Trend Macro

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MACROCOSM

Infectious Fear

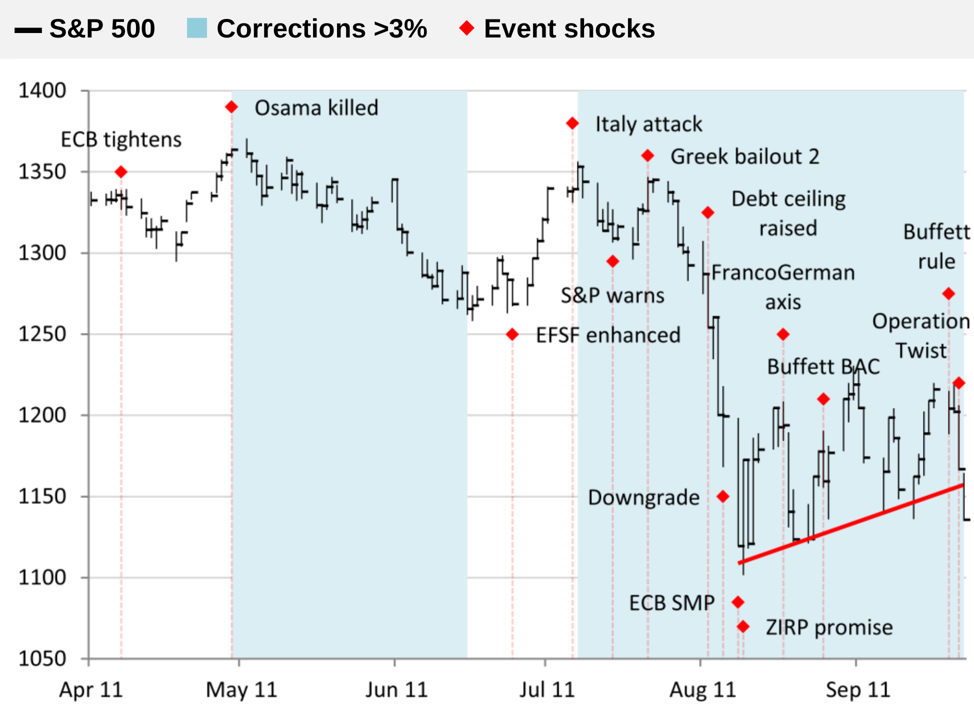
Thursday, September 22, 2011

Donald Luskin

Recession creeps closer -- but absent a systemic hard-stop, stocks are amazingly cheap.

Here we are, back for the fourth time, sorely testing the low end of rising trading range that has defined a potential recovery from the August 9 intraday bottom (please see the chart below). We said on August 8 that "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). There haven't been any chaotic systemic consequences so far. But over the last six weeks, the constant fear of them has been infectious. Yesterday the FOMC got infected, implementing a dubious "Operation Twist" for fear of what it called "significant downside risks" -- *not realities*, mind you, just *risks* -- "to the economic outlook, including strains in global financial markets" (see "On the September FOMC" September 21, 2011).

This infectious fear has been persistently eating away at most of the pillars of our hopeful outlook. No indicator we respect is flashing an outright fire



Source: Bloomberg, TrendMacro calculations

Update to strategic view

US STOCKS, US MACRO: Stocks are testing the August lows. All our most trusted indicators have deteriorated somewhat since then, eaten away by persistent fear. None is flashing an outright fire alarm, but all are moving in the wrong direction. The chances of recession have gone up considerably, but absent a global credit hard-stop like 2008, which we don't expect, it would be a shallow one. And with stocks already considerably off their April peak, there's probably not a lot more downside risk in such a scenario. The equity risk premium is near record highs, about where it was at the bottom in March 2009. It's painful for us to say this, but our sense remains that this is where you buy, not where you sell.

