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MACROCOSM

It's This Simple

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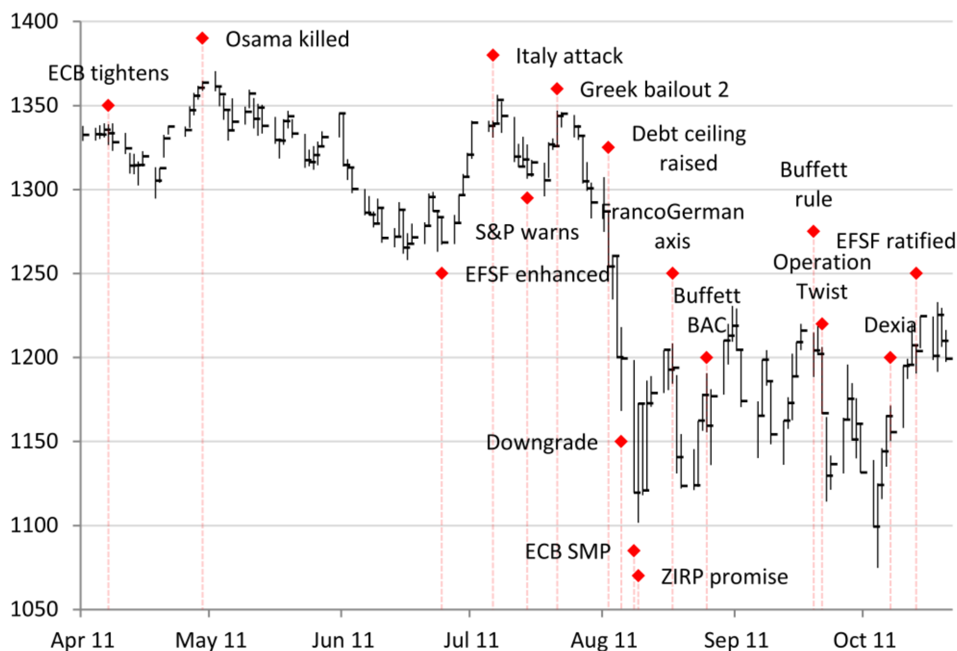
Either Europe blows up, or not. When it doesn't, we'll learn how much damage we've taken.

Since the very hour we wrote that "stocks are crazy cheap" (see "Europe Fails, US Stocks Flail" October 4, 2011), the S&P 500 has made an almost 15% move from below the bottom of the trading range to above the top of it (see the chart below). So why doesn't anyone feel any better? As we've talked to clients over the last two weeks of recovery, our sense is that the recovery is barely even perceived, or that it just doesn't matter. *Why?*

- This has been a valuation rally. Stocks were crazy cheap. Now they're just cheap. Arguably, if you missed that one moment, you missed it.
- None of the risks over-hanging the global economy -- neither the non-linear ones or the plain vanilla ones -- has been resolved.
- The improbable but potentially catastrophic possibility of a contagious global banking hard-stop arising from Europe remains.

S&P 500 ◆ Event shocks



Source: Bloomberg

Update to strategic view

US STOCKS: After an almost 15% rally in two weeks, US stocks aren't crazy cheap anymore. But they're still very cheap by the standards of the last several decades. They are poised for more upside once promised "decisive action" on Greece is delivered, even though that will be some form of default. A panic in the wake of that news would be the fourth buying opportunity in the current severe correction.

US MACRO: Corrosive fears have nudged the US economy close to technical recession -- but it's not inevitable, and wouldn't be significant anyway without a credit catastrophe in Europe. Some stability in Europe after a Greek default would allow the economy to right itself promptly.

[Strategy Dashboard home]

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- Months of ongoing fear of that fat-tail outcome has restrained spending, credit, investment, hiring and risk-taking in general. So even without the worst-case scenario, much of the world faces the real possibility of a double-dip recession, and some emerging markets face outright credit crunches.

It's just this simple: the debt crisis in Europe is going to have to come to a head, and then the fat-tail contagion catastrophe has to either happen or not happen.

- This week, markets hang on every word out of Europe -- with stocks heaving up or down 1% at a clip, with every rumor of agreement or disagreement among the Great and the Good on how to leverage the EFSF (or not), recapitalize the banks or hair-cut Greek debt. European sovereign spreads to the German benchmark have been widening alarmingly, and liquidity indicators like gold and copper have been weak.
- This morning, markets have been shaken by reports lowering expectations for the much-anticipated European Council summit this weekend, perhaps even delaying it. It was to be a key meeting, promising "decisive action on Greece – so that all doubt is removed…" (see "Six Days to What?" October 17, 2011).
- A tall order indeed, especially if the summit doesn't even happen. So we'd have to wait -- even longer! -- while the European "troika" pays out the sixth tranche of aid to Greece from the 2010 rescue, keeping it on life support until "decisive action" can finally be taken.
- Any decisive action on Greece will involve some form of default -- even if it's wrapped in programs making Greece effectively a protectorate. This will likely aggravate doubts about the stability of Europe's sovereign debt and its banks. But then again a solution to *that* has been promised, too (again, see "Six Days to What?").
- Even if whatever comes out of the summit -- if it occurs -- is as thoroughgoing as the promises imply, it will still have to be rigorously tested by markets.
- Nevertheless, we continue to think the odds strongly favor a Greek default being an upside catalyst. There may be some panic at first, and a great deal of improvisation by the authorities -- but our call is that putting this very well-anticipated piece of bad news in the rear-view mirror will be a strong positive.

