Trend Macrolytics, LLC
Donald Luskin, Chief Investment Officer
Thomas Demas, Managing Director
Lorcan Roche Kelly, Chief Europe Strategist
John Clinton, Principal

MARKET CALLS

Can Stocks Keep Melting Up?

Friday, February 10, 2012

Donald Luskin

If risk aversion retreats as much as it did a year ago, stocks would be 34% higher.

It's a risk-off day in world markets, with a soft trade number from China, and Europe struggling again with the second rescue plan for Greece -- which has been agreed in principle since last July (see "Whatever It Takes" July 22, 2011). We think the Greek matter is the main event. After many weeks of a slow-motion melt-up in stocks, it awakens the scariest ghost of 2011 -- the prospect of a Lehman-type global systemic banking crisis emanating from Europe. The removal of that threat has been the key to the melt-up (see "Risk Reappraisal" January 20, 2012). Is it over now?

- The present stand-off in Greece has a different quality than last year's crises. Time has passed. We've moved on. These risks have been discounted, and the system of the world has been strengthened against them.
- In our judgment even the existential threat of Greece leaving the euro is not so existential any more. Since the aborted referendum on euro membership last November (see, first, "On the Greek Referendum Surprise" November 1, 2011), the euro area has achieved considerable economic policy integration, and that progress is likely to assure markets that Greek exit would not mean the end of the euro as a currency.
- Most critical, come what may in Greece, the ECB's 3-year LTRO program has effectively eliminated any chance of a Lehman-type funding crisis that might have otherwise arisen (see "On the ECB Monetary Policy Decisions" December 8, 2011, and "Europe's Wall of Liquidity" December 21).

We expect the Greek impasse to be resolved shortly, as it is mostly the product of internal political noise (we'll publish a report with more color on that on Monday). If it's resolved well, then after the usual bad day or three typical of slow-motion melt-ups, we expect the advance in stocks to continue. If it's resolved poorly, then the correction will be sharper -- but we expect it will only be a correction, and thus a buying opportunity.

- The systemic risk of a banking crisis in Europe is either off the table or it's not. If it's not, then we're wrong, and we're looking at very serious risks again. But if it *is*, as we believe, then we're looking at a classic situation in which the quantity of risk in the world is

Update to strategic view

US STOCKS: Another crisis in rescuing Greece evokes all the ghosts of 2011. But we think the world has moved on -- at this point, even Greece leaving the euro would mean only a market correction, not the crisis it would have meant last year. Stocks remain deeply undervalued, with a great deal of room to run on the upside based on the standards of the slow-motion melt-up we experienced this time last year.

