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How We Didn't Blow It in 2010

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We didn't abort the recovery from the Great Recession -- now, some modest expansion.

In this brief note to wrap up the year, we present for the last time the chart below -- the comparison of the S&P 500 at the onset of the "depression inside the Depression" in 1936 and 1937, versus the S&P 500 today. Through mid-year this year, the two had tracked with eerie precision for 12 months. At that time we seemed destined to repeat the two great economic policy errors that aborted the late-30's recovery from the Great Depression and triggered the longest and second-deepest bear market for US stocks -- *in the face of lingering economic weakness, hiking tax rates and running a too-tight monetary policy.* With QE2 and the extension of the Bush-era tax rates, those risks have passed -- and the chart makes it crystal clear.

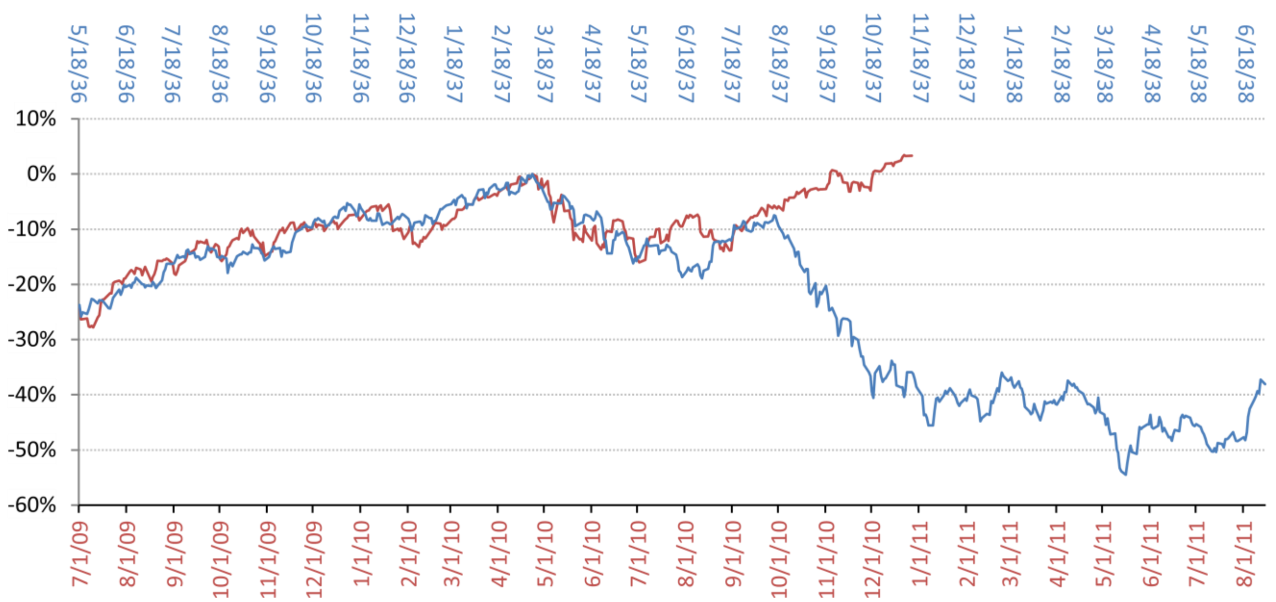
- The two paths of the S&P 500 then and now have massively diverged, beginning at mid-year when we called the bottom in US

Update to strategic view

US MACRO: We have passed through the first phase of recovery from the Great Recession without repeating the mistakes that aborted the recovery from the Great Depression. We expect better-than-consensus US real GDP…

[continued on next page]

S&P 500 in the "depression inside the Depression" **S&P 500 now**
Percent change from respective recovery peaks in March 1937 and April 2010



