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MACROCOSM

It Only Feels Like Blood in the Streets

Thursday, December 1, 2011
Donald Luskin

Stocks are still very cheap, with little risk of recession, and a bet that Europe will survive.

As always, emotions can be deceiving. It feels like an endless bear market, with an unending flow of potentially existential event shocks hitting the tape every few days (please see the chart below). Yet on a closing basis from April 29 to October 3, the maximum loss has only been 19.4%, which doesn't even qualify as an "official" bear market. The volatility is exhausting. Yet it is all daily, not cumulative. From July 29, after which the VIX has been above 25 almost every day, stocks have moved more than 1% in two-thirds of market sessions. They have moved more than 4% about once every ten sessions. Yet, on net over the entire period, they have moved only 3.5%.

All that means it's been a good time to buy when it seemed there was blood in the streets -- all the more so because there actually hasn't been any. We wish we could say we saw this time of duress coming (we didn't). But while it's played out, we've called the bottom at the four perfect moments to have done so (see "Downgrade: At Least the News is Out"

Update to strategic view

US STOCKS, EUROPE STOCKS, EUROPE BONDS: Stocks remain cheap worldwide, especially if most nations avoid recession -- as now seems likely in the US. Notable exceptions are Spain and Italy, where high long-term sovereign yields and sharply falling forward earnings are holding equity risk…

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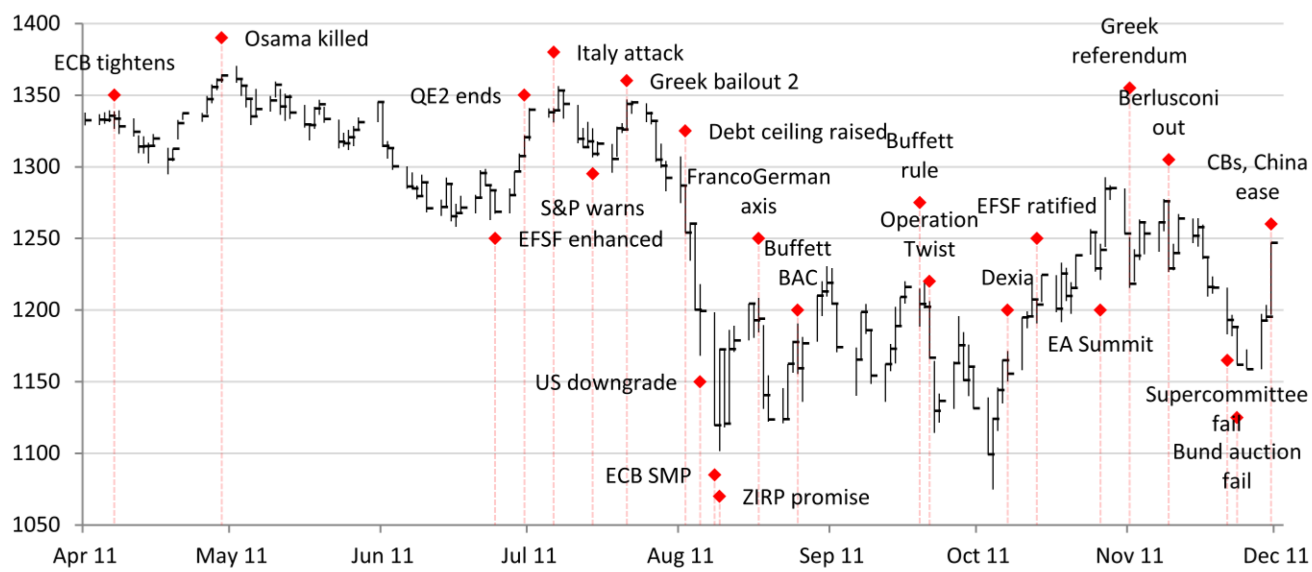
S&P 500 ◆ Event shocks



Source: Bloomberg, TrendMacro analysis

August 8, 2011, "Infectious Fear" September 22, "Europe Fails, US Stocks Flail" October 4, and "On the Super-Committee Failure" November 22). Here in the middle of the trading range we are still optimistic. We don't see why stocks shouldn't close out the year at the year's highs. At the same time, we are keeping our eyes on the one factor that could trigger a non-linear downside event.