If that's right, then the question becomes: how much damage has been done by months of corrosive fear of the worst-case contagion scenario?

As we've discussed this with clients, some are eager to think of the global economy as a beach-ball that's been held underwater, just waiting to be released so it can rapidly rise to the surface. But a beach-ball held underwater for too long will spring leaks.

- Typical macro indicators have been mixed, to be sure. But overall they have been sufficiently robust to indicate only a soft-spot. Very

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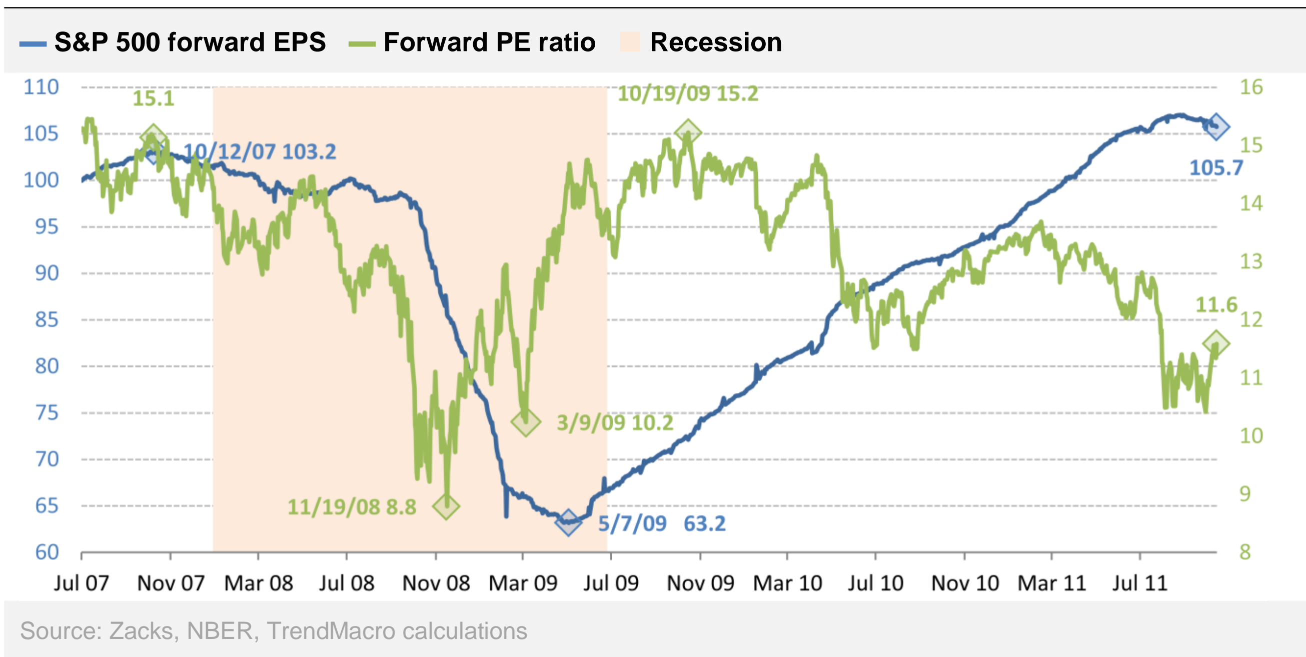
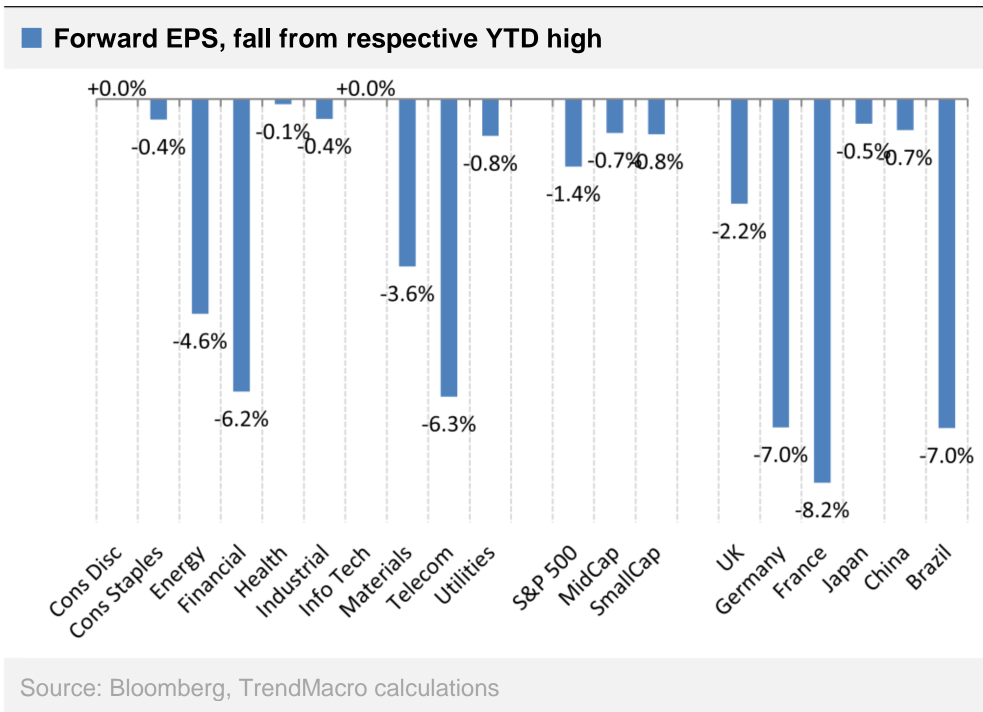


