TrendMacro

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MACROCOSM

Time Is Our Frenemy

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Donald Luskin

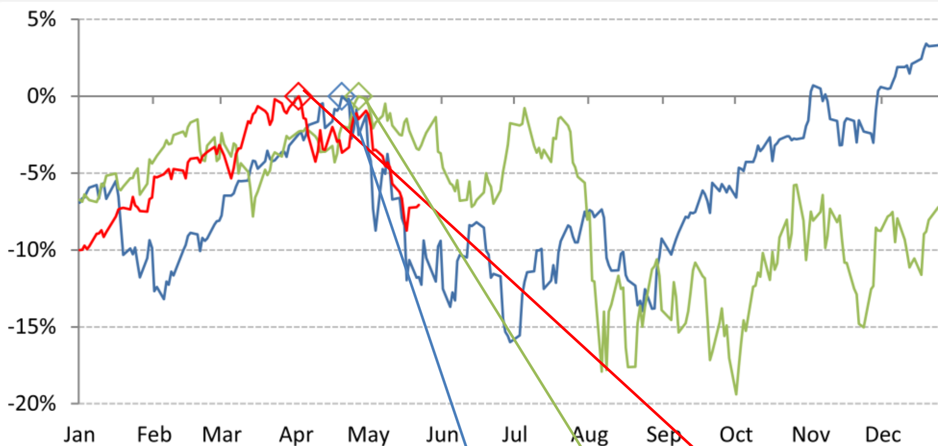
We need the gift of time to secure the euro. But every day brings the fiscal cliff closer.

We hear it over and over in client conversations: *looking at the world top-down, I really want to take risk off the table -- but looking at my portfolio and the way my stocks are valued, I can't find anything I want to sell.*

In our words: *we're into the third year in a row of "sell in May and go away" -- but this is the first year we've begun the cycle with the equity risk premium above the crisis era average* (please see the chart below).

Sell in ~~May~~ April and go away? — 2010 — 2011 — 2012

S&P 500 percentage change from year's respective April closing high



— S&P 500 risk premium --- Crisis-era average ▪ Recession

Source: Bloomberg, Zacks, NBER, TrendMacro calculations

Update to strategic view

US STOCKS: Rising systemic risk from Europe has elevated the equity risk premium toward extreme levels. Falling stock prices, rising forward earnings, and falling Treasury yields have made US stocks extremely cheap. We don't expect a Greek exit from the euro in the near-term, and over the longer-term Europe will be able to condition the market to accept exit if it does happen. But while we wait for Europe to sort itself out we come closer to a potential political "freak show" as the year-end fiscal cliff and debt ceiling approach. We don't see why stocks ought to go down from here -- but we're running out of time to rally back to new recovery highs.

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The equity risk premium has risen considerably from its already elevated level at this year's early April high in stocks. That's because while stocks have fallen 7.1%, forward earnings have risen 1.9%, and long-term Treasury yields have fallen by 54 bp.

- That makes stocks *extremely* cheap, which is why clients say they can't find anything they want to sell.
- Since 1984 there have been only three month-ends (November and December 2008, and September 2011) at which the equity risk premium was higher than it is now.

Yet there is the widespread sense of dread that stocks could get cheaper still. It's more than just superstitious belief in seasonal patterns. This is, in reality, the third year in a row in which credible global systemic threats have arisen in Europe (see "Sell in May and Go Away -- Volume 3?" Thursday, May 10, 2012). We've argued that the rally in stocks from last year's October bottom was mostly about the *withdrawal* of those threats -- not any substantive improvement in growth prospects, or improvement in investor risk tolerance (see "Risk Reappraisal" January 20, 2012). So for us it's perfectly understandable to see the equity risk premium rise again as those threats have re-emerged. After all, risk premia are there to compensate you for risk-bearing.

But consider what would happen if the equity risk premium *keeps rising from here* -- as it kept rising during the corrections of the last two years:

- If the equity risk premium rises by as much as it did during the corrections of 2010 and 2011, it will surpass its peak of October 3, 2011, and equal the higher peak of November 20, 2008.
- That's a level not seen since 1954 (please see the chart below).