Please forgive us if we repeat ourselves, but our strategic outlook remains based on three ideas which, as they evolve, continue to be salient:

- **Valuation:** Stocks are generationally cheap almost everywhere in the world.

  This is not a "value trap" because:

- **Business cycle:** US recession is possible, but not preordained. If it comes simply as the result of persistent fear, or spillover from a European recession, then it will be short and mild.
- **Europe risk:** A global banking hard-stop emanating from a systemic failure in Europe is, obviously, the wild-card in the deck. But it is very unlikely.

By now clients should all be familiar with our chart tracking the S&P 500 equity risk premium back to 1900 -- which demontrates how rarely in our lifetimes stocks were as cheap as they have been this year (again, see "Europe Fails, US Stocks Flail"), Let us only say by way of update that now, with stocks having rallied from their October lows, the equity risk premium remains very elevated. A mean-reversion of the equity risk premium now, merely to its average value since mid-2007 -- the crisis era -- implies stock prices 29.2% higher. Stocks are still very cheap, and have considerable room to run even without any heroic fantasies about economic growth.

The equity risk premium is very elevated in most stock markets around the world. Intriguing exceptions are Spain and Italy, where high long-term sovereign bond yields -- and rapidly falling forward earnings -- have held the equity risk premium down (please see the charts on the following page).

- This does not mean necessarily that Spanish and Italian stocks can't or won't rally with the rest of the world if conditions improve over the coming months.
- If credit tensions ease in Europe, Spanish and Italian sovereign yields will fall -- indeed that is, in essence, what it would *mean* for tensions to ease. When that happens, Spanish and Italian stocks will surely rally -- as would stocks everywhere in the world. But the relatively low Spanish and Italian equity risk premium -- that is, low in comparison to the US or China -- is telling us that in Italy and Spain *bonds* are the way to play an easing of Europe's crisis, and in the US and China *stocks* are.

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…premia down. If the euro crisis eases, stocks there will surely rally, but the relatively low equity risk premia mean bonds are the better way to bet on it.

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[About us]

