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

MACROCOSM

The Crisis Score is Four for Four

Monday, March 4, 2013

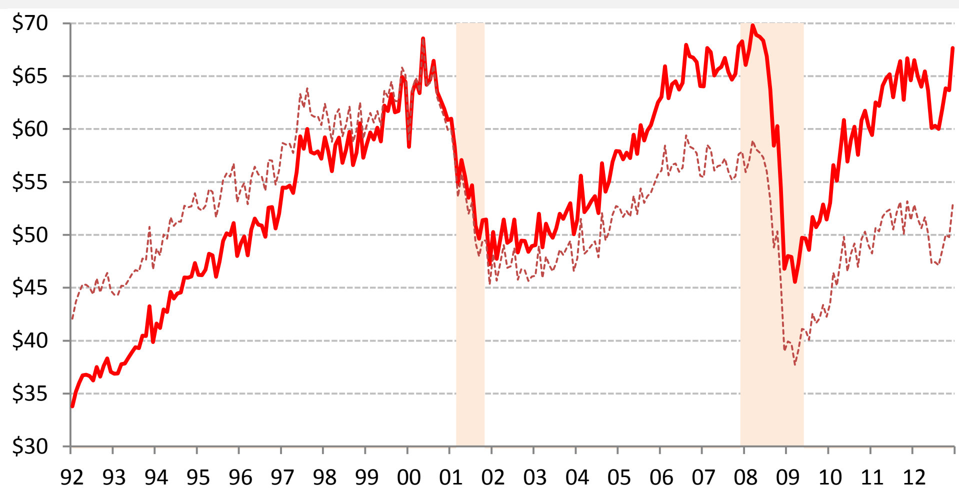
Donald Luskin

Fiscal cliff, debt ceiling, sequesters and the continuing resolution -- done! But now what?

We've played along with 2013's bull move in stocks, but always skeptically characterized it as a "relief rally." We warned that once all the relief has occurred, there's not necessarily anything else to fuel more upside (see "Oh What a Relief It Is" January 23, 2013). Last week we got two big booster doses of relief:

- The budget sequesters went into force -- and we maintain they will have no substantive macroeconomic downside (see "Do the Sequesters Matter?" February 8, 2013). *The relief is that the GOP did not succumb to the White House or its own defense-hawk wing -- nor to the siren call of the impossible "grand bargain" -- by conceding new tax hikes to avert the sequesters.* House and Senate GOP leadership were utterly clear that more tax hikes are absolutely not on the table.
- And coming out of all the posturing preceding the onset of the sequesters, it seems that Democrats and the GOP have substantively agreed to extend the continuing resolution that funds the US government. *The relief is that this averts the risk of a government shutdown if it had expired on March 27.*

New orders, non-defense cap goods ex-aircraft **Inflation adjusted**
Recessions Monthly, SA, USD billions



Source: Census Bureau, BLS, NBER, TrendMacro calculations

Update to strategic view

US STOCKS, US MACRO: The sequesters are here -- economically insignificant, and a relief that the GOP didn't cave in to tax hikes to avert them. Now the Democrats and the GOP have seemingly declared a truce on the continuing resolution, likely averting a government shutdown. Following on the resolution of the fiscal cliff and the debt ceiling, the quadruple-threat of political crises in the first quarter is over. These resolutions have powered a relief rally. But now the news is out, the equity risk premium is very narrow, and there are only tentative signs of accelerating growth. We continue to expect a substantive correction, and underperformance by US stocks.

[Strategy Dashboard home]

Copyright 2013 Trend Macrolytics LLC. All rights reserved. This document is not to be forwarded to individuals or organizations not authorized by Trend Macrolytics LLC to receive it. For information purposes only; not to be deemed to be recommendations for buying or selling specific securities or to constitute personalized investment advice. Derived from sources deemed to be reliable, but no warranty is made as to accuracy.

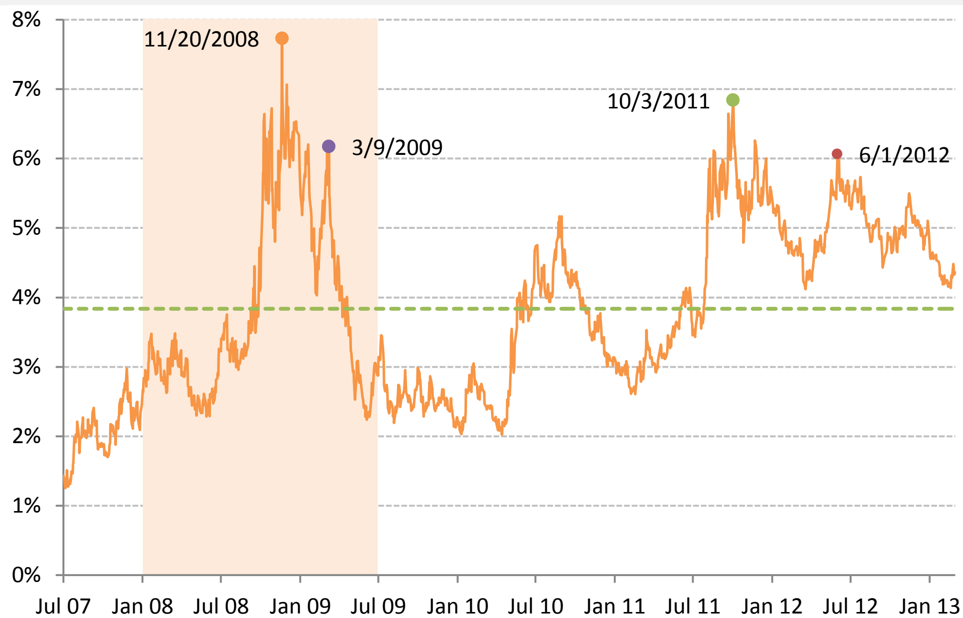
That's probably it for the relief. These two positive developments last week now resolve the full quartet of political threats that markets have long known would have to be confronted in the first quarter.

