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A Question of Sentiment

Thursday, January 6, 2011

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After the 4th-best December in 110 years, stocks haven't gotten ahead of themselves.

Stocks have made a big downpayment on our expectation that they'd get back to all-time highs in 2011. That goal used to be 32.8% away when we first wrote about it (see "Sell On Good News" October 20, 2010) -- now it's 23.5% away. We stand by that as our price target for the year, with high confidence (see "Stock Outlook: Differences Make a Difference" November 10, 2010). But looking ahead to the near-term, we are struggling to understand the state of investor sentiment. A month ago we took perverse comfort from the overwhelmingly skeptical reaction we were getting from clients on our bullish outlook for stocks and the economy in 2011 (see "The Enemy of the Good" December 2, 2010). Since then stocks have experienced the 4th-best December in 110 years. After that, has sentiment shifted so much to the bull-side that a correction must be just around the corner?

Anything's possible, but we don't see a major interruption just ahead. One thing that gives us courage is that we hear so often now in market chatter that sentiment is too bullish. Yet what, really, is the evidence for that?

- We keep hearing that *Barron's* reports 9 out of 10 "strategists" are bullish on stocks for 2011. But the average predicted gain is only 10%. That's not an especially bullish forecast -- in fact it's pretty much just the long-term average annual total return for stocks. For us, the more salient sentiment evidence here is that the prediction of merely average gains is seen as excessively bullish.
- We keep hearing that retail investors surveyed by the American Association of Individual Investors are overwhelmingly bullish. Okay, but they were actually *more* bullish a month ago, before the best December in 19 years. And at that point they'd just expressed their supposedly extreme bullishness by moving a net $390 million into stock mutual funds -- but only after having withdrawn a net $68 billion, 174 times as much, over the prior six months.
- For us, the most comprehensive statistical portrait of sentiment is the *equity risk premium* -- the difference between the forward earnings yield of the S&P 500 and the 30-year Treasury yield. Today it stands at 2.91%. That's the *lowest* -- that is, the most *exuberant*, the most risk-*tolerant* -- since the top in stocks last April. Sounds like it's telling us that sentiment is getting excessively

Update to strategic view

US STOCKS: We are hearing that sentiment is getting too frothy. But that view is itself part of a continuing bearish consensus that denies what, to us, is self-evident ongoing improvement in the economy. We don't expect a serious near-term correction for stocks here, but rather the continuation of the slow-motion melt-up.

US MACRO: We take the ADP payroll surprise as a serious indicator of an improving jobs picture. Who knows what will come through the noise in tomorrow's jobs numbers, but there's no reason why private payrolls shouldn't be growing at 200,000-plus on a regular basis from here.

GOLD: With improving growth prospects, we remain ambivalent about gold, and continue to rate it a hold. We will be watchful for how it reacts to tomorrow's jobs number, especially if there is an upside surprise.

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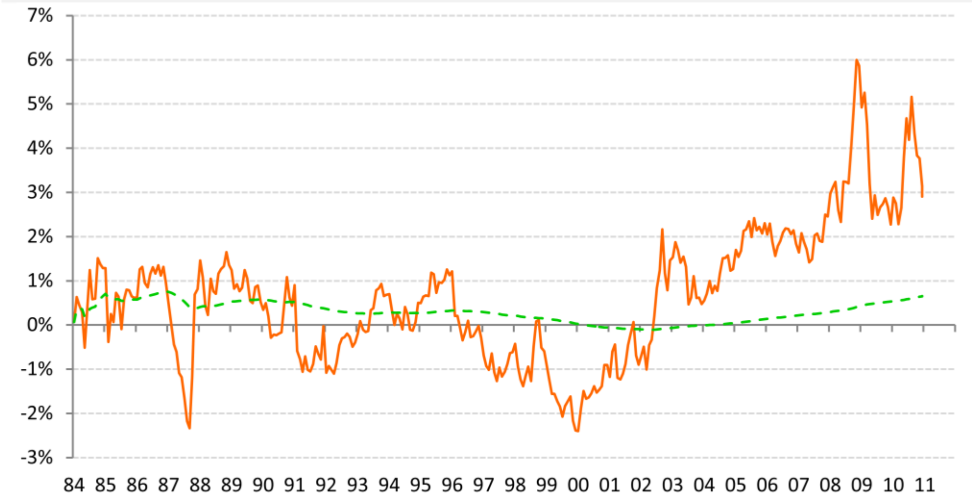
bullish, and we suppose in the recent context that's true. But the recent context is a nearly unique crisis environment, and treating it as the norm is unduly myopic at this point. In a longer-term context, the equity risk premium is actually quite *high*. On a monthly basis the equity risk premium has only been this *high* -- that is, this *pessimistic*, this risk-*averse* -- 22 times in more than a quarter century (please see the chart below).

