Trend Macro

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MACROCOSM

Risk Reappraisal

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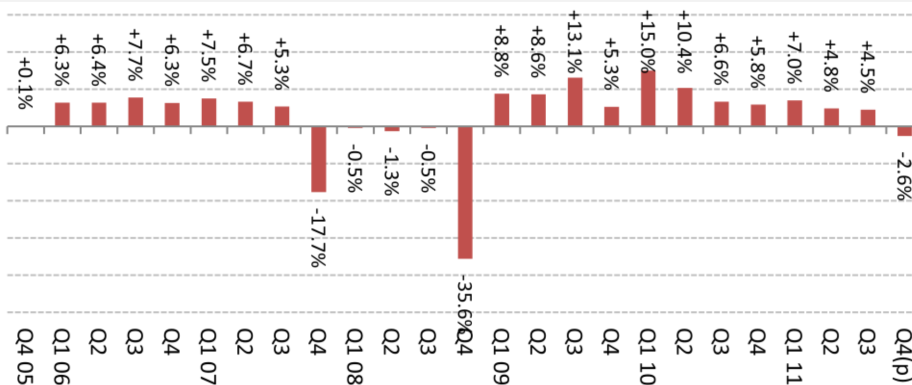
Donald Luskin

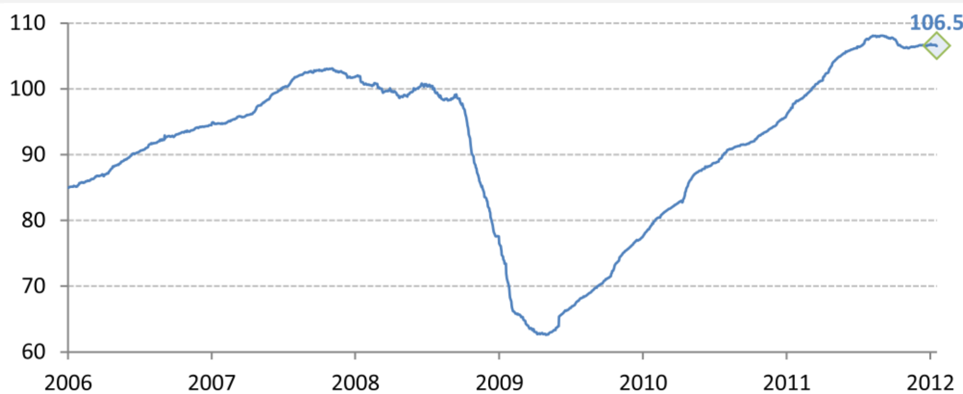
Stocks rise as earnings disappoint, while investors rethink how risky the world really isn't.

So far this earnings season has been the worst in three years, with weighted average EPS missing estimates by 2.6% (please see the first chart below). At the same time, year-ahead S&P 500 forward earnings have started to edge lower again, possibly ending an attempt to reattain their summmer all-time highs (please see the second chart below). Yet stocks are in a "slow-motion melt-up" very much like they were one year ago at this time. Our trader's gut tells us its time for a little rest, but the positive change in tone is palpable. What's the catalyst?

Average EPS surprise, by earnings season Q411 preliminary



S&P 500 forward EPS, one-year-ahead consensus estimate



Source: Bloomberg

Update to strategic view

US STOCKS, US MACRO: Stocks are in a "slow-motion melt-up" as earnings season disappoints. The generationally wide equity risk premium that made stocks crazy cheap last year has been more than enough to make up for it. Our trader's gut senses that it's time for a little rest, but now that global systemic risk is being favorably reappraised, the equity risk premium is narrowing and stocks are rising. We still face appreciable recession risk, despite continued not bad macro data. But without a Lehman-type global systemic hard-stop, any recession will be mild and need not trigger a bear market in stocks.

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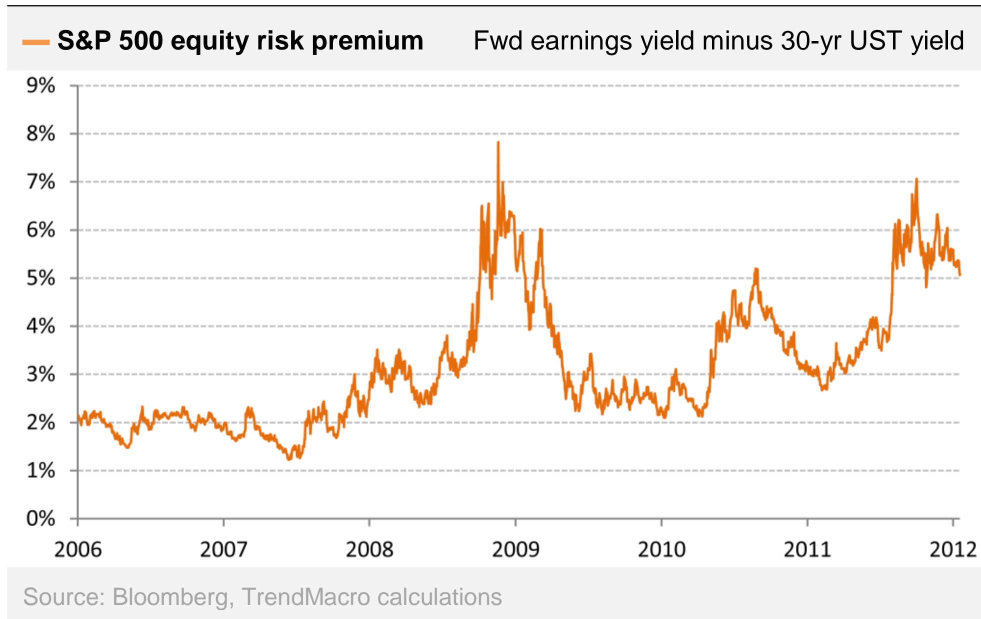
- Extreme undervaluation is the context, if not the catalyst. Even though, on paper, EPS estimates were apparently set too high, *real* estimates -- the ones impounded in stock prices -- were apparently set too low. That is simply to say: stocks have been crazy cheap, as we've been asserting since the day of the 2011 bottom (see "Europe Fails, US Stocks Flail" October 4, 2011).
- Our way of judging valuation -- the equity risk premium -- is a tool for arbitraging the contradiction between EPS in official estimates and EPS impounded in stock prices (consensus estimates and market cap are two of the model's three inputs, the third being long-term interest rates). When the equity risk premium reaches generational extremes as it did in late 2008, early 2009, and again last October, it means that stock prices are going up and consensus earnings are coming down, in order to re-equilibrate their relationship toward historical norms (please see the chart below). By this measure, stocks are still cheap. Since the onset of the Great Recession, the equity risk premium has been consistently high by long-term historical standards, and now it is high even within that unusually high regime.



