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MACROCOSM

New High, Fat Tail

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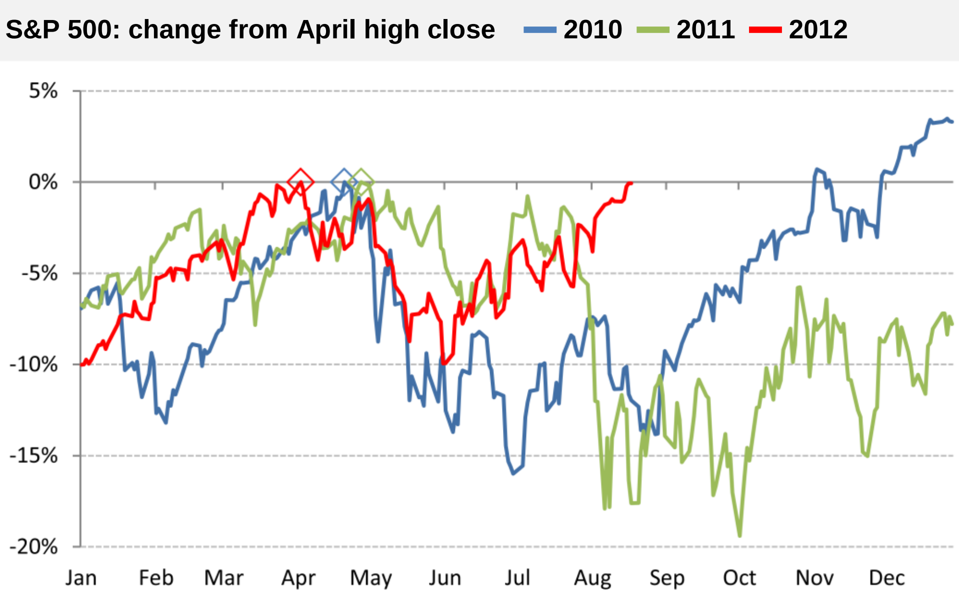
Donald Luskin

Fully recovered, stocks look better than ever -- but political risk is greater than ever, too.

For about an hour and a half yesterday morning stocks made new recovery highs, higher than the April 2 peak, and an all-time high on a total return basis. We're delighted that our bottom calls in the depth of this year's correction have been vindicated (see "Time Is Our Frenemy" May 24, 2012 and "Light at the End of the Cliff?" June 11), and that the "sell in April and go away" pattern of 2010 and 2011 has been broken (please see the chart below). But yesterday didn't feel like a break-out. There was no leadership -- In fact, while the S&P 500 made a four-year high, not a single one of its ten major sector components did so.

Stocks have survived the 2012 correction so much better than they did the 2010 and 2011 corrections because they were cheap from the get-go (see "Sell in May and Go Away -- Volume 3?" May 10, 2012). At the April 2 top, the equity risk premium was 0.4 standard deviations *above* the crisis era mean, indicating that stocks were cheap even at the peak (at the 2010 and 2011 peaks it was *below* the mean). Now, with stocks back at the level of

S&P 500: change from April high close



Source: Bloomberg, TrendMacro calculations

Update to strategic view

US STOCKS: Stocks hit new recovery highs, and new all-time highs on a total return basis. With forward EPS higher and Treasury yields lower than at the previous high in April, stocks are even cheaper than they were then. Despite this, and despite a breakthrough in Europe, and despite Jackson Hole coming up, we are cautious about how much upside can really be expected here. Markets face a starkly binary probability distribution with the upcoming election, a risky referendum on capitalism and government, with one very fat tail leading straight to the bottom of the fiscal cliff. And because stocks could tip the balance of economic confidence in favor of Obama, the more stocks rise, the more likely that fat tail becomes. Until conclusive evidence on the election emerges, we expect a nervous trading range.

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this year's April peak, they're even cheaper still -- the equity risk premium is now 0.9 standard deviations above the mean (please see the chart below). That's because both forward earnings per share have grown by 1.6% over the intervening 20 weeks, *and* long-term Treasury yields have fallen by 42 bp.

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

Source: Zacks, NBER, Bloomberg, TrendMacro calculations

With stocks cheaper now at new highs than at the year's previous peak, we don't want to err by being too cautious. We are uncomfortable being anything less than gung ho, given that Europe is on the verge of a breakthrough solution to its sovereign debt crisis (see "The August before the Fall?" August 20, 2012) -- and that the Fed's Jackson Hole conference is coming up, with a strong possibility that Ben Bernanke will belatedly (see "On the August FOMC" August 1, 2012) signal a new round of quantitative easing. Yet cautious we must be.