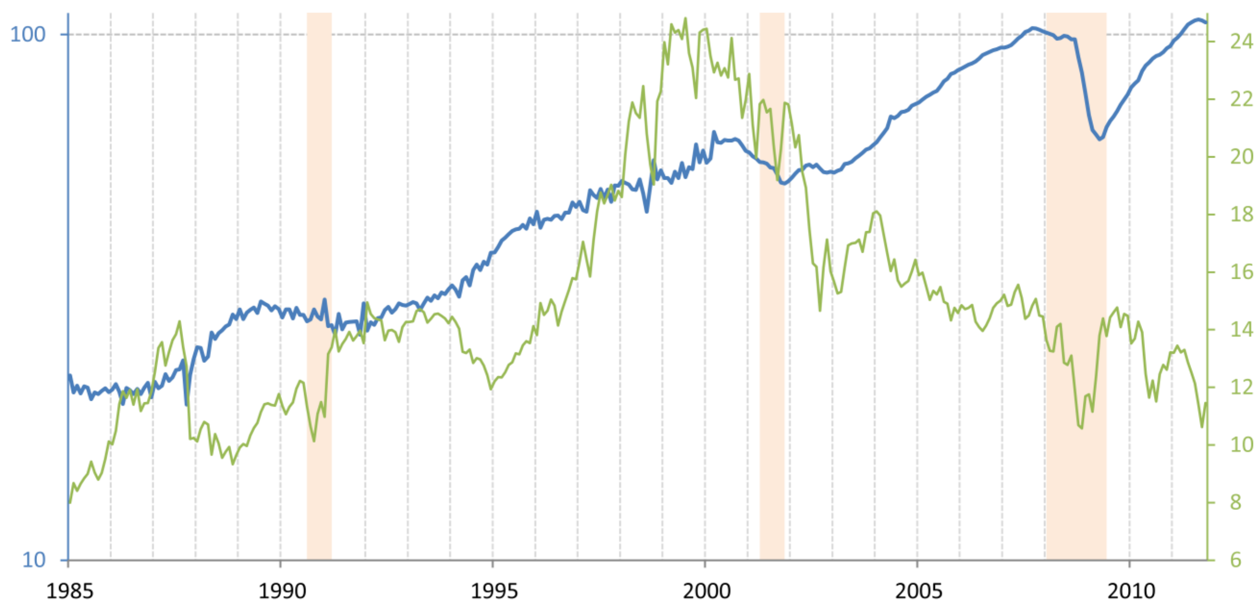
Source: Zacks, NBER, TrendMacro calculations

little has gotten bad enough to merit saying a recession is upon us already, or is inevitable.

- We continue to be haunted by the deterioration of our single favorite macro indicator -- the trajectory of S&P 500 consensus forward earnings (please see the chart above).
- In the US, the most notable deterioration has been in the financial and energy sectors -- lower by 4.6% and 6.2% respectively (please see the chart below).
- Overall S&P 500 forward EPS peaked on August 29, and have since fallen 1.4%. Forward earnings in Europe have fallen much



Source: Bloomberg, TrendMacro calculations



more -- in Germany 7.0%, and in France 8.2%.

