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Are We Running Out of Armageddons?

Thursday, February 3, 2011

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Stocks are not vulnerable on value or sentiment, and Egypt is likely not a systemic risk.

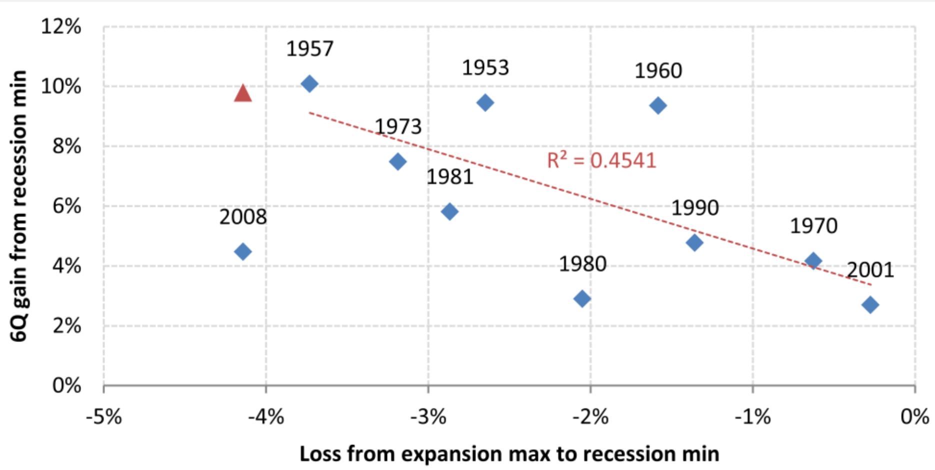
So far the turmoil in Egypt hasn't triggered a correction in US stocks, with the exception of a single bad day last Friday. Granting the inherent unpredictability of situations like this, from what we can see there's little reason to assume that it will. We think at this point it will take a much more palpable shock than instability in a third world police state to seriously threaten the ongoing slow-motion melt-up of US stocks. To see why we say that, let's quickly review the history so far of our present bull market.

At the bottom for US equities in March 2009, we were on the brink of two Armageddons at once -- a financial one and a political one. When the banking crisis was solved, that was one Armageddon down, one to go.

- That was enough to end the Great Recession, and inaugurate an "expansionless recovery" -- six quarters of merely trend GDP growth, even though we'd just endured the single worst post-war recession (please see the chart below).
- That was enough to power stocks to a 79.9% gain over 410 days, the fifth best rally in the recorded history of daily US stock prices.

Real output loss in recession, versus gain in first 6 quarters of recovery

◆ Actual --- Regression for 1948-2001 ▲ Theoretical for current recovery



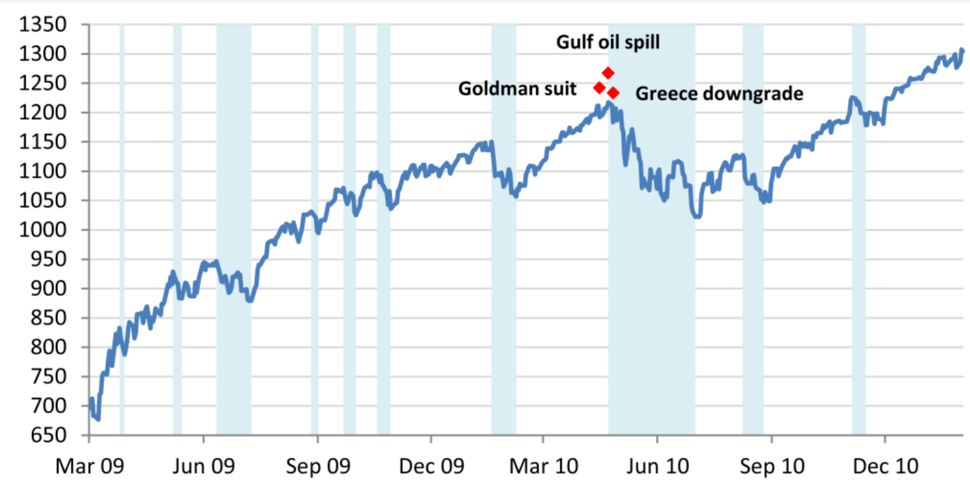
Source: Bureau of Economic Analysis, NBER, TrendMacro calculations

Update to strategic view

US STOCKS: The turmoil in Egypt is being shoe-horned into the tired narrative of systemic risk, but we don't see it as especially salient. It lacks the power to derail stocks the way a triple threat of event-shocks did last April. At most, we see a short, shallow correction ahead based on nothing more than how overdue one is -- but stocks are not overvalued at all here, and we don't see sentiment as excessively bullish. If there is a correction -- if -- it would be a buying opportunity.

US MACRO: Two years ago the economy faced twin Armageddons, financial and political. Both are off the table, confidence is being restored, and this should be a year of better-than-trend growth. We're seeing it already in leading indicators such as load demand, and lagging ones such as the ISMs. Can an upside surprise in jobs be far behind?

