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MACROCOSM

2011: A Lost Year

Thursday, December 29, 2011

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So much risk -- yet nothing happened. Sadly, the key risks of 2011 are still in place for 2012.

Update to strategic view

US MACRO, US STOCKS: Multiple profound event shocks in 2011 have frayed nerves, eroded confidence and exhausted spirits. The risk vectors of 2011 are all still active heading into 2012, so we don't expect much immediate relief. It's…

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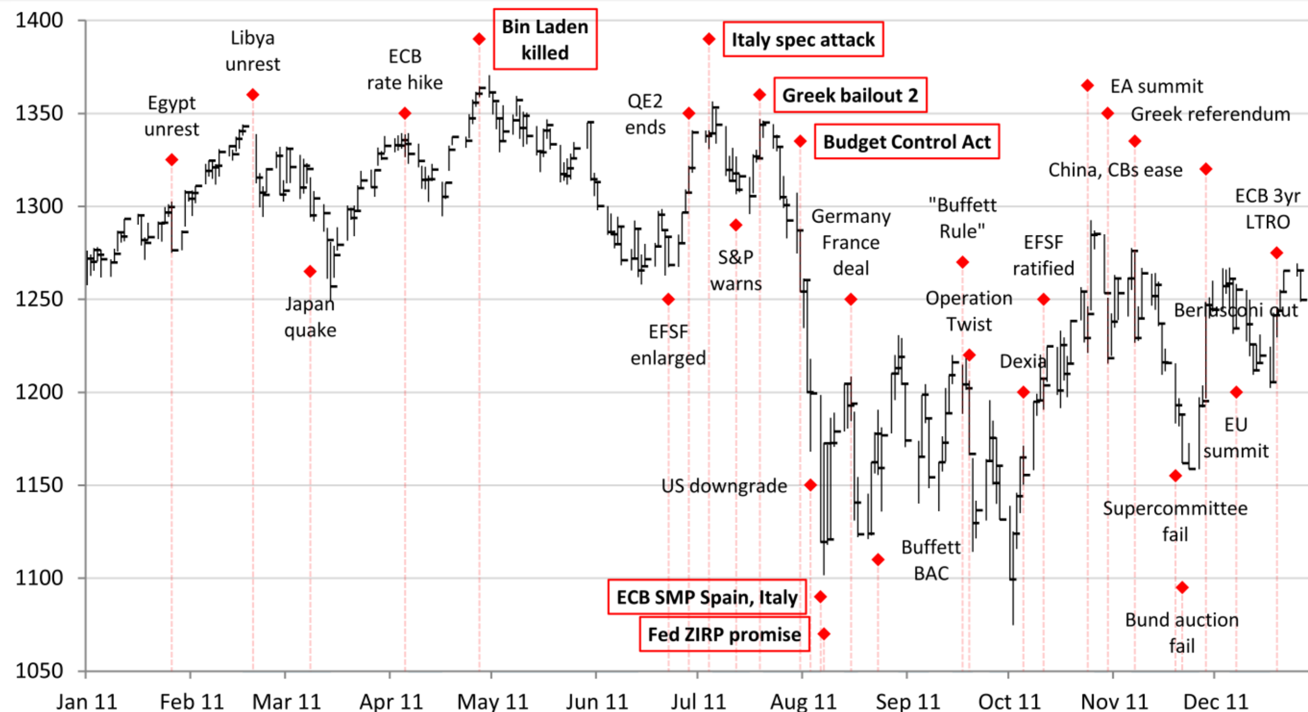
For US equities and the US economy, 2011 was a lost year -- *end to end, nothing happened*. Yet at the same time it was a miracle year -- there were many event shocks, six of which we think really mattered (please see the chart below). But *none of many credible end-of-the-world risks actually became realities*. We ran between the raindrops and didn't get very wet. But we didn't get very far, either.

- The deepest issues we faced in 2011 are all still on the table, and will have to be faced again in 2012.
- The fear and uncertainty of the experience has left us weaker, but at the same time it has left stocks deeply undervalued worldwide. In the US, stocks were arguably undervalued a year ago -- now they are basically unchanged for the year, while forward earnings are

S&P 500 Index ◆ Event shocks



Source: Bloomberg, TrendMacro research

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almost 12% higher, and long-term discount rates are sharply lower.

