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Tear Down This Wall of Worry

Friday, May 20, 2011

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Pervasive pessimism is out of proportion to what's happening in markets and the economy.

It's another "risk-off" day, yet we must take another swing at challenging the pervasive mood of deep pessimism we see among our clients. By one reckoning, we find the pessimism strange. Just three weeks ago the S&P 500 made new recovery highs. As of this writing it is off only 2.38% from those highs -- and up 5.92% from where we called the bottom in March (see "Meltdown in Japan" March 15, 2011) -- having in the meantime not put in so much as a 3% correction. It seems to us that what we've been calling all year a "slow-motion melt-up in stocks" (see "A Question of Sentiment" January 6, 2011) is ongoing.

That said, much of the macroeconomic data over the last couple months has been poor -- not outright negative, but definitely lackluster. There's no getting around it: this is a disappointment for us after we called the end to what we'd called the "expansionless recovery" late last year (see "Stock Outlook: Differences Make a Difference" November 10, 2010). Now we have a paradox: after a couple months of sharply better growth, the overall economy really hasn't delivered on our expectations -- yet at the same time our bullish outlook for US equities has been vindicated. We choose to resolve the paradox in favor of forward-looking stocks, which we think are judging the recent spate of poor data to be transitory.

- First and foremost, nothing has changed our *strategic* appraisal. We still see the economy as having successfully passed through three overlapping crises -- the global banking collapse, the failure of the Fed to supply sufficient liquidity, and anti-growth political radicalism (see "Are We Running Out of Armageddons?" February 3, 2011). We've finally followed the First Rule of Holes -- when you're in a hole, stop digging. Having done so, the economy has the opportunity to really grow.
- Against that backdrop, the economy has been hit by several substantive event-shocks over the last couple months -- the rise in gasoline prices driven by Middle East instability (see "An Oil Shock Tipping Point?" March 3, 2011), a global inflation scare (see "The Fed is from Venus, The ECB is from Mars" March 9, 2011), the Japan earthquake (again, see "Meltdown in Japan"), continuing debt drama in Europe (see "EUicide" April 7, 2011), the high-stakes game of chicken played in Washington over government

Update to strategic view

US STOCKS: Sentiment among our clients is about as pessimistic as we've ever seen it. Yet stocks are actually performing well. The slow-motion melt-up painfully continues.

US MACRO: Growth has disappointed us, and there has been a recent spate of poor macro statistics. But the most important strategic macroeconomic data continues to point to an upshift in growth.

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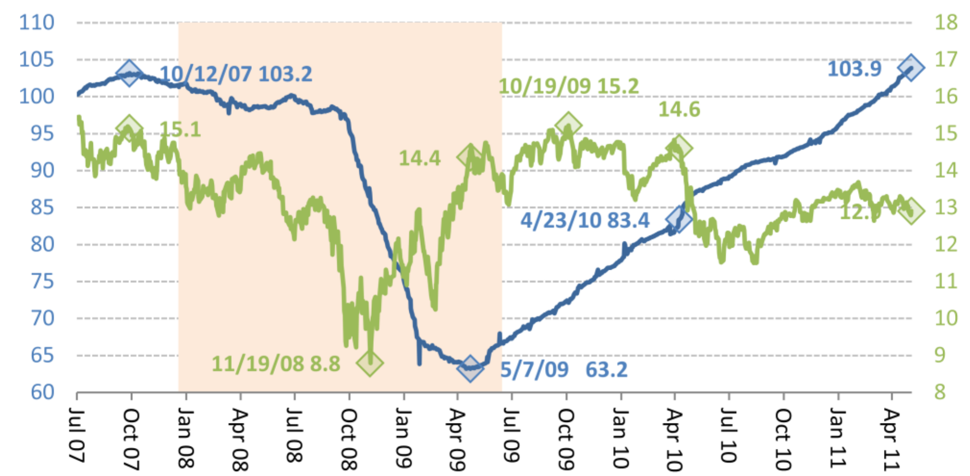
spending (see "Growth Wins Another Skirmish" April 11, 2011), and fears of the end of QE2 (see "Will the World End when QE2 Does?" April 4, 2011).