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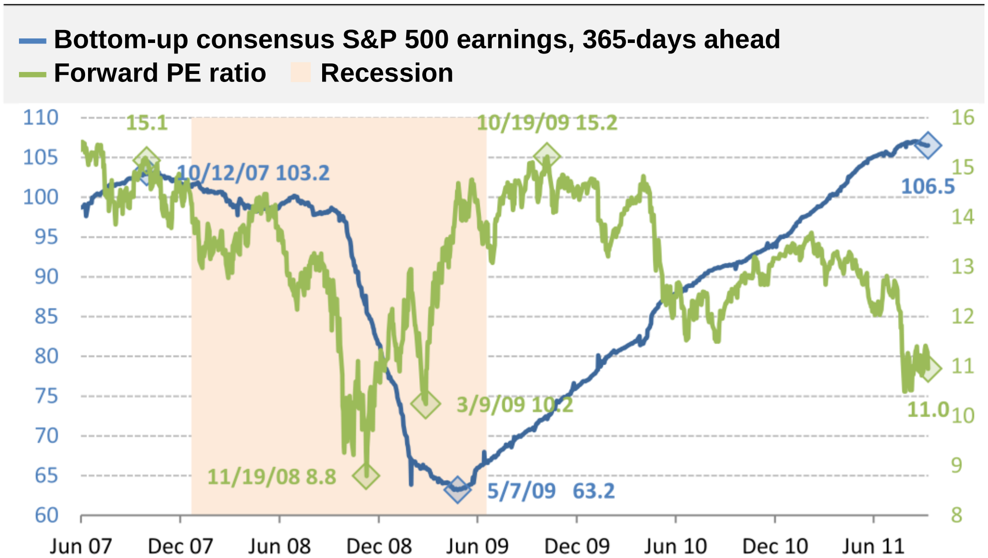
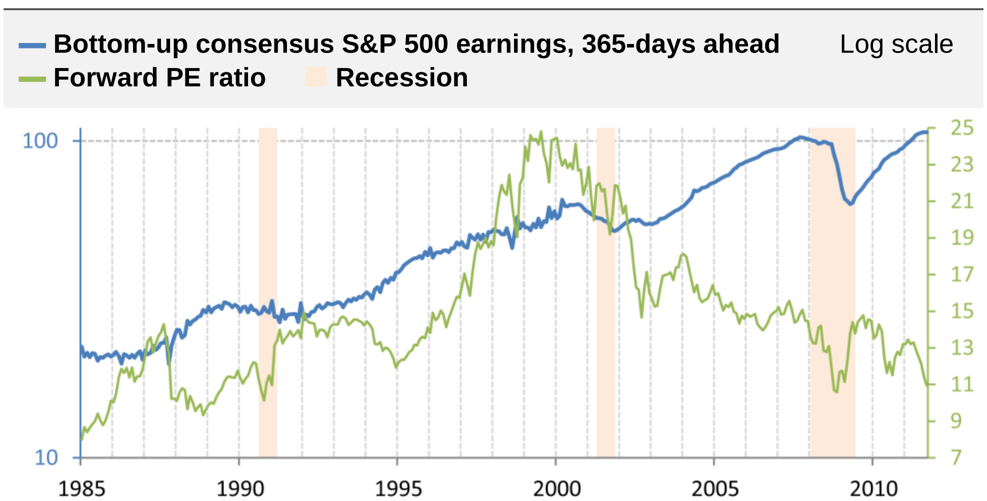
alarm, and stocks strike us as still very cheap. *But we're seriously concerned*. It's a fact that we can't point to anything that's gotten better, and a lot of things have gotten worse.

- Of greatest concern to us is the earnings outlook. Bottom-up S&P 500 consensus forward earnings-per-share peaked on August 29, and have been very gradually moving lower ever since (please see the chart below).



Source: Zacks, NBER, TrendMacro calculations

- They're off only one half of one per cent from peak, and they still imply 21.7% growth over trailing earnings. Nevertheless, our experience has been that when forward earnings turn lower, a recession follows (please see the chart below).



Source: Zacks, NBER, TrendMacro calculations

- That is not to say that a recession now would have to be severe or long-lasting, unless it were triggered by a 2008-style systemic event. Otherwise, anything now that the history books would record

