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MACROCOSM

Sell in May and Go Away -- Volume 3?

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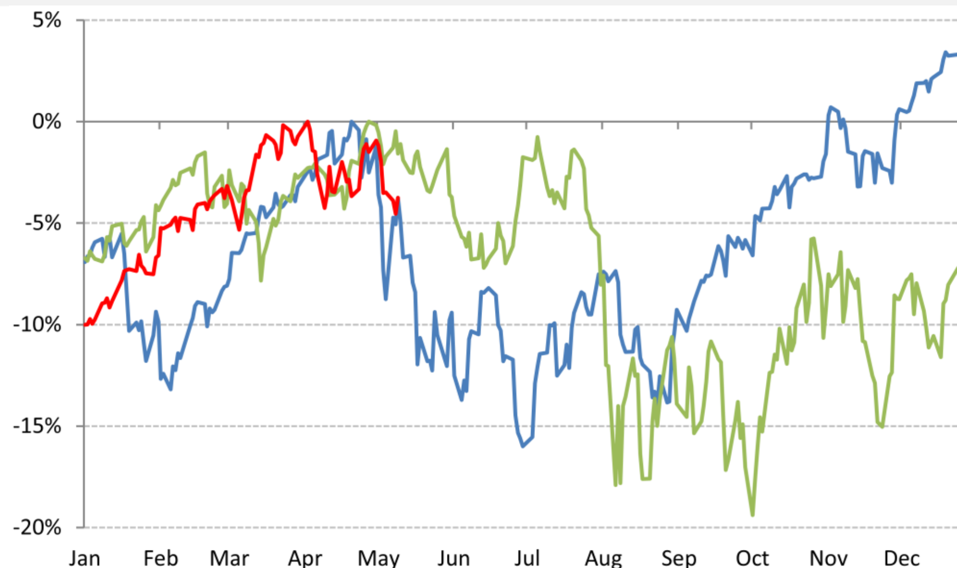
Still just a correction, but now it has a dangerous theme -- existential risk to the euro.

With another panic in Europe in the wake of the French and Greek elections and turbulence in Spain's banking sector, the correction in US stocks has a real story behind it. It's no longer just a technical reaction to a record-length uninterrupted slow-motion melt-up. But for all the panic in the air, as of this writing it's still only been a 5.6% correction from the high tick on April 2 to yesterday's low tick. But that does breach the lows of April 10 -- albeit by less than a percentage point -- which we had hoped might hold (see "A Glass of Snapple, Half Full" Friday, April 20, 2012). So will this be the third year in a row to "sell in May and go away"?

Actually that should be "sell in April" (please see the chart below). But obviously, even such apparently compelling repeating patterns are illusions. Investment decision-making can't be that simple. We need to evaluate what's going on in the world, not what month it is. That said, our concerns about the US political brinksmanship event that seems destined to happen in this year's lame duck session of Congress *has* had us on alert

Sell in April and go away? — 2010 — 2011 — 2012
S&P 500 percentage change from year's respective April closing high



Source: Bloomberg, TrendMacro calculations

Update to strategic view

US STOCKS, FX, EUROPE MACRO, US FED: The correction in US stocks is still just a correction, but it now has a story behind it -- the existential threat to the euro if Greece exits. That's a threat, but we don't think it will happen. And if it does we think the authorities will know how to handle it. But stocks have to discount threats. We don't expect Europe to cause the bottom to fall out like it did in 2010 and 2011, and if the market comes to share our view on its ultimate triviality then stocks ought to break out to new highs on all-time high forward earnings, and the increasing inevitability of more Fed easing this summer. But if this correction drags on long enough, then before stocks have had the chance to break out, the threats from a year-end crisis in the lame duck session of Congress over taxes and the debt ceiling could intervene.

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for an exit point (see "What Could Possibly Go Worng?" March 8, 2012 and "The 2013 Fiscal Cliff Could Crush Stocks" May 5, 2012).

It may be a form of picking up pocket change in the face of an oncoming steamroller, but we nevertheless think that it's too soon to exit. We continue to think this correction is just a correction -- there's even a decent chance it's already run its course. 2010's and 2011's April tops were driven by risks arising in Europe. And that's what we've got again in 2012. But we think both the magnitude and probability of Europe producing a truly serious systemic shock this time around are both quite low.

