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MACROCOSM

The Post-Osama Slow-Motion Drip-Down

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The existential implications of bin Laden's death, and what gold is telling us now.

There's a real correction going on to be sure, but we continue to find it remarkable how deeply pessimistic most of our clients are about it (see "Tear Down This Wall of Worry" May 20, 2011). It's not panic by any means, but it's more than just pessimism. They seem haunted by an apprehension that things are going terribly wrong, and that there is no hope that they can be righted. We see this depth of feeling as out of proportion to what has happened in markets over the last six weeks, since the death of Osama bin Laden -- the event shock that seems to be the pivot-point in the present market cycle (please see the chart below).

- Stocks around the world are lower, with the S&P 500 off 6.7% from its recovery high made the trading day before bin Laden's death. We don't understand the level of dismay this is causing, or why it should be especially surprising. It follows eight straight winning months with a 35.5% total return (and an overall total return for the bull market from the March 2009 bottom of 110.2%). 41 days so far, the present correction is the second-longest in the bull market. But it is only average in terms of the loss involved (among all 12 corrections). We've been talking about a "slow-motion melt-up," but

Update to strategic view

US STOCKS, GOLD, COMMODITIES, US RESOURCE STOCKS: Gold -- which is hanging in there during a general commodity correction -- is signaling that there is no shortage of the liquidity that has fueled this bull market for more than two years, despite the pending completion of QE2 and clear evidence of an economic soft-spot. Even though QE3 is unlikely now, that soft-spot will surely extend the "extended period" of liquidity-driven policy for the Fed, which should continue to be supportive of gold and other inflation plays. That, in turn, supports stocks, so we are looking for an entry-point in this correction.

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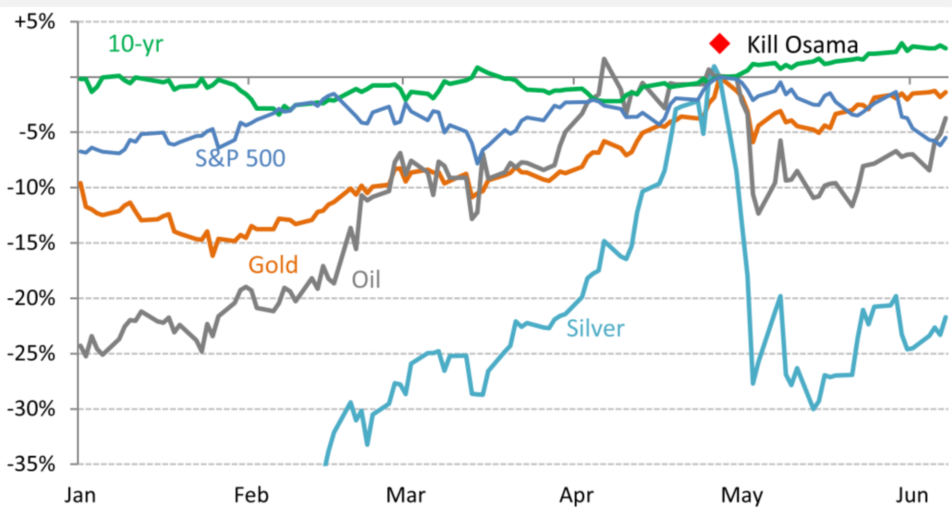
Performance of various assets, normalized to zero at April 29, 2011



Source: Reuters, TrendMacro calculations that's obviously been interrupted. Yet this is no "melt-down," though it is in slow-motion. It's a drip-down. Setting aside all the metaphorical descriptions, we think this is just a correction, and we're looking for an entry point. If the usual pattern is followed, the pessimism will have to turn a bit panicky -- and then we're there.

- The commodities correction we called for (see "Gold Hits Our $1500 Price Target" April 20, 2011) has come, but the only serious train-wreck is silver. It's off 24.2% from its all-time high, which was surely a speculative blow-off. But even at that, it remains up 17.2% year-to-date. We take special note of how little gold has corrected. We will come back to that point in detail in a moment.

IS THERE A BIN LADEN CONNECTION? Let's consider the possible implications of the curious fact that the present correction began precisely following the death of Osama bin Laden (the announcement was on Sunday, May 2, and the top in risk-assets was Friday, April 29). Yes, it could be just a coincidence, and coincidence is not causation -- and the spate of disappointing macro data over the intervening weeks is sufficient explanation. But the coincidence is so striking we can't resist at least speculating upon its significance.

