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MACROCOSM

Houston, You're the Problem

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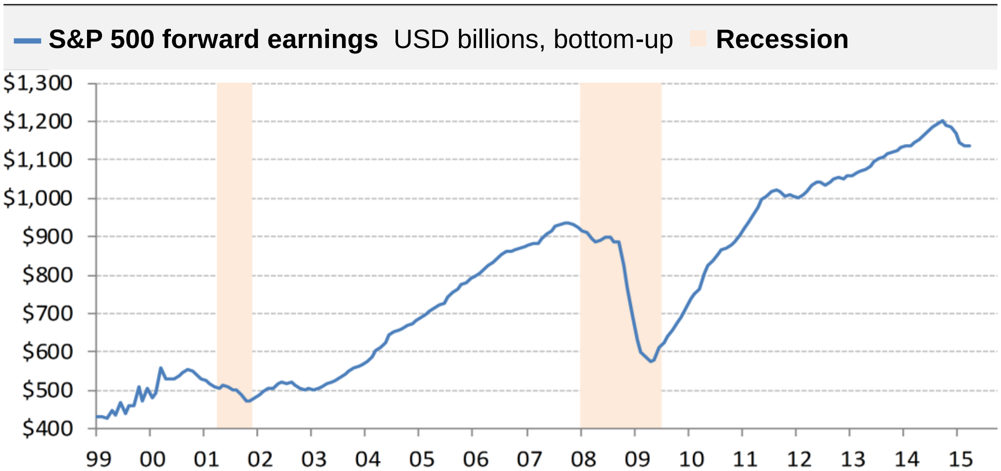
Thanks to oil, forward earnings have rolled over with the highest PE for stocks in 11 years.

We could hardly be more bullish for the long-term. Our secular vision of permanently low oil prices is falling into place, driven by exponential productivity improvements in exploration and extraction, following the business model of "Moore's Law" (see most recently, among many, "I Have Seen the Future, and It Fracks" February 24, 2015).

But in the near-term, we are looking at risks. The image in our mind is that of young András István Gróf, a holocaust survivor who, nine years before Intel founder Gordon Moore wrote his prescient 1965 paper, crawled across a minefield to escape communist Hungary. He came to America, changed his name to Andrew Grove and helped found Intel, eventually leading it as CEO. But first he had to get across that minefield. *That's us: before the global economy can realize freedom from a decade of history's highest real oil prices, it has to get across the minefield of short-term business and credit disruptions caused by the massive and sudden drop in oil prices that began last June.*

- The most alarming symptom is the sharp drop in bottom-up S&P 500 year-ahead forward earnings since Q3 2014, driven by distress radiating from the energy sector.
- Similar rollovers in forward earnings perfectly predicted the prior two recessions (please see the chart below).



Source: Zacks, Bloomberg, NBER, TrendMacro calculations

Update to strategic view

US MACRO, US STOCKS, US RESOURCE STOCKS, US FED: S&P 500 forward earnings have rolled over since their peak at the beginning of Q4 2014 -- in the past this has been a reliable recession indicator. The drop in oil prices has been a shock to the US energy sector, which is radiating distress to the rest of the economy -- especially the consumer staples sector through the strength of the US dollar. We don't think the economy will tip into recession this year, but we think we're in a near-term minefield where the probability is higher than at any time since the end of the Great Recession. From here the economy has further to fall than it did in prior recession scares, with the labor market by some measures near full employment. Stocks appear richly valued in PE terms, but low long-term yields mean the equity risk premium remains wide. Fed "liftoff" won't spike long-term yields. Only a growth acceleration can do that, and in that world stocks will do just fine.

