30% rally by year-end 2011. We're getting lots of pushback on our upgraded forecast for 2011 real growth, but we're also starting to see signs that the consensus is going to move slowly toward us. The more growth improves, the lower the risk of the exogenous systemic shocks that now make optimism feel so impossible.