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

MACROCOSM

A Glass of Snapple, Half Full

Friday, April 20, 2012

Donald Luskin

Forward EPS at new highs, with no Apple. Stocks are getting to be a value play again.

The inevitable and overdue stock market correction that set in after a record-breaking 76-day winning streak is now two weeks old (please see the chart below). We said on Monday of last week that we thought it would be just a correction, another opportunity to buy the dip (see "Bad Friday for Jobs" April 9, 2012). So far, the day after that has turned out to be the low in this move, notching a 4.6% cumulative drop. We're not adamant about that being all the correction we're going to get. There are lots of cross-currents to be sure, but there are good reasons to think that stocks can now work to new recovery highs.

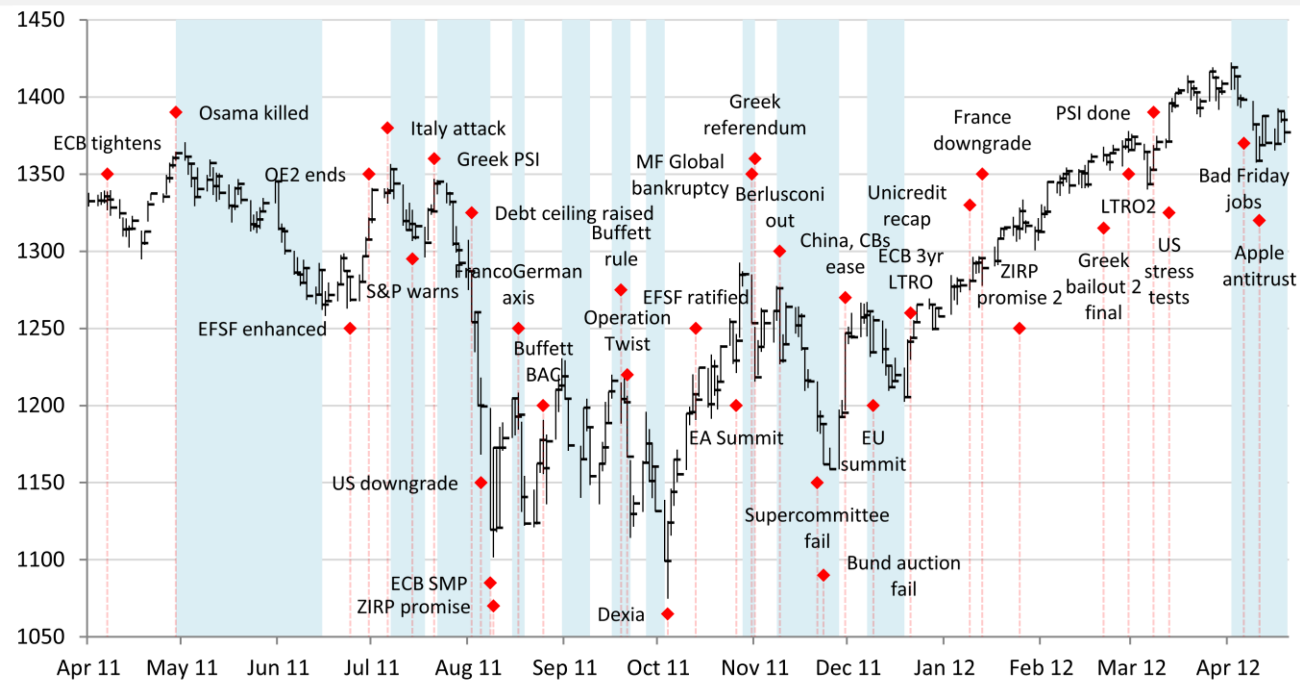
- **The dark tone of earnings and forward estimates over the last six months has considerably brightened.** This earnings season is shaping up as best of the last seven (please see the chart at the top of the following page), with a weighted-average beat of 8.5%

Update to strategic view

US STOCKS, US MACRO, US FED: After two weeks of an almost 5% correction, stocks are an interesting value proposition again -- with an excellent earnings season moving forward EPS to all-time highs even without Apple, and Treasury yields having backed off last…

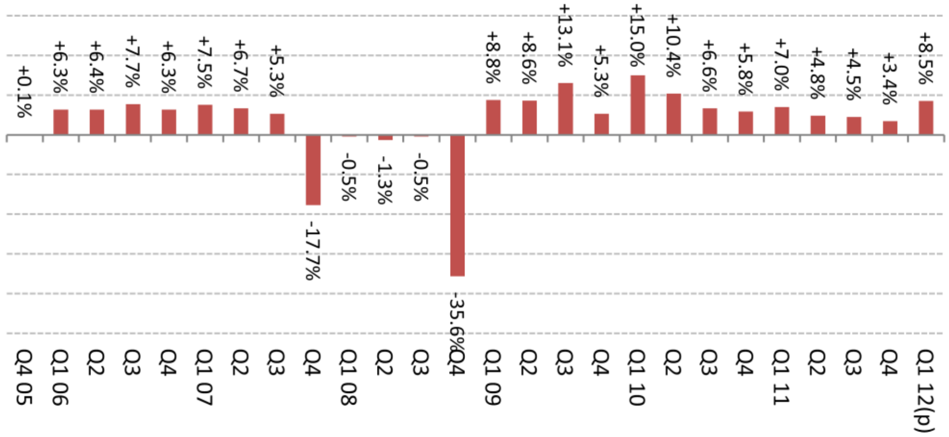
[continued on next page]