- Along the way there were seven brief, small corrections (countermoves of greater than 3%) -- lasting from four to 28 days, and ranging from a 3.5% loss to a 8.1% loss (please see the chart below).
- The move was ended with the arrival of three event-shocks over 11 days in April 2010 -- the SEC's suit against Goldman Sachs, the Gulf oil spill, and the downgrade of Greek debt to junk. Cumulatively, those three shocks represented a lot of macro risk, some of it systemic (again, please see the chart below).



Source: Reuters, TrendMacro calculations

- When those three shocks hit, stocks were vulnerable. The forward PE of the S&P 500 was 14.5 -- almost all the way back to the 15.1 seen at the peak for stocks in October 2007. The equity risk premium had fallen to 2.24%, below the mean risk premium of the current epoch (that is, post Q3-2002).
- So the three shocks triggered a lengthy, serious correction in vulnerable stocks -- lasting 70 days and ending with a 16% loss.

The correction ended, and what turned out to be a second leg up in a bull market began at mid-year. We said the correction was over when, first, the Fed signaled QE2, pointing to urgently needed relief from too-tight monetary policy (see "Betting Against a "Double Dip"" June 30, 2010). Then second, and more important, it became clear that a major political realignment was occurring (see "Good Week for Growth" July 26, 2010), culminating in the GOP takeover of the House, the extension of the Bush-era tax rates, and President Obama's pivot to the center (see "To Get Rich is Glorious Again" December 7, 2010). Once all that was accomplished by November, the second Armageddon -- the political one -- was avoided.

- Having pulled back from both of the two Armageddons, we think the US economy now is already embarking on a period of above-trend growth as confidence is restored (see "Stock Outlook: Differences Make a Difference" November 10, 2010).

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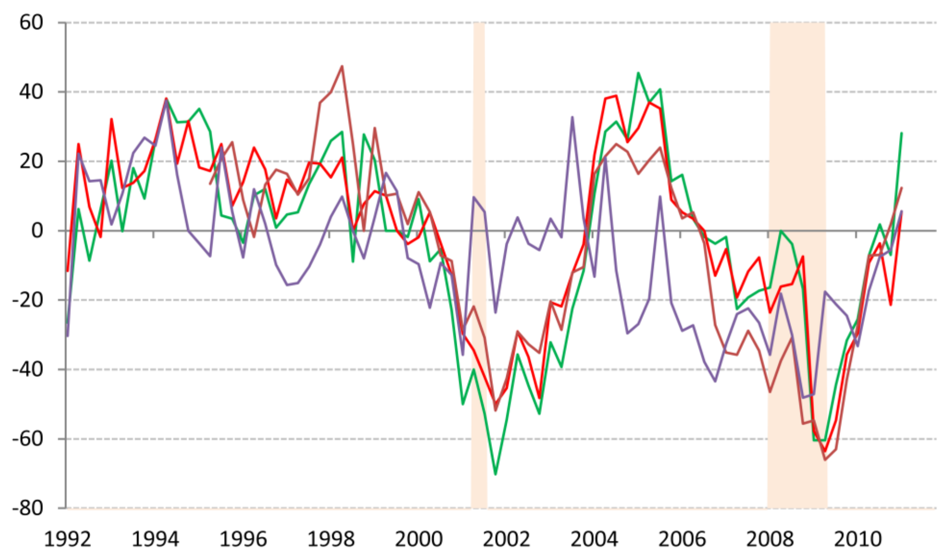
[About us]

- It's not important that we likely won't get the kind of hyper-accelerated growth we've typically seen coming out of recessions as we race back to trend output *levels*. It's important that growth *rates* will be above trend -- instead of merely at trend as they have been. And it's important that the basic economic infrastructure that is the precondition of superior growth is being repaired -- instead of merely kept on life-support.
- An especially salient example: for the first time since the recession formally ended, commercial and industrial loans from commercial banks are starting to grow -- yes, banks are lending again (see "How We Didn't Blow It in 2010" December 28, 2010). But this is more than the result of greater *supply* of loans. This is a *demand-side* phenomenon, with loan demand growing in all non-mortgage categories for the first time in 6 years -- and with growth in demand for large/medium commercial and industrial loans near the highest levels ever recorded (please see the chart below).

Senior loan officers reporting increasing demand for loans
Large/medium C&I Small C&I CRE Consumer Recessions



Source: Federal Reserve Senior Loan Officer Survey, NBER

- There are many other examples beginning to crop up, such as this week's very strong ISM readings -- but we like this one because of its deep *causal* implications for *future* growth. Soon enough such *causes* of growth will turn into *effects* visible in lagging statistics such as employment. One of these first-Fridays there's going to be an upside surprise in jobs. We're not betting the family farm, but we've got a feeling it could be tomorrow. If it's not, we won't have long to wait.
- In the second leg of the present bull market, stocks have now rallied 27.5% from the mid-year bottom (for a cumulative gain since March 2009 of 92.7%). There have been two corrections in the

second leg, lasting 17 days and 11 days, and putting up losses of 7.1% and 3.8% respectively.