- Unfortunately, these are the two sectors that the consensus is relying on to produce almost half the earnings growth in the coming year.
- Historically, when forward earnings start to fall, recession soon follows (please see the chart above).
- If the present fall in forward earnings portends recession, we think that without the worst-case contagion scenario from Europe, the recession will be trivial. Stocks wouldn't necessarily have to fall any more than they already have. The 21.6% decline we have already experienced -- measured from high tick to low -- could well be enough (see "Testing 1, 2, 3" September 7, 2011).
- This expectation is supported by the fact that forward price/earnings ratios are consistent with levels seen at the *end* of recessions, not the *beginning* of them.
- The last two times forward earnings rolled over -- ahead of the recessions of 2001 and 2008-2009 -- the S&P 500 forward P/E was at cycle highs (please see the chart above). So severe bear markets ensued as recession set in. *Now* the market P/E is closer to cycle lows, as it was ahead of the 1990-1991 recession -- in which stocks generally *rallied* once recession got underway.
- Another difference now is the behavior of earnings surprises. So far in this earnings season, there have been a handful of large EPS misses that have driven the unweighted average surprise factor to negative 12.9%. But on a dollar-weighted basis -- which is what really matters economically -- the average surprise factor is a positive 7.9%. This is far better behavior for the surprise factor than last time forward earnings rolled over.

- When earnings were reported in the earnings season beginning in January 2008 -- with respect to results achieved in Q4-2007, the quarter in which forward earnings finally peaked -- the miss was catastrophic, led by enormous disappointments in key financial firms (please see the chart below).

Earnings surprise factor, dollar-weighted

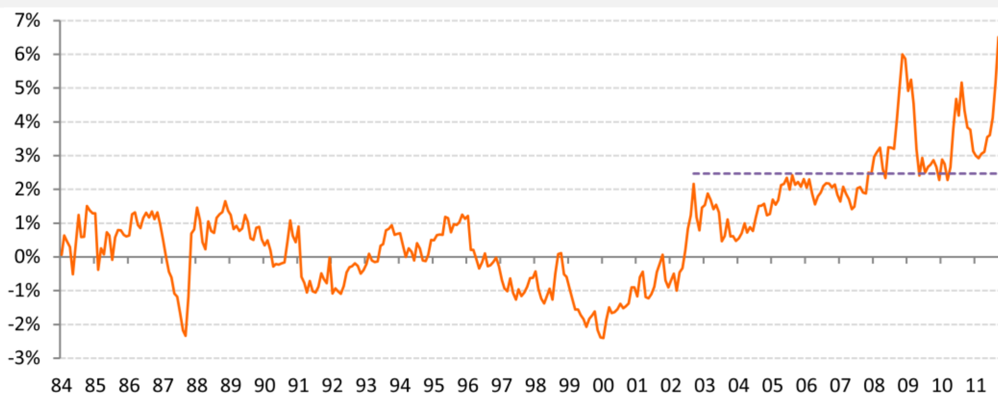
Source: Bloomberg

- The positive earnings surprise factor this earnings season -- generally in-line with the magnitude of the last year or so (a little better so far, if anything) -- confirms that expectations are properly aligned to the damage the economy is suffering from continued exposure to risk arising from a worst-case in Europe.

This is all intended to suggest that if Europe proves to be robust to "decisive action on Greece" -- in other words, default without massive contagion -- then there's no reason why the economy and the markets shouldn't get back to business as usual. Sadly, in the present context, "as usual" means slogging through the weakest recovery on record in the wake of the worst recession on record.

But with stocks still cheap -- not as crazy cheap as they were two weeks

S&P 500 equity risk premium --- Post Q32002 average Recession
Forward earnings yield minus 30-year Treasury yield



Source: IBES, Zacks, FRB, TrendMacro calculations

ago, but with the equity risk premium still at the very high end of the experience of the last several decades (please see the chart at the bottom of the previous page) -- there should be considerable upside once forward earnings can right themselves and start moving higher again.

If this analysis is right, then when to buy? Perhaps the perfect moment has passed -- or *moments* (plural): we've called the bottom three times at the three perfect moments over the last three months (see "Downgrade: At Least the News is Out" August 8, 2011, "Infectious Fear" September 22, 2011, and "Europe Fails, US Stocks Flail" October 4, 2011). If there is a panic next week -- or soon after, whenever "decisive action on Greece" is finally announced -- then maybe that's moment number four.

Bottom line

After an almost 15% rally in two weeks, US stocks aren't crazy cheap anymore. But they're still very cheap by the standards of the last several decades. They are poised for more upside once promised "decisive action" on Greece is delivered, even though that will be some form of default. A panic in the wake of that news would be the fourth buying opportunity in the current severe correction. Meanwhile, corrosive fears have nudged the US economy close to technical recession -- but it's not inevitable, and wouldn't be significant anyway without a credit catastrophe in Europe. Some stability in Europe after a Greek default would allow the economy to right itself promptly.