- The first threat of the quartet was the expiration of the Bush-era tax rates at year-end 2012. We ended up falling about one third of the way off the fiscal cliff with the end of the payroll tax holiday, and new higher rates on wages, dividends and capital gains for top earners (see "Tax Hikes Have Consequences" January 2, 2013). *The relief is that we didn't fall all the way off, and now the tax code for individuals is virtually free of cliffs.*
- The second threat was raising the statutory debt ceiling over the objections of the most conservative House members. That has been finessed by not *raising* it, as such, but rather *suspending* it for three months at a time (again, see "Oh What a Relief It Is"). *The relief here, obviously, is that it averts the threat of a default on Treasury securities*.

With all relief now delivered, stocks are going to need another reason to go up -- without such a reason, the news is out, so sell on the news. Or at least correct on the news.

- Valuation isn't much of a reason for stocks to move higher. The equity risk premium is less than half a standard deviation above its crisis-era mean. It was less than a quarter above two weeks ago when we called for a correction (please see the chart below, and "The Incredible Shrinking Equity Risk Premium" February 21, 2013).
- Perhaps the reduction of risk from having passed through the quartet of political risks this quarter will render obsolete the crisis-

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



Source: Zacks, Bloomberg, NBER, TrendMacro calculations

Contact TrendMacro

On the web at
trendmacro.com

Follow us on Twitter at
twitter.com/TweetMacro

Donald Luskin
Chicago IL
312 273 6766
don@trendmacro.com

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

Lorcan Roche Kelly
Sixmilebridge Ireland
617 600 6969
lorcan@trendmacro.com

[About us]

era mean in the equity risk premium. Investors may not become more risk tolerant, but at least the world is asking them to bear less risk -- so stocks could offer a narrower equity risk premium without being overvalued. Such ideas get into the art, rather than the science, of the equity risk premium. At this moment our intuition makes us unready to go there -- we are not willing to declare the crisis era over.

- In macro terms, the same idea would be that greater confidence creates a new platform on which better economic growth can flourish, thus driving higher earnings expectations.
- But it remains to be seen whether risk reduction can outweigh the substantial chilling effect on both the supply side and the demand side from having just raised taxes on all American taxpayers, rich and middle class (again, see "Tax Hikes Have Consequences").
- We put more hope on our expectation that 2013 will be the first year in four in which there will not be a currency crisis in Europe, freeing the US economy from the threat of a Lehman-like systemic banking crisis (see "2013 Outlook: Think Globally, Shrink Locally" January 14, 2013). The current electoral turmoil in Italy doesn't change our view on this (see "Italy Gets Hung" February 26, 2013).
- There's only one macroeconomic datapoint, so far, that supports the idea of a reacceleration of growth out of what has been almost four years of Not So Great Expansion following the Great Recession. This is the move last week to new nominal highs in new orders for non-defense capital goods ex-aircraft (please see the chart on the first page of this report).
- This has always been one of our favorite forward-looking growth indicators (please see "Data Insights: A Few of Our Favorite Things" February 6, 2013). It is all the more important now, because a shortfall in fixed investment has been a signature feature of the Not So Great Expansion.
- Being forward-looking, there's the risk that it's just a blip. It could be an artifact of post-Sandy rebuilding; of an income surge driven by accelerated dividend payouts in December (see "On Q4 GDP" January 30, 2013); or of tax incentives from the one-year extension of bonus depreciation, Section 179 expensing and research and development tax credits in the American Taxpayer Relief Act (again, see "Tax Hikes Have Consequences").
- It's not being confirmed so far by another favorite -- forward earnings growth. We watch this carefully because it arises from a consensus bottom-up process that factors in an enormously diverse set of macro and micro expectations. S&P 500 forward EPS are making new all-time highs, but they are not accelerating. They are only growing at a weak 5.5% year-over-year rate, barely the necessary dial tone to support serious growth, or a bull market.

Bottom line

The sequesters are here -- economically insignificant, and a relief that the GOP didn't cave in to tax hikes to avert them. Now the Democrats and the GOP have seemingly declared a truce on the continuing resolution, likely averting a government shutdown. Following on the resolution of the fiscal cliff and the debt ceiling, the quadruple-threat of political crises in the first quarter is over. These resolutions have powered a relief rally. But now the news is out, the equity risk premium is very narrow, and there are only tentative signs of accelerating growth. We continue to expect a substantive correction, and underperformance by US stocks.