- We don't see any of them, or all of them cumulatively, as large or durable enough to really change the strategic outlook.
- We don't want to play the game of data apologetics. But the fact is that the macro data we take most seriously *for making strategic judgments* still looks very encouraging.
- Forgive us, please, for beating this particular drum so repeatedly -- but we can't emphasize enough the importance of the fact that forward EPS for the S&P 500 have broken to new all-time highs, and are being upgraded now at a 33% annualize rate (please see the chart below, and "A New EPS High-water Mark" May 11, 2011). This is our favorite macroeconomic indicator -- because it is forward-looking, because it is high-frequency and real-time, and because it is crowdsourced from thousands of independent microeconomic inputs.



Source: Zacks, TrendMacro calculations

- We see no diminution in liquidity. We would be worried if we saw gold -- the best indicator of liquidity conditions -- showing any substantial sign of trend reversal (see "Gold Hits Our $1500 Price Target" April 20, 2011). But it is not, even as the completion of QE2 approaches, and in the face of the release of speculative pressures in many commodity markets (see "The bin Laden Commodities Crash" May 6, 2011).
- The momentum in private sector job growth has continued to gradually build, hitting the best level of net payroll gains in more than five years in April (see "On the April Jobs Report" May 6, 2011).
- Bank credit activity continues to be robust. Commercial and industrial loans are growing at a 10.4% 13-week annual rate, the best pace since the end of the recession.

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[About us]

Recommended Reading

The American Recovery and Reinvestment Act: Public Sector Jobs Saved, Private Sector Jobs Forestalled
Timothy Conley and Bill Dupor
May 12, 2011

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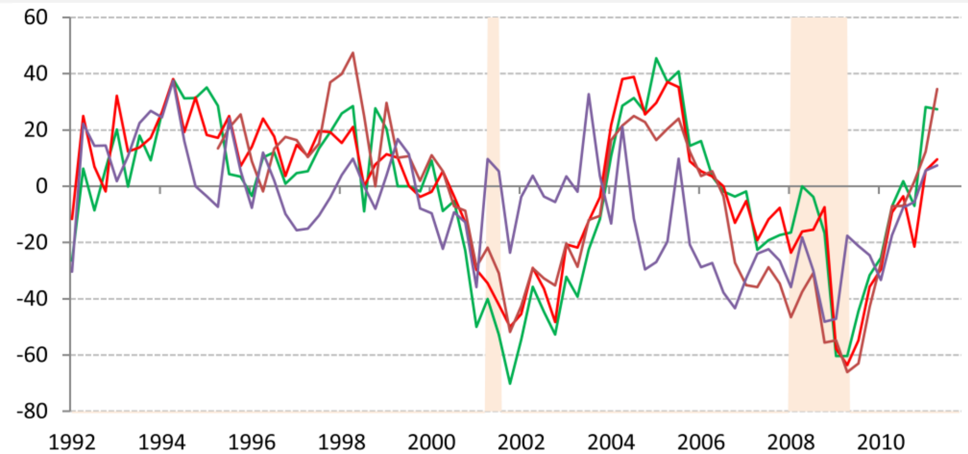
- In the Fed's Senior Loan Officer Survey, demand for large and small commercial and industrial loans, commercial real estate loans, and consumer loans all continue to grow. This is now the second quarter of rising credit demand in all four categories, something not seen since the peak of the housing market in late 2005, which marked the onset of a five-year cycle of deleveraging (please see the chart below).

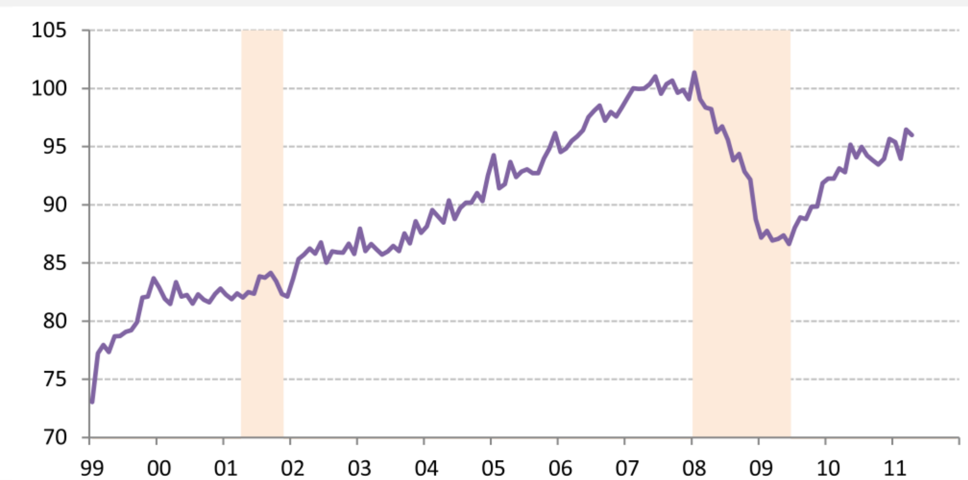
Loan demand C&I large/med C&I small CRE Consumer



