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MACROCOSM

Testing 1, 2, 3

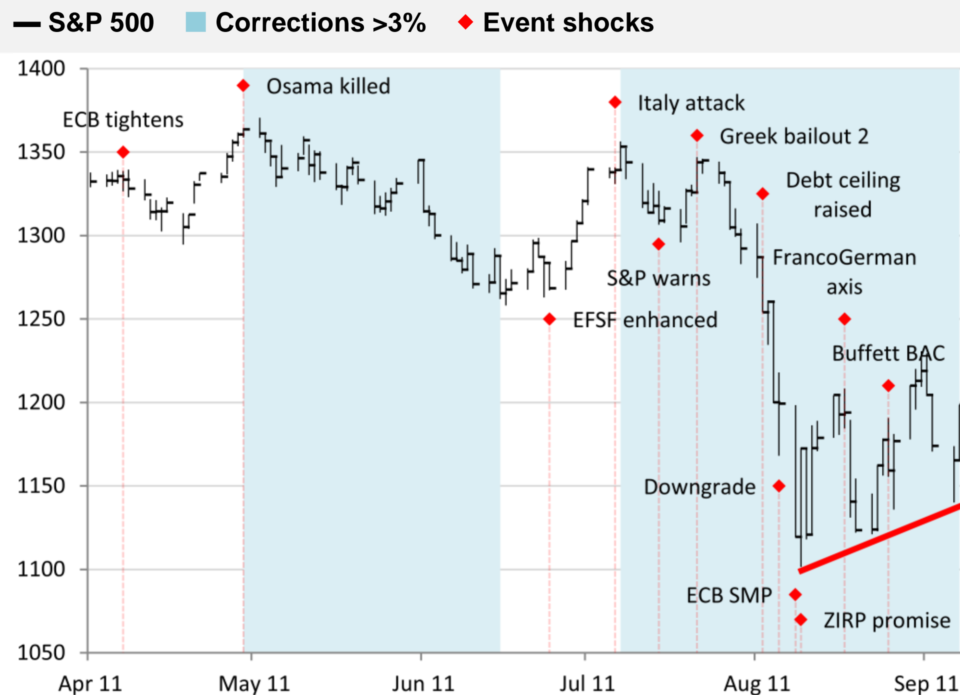
Wednesday, September 7, 2011

Donald Luskin

Stocks are bottoming -- it's a bet on Europe holding together, and no US double dip.

US stocks have now tested the bottom three times, with each successive low higher than the last. Just looking at the chart (please see below), it's tempting to conclude that the sharp downdraft that began in July was just a correction, and that the recovery from it is underway. That is, in fact, our view. But we continue to have respect for potential event shocks -- particularly the very fragile situation in Europe -- that are highly unlikely yet highly dangerous. As we said a month ago on the day of the bottom, "this is where you buy, not where you sell, unless you expect chaotic systemic consequences" (see "Downgrade: At Least the News is Out" August 8, 2011).

So the bull case here depends on the bet that Europe will muddle through, or at least avoid a systemic banking crisis. With eyes open, we're willing to make that bet. Indeed, stocks made their closing lows on the day that the



Source: Bloomberg, TrendMacro calculations

Update to strategic view

US STOCKS, US MACRO: The bottom has been tested three times, and it's looking like the dramatic July/August drop is going to be confirmed as just a correction. It's not "2008 all over again" unless Europe collapses. Absent that, we don't even expect a double-dip recession -- but we are watching forward earnings as the key clue to tell us if we're wrong. If this quarter's blow to confidence is deeper than we think, then from today's low base, a recession would be short and shallow.

[Strategy Dashboard home]

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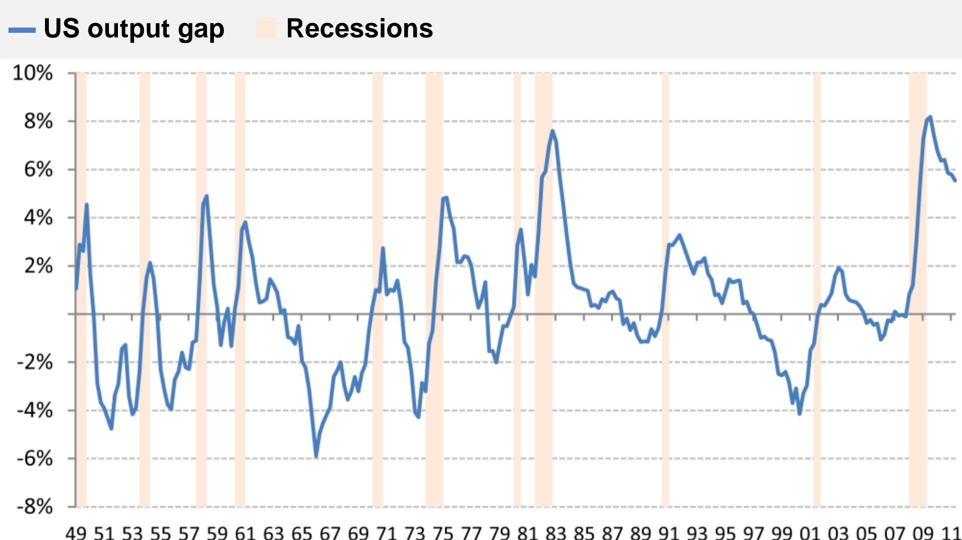
European Central Bank restarted its program of buying Spanish and Italian bonds, turning back a catastrophic collapse of confidence in the Euro area's two largest peripheral economies. Today's decision in favor of the European Financial Stability Facility (EFSF) by the German Federal Constitutional Court is another example -- Europe's institutions always find ways to overcome threats to ongoing economic integration (see "On the German Court EFSF Decision" September 7, 2011).