- We think there is a real chance of a US recession, but a mild one that needn't be associated with an important bear market in stocks.

Of the many event shocks that presented themselves in 2011, *one stands out as uniquely salient* -- the death of Osama bin Laden. This is typically not thought of as having had any market impact. Yet in an "event-study" framework (please see the chart on the previous page), *it's perfect*: this shock was both completely unexpected and it perfeclty marks the year's top in US stocks.

- Our immediate prediciton after bin Laden's death was that it would mark a secular turning point in energy prices and in defense spending (see "The bin Laden Commodities Crash" May 6, 2011) -- a double "peace dividend" arising from the US now being able to honorably stand down from its combat commitments in the Middle East. This appears to have been correct.
  - Bin Laden's death clearly marked the top in oil. Now, despite ongoing regime risk in the Middle East and North Africa, the Brent crude oil price is about 13% below where it was when bin Laden was killed.
  - Pragmatically unthinkable a year ago, US presence in Iraq and Afghanistan is now being drawn down. And the Budget Control Act of 2011, enacted in the context of the summer's debt ceiling crisis, imposes sharp reductions in discretionary defense spending (see "Debt Ceiling Crisis Over -- Now What?" August 2, 2011). Congress's so-called "super-committee" did nothing to halt those reductions (see "On the Super-Committee Failure" November 22, 2011).
- But a month later we reappraised the impact of bin Laden's death, seeing it as a source of market malaise and disorientation (see "The Post-Osama Slow-Motion Drip-Down" June 10, 2011). Looking aside from its secular positives, we noted:

> …bin Laden's death has an aspect of existential uncertainty… 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... 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 new structure. All this, we think, contributes to the mood of helplessness in the face of uncertainty that we sense pervades the market.

The malaise and disorientation we'd identified made the world especially vulnerable to intertwined shocks that hit during the summer -- the worsening of the debt crisis in Europe, and the politial chaos in the US over extending the statutory debt ceiling.

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…touch-and-go now as to whether we face a US recession. With a Lehman-type systemic banking crisis ruled out by the ECB's massive liquidity programs, any recession will be short and mild. Stocks are extremely cheap world-wide, poised for some catalyst that will improve confidence and trigger a revaluation.

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[About us]

- We won't recount these events blow by blow, having already covered them in detail and in real-time in many reports during 2011.
- Suffice it to say that for Europe, the first big event was the speculative attack on long-term Italian sovereign debt, coming just when US stocks had almost recovered to the highs they had achieved just before bin Laden's death, triggering a sharp correction (again, please see the chart on the first page). This signified that the European debt crisis had moved beyond small peripheral economies -- Greece, Portugal and Ireland -- jumping across Spain, the large European economy most expected to be next in line for contagion, all the way to a G7 nation (see "The Sack of Rome" July 13, 2011).
- The second big event for Europe, again coming just as stocks had almost recovered (again, please see the chart on the first page) was the announcement of a second bail-out for Greece, requiring that private sector bondholders take losses (see "Whatever It Takes" July 22, 2011). This signified the end of the post-Lehman epoch of unbounded moral hazard, in which all bondholders would be bailed out all the time. Like bin Laden's death, it was necessary and all to the good -- but nevertheless a profoundly disorienting regime change from which the the world is still reeling.
- While this was transpiring in Europe, the US government was engaged in a chaotic and risky battle over extending the statutory debt ceiling. A debate on US debt needed to be had, and the ultimate result was entirely sensible (again, see "Debt Ceiling Crisis Over -- Now What?"). But the brinksmanship involved was destabilizing, especially on the part of newly ascendant Republicans who ought to have been pointing the way toward pro-growth policy. The result was a harrowing near-miss with default, and a deepened political polarization heading into the 2012 elections in which the Obama administration was drawn back from its move toward the center, reverting to its most corrosive anti-capitalism class warfare positions.

This cluster of events defined the top for US stocks in 2011, and a short, sharp bear market in which, from highest tick to lowest, the S&P 500 lost 21.6%.