Source: Federal Reserve, NBER, TrendMacro calculations

- We are especially concerned with gauging the impact of high oil prices, watching for a degree of shock that could be a recessionary tipping point (again, see ["An Oil Shock Tipping Point?"]). It is encouraging that the [Ceridian-UCLA Pulse of Commerce Index], which tracks diesel fuel consumption in real-time at the individual truck level, rose to new recovery highs in March and gave back almost none of it in April (please see the chart below).

Ceridian-UCLA Pulse of Commerce Index **Recession**

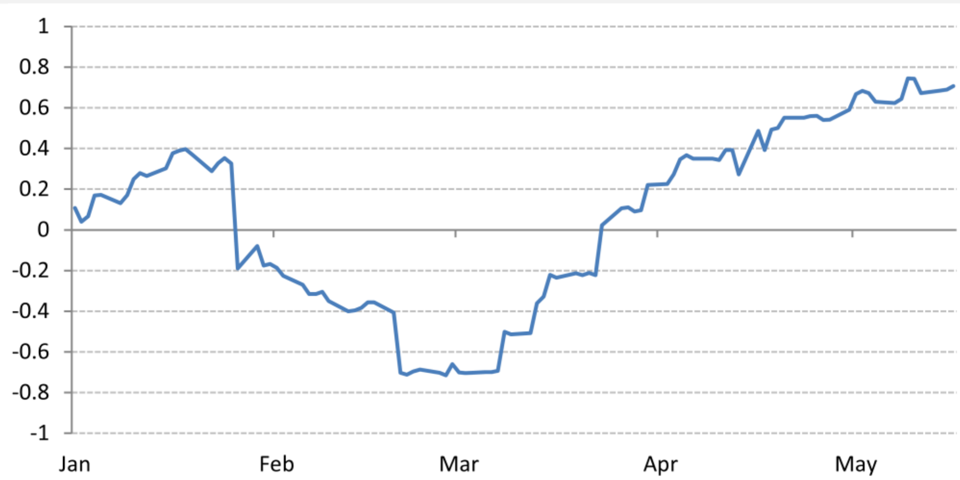


Source: UCLA Anderson, NBER, TrendMacro calculations

- We note that when the domestic crude oil price first broke above $100 in February, as turmoil in Libya erupted, stocks experienced their sharpest correction in six months. At that time a panicky narrative about contagious revolution in the Middle East prevailed, and absurdly high crude price forecasts were bandied about with great assurance. Now that crude prices have fallen -- following the death of Osama bin Laden (again, see "The bin Laden Commodities Crash") -- it strikes us as ironic, and emblematic of the pessimism in the marketplace, that the drop has caused as much panic as the previous rise did. The new narrative is that the lower oil price signals a catastrophic hard-stop in the "risk-on" trade in anticipation of the completion of QE2.

- It looks to us like all that has happened is that some of the geopolitical risk premium has come out of oil. This is reflected in the evolution of the correlation between the oil price and stock prices (please see the chart below). Generally stocks and oil are very positively correlated, as both are forward-looking indicators of economic growth. When they become negatively correlated for short periods, it generally means some exogenous factor is impacting the oil price. In February and March, it was geopolitical risk -- oil prices rose for that exogenous reason, which in turn were a shock to growth expectations that caused stocks to fall at the same time. Now, stocks and oil being back in synch implies that growth expectations have fully taken on board the impact of that exogenous risk -- in other words, we should expect no further damage to growth unless geopolitical risks worsen further.