The threat of a US double-dip recession is also very real. We don't think it's going to happen -- but we are respectful of certain signs that it might. But unless it is triggered by a systemic collapse in Europe, we don't see how it could be deep enough or long-lasting enough to have much impact.

- The macro data for August has been mixed -- downside surprises like last Friday's jobs report (see "On the August Jobs Report" Friday, September 2, 2011), and at the same time upside surprises like yesterday's non-manufacturing ISM.
- Nothing has confirmed the cliff-dive economic collapse implied by the August Philly Fed survey, which inspired a month of market chatter about "2008 all over again."
- The only thing that could trigger a 2008-style cliff dive would be a 2008-style systemic event. The debt ceiling crisis had the potential for producing such an event, but it didn't. The Europe sovereign debt crisis has that potential -- but so far so good on that one. Without such events, all we have is another lost quarter -- this one driven by the deep loss of confidence resulting from scary close calls with the debt ceiling drama and Europe's continuing woes.
- It's very hard to do a cliff-dive if you aren't on a cliff. According to the Congressional Budget Office's model, the output gap is 5.6% of GDP. No recession has ever started from such a high level of resource underutilization, or anywhere remotely close (please see the chart below). Typically levels lower than this are where recessions *end*.



Source: CBO, NBER

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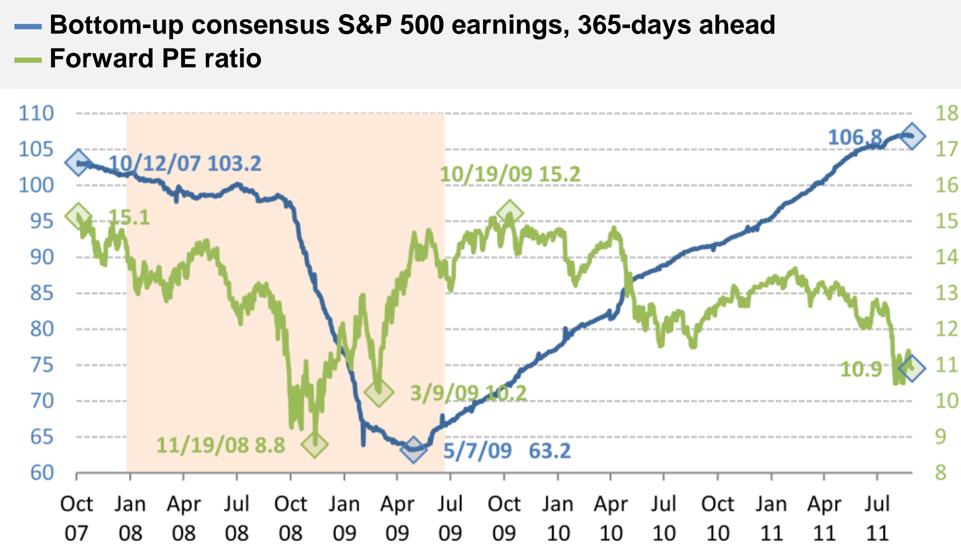
[About us]

- This is a sweet-spot for corporate earnings. It costs nothing for firms to hire the marginal worker or light up the marginal factory at this point, because so many resources are so easily available. Sure, we love it when there is full employment and full capacity utilization, but at such times growth is very difficult -- the resources just aren't there. From where we are today, anything that catalyzes even the smallest increase in growth amplifies into far greater increments to profits -- that's operating leverage.
- Indeed, earnings have flourished since the bottom of the Great Recession despite extremely anemic economic growth (see the chart below). For that reason, the flattening of consensus S&P 500 forward earnings over the last couple weeks remains troubling to us (see "Being Ben Bernanke" August 22, 2011). If this flattening were sustained, it would imply even slower growth ahead. If a *decline* in earnings were sustained, we'd have to start worrying about something more than just slow growth -- some kind of mild recession. We note that over many years a change in the direction of forward earnings has always been an excellent business cycle indicator. It's too soon to make the call, but we are watching this very closely.

And incidentally…

Students of history may wonder whether the severe 1937 "recession inside the Depression" is a stark contradiction to the principle that you can't do a cliff-dive if you aren't on a cliff. We don't think so. Highly granular GDP data is not available from that period, so we can't measure the output gap precisely. But it is known that by mid-1937 industrial production had already exceeded the peak seen in 1929 by 5%. Today we are still 6.5% below the 2007 peak.



Source: Zacks, NBER, TrendMacro calculations

Bottom line

The bottom has been tested three times, and it's looking like the dramatic July/August drop is going to be confirmed as just a correction. It's not "2008 all over again" unless Europe collapses. Absent that, we don't even expect a double-dip recession -- but we are watching forward earnings as the key clue to tell us if we're wrong. If this quarter's blow to confidence is deeper than we think, then from today's low base, a recession would be short and shallow.