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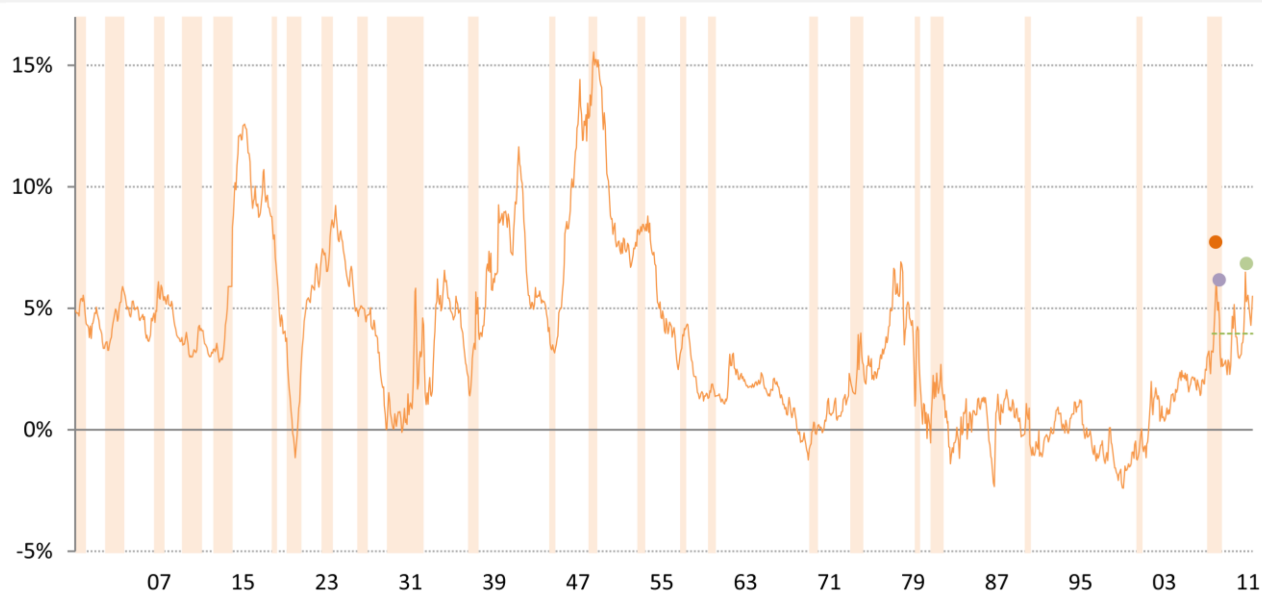

Source: Various, TrendMacro calculations

- All else equal, that risk premium would mean that stocks would be 21% lower. The S&P 500 would be at 1040 -- that's 5.4% lower than last year's October 3 bottom.

If we're right to call stocks extremely cheap *now* -- and if we were right to call them "crazy cheap" on October 4 last year (see "Europe Fails, US Stocks Flail" October 4, 2011) -- then what would we call them if they go even lower than that? "Stupid cheap"? "Smokin' cheap"?

Ah, but as always, *it depends*. As in the previous two years' corrections, it depends on the systemic threat from Europe being contained. Our strongly held baseline assumption is that this year's Europe threat -- a potential Greek exit triggering a messy break-up of the euro currency -- *will* be averted.

But it will take time. So time is our friend.

- Greece needs time to form a government that can make decisions about its adherence to the bailout programs and participation in the euro (see "What's Greek for 'Groundhog Day'?" May 15, 2012).
- Europe needs time to work out a contingency plan in case Greece does exit. The creation of such plans are now being openly talked about. That's spooking the market because it implicitly admits that exit is *even a possibility* -- something that has been officially denied until now.
- But it must be done, because while in some sense preparing for exit makes exit possible, it also makes it survivable. Before too long this will condition the market to have confidence that the other 16 euro nations will adhere to the currency union, no matter what Greece does or doesn't do. That way the market will come to regard an eventual Greek exit, if it even happens, as a non-event -- as it did Greece's debt default.

Yet time is also our enemy. While the politics play out in Europe, it will be a noisy and nervous-making process. And even if Europe's risks are eventually ameliorated -- as we expect they will be -- every passing day moves the US year-end "fiscal cliff" from over-the-horizon to on-the-horizon to coming-right-up.

- As much as it is becoming a cliché, we very much respect the risks involved. We are *not* worried about the small cuts in government spending. We are more worried about the expiration of the Bush-era tax rates on labor and investment income (see "The 2013 Fiscal Cliff Could Crush Stocks" May 5, 2012).
- We are *especially* worried about the chaotic political process that will potentially be involved, as hiking the statutory debt limit is inextricably mingled with other issues in the fiscal cliff (see "What Could Possibly Go Worng?" March 8, 2012).
- Even if everything somehow turns out all right in the end, it will be, as Wilbur Ross has put it, a "freak show" -- and markets will be very freaked out by it.

Recommended Reading

Economic Effects of Reducing the Fiscal Restraint That Is Scheduled to Occur in 2013
Congressional Budget Office
May 22, 2012

Three Views of the Fiscal Cliff
Edward Lazear
Wall Street Journal
May 21, 2012

[Reading home]

Over the last two weeks we're hearing clients say that the matter is beginning to become salient in decision-making. But at this point it's hard to say whether that explains why stocks have been falling -- or whether the fact that stocks have been falling is making clients say that.