Source: Bloomberg, TrendMacro calculations

- It is also the case that the disappointments this earnings season have come predominantly from the financial sector. Removing this sector, the average surprise so far flips from a *miss* of 2.6% to a *beat* of 2.3%. Now, with most of the big banks already reported, we could well see enough beats in other sectors to swing the overall surprise to positive for this season, once all is said and done.
- Financials have also borne the brunt of the drop in S&P 500 forward EPS -- the sector's aggregate EPS estimate is down 10.8% from its 2011 peak.

More broadly, the catalyst for stocks is a general favorable reappraisal of

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the level of systemic risk in the world. As the perceived level of risk recedes, perforce the equity risk premium narrows, and stocks rise almost no matter what is happening with earnings.

- At the start of this new year, markets are realizing that not a single one of the admittedly credible end-of-the-world narratives that got so much attention last year actually eventuated (see "2011: A Lost Year" December 29, 2011).
- Most important, even though Greece is technically in default, and even now with Standard & Poor's sovereign downgrades, contagion in the euro area has been contained at an acceptably low level. The most at-risk banks have already taken the pain of expensive recapitalizations, and the most at-risk sovereigns have already made significant down-payments on rolling this year's maturities. We continue to think that Europe's banks have turned the corner (see "S&P Reprise Reprieve" January 17, 2012), thanks to the European Central Bank's massive -- though covert -- quantitative easing program (see "Cash for Gold!" January 11, 2012, and "Europe's Wall of Liquidity" December 21, 2011). The consequent elimination of the risk a Lehman-type event emanating from Europe is a global game-changer.
- The risk of a hard landing in China is significantly reduced by the beginning of easing measures (see "It Only Feels Like Blood in the Streets" December 1, 2011). This week's upside surprise in Q4 growth is one confirmation, if we can believe official Chinese statistics. The break-out recovery to 4-month highs in the copper price is an even better one.
- Despite ongoing turmoil in the Middle East -- including saber-rattling in Iran -- the price of oil has not risen to growth-snuffing levels as it did briefly last year. In fact, it continues to yield an incipient "peace dividend" in the aftermath of the death of Osama bin Laden (see "The bin Laden Commodities Crash" May 6, 2011).
- More generally, the inflation scare that began a year ago -- remember when the "Arab Spring" was blamed on QE2-driven food prices? -- has receded. Inflation rates around the world are falling to the point where deflation is now beginning to be discussed as the real risk.
- There are other pessimistic narratives that were in circulation last year that we could mention, none of which eventuated either. But the purpose here isn't to be smug by reciting a list of failed predictions by others. This is a tough business and we respect that, and we acknowledge the fact that we live in an unusually risky post-crisis world.

The fear of a double-dip recession in the US has been blunted by a continous outpouring of good macro data reports (to be sure, none of them *great*, but nevertheless all surprisingly *not bad*). Despite that, we continue to take the risk of a double-dip seriously, simply because over the years we have come to have enormous respect for the linkage between business cycles and forward earnings. Forward earnings are

falling -- and as long as they keep falling, we will worry about recession no matter what the other data tell us.

- That said, we continue to believe that in the absence of a Lehman-type global credit hard-stop, any recession that materializes will be insubstantial. And given the deep undervaluation of equities, such a recession need not be associated with a serious bear market in stocks.
- This is because we have had so little recovery since the supposed trough of the Great Recession more than two and a half years ago -- there just isn't very far to fall. The so-called output gap is just too great (see, among many, "Testing 1, 2, 3" September 7, 2011). This is why, despite Europe surely falling into recession already, and despite so much fear about so many risks, the macro data continues to be so relentlessly *not bad*.

We have had many conversations with clients over the last several difficult months about what catalyst could turn things around, unlocking the value in US stocks. We speculated that the long-feared default of Greece could be one -- that is, once we learned we could survive it. It's taken several months to learn that, but now it does seem to be taking hold in investors' minds. We also argued that the mere passage of time -- that is, without one of the many end-of-the-world risks other than Europe eventuating -- would gradually but effectively restore confidence. That, too, seems to be taking hold. It's not a dramatic event-driven catalyst, but at least it's happening.

Bottom line

Stocks are in a "slow-motion melt-up" as earnings season disappoints. The generationally wide equity risk premium that made stocks crazy cheap last year has been more than enough to make up for it. Our trader's gut senses that it's time for a little rest, but now that global systemic risk is being favorably reappraised, the equity risk premium is narrowing and stocks are rising. We still face appreciable recession risk, despite continued not bad macro data. But without a Lehman-type global systemic hard-stop, any recession will be mild and need not trigger a bear market in stocks.