- At first blush the reaction in risk-assets to bin Laden's death is perverse. You'd think it would be good news. Indeed, we believe it probably will prove to be. Best case, it could be the trigger for a secular decline in the oil price as its geopolitical risk premium narrows -- both because a key terror network has lost its leader, and because American troops will be able to disengage from the Middle East and Afghanistan (see "The bin Laden Commodities Crash" May 6, 2011).
- On the minus side, taking a shorter-term view, that there is now a heightened risk of reprisal terrorist attacks.
- Bin Laden's death has boosted President Obama's popularity, and allowed him to own a signature GOP issue. Thus he has wider scope to resist GOP efforts to roll back the anti-growth policy errors made in the first two years of his administration. And at the same time, the GOP House and its presidential field has found it difficult to set aside its apparent obsession with spending reduction, and has failed to articulate a compelling pro-growth and pro-jobs message (see "The Political Brick in the Wall of Worry" May 27, 2011).
- Finally, if we may be permitted a very abstract observation, it strikes us that bin Laden's death has an aspect of existential uncertainty in somewhat the same way as the Japan earthquake and tsunami, even though the one is good news and other is bad news. Bin Laden has been a fixture in world consciousness for a decade, an axiom around which the structure of the world can be understood to be organized -- like the idea that the earth is firm, and that the ocean is bounded by the shore. A world without bin Laden will probably be a better world, but it will be a different world. In the extreme, a world without the "war on terror" would be a *very* different world, one in which key geopolitical alignments -- such as the one between the US and China -- would have to find

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new structure. All this, we think, contributes to the mood of helplessness in the face of uncertainty that we sense pervades the market.

SOME THOUGHTS ON GOLD We are especially fascinated by the performance of gold over the last several weeks. We expected it to be strong in a commodities correction, and it is off only 1.8% from the all-time high it made the trading day before bin Laden's death. We see gold as the quintessential "risk on" asset, representing the market's appraisal of and expectations for liquidity conditions (ample liquidity being the *sine qua non* of risk-taking). That it has hung in so well during six weeks of strong "risk off" sentiment makes gold the dog that didn't bark in the night. Other than the fact that forward earnings for the S&P 500 continue to march to new highs every day despite some economic softness (see "A New EPS High-water Mark" May 11, 2011), we see gold's strength as an indicator that *there has been no fundamental interruption in the liquidity-driven recovery that has been underway in fits and starts for two years now*.

- When things really are going terribly wrong, and there really is no hope that they can righted, gold goes down hard. This flies in the face of the conventional wisdom that gold is a safe-haven asset. And it is contradicted by the memory that many people seem to have that gold soared in the financial panic following the failure of Lehman Brothers. *But this is a false memory.* In the financial panic of 2008, gold fell right along with stocks and everything else. In the three months from the collapse of Fannie and Freddie in mid-September 2008, gold fell 33.9%.
- Thus we can say that gold represents the market's appraisal of and expectations for liquidity conditions. After Lehman's failure, there was a global liquidity crisis that drove a fire-sale liquidation of *all* assets, including gold.
- The signature theme of the recovery from the abyss of the Great Recession has been reliquefication, and gold has always been its herald. Gold was the first risk-asset to bottom. It did so definitively in October 2008, foreseeing that the Fed would undertake large-scale MBS purchases a month later, and set the funds rate to zero on an indefinite basis two months later. Those and further actions along similar lines, including QE1 in March 2010 and QE2 in November 2010 made possible the March 2009 bottom in stocks -- coming more than five months after the bottom in gold -- possible.
- Speaking of that bottom, we note -- without wanting to overemphasize what amounts to a technical indicator -- that the difference between the gold price and the S&P 500 is back to exactly the peak level it attained on March 9, 2009 (please see the chart at the top of the following page).
- The gold price rose through last spring's correction, which contributed to our confidence that it was just a correction -- and our early call that the Fed would do QE2 (see "So Much For The 'V'" May 21, 2010). Our reading now is that the gold price -- resilient, but not rising -- means the Fed *doesn't have to* do QE3.

Gold minus S&P 500

Source: Reuters, TrendMacro calculations

- This should inspire confidence as QE2 nears its completion. Yes, falling Treasury yields and falling stock prices signal a soft-spot (as if the data weren't already enough evidence) -- but gold is being clear that it's not the result of the Fed being too tight. That means there is no *systemic* reason now why the recovery can't right itself once transitory factors like the Q1 jump in oil prices (see "An Oil Shock Tipping Point?" March 3, 2011) and the Japan earthquake (see "Meltdown in Japan" March 15, 2011) work their way through.

Bottom line

Gold -- which is hanging in there during a general commodity correction -- is signaling that there is no shortage of the liquidity that has fueled this bull market for more than two years, despite the pending completion of QE2 and clear evidence of an economic soft-spot. Even though QE3 is unlikely now, that soft-spot will surely extend the "extended period" of liquidity-driven policy for the Fed, which should continue to be supportive of gold and other inflation plays. That, in turn, supports stocks, so we are looking for an entry-point in this correction.