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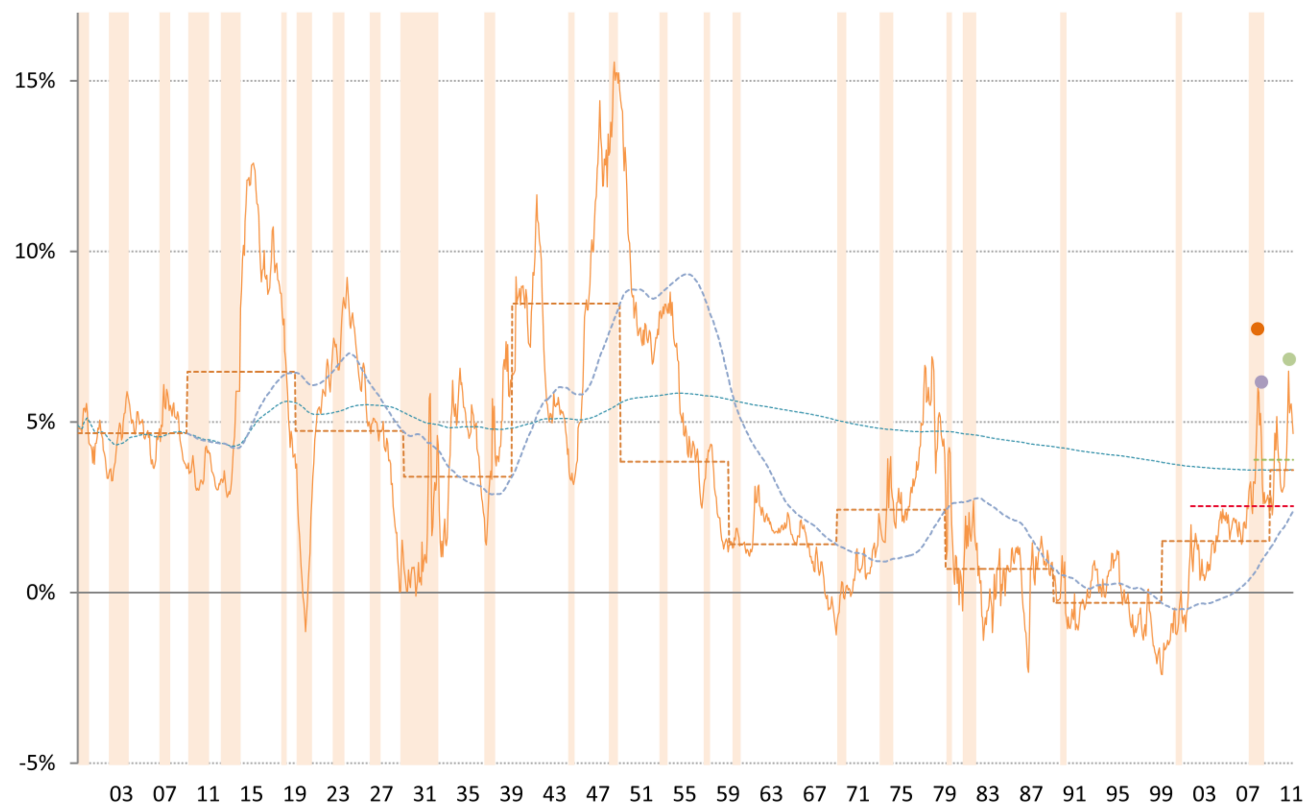
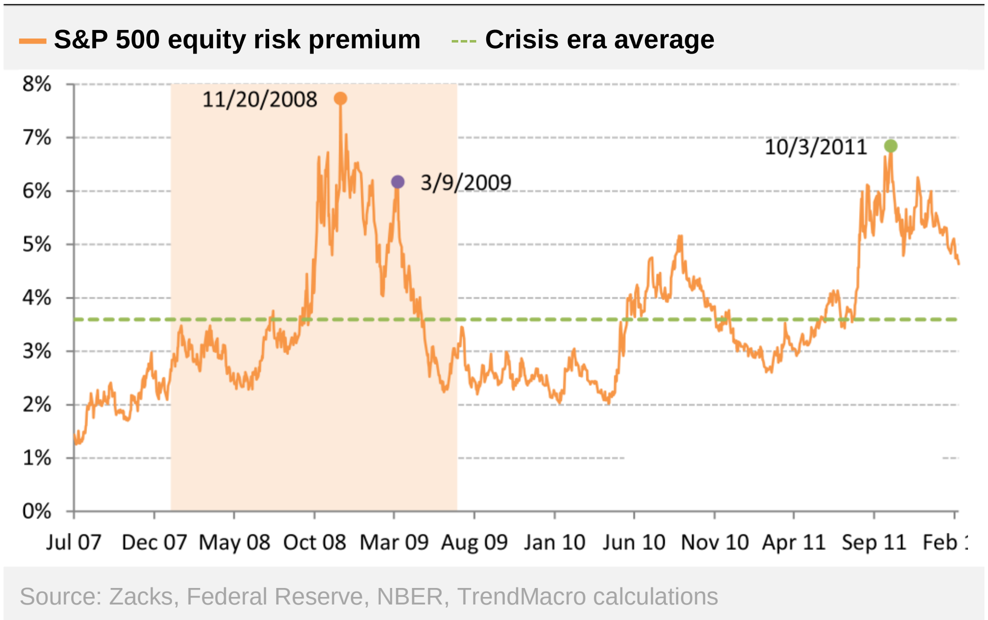
suddenly reduced -- and it becomes just a matter of time for investors to gradually recover from shell-shock and recognize the new reality.

- Peaks of risk aversion, such as last year's -- in which the equity risk premium was driven to a generational high greater than the one reached in March 2009 (please see the chart below) -- are as much bubbles as peaks of irrational exuberance. As Mackay famously wrote of such things in 1841, "Men…only recover their senses slowly, and one by one."
- Many clients have remarked that the present slow-motion melt-up seems like an exact replay of the melt-up this same time last year. We agree -- that one, too, was all about gradual recognition of a suddenly less risky world. It was triggered by the mid-December extension, in the post-election lame duck session of Congress, of the Bush-era tax rates -- thus avoiding what would surely have been a double-dip recession (see "The Double-Dip Doomsday Machine" September 21, 2010, and "Tax Cut Endgame" December 13, 2010).
- In last year's melt-up, the S&P 500 equity risk premium went from above its crisis era average (where it is now), to below that average (please see the chart on the following page). If it were to fall now as far as it did last year, the S&P 500 would be 34% higher (holding forward earnings and 30-year Treasury yields constant).