US: S&P 500 equity risk premium

China: Shanghai SE equity risk premium

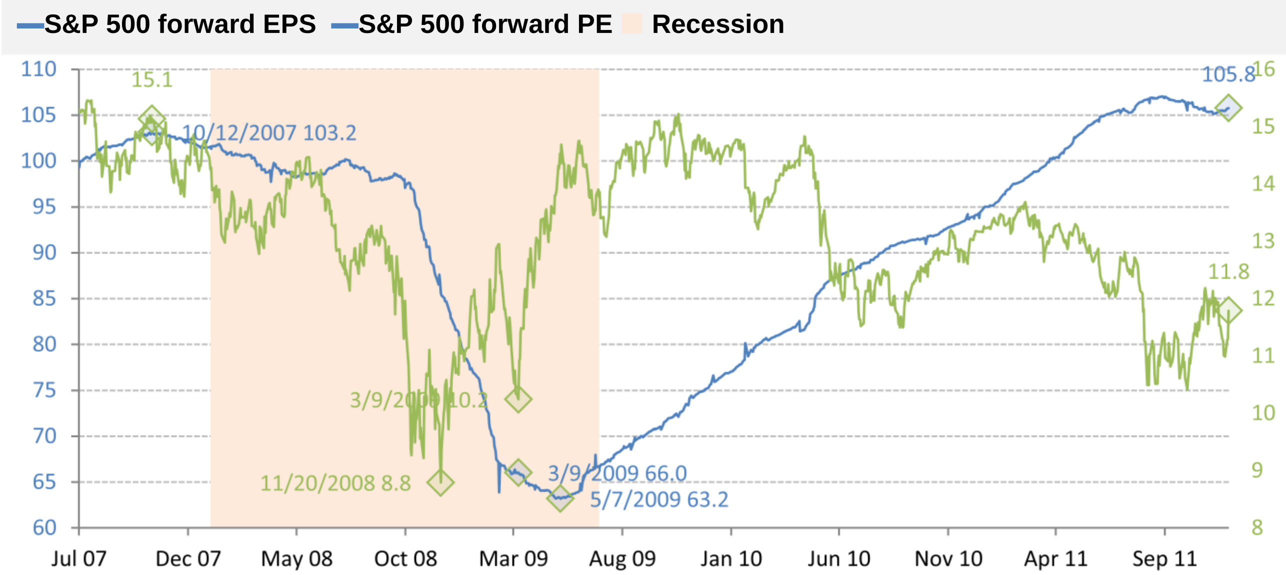
Italy: FTSE-MIB equity risk premium

Spain: IBEX equity risk premium

Source: Bloomberg, TrendMacro calculations

The equity risk premium would prove to be a "value trap" if growth collapses. In the US, if we were just looking at the standard macro data, we wouldn't have any particular fear of recession at all -- just more of the same substandard recovery we've had since the mid-2009 end of the Great Recession. The *usual* evidence gives no sign of recession. None.

- What has concerned us, and still concerns us, about the US economy has been the decline in S&P 500 forward earnings from their late August peak. Having watched this indicator for decades now, we've found it to be a superlative recession warning.
- Forward earnings are still 1.5% off peak. But they've been slowly recovering now since early November -- and we are hoping that they will yet march to new highs above the August peak (please see the chart on the following page). That would make the brief

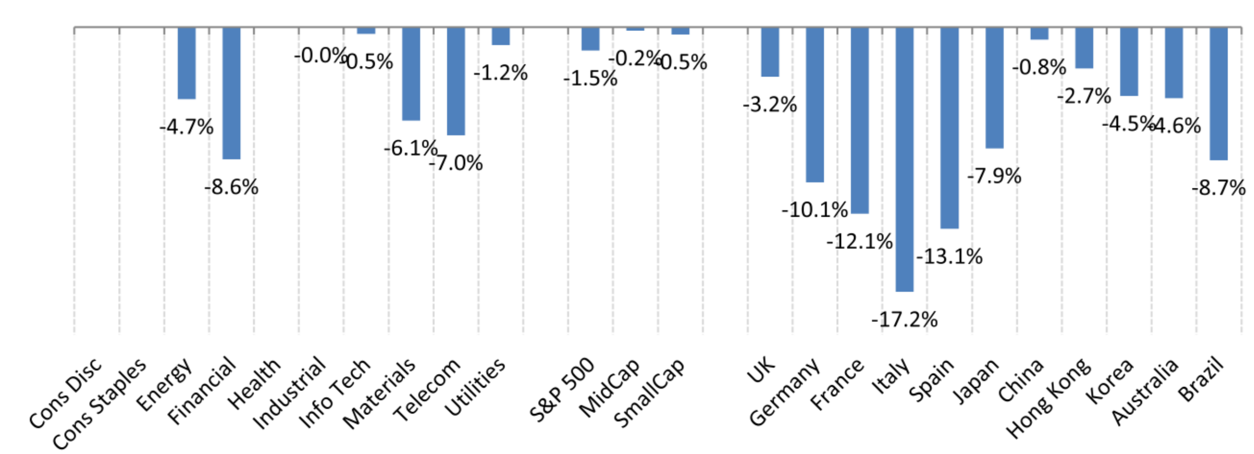


Source: Bloomberg, TrendMacro calculations

drop a false alarm, similar to the transient drop, quickly reversed, that was experienced in the immediate wake of the stock market crash of October 1987.