- We think the bottom is in for that bear market. It began with two key events, occuring a day apart (again, please see the chart on the first page).
- In early August the European Central bank departed from its traditional parsimony, and its disdain for quantitative easing, by beginning purchases of Italian and Spanish sovereign debt in its Securities Markets Programme (see "Downgrade: At Least the News is Out" August 8, 2011). This signaled the reversal of the ECB's catastrophic tightening error in April, which we correctly predicted would worsen Europe's debt crisis and weaken the euro (see "EUicide" April 7, 2011). And it demonstrated that the authorities in Europe remained committed to intervening *in extremis* to prevent systemic debt contagion.

- The next day the Fed announced that the so-called "extended period" of extremely low interest rates would run until at least mid-2013 (see "On the August FOMC" August 9, 2011). This, at last, was the policy maneuver we had long recommended to the Fed (see "What Should the Fed Do?" August 5, 2010) -- one that would both ease and reduce policy uncertainty at the same time. This signified that the Fed would not make the classic error of jacking up interest rates in a vain and self-destructive attempt to restore confidence in the wake of S&P's downgrade of US debt.

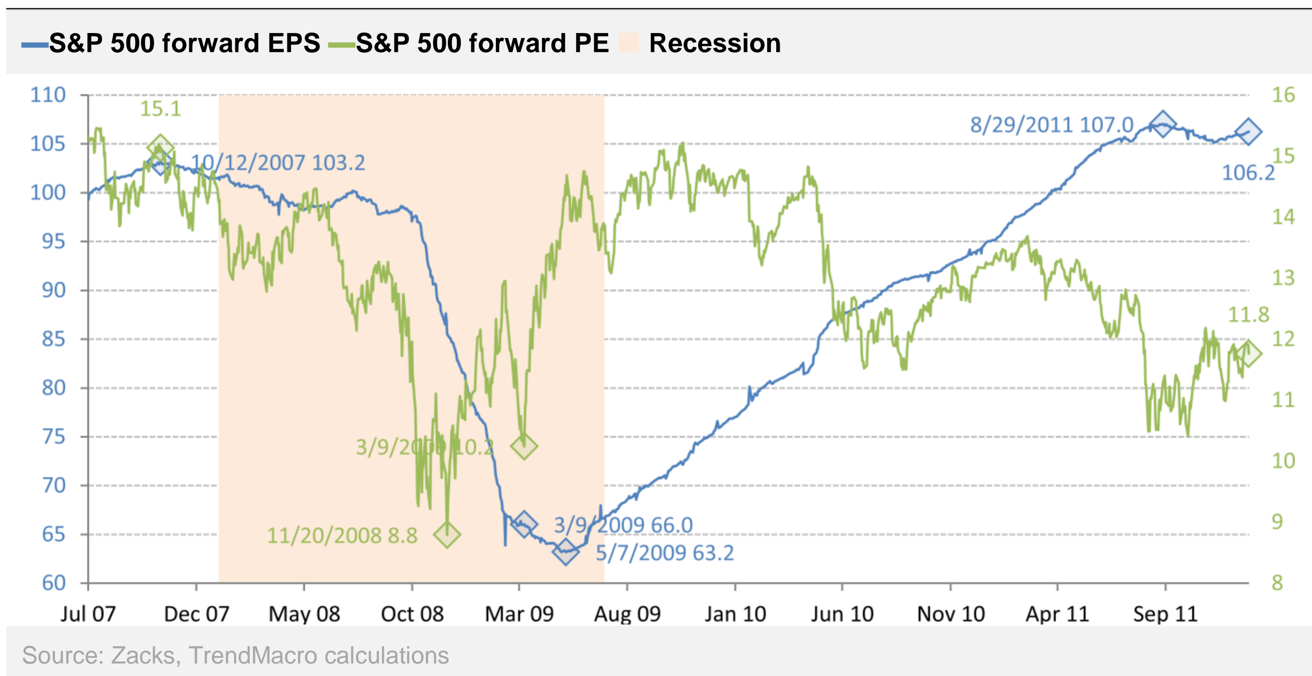
So where do we go from here?