S&P 500 equity risk premium (forward earnings yield minus 30-year Treasury yield)
● November 20, 2008 ● March 3, 2009 ● October 3, 2011 --- Crisis era average Recession



Source: Various, TrendMacro calculations



- Much of this is due to the sharp drop in the 30-year yield over the last year. Making the extreme experimental adjustment of setting the 30-year yield back to 4.7%, where it was last year, leaves 6% on the upside from here. On the face of it, that would seem to take much of the force out of our valuation case -- as a number of clients have argued. We respect that, but a low 30-year yield is a durable reality -- even if it is caused by the Fed's interventions (see "On the January FOMC" January 25, 2012). Under that reality, bonds are not much competition for stocks.
- Okay, let's split the difference. If the 30-year retraces half-way, to 3.9%, stocks have 20% on the upside.
- Furthermore, we would posit that a rise in Treasury yields would likely be associated with heightened perceptions of strong economic recovery, which would feed back positively into the equity risk premium model in terms of higher forward earnings.

For now, holding all else equal -- other than improving investor risk sentiment -- is probably wise. Our outlook for economic fundamentals remains decidedly mixed.

- Many clients have reported to us how impressed they are by the decline in initial jobless claims, and by the unexpected improvement seen in last week's January jobs report (see "On the January Jobs Report" February 3, 2012). Fair enough. But so far these are dispositive only with respect to the resiliency of a stagnant economy that's been beaten down so hard it can't help but grow at least a little. In other words, without an extreme exogenous shock -- such as a global banking crisis emanating from Europe -- the "output gap" is too wide for any kind of *serious* recession to get started (see "Testing 1, 2, 3" September 7, 2011).
- Moreover, we do not tend to see labor market statistics as leading indicators. Hiring is a supreme act of risk-taking, and thus forward-looking. We will see serious job creation -- not just today's "green

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trendmacro.com

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Donald Luskin
Menlo Park CA
650 429 2112
don@trendmacro.com

Thomas Demas
Charlotte NC
704 552 3625
tdemas@trendmacro.com

Lorcan Roche Kelly
Sixmilebridge Ireland
212 537 9067
lorcan@trendmacro.com

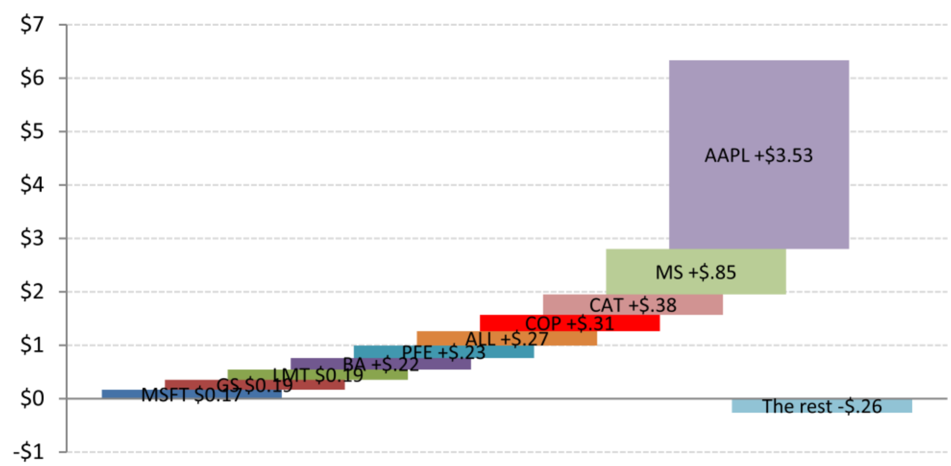
John Clinton
Charlotte NC
704 552 3629
jclinton@trendmacro.com

[About us]

shoots" -- when risk aversion in all its forms begins to seriously retreat.

- We'll feel better about the macroeconomy when we see corporate earnings expectations start to get upgraded again. We apologize for repeating this so often, but we must -- it is our most valuable macro indicator: S&P 500 forward earnings peaked in late August, and have been drifting flat to lower ever since. Historically this has been an excellent business cycle indicator -- as you'd think it would, since it proxies for the corporate growth expectations that inform hiring and investment decisions.
- We're now winding up the worst earnings season in three years. The aggregate upside surprise was meager, and one single company -- Apple -- accounted for 58% of the aggregate. Ten companies accounted for more than all of it -- together, all the other companies, *missed* expectations (please see the chart below).

S&P 500 earnings surprise, companies reporting Q4 2011 USD billions



Source: Zacks, TrendMacro calculations

Bottom line

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