- The current slow-motion melt-up since the 3.8% post-election correction has lasted for 78 days. So it's getting a bit long in the tooth -- in three days it will tie for the longest uncorrected run in this bull market.
- But for all the talk about how sentiment has become too bullish, in fact stocks don't look especially vulnerable. The S&P 500's forward PE is only 13.4, a full point below where it was at the onset of the large corrections that began in January 2010 and April 2010. The equity risk premium is 2.84 -- more than half a point above where it had been then, well above the average. Stocks simply aren't over-valued by the numbers.
- We continue to hear that stocks are vulnerable because sentiment is so bullish (see "A Question of Sentiment" January 6, 2011). But in the spirit of Yogi Bera's statement that "No one goes there anymore -- it's too crowded," it seems to us that the very unanimity that sentiment is too bullish is itself too bearish.
- The market chatter in reaction to the escalation of instability in Egypt tells us that there isn't any deep complacency among investors. We see instead evidence of an enduring tendency to project large-scale systemic risk into any event-shock. Investors have become conditioned to systemic risk -- it's been the dominant narrative, betting on it was "what's working" during the darkest days of the last several years, and there persists the belief that it's "what all the really smart people are doing." So not a day goes by when we don't hear entirely understandable fretting about Europe, US states and municipalities, bubble in China, and so on. So when Egypt showed up on the radar screen, it was immediately absorbed into the narrative of systemic risk -- we think, inappropriately. So far, there's been only a single bad day in the stock market because of it.
- Let's set aside the matter of sentiment, and look at the reality of the situation in Egypt. We don't claim to have any particular expertise or inside information. What we do know, and what common sense tells us, is that the systemic risk said to arise from it -- that is, contagion to other countries -- is being overplayed. Surely no one can be surprised that there is instability in the Middle East. And the idea that the Twitter generation in China will now suddenly threaten the Communist regime there and trigger a recession in one of the world's key economies strikes us as utterly remote -- though we hear it suggested repeatedly. What would youth in China rebel against at this point -- too much prosperity?
- We are also not persuaded by the other systemic risk narrative we keep hearing about Egypt -- that the instability there was triggered by high food prices caused by too-loose monetary policy from the US Federal Reserve. If that were true, then there really would be a salient systemic risk concern, because that policy isn't going to change anytime soon. We understand that the Fed is deliberately trying to increase US inflation. We understand that such efforts have unpredictable effects, influencing some prices more than others, and some more quickly than others -- with commodities

such as food being especially likely targets. We've been commodity bulls for several years because of this. However, there is no rational way to explain the surge in food prices in terms of Fed policy -- the speed, force and magnitude of the price moves are simply too great -- unless we posit that the Fed has the power to control the weather in Russia, which has just experienced the worst crop failures in 50 years. To the extent that the run-up in food prices *are* monetary -- and if they are being experienced more intensely in the developing world -- then those nations have the power to detach themselves from the influence of Fed policy any time they wish by ending their management of their currencies vis-à-vis the US dollar.

So where does that leave us?

- First there were two Armageddons. Then there was one. Now there are none. The "expansionless recovery" is over. We're embarking on a year of above-trend growth rates, with lots of room to run before we hit trend levels.
- Stock prices haven't taken this reality on board yet. Real GDP is at all-time historic highs as of Q4 2010, consensus forward S&P 500 earnings are only 5.8% below all-time highs. Yet the S&P 500 is still 20% below all-time highs. Stocks are not as fully valued as they were at the tops in January or April of last year.
- The potential systemic risks that everyone talks about -- Europe, state and municipal finances, China bubble -- are certainly worth keeping on the radar, but these are very well ventilated ideas at this point.
- The turmoil in Egypt, on the other hand, is a legitimately new event-shock. But we don't see how it has the same power as the triple-threat of event-shocks that rocked markets last April.
- In fact, we see the reaction to it in market chatter as evidence of how excessively pessimistic sentiment remains. But we see the reaction in markets themselves -- where stocks have moved back to all-time highs following a one-day hit last Friday -- as evidence that the reality is nowhere near as bad, and that stocks are not especially vulnerable coming into this.
- Our only slight hesitation here is the present rally in stocks in simply getting a little aged. So we wouldn't be shocked if there had to be a brief, shallow correction at some point over the next two weeks. But based on everything we know now, we would expect to see that as a buying opportunity -- we think the slow-motion melt-up in stocks will continue.

Bottom line

The turmoil in Egypt is being shoe-horned into the tired narrative of systemic risk, but we don't see it as especially salient. It lacks the power to derail stocks the way a triple threat of event-shocks did last April. At most, we see a short, shallow correction ahead based on nothing more than how overdue one is -- but stocks are not overvalued at all here, and we don't see sentiment as excessively bullish. If there is a correction -- if -- it would be a buying opportunity. Two years ago the economy faced twin Armageddons, financial and political. Both are off the table, confidence is being restored, and this should be a year of better-than-trend growth. We're seeing it already in leading indicators such as load demand, and lagging ones such as the ISMs. Can an upside surprise in jobs be far behind?