- In 2010 and 2011, the risk in Europe was that its banks would undergo a Lehman-type liquidity crisis, leading to cascading failures that would ripple though the global banking system.
- But now the authorities have put a very effective safety net under the banks. They have been very clear that private bondholders will never again be forced to take haircuts on European sovereign debt -- "Greece is unique" is the mantra. And the ECB's massive LTRO operations have pre-funded the banks for two to three years, and there's more where that came from -- there simply can't be a funding crisis now (see "On the Second 3-year LTRO" February 29, 2012).

For all the exaggerated chatter that the French election somehow represents a global rejection of fiscal responsibility, we think it is a non-event.

- This was a French election, not a global election. Austerity -- or, in fact, reform of sclerotic labor and product markets -- goes on where it is needed in Europe, that is, Spain and Italy (see "On the French and Greek Elections" May 7, 2012).
- What's important for any French president is that he continue to be Germany's partner in the power axis driving the fiscal and political unification of Europe. François Hollande is a committed life-long integrationist. He'll be perfect in the role.

The Greek election is more momentous, because the rise of anti-bailout power in the parliament raises the probability that Greece will exit the euro currency.

- We warned about this months ago, saying "…with Greek elections looming in April, there is a heightened risk that Greece may exit the euro currency. While not the catastrophe it would have been last year – and still unlikely – managing it would be a serious challenge and a serious risk" (see "Greece Re-Re-Revisited" February 13, 2012).
- But at least as a going-in position, the three parties that earned the most seats in parliament in the election -- who are now struggling to form a government -- are all committed to staying in the euro (again, see "On the French and Greek Elections"). Polls continue to show that the strong majority of the Greek people favor remaining

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May 8, 2012

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in the euro, as they have learned over decades of painful drachma devaluations that the euro is a more reliable store of value.

- We could end up in a bizarre situation in which Greece becomes a pariah in Europe by repudiating the bailout, and yet still stays in the euro. There is no treaty mechanism for ejecting a nation from the euro, so the Bank of Greece would remain in the Eurosystem and its representatives would play their normal role in the policy deliberations of the ECB.
- Nevertheless, if the demanding terms of the bailout are to be renegotiated, the threat of exit will surely be used by Greece as a bargaining chip.
- Such brinksmanship cuts both ways. In fact the first threat of Greece's euro exit has come not from Greece, but Germany and the ECB. No less an *éminence grise* than Germany's representative on the ECB executive board Jörg Asmussen said, "Greece needs to be aware that there is no alternative to the agreed reform programme if it wants to remain a member of the eurozone."
- *This is epoch-making: it marks the first time the ECB has ever admitted in public that it is even a possibility for a nation to exit the euro.*
- Other similar speakings of the unspeakable came out yesterday from German officials outside the ECB.
- As we have explained many times (see "On the Greek Referendum Surprise" November 1, 2011), the risk of a nation leaving the euro is that it creates a precedent and a template for other nations to do the same. From the standpoint of the risk-averse market, a euro without Greece may objectively be stronger. But with one country gone, the irrevocability of the euro compact -- marriage for life with no pre-nup -- is shattered. Now *any* country could leave, including an anchor country such as Germany. Such a prospect, if uncontrolled, would lead to massive capital flight of euros to the strongest countries, especially Germany.
- But with the right expectations management from the authorities, such a scenario could be effectively contained. All it would take would be credible statements of commitment from the rest of the euro nations -- especially the anchor nations like Germany and France, and other large nations seen as exit risks like Spain and Italy.
- Such statements would be effective if they were paired with parallel commitments to greater fiscal and political integration, binding the nations of Europe even more closely and irrevocably than the currency alliance does. *If such commitments were the result of Greece's euro exit, it would end up being just another case of a crisis moving Europe closer to the federalization that is its destiny, its only stable end-state.*
- The fact the Asmussen would say what he did -- unless we think this sober man has suddenly become an impulsive fool -- implies that the authorities are preparing some kind of contingency plan along these lines.
- We learned by experience that the European authorities, for all their apparent bumbling, are actually quite good at conditioning

market expectations in such a way as to absorb considerable instabilities.

- Bottom line, we expect that Greece will stay in the euro, because it is in Greece's interest to do so, whatever else it may do. If a failure of judgment under duress causes it to exit, there would be a period of market turbulence while the event is absorbed -- but we are highly confident that the authorities will manage their way out of it, and that even tighter European integration will be the happy pay-off.