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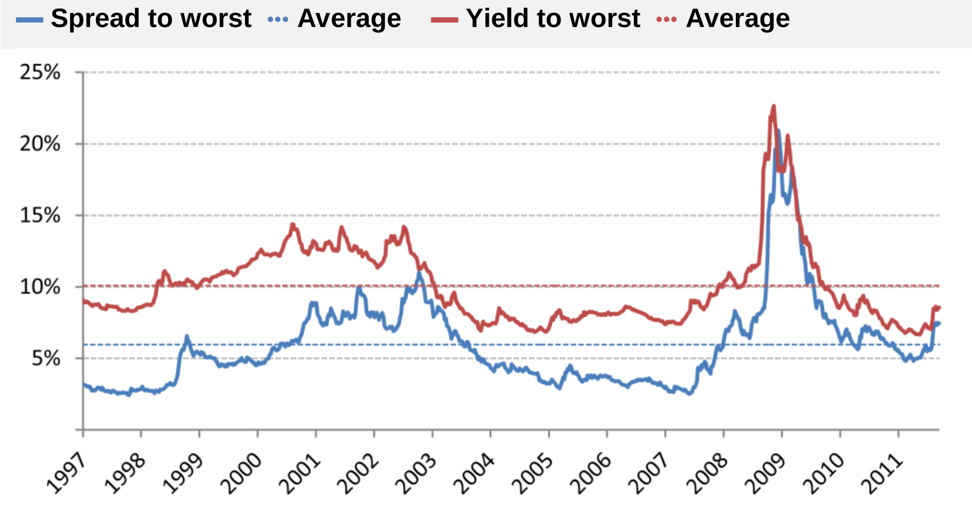
as a recession would probably be as much a recession as the recovery of the last two years has been a recovery -- not much of one. The output gap today is just too great: it's at a level where recessions end, not where they begin. As we've been saying, you can't experience stall speed if your plane isn't in the air, and you can't do a cliff-dive if you aren't on a cliff (see "Testing 1, 2, 3" September 7, 2011).

- So we don't take very seriously all the talk we've heard over the last couple weeks of 2012 S&P 500 EPS coming in at 75, when they're now at 87, and forecasted for 107.
- But now forward earnings could easily continue to fall somewhat unless the economic and sentiment backdrop improves. One harbinger of that is the poor surprise factor so far in the August quarter-ended earnings sub-season now underway. Of the 10 out of 29 companies reporting so far, only 6 have beaten consensus estimates. Among all 10, the average surprise was only 2.2% (for the main June quarter-ended season, the average surprise was positive 9.8%, and the July quarter-ended sub-season it was positive 5.0%).
- We have been encouraged by high gold prices as a sign that liquidity conditions are generous enough to absorb strains in the banking system (see "Plan B-Plus for Gold" July 14, 2011). By contrast, the steep drop in gold in 2008 indicated a dearth of liquidity that made the shock of the Lehman failure into a global credit hard-stop. So it gets our attention -- because it's a move in the wrong direction -- when gold fell hard following yesterday's FOMC statement announcing the new "Operation Twist" (again, see "On the September FOMC"). That was supposed to be a liquidity cushion against "significant risks" -- but apparently, perhaps it isn't. We said several weeks ago that seeing gold and stocks both fall at the same time would be a very bad sign (see "Gold's Rollercoaster" August 25, 2011). That's what we've seen the last three days, and if it continues it will be quite alarming.
- We are concerned that the copper price has just broken below $4, and fallen now to as low as $3.50 in just a matter of days. We don't slavishly worship "Dr. Copper," but we respect the copper price as a general rough-and-ready forward indicator of global manufacturing activity.
- It worries us that high-yield bond spreads have suddenly lurched well above their historical average, back to a level not seen for two years. Historically, this has indicated both rising risk aversion and rising default risk -- both harbingers of recession. That said, we note that this may be largely an artifact of unusually low Treasury yields, and of perverse portfolio effects triggered by Standard & Poor's Treasury downgrade (again, see "Downgrade: At Least the News is Out"). Absolute junk yields -- as opposed to spreads -- are still well below average (please see the chart at the top of the following page). And commercial and industrial loans by banks continue to grow.
- Finally, stepping away from the realm of indicators and looking instead at the world of real events, we are concerned by the growing perception -- indeed, the reality -- that government actors

Merrill Lynch High Yield Master Index II



Source: Merrill Lynch, TrendMacro calculations

around the world are not only unable to substantively help the economy, but are actively making it worse.

- It's not just Europe's political chaos. Among clients, there is outright astonishment that President Obama would choose this moment of deepening economic weakness to unveil a new initiative to tax job-creators, dressing it up with the moralistic moniker the "Buffett rule." There is no chance that this initiative could get through the GOP-dominated House. But we think the mere discussion of it is chills economic activity. If nothing else, it crowds out consideration of measures that might really help -- it’s a conspicuous example of fiddling while Rome burns. We note that the announcement of the "Buffett rule" initiative over the weekend marked the rally failure that broke the pattern of successive higher highs in the chart on the first page.
- We doubt that the Fed's new "Operation Twist" will do much to help, and perhaps the spectacle of having the Fed go to so much trouble (and risk so many unintended consequences) for so little purpose had a lot to do with yesterday's post-FOMC sell-off. But unlike with the "Buffett rule," at least there's a good story to tell. Coincidence or not, the fact is that when the Fed implemented the original Operation Twist in February 1961, it precisely marked the trough of a recession, and began history's second-longest peacetime expansion.