- Our thinking is dominated by politics. Mitt Romney's choice of the lightning rod Paul Ryan as his running mate has radicalized the November election. It's now a dangerous referendum on growth, wealth and the role of government (see "On Ryan as VP Nominee" August 13, 2012).
- If President Obama wins, he'll come into the debate over the year-end fiscal cliff -- extending expiring tax provisions and raising the statutory debt limit -- with a perceived mandate to take the most aggressive stance on taxing high earners, preserving government spending, and expanding borrowing. The bargaining failure that would likely ensue would lead to a collapse of disposable personal income and a Treasury default -- and a sharp recession.
- We are not saying Obama *will* win. Let's say it's a toss-up. We're not saying that cooler heads can't possibly prevail as we face the fiscal cliff, as they did in similar circumstances in 2010 and 2011 (see "Tax Cut Endgame" December 13, 2010 and "Debt Ceiling Crisis Over -- Now What?" August 2, 2011). Let's say that's a toss-

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Obama's Gotta Go
Niall Ferguson
Newsweek
August 19, 2012

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up, too. *But even that leaves a 25% joint probability of a catastrophe.* That's an extremely fat tail, and we have a great deal of respect for it.

- *That* means that the art of investing now consists largely of correctly forecasting whether that fat tail will actually happen.
- So the first question to ask is: what circumstances would tilt the toss-up one way or the other?
- The only stratagem in the purely political domain we can see would be Obama substituting Hillary Clinton for Joe Biden as his running mate -- we can't see how that wouldn't be a killer app for Obama. We'll know about that in a matter of weeks, one way or the other.
- Other than that, there are any number of exogenous geopolitical risks that could occur, and an infinitude of idiosyncratic personal developments that might arise for the candidates. We have no choice but to stay closely tuned every minute for such things, constantly monitoring for the one that might be conclusive.
- *But the big and inexorable force that will move the election is the economy*.
- It is a truism that an incumbent president can't be re-elected if the economy is weakening -- and that a challenger can't be elected if it is strengthening.
- The macroeconomy as understood through the usual statistics is maddeningly ambiguous -- we remain stuck in the Not So Great Expansion (see "Cupertino, We Have a Problem" July 25, 2012). As a result, the famous and powerful model of the Yale econometrician Ray Fair, which uses just a handful of economic variables to predict presidential election vote-shares, is now calling this election a toss-up (with Romney favored ever so slightly, well within the standard error of the model).
- Under these circumstances the stock market may be the deciding economic factor in the election. If it falls, it would likely elect Romney. Over the last twelve months the probability of a GOP victory in November has peaked precisely at the two market bottoms (please see the chart below).

Futures-implied probability of GOP presidential win 2012

Source: Intrade, TrendMacro calculations

- If it rises, it would likely re-elect Obama. We think this fact may have been an influence in the Fed's decision at the July FOMC to stand pat (again, see "On the August FOMC"). The upcoming Jackson Hole conference is thus a wild-card here -- and gold testing the top of its 3-month trading range might be an indicator that it will be played.
- As we have commented before (see "The Fiscal Cliff Bites" July 12, 2012), this is a most paradoxical state of affairs. A *rising* stock market would elect a president who may well lead the US off the edge of the fiscal cliff -- which would surely lead to *lower* stock prices. A *falling* stock market would elect a president who would extend expiring tax provisions, easily get the debt ceiling hiked, and work toward a lessening of government spending -- which would surely lead to *higher* stock prices.
- Markets are very bad at pricing sharply binary probability distributions even in the best of times. All the more so when stock prices themselves can play a decisive and potentially inverted role in the outcomes they are supposed to be discounting.
- So even though we have made new highs, and even though stocks are cheap, we nevertheless have to expect a nervous trading range while this strange dynamic plays out -- while we wait for the clues that will give us an edge as to how this will all turn out.

Bottom line

Stocks hit new recovery highs, and new all-time highs on a total return basis. With forward EPS higher and Treasury yields lower than at the previous high in April, stocks are even cheaper than they were then. Despite this, and despite a breakthrough in Europe, and despite Jackson Hole coming up, we are cautious about how much upside can really be expected here. Markets face a starkly binary probability distribution with the upcoming election, a risky referendum on capitalism and government, with one very fat tail leading straight to the bottom of the fiscal cliff. And because stocks could tip the balance of economic confidence in favor of Obama, the more stocks rise, the more likely that fat tail becomes. Until conclusive evidence on the election emerges, we expect a nervous trading range.