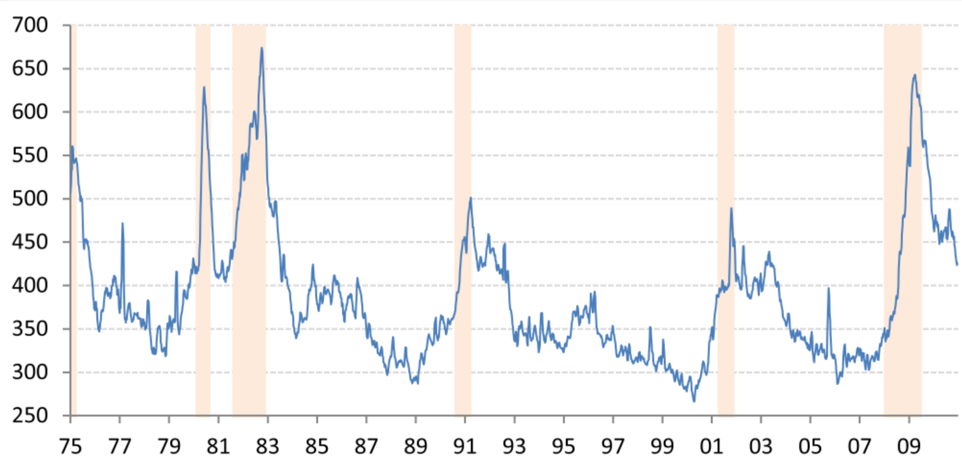
Source: Standard & Poor's, TrendMacro calculations stocks (see "Betting Against a "'Double Dip'" June 30, 2010). We set a price target for the S&P 500 of 1217 -- the April recovery high -- and today we are 3.3% above that. On the comparable day in the Depression, November 11, 1937, the S&P 500 had fallen 35.9% from its March recovery high.

- The divergence began after the market started talking about the possibility of QE2, which we had first written about in May (see "So Much For The 'V'" May 21, 2010), and ultimately occurred in two steps in August and November. The 1936 Eccles Fed tightened, doubling reserve requirements in the name of fighting inflation, when it was running no higher than it is today.
- The divergence got locked in as the market started taking on board the prospect of the extension of the Bush-era tax rates. In 1937, Roosevelt signed a bill raising the top marginal income tax rate to 81%, and imposing a tax on corporate retained earnings. Today's extension of low rates for "the rich" -- including wages, dividends, capital gains and estates -- was first championed by Democrats (see "Good Week for Growth" July 26, 2010). This signals a cultural realignment in favor of capital, capitalists and capitalism (see "The Pendulum Swings Back" November 2, 2010).

There are still challenges and risks ahead as we struggle to recover from a world-historical global credit collapse. But it's a critical positive that we have successfully passed this milestone. That doesn't in itself now entitle the economy to expand as robustly as history suggests it ought to following a severe recession. But we think it's enough to make 2011 a meaningfully better year, with US real GDP growth in the high 3% range (see "Stock Outlook: Differences Make a Difference" November 10, 2010).

So far there hasn't been any dramatic upside breakout in headline economic data. Last month's jobs report was certainly nothing to celebrate (see "On the November Jobs Report" December 3, 2010). The best-known positive has been the constant erosion in new jobless claims (see the chart below). The peak in claims in April 2009 was our first solid indicator that

Initial claims for unemployment benefits **Recession**
Thousands, 4-week moving average



Source: Department of Labor, NBER, TrendMacro calculations

[continued from page 1]

…growth in 2011 in the high 3% range. It's not showing in the data yet, but this view is starting to be supported by a few key leading indicators.

[Strategy Dashboard home]