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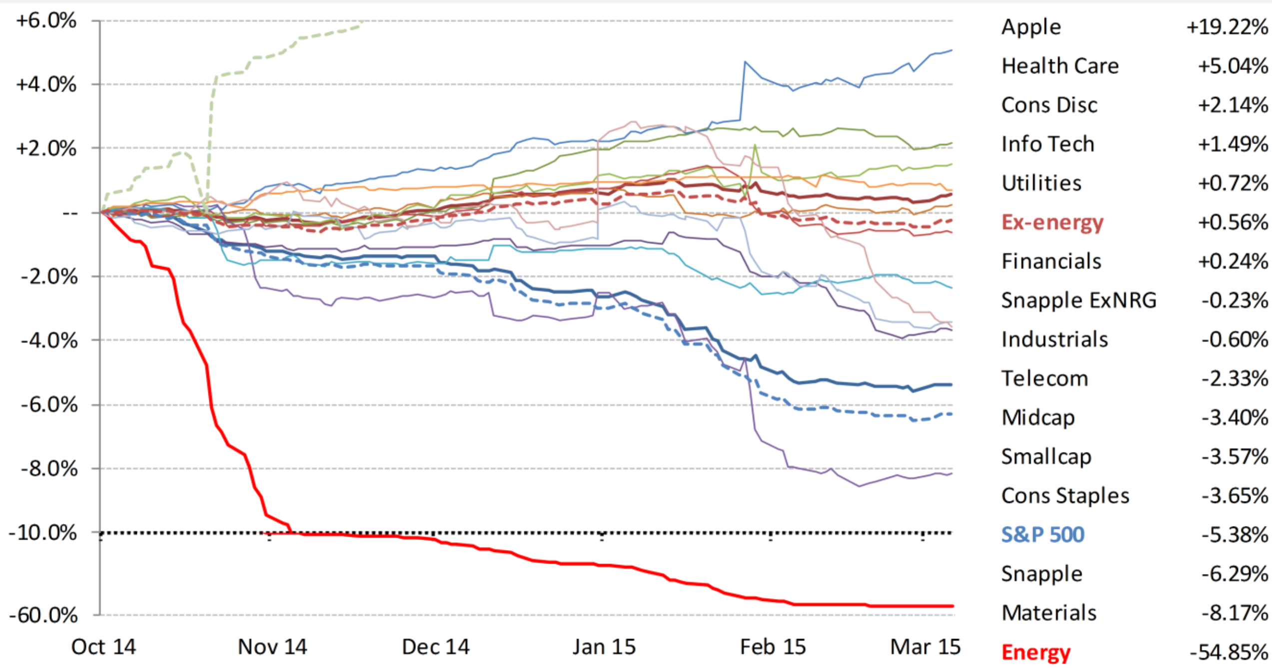
- Today, S&P 500 forward earnings are off 5.38% in the five months since their peak on October 2, 2014 (please see the chart below).
- The energy sector more than explains it all, with forward earnings off 54.85%.
- *Ex-energy, S&P 500 forward earnings are up 0.56% for the period. We believe dislocations in the energy sector are radiating outward to other sectors -- because even when we back out the energy sector's drop in forward earnings, what's left in the other sectors is so paltry. In a bull market and a business cycle expansion, forward earnings should grow by at least 3% over any given 5-month period.*
- Indeed, the only reason why S&P 500 ex-energy forwards are positive at all is a single stock, Apple, a large contributor to aggregate earnings whose own are up 19.22%. Looking at the S&P 500 with no Apple, and also backing out the energy sector, leaves us with a drop in forward earnings of 0.23%.