Equity risk premium **Moving average**
S&P 500 forward earnings yield minus 30-year Treasury yield



Source: Zacks, Federal Reserve, TrendMacro calculations

Say what one will about this or that sentiment measure -- in our view there's no doubt that conditions are getting demonstrably better (see "How We Didn't Blow It in 2010" December 28, 2010). And our most acute sense of sentiment comes from the relentless skepticism with which each improving data point is greeted. A case in point is yesterday's upside surprise in ADP private payroll growth, with a gain of 297,000. Unless you think that ADP literally calculated it incorrectly, you have to take the number at face value. It is what it is -- a sign of stronger growth. The 10-year Treasury yield rising 13 bp, and the year-ahead futures-implied funds rate rising 11 bp, would seem to agree. Yet it struck us that market chatter was dominated by a reflexive urge -- based on what we see now as deeply embedded conventional wisdom -- that this good news simply could not be true, if for no other reason than because it is good.

- We kept hearing that it's the largest gain in the history of the series, as though that *ipso facto* makes it not credible. But the series only goes back ten years.
- We kept hearing that the last time ADP payroll growth was nearly this big was in February 2006 at 257,000, in a quarter when real GDP grew by 5.4% at an annual rate. But ADP payrolls grew by more than that in November 2005, by 264,000 -- and in *that* quarter GDP grew by only 2.1%. So there's nothing remotely impossible about yesterday's ADP number in the present growth context.

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[About us]

Recommended Reading

What Does the Change in the FOMC's Statement of Objectives Mean?
Daniel Thornton
Federal Reserve Bank of St. Louis *Economic Synopses,* 2010, No. 1

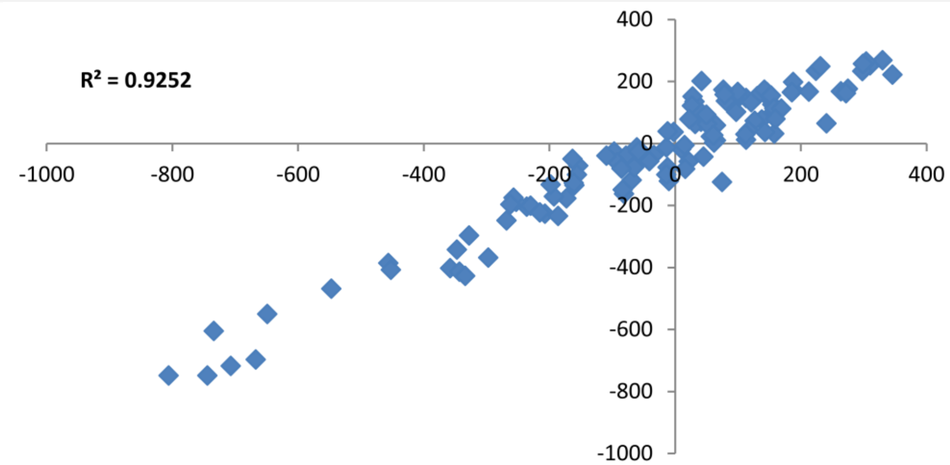
[Recommended Reading home]

Correction

In our previous report, "How We Didn't Blow It in 2010," we accidentally omitted a description of the data displayed in the chart of consumer and industrial lending. We should have said that it was 13-week annual growth. We regret the error. Please download a corrected version of the report by clicking here.

- We kept hearing that the ADP report has been a poor predictor of overall private payroll growth recently -- so don't get too excited about a big jobs number on Friday. But all the errors have been that the ADP number was *too small.* If the recent pattern of error continues, Friday's jobs number will be stellar.
- We kept hearing that the ADP payroll growth number wasn't confirmed by the employment index in [yesterday's ISM non-manufacturing Report on Business](), which fell from 52.7 last month to 50.5. But changes in ADP payrolls correlate with overall payrolls with an R-squared of 92.5% (please see the chart below) -- while changes in the ISM-NM employment index are virtually uncorrelated, with an R-squared of 6.5%.