- If the decline in forward earnings proves prescient, and the US slips into something the history books will call a recession, we continue to expect it to be shallow and brief. Deep recessions simply can't begin from an output gap as deep as the one that still remains in the US (see "Testing 1, 2, 3" September 7, 2011). Again, please forgive us if we repeat ourselves -- but you can't fall out of the basement window.
- Forward earnings have fallen much further in other economies, especially in Europe -- Germany off 10.1%, France off 12.1%, Spain off 13.1% and Italy off 17.2% from the their respective 2011 peaks (please see the chart below). It is nearly inconceivable that these countries can avoid recession -- by any reasonable definition,

Forward earnings per share, difference from year-to-date high



Source: Bloomberg, TrendMacro calculations surely some of them have already been in recession for a while now. Euro area manufacturing PMI reported this morning at 46.4, another new low from the February peak. It's been below 50 since mid-year, and this morning's report is the first since 2009 in which every member nation's individual PMI is below 50.

- Forward earnings have fallen only slightly in China -- off just 0.8%. There is some evidence of cooling in China -- including this morning's November manufacturing PMI reading at 49, the first sub-50 print since the Great Recession. Given China's reliance on troubled Europe as an export partner and many months of financial tightening, this is anything but a surprise. Now, as we predicted two weeks ago, China has already begun to ease credit conditions with yesterday's cut in reserve requirements (see "Europe Gets MAD" November 15, 2011), and RMB appreciation has slowed to zero, on net, over the last month.
- Throughout this year's difficulties, we've kept a close watch on indicators of global financial liquidity -- such as gold -- and global growth -- such as copper. If there were going to be a serious global banking crisis, or a serious global recession, we would have seen far worse behavior in those assets. Instead, they've been remarkably strong.
- Gold in particular has been an essential signal. If China had not been poised to ease credit as it did yesterday, and if the central banks of the world had not been poised to ease dollar liquidity as they did yesterday (see "Saved by an Acronym" November 30, 2011) -- indeed, if there were not more sources of liquidity still primed to release as needed -- gold would be at $1050 and falling, not $1750 and rising.

We'll conclude with a word about Europe. It should hardly be necessary, considering the extremely detailed blow-by-blow coverage we've given to the ongoing debt crisis (see, for example, "QE Nein" November 23, 2011). But it's critical, because more than any other element in the strategic mix, Europe serves up a very real risk of a non-linear downside event.

- We don't want to be mistaken as Europe bulls or Europe apologists. We know well everything that's wrong there, and how risky the situation is. But in relation to the dominant narrative that Europe is in an irrecoverable death-spiral, perhaps we are both.
- We see Europe's debt crisis as not only an economic reality, but more important a political one. We see it as part of a managed economic war, aimed at politically unifying Europe for only the fifth time in 2,000 years -- this time under German/French leadership.
- The real risk is that the economic pressure consciously being applied to prosecute this war will get out of the control of those applying it. The most tangible evidence of such a risk was last week's failed bund auction, which inverted the spread between 10-year German debt and 10-year US debt (again, see "QE Nein").
- It was a milestone in the euro crisis for sovereign debt contagion to touch the sacred German bund. If that situation worsens, it will surely indicate that the crisis has indeed fallen into the death spiral of the dominant narrative.

- But as we pointed out as it happened last week (again, see "QE Nein"), we expect it will turn out to be a different kind of milestone. It will more likely prove to have been a signal to Germany to turn down the heat in this managed crisis for a while. Since then, we've already seen significant relief for the most beleaguered sovereign debt markets, Spain and Italy.
- This is the true significance of yesterday's announcement of coordinated central bank easing of dollar liquidity, and why world markets rallied so vigorously on the news despite the reality that what was announced was actually fairly trivial and technical. After several weeks of agonizing neglect -- while it seemed the crisis was being allowed to get worse, as indeed we believe it was -- at last someone "did something" designed to make things better.

Bottom line

Stocks remain cheap worldwide, especially if most nations avoid recession -- as now seems likely in the US. Notable exceptions are Spain and Italy, where high long-term sovereign yields and sharply falling forward earnings are holding equity risk premia down. If the euro crisis eases, stocks there will surely rally, but the relatively low equity risk premium says bonds are the better way to bet on it.