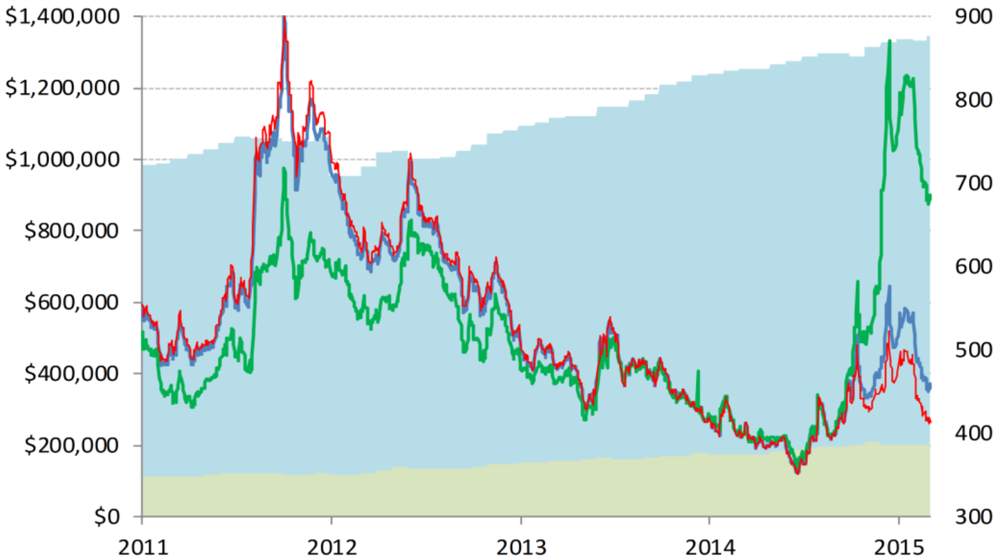
Forward earnings Percentage change from October 1, 2014 *"Snapple" is S&P 500 with no Apple*



Source: Bloomberg, TrendMacro calculations

- Apple's forward earnings growth has been so dramatically positive, at the same time as the energy sector's has been so dramatically negative, that now the dollar amount of what's left of the energy sector's forward earnings is roughly equivalent Apple's.
- Further evidence of radiating distress from falling oil prices is the sharp drop in forward earnings in the consumer staples sector, thanks to its large exposure to foreign earnings while the US dollar has strongly appreciated. *We blame this on oil because, while we don't necessarily understand all the causal linkages, it is an empirical fact that dollar strength is always associated with oil weakness, and vice versa.*
- What is alarming in all this is that the analysts who make up the

US non-investment grade bond market
Left axis: **Face value outstanding** USD millions **Energy** **Other**
Left axis: **Spread to Treasuries** basis points **Total** **Energy** **Ex-energy**



Source: Merrill Lynch, TrendMacro calculations

consensus reflected in aggregate forward earnings are not "looking across the valley" now. Usually, when there is some exogenous shock -- say, Hurricane Katrina in 2005 -- it doesn't really matter to year-ahead forward earnings, because earnings lost in a near quarter are assumed to be picked up in later quarters. For some reason, it seems that the analyst community is treating the drop in oil prices as a permanent shock to earnings -- or at least one from which earnings won't recover within the year-ahead frame work of their forward view.

- This points in the same direction as what we've been saying, that the pain from suddenly and sharply lower oil prices in the energy sector and other sectors that interact with it is immediate, while the benefits to the rest of the economy will be gradual (see "Oilmageddon: The Sequel" January 15, 2015). But we think the consensus is being too pessimistic about how long it will take for the rest of the economy to up-shift to a new higher level of growth enabled by lower energy prices, which in turn will increase the demand for energy goods and services.
- Perhaps the consensus, groping for a model with which to process the recent drop in oil prices, is looking to the previous drop -- from the all-time highs at $147 in July 2008 to $32 just five months later. But that's not a valid comparison. That price drop was driven by a severe demand shock -- the Great Recession.
- The present price drop is nearly without historical precedent, the result, primarily, of a discontinuous leap in technology that has unlocked vast new supplies. *It's history's greatest positive technology shock, coming after a decade of crippling high prices.*
- Be that as it may, in the near-term, it's been a severe blow, with few offsetting benefits. Yet five months past the peak in S&P 500