S&P 500 ♦ Event shocks Corrections of 3% or more



Source: Bloomberg, TrendMacro calculations

Weighted average earnings surprise, by earnings season
(p) = preliminary

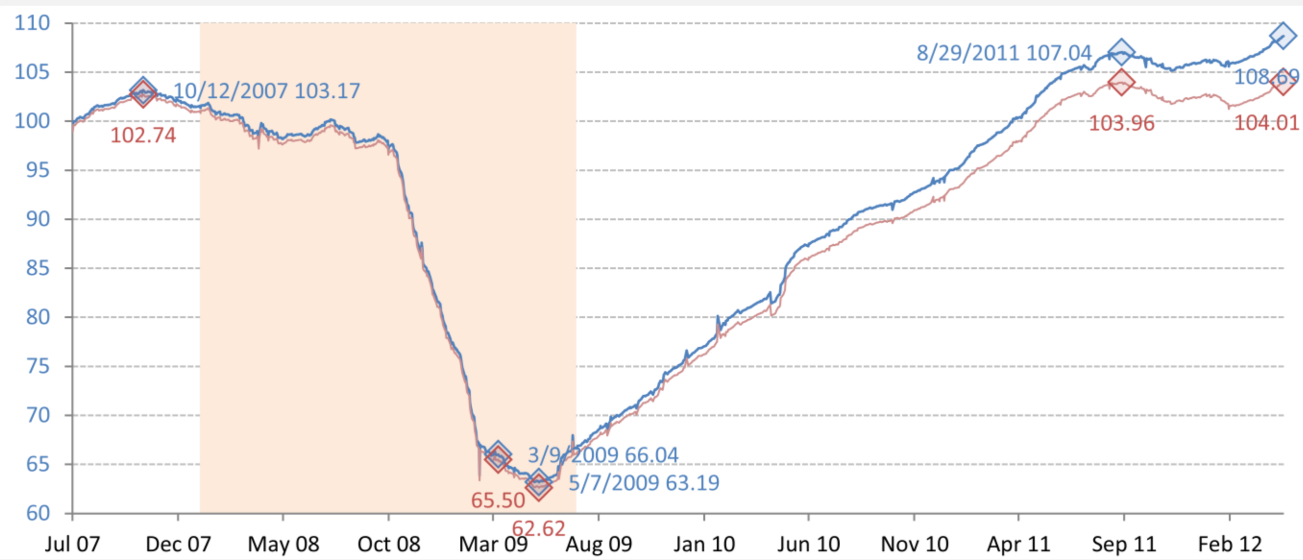


Source: Bloomberg TrendMacro calculations

diversified nicely across an overwhelming 6:1 ratio of beats to misses. This is a huge bounce back from the previous season, which was the worst of the last 12, saved from utter disaster only by Apple (see "On Q4 2011 GDP" January 27, 2012).

- With expectations settled down to where companies can comfortably beat, there seems now to be room for S&P 500 year-ahead forward estimates to move upward again. We have been very concerned that forwards had stalled in late August, able to finally recover to new highs a month ago thanks only to Apple (see "We Love Our New iPhone, But..." March 22, 2012). Now, as of yesterday, forward EPS for "Snapple" -- the S&P no Apple -- has also moved to new highs (please see the chart below).
- The momentum of forward EPS is positive for the S&P 500, for

Consensus forward EPS — S&P 500 — Snapple Recession
Bottom-up, cap-weighted



Source: Zacks, TrendMacro calculations

Update to strategic view

[continued from first page]

…month's false alarm spike. As Europe struggles again, there's no evidence of global systemic risk. And the Fed's most influential voices are specifically committing to intentionally erring on the dovish side. The slow-motion melt-up is over, but stocks should be able to work to new recovery highs. Intermediate term, year-end political chaos remains an imposing risk factor.

[Strategy Dashboard home]

Snapple, and for all ten S&P 500 sectors but one (the Industrials, which up to now has been one of the only sectors with forward EPS making new highs consistently over the last month).

- It must be said that all this could potentially change next Tuesday when Apple reports earnings. At 4.3% of S&P 500 market cap and 4.3% of S&P 500 forward earnings, we can't think of an historical parallel for any one single company, and with such volatile earnings, exerting such a powerful aggregate effect.
- We have absolutely no expertise about or insight into the reality of Apple's earnings this quarter. But our trader's gut senses that any surprise will be on the upside, if for no other reason than that we are picking up so much obsessive chatter to the contrary, and so much hand-wringing about Apple's stock price over the last week.
- No one is acting as though this is a serious threat, but if you want to worry about Apple, worry about the Department of Justice's antitrust suit against it. Something similar marked the beginning of the end for then politically naive Microsoft over a decade ago. Apple is savvier, having put Al Gore on its board for protection -- *but make no mistake about it: this is a shot across Apple's bow*.