- Unfortunately, the key risk factors from 2011 are all still in place.
- We remain in a post-bin Laden world of unpredictable geopolitical realignment. In the nature of such things, we can only guess at where this might lead. By way of example, let us note that the so-called "BRIC decade" was made possible by the war on terror, turning the US defense policy establishment away from harassing China and Russia. Now the one thing that President Obama and GOP front-runner Mitt Romney can agree on is that China represents an existential threat to the US economy, and it must be forced to revalue its currency with the threat of punitive tariffs.
- The debt crisis in Europe is not over. It is part of a long-term war for European unification -- the application of intense economic pressure to force the nations of Europe to adopt German-style growth policies and federalize under implicit German/French leadership. It is Germany's and France's ongoing strategy to keep that pressure in place. But they will intervene as necessary to keep systemic contagion from destroying Europe's banks, as they have with the ECB's most recent massive provision of liquidity to the banking system (see "Europe's Wall of Liquidity" December 21, 2011). Europe's ongoing woes can't help but have direct spillover effects on other economies with whom it has critical credit and trading relationships, including the US and emerging Asian economies.
    - Our conviction that Europe can limp through a lingering sovereign crisis while avoiding a systemic banking crisis is contingent on the ongoing provision of sufficient monetary liquidity. Such liquidity appears to be there, but we cannot fail to respect the contrary signal coming from the sharp decline in the gold price since the ECB's last policy meeting (see "On the ECB Monetary Policy Decisions" December 8, 2011).
- Political risk in the US remains intense and dangerous. Chaos rules, as we have seen over the last couple weeks of negotiations over extending the payroll tax cut (in which Republicans sought with predictably little success to pressure Democrats by threatening to block a policy which they themselves support). Our issue here is not the lack of "bipartisanship" or "cooperation" (again, see "On the Super-Committee Failure"). Rather, heading into the 2012 presidential election, there is the opportunity to turn away from two years of anti-growth policy and realign toward pro-growth policy -- and the present chaos is not supportive of capturing that

opportunity. The political futures markets now give the Republicans a commanding probability of retaining House control and gaining Senate control, but only a 45% chance of taking the White House (and that with a likely candidate who is not strongly pro-growth).

It's been a very rough ride in 2011, and it will likely continue to be so in 2012. We can vividly sense how much nerves are frayed, confidence is eroded and spirits are exhausted.

- For equity investors this is a great starting point. Its result is that stocks are massively undervalued world-wide (see "It Only Feels Like Blood in the Streets" December 1, 2011). We can't say exactly what catalyst will crystalize an upward revaluation, or how much patience might be required before some measure of confidence is restored. But stocks are truly cheap.
- At the same time, a critical consequence of so many event shocks and such dismal sentiment is that we may have talked ourselves into a recession in the US -- and a recession in Europe, already evidently underway, doesn't help.
- There is no evidence of recession in the US macro data, but as we have mentioned often over the last several months, forward S&P 500 earnings per share have rolled over (please see the chart below), and we regard this as our single most valuable business cycle indicator (for example, again see "It Only Feels Like Blood in the Streets"). The 2011 EPS peak was August 29. Since then, EPS has provisionally troughed on November 9 -- so it's still touch and go. But earnings reports coming out in December have been discouraging. And EPS are falling world-wide, in many cases much more steeply than in the US. So we have to take cognizance of a significant chance of US recession.



Source: Zacks, TrendMacro calculations

- Barring a Lehman-type systemic banking collapse -- which we now regard as virtually ruled out in light of the ECB's massive new liquidity operations (again, see "Europe's Wall of Liquidity") -- any US recession will be short and mild. The so-called "output gap" is just too great now for any significant downturn to take root (see "Testing 1, 2, 3" September 7, 2011).
- If we experience the short and mild recession we are expecting -- that is, if there is a recession at all -- then stocks are well positioned for it. Severe bear markets (such as the ones beginning in 2000 and 2007) occur when stocks have lofty multiples, regardless of whether the associated recession is steep. Mild recessions, beginning when stocks have modest multiples (such as 1990, when the multiple was substantially the same is it is today), are associated with minimal bear markets or none at all.

Bottom line

Multiple profound event shocks in 2011 have frayed nerves, eroded confidence and exhausted spirits. The risk vectors of 2011 are all still active heading into 2012, so we don't expect much immediate relief. It's touch-and-go now as to whether we face a US recession. With a Lehman-type systemic banking crisis ruled out by the ECB's massive liquidity programs, any recession will be short and mild. Stocks are extremely cheap world-wide, poised for some catalyst that will improve confidence and trigger a revaluation.