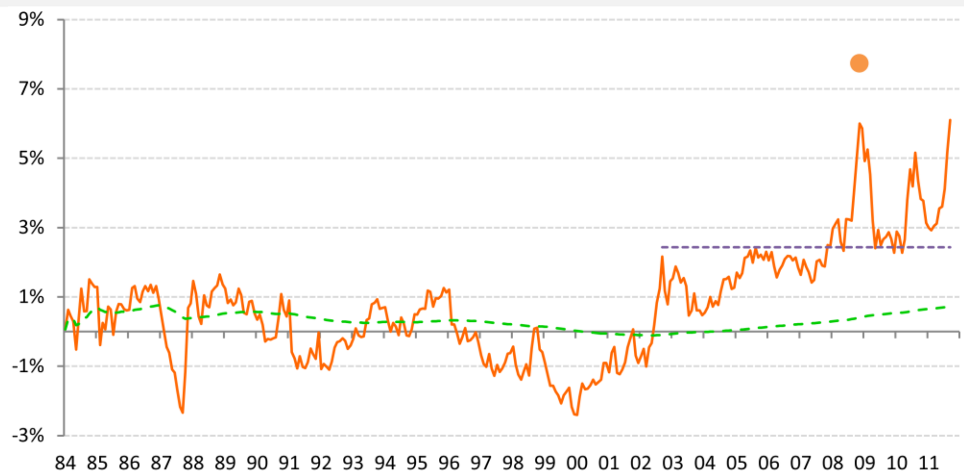
We are fully respectful of the risks out there. There's the catastrophic tail-risk of a systemic event originating in Europe. There's the garden-variety risk of slipping into a recession from the corrosive effects of so much ongoing fear. And at the bottom for stocks (so far) in August, all our indicators were in great shape -- and now, six weeks later, testing the bottom, they have begun to deteriorate.

So if stocks break down from here, it wouldn't be a surprise exactly. Nevertheless, we truly do not expect it. Our modal expectation is that the systemic risks in Europe will be muddled through. If that's right, then any recession we get is likely to be short and shallow, barely worthy of the name. In *that* world, we don't see how it can get much worse for stocks -- and they're so cheap, it might get a lot better.

- The last two times that forward earnings rolled over -- in 2000 and in 2007 -- recessions followed, and there were severe bear markets for stocks. In both case, when the peak in forward earnings came, forward PE multiples were high -- 23 in 2000, and 15 in 2007.
- But when forward earnings rolled over in 1989 -- accurately predicting the recession of 1990-91 -- the forward PE multiple was only 11, the same as today's multiple. Stocks fell about 19% before that recession even began -- the same amount they've fallen already since the April peak. In 1990, as soon as the recession was officially underway, stocks recovered aggressively.

It's all summed up in a single touchstone: the equity risk premium -- the forward earnings yield of the S&P 500 minus the 30-year Treasury yield, which can be understood as the expected differential return earned for bearing equity risk (please see the chart below).

Equity risk premium Month-end observations, and yesterday's close
Moving avg from 1984 **Moving avg from '02-Q3** **11/20/08 peak**



Source: I/B/E/S, Zacks, FRB, TrendMacro calculations

- There are no month-ends since 1978 when the equity risk premium was a high as it was at yesterday's close.
- Using daily data, there have been only 35 individual days, almost all in late 2008, when it was greater.
- At yesterday's close it was just a few basis points less than where it was at the bottom in March 2009.
- In other words, it's a very rare event to get paid this much for taking the risk of owning stocks.

The real risk is that Europe blows up the world, and then all bets are off -- the equity risk premium won't make up for that, if it happens. If it *doesn't* happen, then the equity risk premium should be sufficient to cushion against the plain-vanilla economic risks that remain, and to provide significant room on the upside when the fear subsides.

Bottom line

Stocks are testing the August lows. All our most trusted indicators have deteriorated somewhat since then, eaten away by persistent fear. None is flashing an outright fire alarm, but all are moving in the wrong direction. The chances of recession have gone up considerably, but absent a global credit hard-stop like 2008, which we don't expect, it would be a shallow one. And with stocks already considerably off their April peak, there's probably not a lot more downside risk in such a scenario. The equity risk premium is near record highs, about where it was at the bottom in March 2009. It's painful for us to say this, but our sense remains that this is where you buy, not where you sell.