- **The equity risk premium has expanded.** At the same time as stocks have corrected and forward earnings have risen, Treasury yields have retreated sharply, making their brief run-up last month a false alarm. These three factors -- stock prices, forward earnings, and bond yields -- have all pulled together in the right direction to move the equity risk premium higher (please see the chart below).

S&P 500 equity risk premium **Crisis era mean** **Recession**
Forward earnings yield minus 30-year Treasury yield

Source: Zacks, Bloomberg, TrendMacro calculations

Contact TrendMacro

On the web at trendmacro.com

Follow us on Twitter at twitter.com/TweetMacro

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]

Stocks aren't now what we called "crazy cheap" last October (see "It's This Simple" October 20, 2011), but two weeks of correction have restored a decent risk premium.

- **Systemic risk appears to be under control**. We believe that the single most powerful explanator of the stock market's bull run from last October's bottom has been the sharp lowering of systemic risk in Europe's banking system (see "Risk Reappraisal" January 20, 2012). While we are disappointed that euro area bank stocks have given up so much of their spectacular gains from earlier this year (see "A Spaniard in the Works" April 11, 2012), we are nevertheless gratified that their drop this month has not been accompanied by an increase in stress in local or global funding markets (please see the chart below). So whether or not there's a *local bull case* to be made for euro area banks here (and we think there *is* one), we still can't make a *global bear case* on Europe's debt problems being systemically infectious. To that extent at the very least, the ECB's LTRO strategy has been a success (see "Unquestionable Success?" March 9, 2012).

LIBOR/OIS spread — **Euro** — **USD**

Source: Bloomberg, TrendMacro calculations

- **The Fed is finally easy -- and if anything will get easier**. We have argued for almost two years that the Fed has been too tight (see, at the earliest, "Fixed Income Strategy: Take The Low Road" June 16, 2010). Recently we have noted that it has *finally* switched course and become too easy (see "On the March FOMC" March 13, 2012). Now, in the wake of a disappointing jobs report, the Fed's highly influential ultra-doves Janet Yellen and William Dudley have both made ultra-dovish speeches to contradict Bernanke's apparent policy agnosticism -- just as we predicted they would (see "Bad Friday for Jobs" April 9, 2012).
- We take particular note of Yellen's speech in which she, first, specifically defends the more aggressive version of the Taylor Rule that we have now been describing for two years -- the one that prescribed a fed funds rate of negative 6%, and justified QE2

(again, see "Fixed Income Strategy: Take The Low Road"). Having defended the Taylor Rule's seemingly radical prescription, she specifically argues for ignoring it now that it prescribes a funds rate of only negative 70 bps. She is relying on the notion of deliberately erring by staying too easy to compensate for the prior error of having been too tight.

- Let's set aside whether she's right or wrong. We are saying as a practical matter that we think this view -- which Dudley shares, and about which Bernanke is too politically weak to do anything -- is dominant now at the Fed. The Fed will ease in one manner or another at the slightest sign of economic weakness, and will only tighten after the most obvious and persistent signs of strength.
- We don't expect to see very many of those signs. To be sure, the recovery to new highs in Snapple forward EPS causes us to be a less worried than we have been about a recession in 2012. But we continue to see no signs whatsoever of a major turning point in which our lackluster recovery, now almost two years old, gets any kind of real momentum behind it (see "Snapple, not Kool-Aid" April 2, 2012).

We don't see any reason to expect another enduring slow-motion melt-up in stocks here -- that is, a persistent move yielding a 15%-plus gain with no corrections. But we think the stage is set to at least work up to new recovery highs before the next correction. When that sets in, as always, we'll reassess.

Especially so as our short-term optimism remains tempered by intermediate term caution. We continue to worry about a catastrophic bargaining failure in the lame duck session of Congress -- or even a near-failure in an atmosphere of extreme brinksmanship -- with the multiple challenges of heading off a tax-hike train wreck and raising the debt ceiling all having to be managed at the same time (see "What Could Possibly Go Worng?" March 8, 2012). We just don't see how we get out of it without damage. The only question is how much. And before that, the question is: when do markets suddenly start thinking of what is now the intermediate term as, inevitably, the short term?

Bottom line

After two weeks of an almost 5% correction, stocks are an interesting value proposition again -- with an excellent earnings season moving forward EPS to all-time highs even without Apple, and Treasury yields having backed off last month's false alarm spike. As Europe struggles again, there's no evidence of global systemic risk. And the Fed's most influential voices are specifically committing to intentionally erring on the dovish side. The slow-motion melt-up is over, but stocks should be able to work to new recovery highs. Intermediate term, year-end political chaos remains an imposing risk factor.