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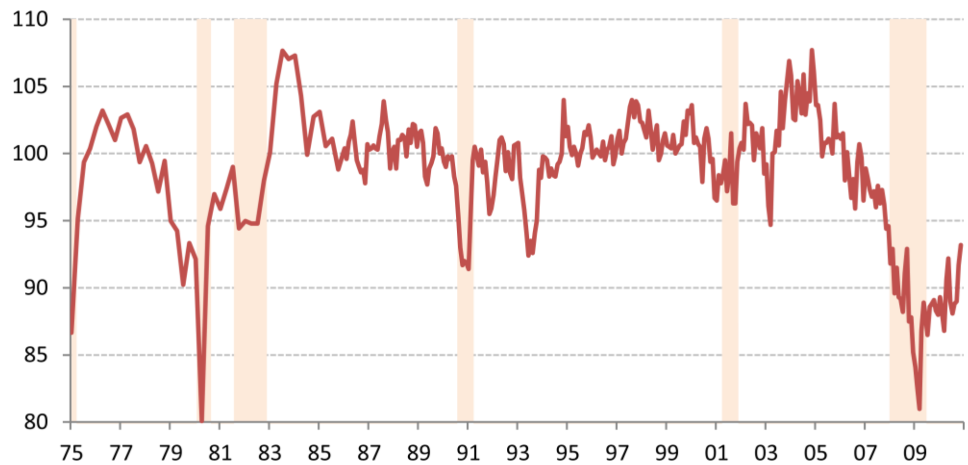
the formal recession was over (see "Stress Test for T-Bonds" May 8, 2009). But there are other lesser-known data points that we take as very important and very positive leading indicators.

- The index of small business optimism of the National Federation of Independent Business has recovered to its highest level since the onset of the recession (see the chart below). Restoration of small business confidence is an absolute prerequisite for recovery, especially in the labor market, since most new jobs are created by firms of fewer than 100 people.

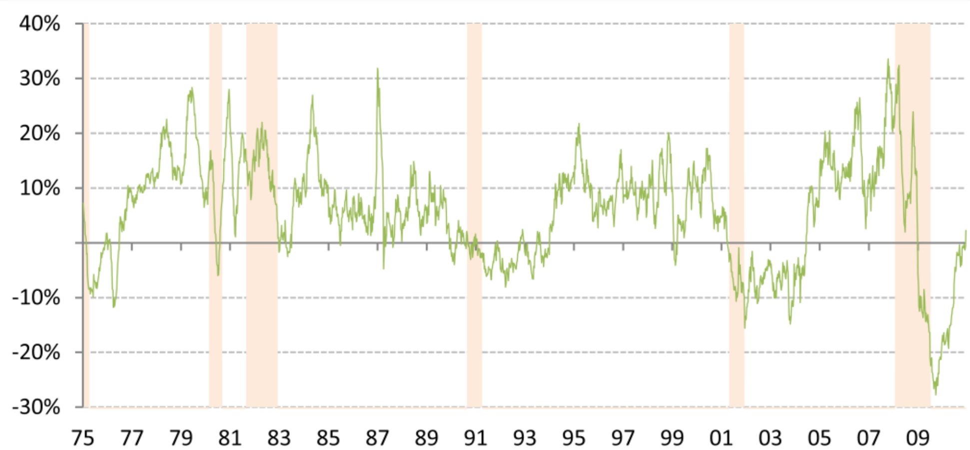
Index of Small Business Optimism **Recession**



Source: National Federation of Independent Business, NBER, TrendMacro calculations

- Commercial and industrial loans by banks are now growing -- modestly to be sure, but *really growing, not just shrinking less quickly* -- for the first time since the onset of the recession (please see the chart below). The non-financial business sector was not

Commercial and industrial loans by US commercial banks **Recession**
13-week annual growth



Source: Federal Reserve, NBER, TrendMacro calculations especially over-indebted at the prior cycle peak, so we don't hold this out as an indicator of the end of deleveraging in the US economy. However, it is an important indicator of restored confidence -- among both borrowers and lenders.

We are not incognizant of the many residual risks left over from the Great Recession. But we find the endless bearish narrative about them to be somewhat shopworn at this point. Yes, if eventuated, those risks could abort a new expansion, and their presence as risks has held back expansion. But the consensus is ignoring that the key risk of 1930's-type policy errors is now passed, and all else equal, that will permit a more robust level of expansion going forward. That better expansion, in turn, makes the eventuation of other remaining risks less likely.

Bottom line

We have passed through the first phase of recovery from the Great Recession without repeating the mistakes that aborted the recovery from the Great Depression. We expect better-than-consensus US real GDP growth in 2011 in the high 3% range. It's not showing in the data yet, but this view is starting to be supported by a few key leading indicators.