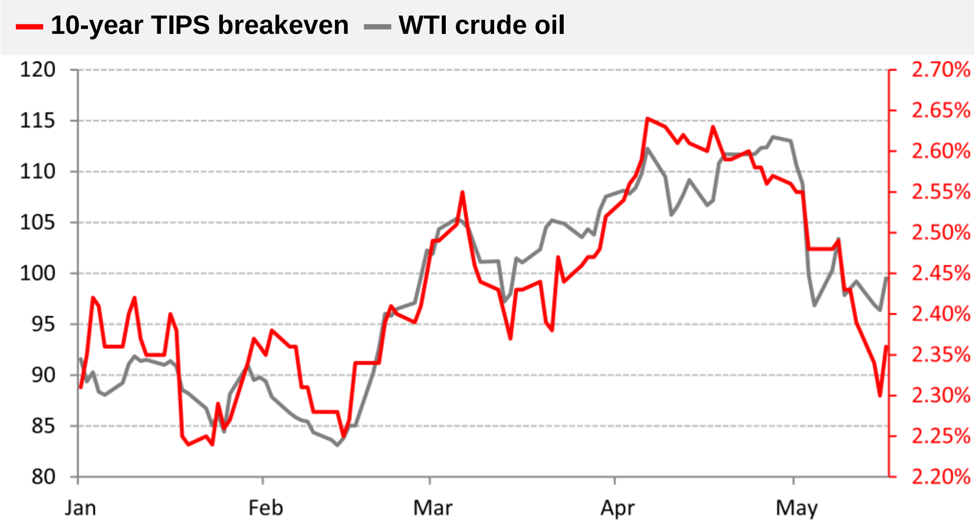
Correlation between S&P 500 and WTI crude oil price
Daily percentage price changes, 1-month rolling linear correlation



Source: Reuters, TrendMacro calculations

- We expect that the geopolitical risk premium in oil will continue to diminish -- possibly on a strong secular basis, with the death of Osama bin Laden allowing the western nations to end their destabilizing combat involvement in the Middle East and Afghanistan (again, see "The bin Laden Commodities Crash"). Perhaps last week's announcement by the UK that it intends to reduce its troop commitment to Afghanistan -- though regarded by the US with alarm -- is the first step down this road. When the market begins to price this, we would see another period of negative correlation -- this time oil prices *falling* and stock prices *rising* -- while the positive impact on growth expectations due to the release of an exogenous risk, gets taken on board.

- The fall in the oil price this month ought to go a long way toward relieving concerns about an immediate threat of runaway inflation. This year inflation expectations embodied in TIPS breakeven spreads have perfectly tracked the oil price -- first on the upside, and now on the downside (please see the chart below). We continue to expect an inflation problem down the road when the Fed likely fails to adjust its balance sheet to reflect the economic improvement we expect (again, see "Gold Hits Our $1500 Price Target"). But that's a long-term issue, well over the present horizon of *tactical* investment decision-making.



Source: Federal Reserve, Reuters

- The high-stakes game of chicken being played in Washington over federal spending continues to be a source of negative sentiment with a lose-lose dynamic. Those who believe that recovery is contingent on cutting the deficit are frustrated that the Republicans aren't able to make more progress, while those who think it's contingent on continued stimulus are afraid that they will. We don't see it in either of those polarized ways. We think the fact that this kind debate is taking place at all is enormously positive (see "To Get Rich is Glorious Again" December 7, 2010). And we're glad it's a debate, not a one-sided rush to judgment. Self-evidently there is time to work out the issue of unsustainable deficits -- and it would not help growth to have spending dismantled helter-skelter the way it was put in place two years ago. Separately, we are mindful that a reduction in US combat involvement in the Middle East and Afghanistan would be a peace dividend that would go a long way toward cutting spending with relatively few tears needing to be shed (yet again, see "The bin Laden Commodities Crash").
- Of all the risks on the table today, the one that continues to concern us the most is the ongoing debt crisis in Europe (again, see "EUicide"). By our intuitive reckoning, we would attribute 100% of the small correction in US stocks this month to this one risk

factor, as we believe all the other factors we've discussed are transitory or insubstantial. The Europe factor plays perversely into what we perceive as the structure of pessimistic sentiment. Many of our clients believe a strong US dollar is a key indicator of economic health. The rally in the dollar over the last couple weeks has been a ray of hope for them in an otherwise dark landscape. But we caution them that they should not take any comfort from a strong dollar that is almost entirely the result of a weak euro. The challenge for the rest of the year will be for troubles in Europe to play out slowly enough to give the other risk factors time to resolve. Europe's strategy appears to be just that -- to slow down the problem rather than to solve it -- so we are optimistic that it will play out constructively overall.

Bottom line

Sentiment among our clients is about as pessimistic as we've ever seen it. Yet stocks are actually performing well. The slow-motion melt-up painfully continues. Growth has disappointed us, and there has been a recent spate of poor macro statistics. But the most important strategic macroeconomic data continues to point to an upshift in growth.