The other element in play this week is the agony of Spain's Bankia, the "bad bank" amalgamating several troubled *cajas*. Yesterday's conversion of the government's interest from debt to equity seems to us as part of an orderly process of working out from under Spain's housing bubble. We think it's unwarranted that Spain's larger "good banks" -- especially the global giants Santander and BBVA that aren't much involved in housing -- have taken so much collateral damage.

- Is Bankia a major risk event? Just the opposite, perhaps -- the conversion of the government's preferred stake into common equity is a pre-programmed contingency built into the government's position from the beginning. As always with the deployment of bail-out safety nets, it is horrifying that they are necessary, but at the same time a great relief that they successfully deploy.
- The only element of the Bankia situation that is a surprise is the revelation of what appear to be irregularities in its financials at the time it was first formed in 2011, and publically listed, which have driven the forced resignation of its chairman. We have been saying in client meetings that in post-LTRO world in which Europe's banks' funding needs are nailed down in advance for years, and with no new stress tests coming, the only really alarming event that can occur would be an outright fraud event -- similar to Worldcom in 2002 -- that would throw every bank's reported numbers into question.
- We don't see at this time that Bankia's irregularities have that quality. Rather, they remind us of the accounting sleight of hand employed by Dexia, the revelation of which led to its closure and orderly wind-up by the French and Belgian governments -- in which not a single depositor or bondholder lost a penny, a confidence-building event which coincided exactly with the very bottom in world stock markets in early October last year (see "Europe Fails, US Stocks Flail" October 4, 2011).

Another element playing into all this is its impact on the Fed. We started changing our view more favorably toward further QE in March, as we came to see the new political dynamics within the Fed that have placed influential extremist doves Janet Yellen and William Dudley in the policy driver's seat (see "On the March FOMC" March 13, 2012). Two back-to-back bad jobs reports (see "On the April Jobs Report" May 4, 2012) have now given them nearly all the intellectual ammunition they need to make it so. Now the new risk of Greece's euro exit could be strike three.

- FOMC statements since last September's have all warned of "significant downside risk" arising from strains in global markets -- that is, without naming names, Europe.
- So now another bad jobs report in three weeks -- and why should we expect a good one? -- would make it official.
- And it's an election year.
- QE3 is probably coming at the FOMC's June 20 meeting. The foreshadowing and the trial balloons should be starting momentarily.

The increasingly obvious prospect of a new easing program by the Fed all the more puts a floor under how bad things can get here. Yet what worries us is that this will take time to play out. If the three top parties in Greece can't form a government, there will have to be another election in June, and it's not at all clear that a government will be able to be formed even then. In the meantime, there's nobody to negotiate with -- and yet Greece all the while will live from paycheck to paycheck, as the so-called "troika" decides how much of the bailout money to pay out -- if any.

The longer this drags on, the more difficult it will be for stocks to shake off the present correction and drift up to the new recovery highs that they ostensibly deserve given the breakout in forward earnings, even excluding Apple (again, see "A Glass of Snapple, Half Full"). Then at some point, stocks will potentially have to start discounting the risks of the November election -- potentially a referendum on capitalism -- and the lame duck session of Congress that will have to deal with expiring tax cuts, pre-programmed tax hikes on capital, and the raising of the statutory debt ceiling -- all at once.

We'd like to think that the black clouds in Europe will dispel soon enough to give stocks some sunny days until the black clouds from Washington roll in. If this seems like a dark view -- it is. Yes, we believe the risks in Europe are not as cataclysmic as they are being played right now in market chatter. But they are a blow to confidence, and a waste of precious time. We don't expect the bottom to fall out any time soon -- we still see this correction as a correction. But it could last longer than we have previously thought -- and the longer it takes to play out, the less upside there will be.

Bottom line

The correction in US stocks is still just a correction, but it now has a story behind it -- the existential threat to the euro if Greece exits. That's a threat, but we don't think it will happen. And if it does we think the authorities will know how to handle it. But stocks have to discount threats. We don't expect Europe to cause the bottom to fall out like it did in 2010 and 2011, and if the market comes to share our view on its ultimate triviality then stocks ought to break out to new highs on all-time high forward earnings, and the increasing inevitability of more Fed easing this summer. But if this correction drags on long enough, then before stocks have had the chance to break out, the threats from a year-end crisis in the lame duck session of Congress over taxes and the debt ceiling could intervene.