Our sense is that it is too soon for it to really bite. For now, it's Europe fears that are driving stocks. But we continue to believe that the matter will become highly salient all of a sudden when some catalytic statement comes from some thought-leader in Washington indicating how the game theory of it will be configured -- some flag run up the pole that gets everyone to salute. We don't see that flag yet, but there are some small pennants.

- So far -- unfortunately, yet all too predictably -- the headlines are all about re-establishing all the same hardened positions taken in last August's debt ceiling debate. The GOP's strategy was clearly expressed in a speech last week by House Speaker John Boehner, in which he enthusiastically embraced the brinksmanship inherent in the must-do nature of the debt ceiling hike: "We shouldn't dread the debt limit. We should welcome it. It's an action-forcing event…"
- The next day at a lunch at the White House for congressional leaders Democrats repeated their strategy of last year to go the brink for tax hikes, saying any debt deal would have to include "revenues."
- Yet there are signs that both sides don't want to repeat last year's near-failure in bargaining.
- So far there has been blessed silence from the Tea Party wing of the GOP, which last year insisted that no hike to the debt ceiling was agreeable under any circumstances. And Boehner was clear in his speech that default was not an option: "If…we have to do a series of stop-gap measures, so be it."
- What may end up being most significant -- at least we hope it will -- was a compromise subtly offered by Democrats yesterday.
- The Congressional Budget Office published a concise and readable report, widely quoted this morning as predicting a severe recession in the first half of 2013 if the tax and spending policies in current law click in at year-end with no modification.
- That much was obvious. The important part was that the CBO modeled an "alternative fiscal scenario" that partially remediates the fiscal cliff, and produces a recession-free forecast for 2013. *That scenario includes two elements that have very pro-growth incentive effects: the extension of low Bush era tax rates for all taxpayers (including "the rich"), and the cancellation of extended unemployment benefits.*
- These are both significant implicit policy concessions from the Democratic side. While the CBO is officially non-partisan, its staff leans liberal, and its director Douglas Elmendorf was hand-picked in December 2008 for a 4-year term by Harry Reid and Nancy Pelosi.
- This "alternative fiscal scenario" is not new -- it first appeared buried in a lengthy CBO publication in January. But we take it as a

signal that it would reappear now in a short, focused document aimed to catalyzing a policy response from Congress.

But we still don't have the kind of definitive signals we had in July 2010 -- in the run-up to the last time the low Bush-era tax rates faced year-end expiration -- when Democrats made it very clear that they would support extension (see "Good Week for Growth" July 26, 2010). At some point, lack of such a definitive signal will itself be a signal -- a signal that we're headed toward the "freak show."

Where do all these deliberations leave us? Let's review the essentials.

- As a starting point, stocks are incredibly cheap. If the worst happens that's a cushion. If the best happens that's a catapult.
- The worst thing that can happen is Greece exits the euro right away, before Europe has conditioned the market to accept it.
- But that won't happen. Greece doesn't want to leave the euro, and Europe doesn't want Greece to leave the euro, and Greece doesn't have a government that could make the decision in the first place.
- In the meantime, brinksmanship between Greece and Europe will keep markets focused on the worst-case scenario.
- This will take a toll on sentiment -- it already has, obviously -- and will be part of what we expect will tip the Fed toward some form of QE at the June FOMC meeting (see "Is Gold Changing Its Mind?" May 18, 2012). This -- and its inevitable foreshadowing -- should go some way toward alleviating elevated risk premia.
- But risk premia will remain elevated until Europe convinces the market that a Greek exit can be survived.
- That could take several more months, which brings us to into election season, in which the various issues entangled in the fiscal cliff will be front and center. Elections generally sharpen the differences between the parties -- not a process for reconciliation.
- So just as we would expect systemic risk from Europe to abate, political risk in the US will intensify.
- All this makes us cool our jets a bit on our prior strong expectation that stocks would make new recovery highs before the election (see, for example, "A Glass of Snapple, Half Full" Friday, April 20, 2012).
- But given how extremely cheap they are, it's unlikely to us that they could go a lot lower from here, either.
- This isn't a message that our clients like to hear, but the plain truth as we see it is: the best thing to do here is to accept the fact that extraordinary valuations mean you're getting paid a lot to take the risk of hanging on to see how it all turns out. You're being paid to wait -- so wait.

Bottom line

Rising systemic risk from Europe has elevated the equity risk premium toward extreme levels. Falling stock prices, rising forward earnings, and falling Treasury yields have made US stocks extremely cheap. We don't

expect a Greek exit from the euro in the near-term, and over the longer-term Europe will be able to condition the market to accept exit if it does happen. But while we wait for Europe to sort itself out we come closer to a potential political "freak show" as the year-end fiscal cliff and debt ceiling approach. We don't see why stocks ought to go down from here -- but we're running out of time to rally back to new recovery highs.