◆ **Monthly payroll change: ADP (vertical) versus BLS private (horizontal)**
Thousands, seasonally adjusted, Jan 2001 to Nov 2010



Source: ADP, BLS, TrendMacro calculations

Based on the historical relationship of the last decade of data, the 297,000 ADP number translates into 260,000 private payroll jobs for tomorrow. Who knows whether that will really happen -- there's a huge amount of statistical noise involved. But we come into tomorrow expecting that it *will*, or at least *could*, and *should*.

- Shall we say 260,000 private payrolls tomorrow would constitute a "blockbuster" number? That's a little less than twice the consensus expectation (as measured before the ADP number was released yesterday). And it would be the best private payroll gain since the recession formally ended.
- But with jobs outside of the housing sector (broadly construed) still down 4.6 million -- even after 10 months of cyclical recovery from the jobs trough (on a non-seasonally adjusted basis) -- that's 500,000 more lost jobs than at the very trough for jobs coming out of the 2001 recession. Even assuming no job growth potential whatsoever in the housing sector -- and even given that we're no longer early-cycle -- the sheer headroom for remaining improvement in non-housing payrolls is enormous.

- So it's a measure of the prevailing pessimism that only 260,000 would be considered a blockbuster at this point. Given what we are seeing as a step-function shift to better growth this year, numbers like that could quickly become the norm.

So overall our sense of sentiment is that it's not too bullish, and doesn't necessitate a serious near-term correction for stocks. We think the macro data is going to continue to develop on the upside, surprising at least in its consistency if not its magnitude, too. So we're inclined to think sentiment is actually too bearish, which would suggest a continuation of the slow-motion melt-up that stocks have already been experiencing.

A quick word on gold

It's not the major topic of this report, but because gold has been a signature strategic theme for us, we want to mention its recent weakness in the context of the improving growth reflected in the stock market. It is quite straightforward that gold's high-level consolidation over the last month, having run to new all-time highs, reflects the withdrawal of gold's biggest bull case -- the idea that the Fed and the world's other central banks will have to fight persistent economic weakness with endless liquidity injections. We first warned on this in mid-November (see "Eyeing an Exit from 'No Exit'" November 18, 2010).

- We're not ready to worry about a lot of downside for gold here (see "Gold is a Hold" December 20, 2010). Grant that there will be no QE3, QE4 or QE*n* to propel gold much higher -- that cuts off the upside. But it's not obvious to us that any of that has been impounded in the price to begin with -- so its elimination doesn't necessitate a big downside.
- More important, there remains a secondary upside case for gold. While we fully expect the economy to grow much faster than consensus in 2011 -- we call for the high 3's, and the consensus is 2.7% -- the Fed may well not react decisively. Even with 4% growth and stocks back at all-time highs, by year-end the unemployment rate will still be in the 9's, and reported inflation probably won't have increased much. So the Fed may do nothing to tighten. That *implicit* easing-by-omission could be as powerful for gold as an explicit easing in the form of QE*n*.
- There's a saying in poker that you should never call a bet -- if you want to be in the hand at all, you should raise. Given our sense of unclarity about the possible scenarios for gold, we can't in good conscience call for a raise in gold right now -- there are surer bets at this point. So for aggressive investors, that implicitly makes gold a sell, simply because it's only a hold. We'll be watching closely -- gold's reaction to tomorrow's jobs number could give useful clues.

Bottom line

We are hearing that sentiment is getting too frothy. But that view is itself part of a continuing bearish consensus that denies what, to us, is self-evident ongoing improvement in the economy. We don't expect a serious near-term correction for stocks here, but rather the continuation of the slow-motion melt-up. We take the ADP payroll surprise as a serious indicator of an improving jobs picture. Who knows what will come through the noise in tomorrow's jobs numbers, but there's no reason why private payrolls shouldn't be growing at 200,000-plus on a regular basis from here. With improving growth prospects, we remain ambivalent about gold, and continue to rate it a hold. We will be watchful for how it reacts to tomorrow's jobs number, especially if there is an upside surprise.