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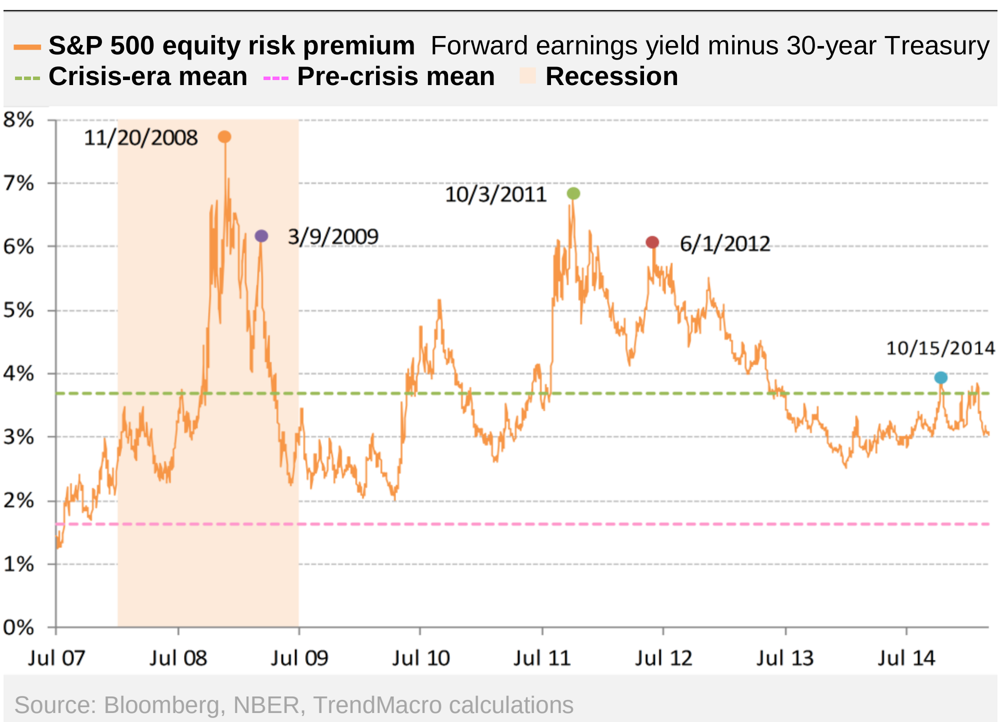
forward earnings, it certainly does not seem that the economy is falling into recession, at least not by measures normally considered most important, such as payroll jobs growth (see "On the February Jobs Report" March 6, 2015).

- So if the rollover in S&P 500 forward earnings is indeed, as in the past, indicative of a coming recession, then it would have to involve some kind of tipping point -- which we don't think has been reached yet. Perhaps it would be shock in credit markets arising from default on a non-investment grade bond issued by an energy company, or the failure of a bank that had overextended itself to energy sector borrowers (see "Oilmageddon" December 16, 2014). Or perhaps a geo-political shock triggered by a desperate oil-producing nation such as Russia or Iran.
- So far so good on all of that. Spreads in the energy sector of the US junk bond market have narrowed considerably from the blow-out of late last year (please see the chart on the following page). And Russia's has been the best-performing stock market among major economies year-to-date in 2015, even when measured in US dollars.
- *Yet for all that, while not calling for a recession here, we are more on the alert to the possibility than at any time since the official end of the Great Recession* -- despite repeated calls by the consensus, all these years, for various "double dips."
- All those risky years we understood what the institutional response was going to be to various highly noisy would-be crises -- Europe's various brushes with default and currency break-up, and several US debt and budget stand-offs. This time, if the present oil shock quietly tips the economy into recession, we don't see any clear institutional response that would make any difference. Certainly raising oil prices wouldn't do it. For that matter, lowering them wouldn't either.
- At the same time, during all the "double-dip" scares of the past almost six years, we've noted how difficult it would be for the economy to fall into recession when it had never truly exited recession. Our slogan was, "you can't fall out of the basement window -- and if you did, it wouldn't hurt."
- While the "output gap" -- the difference between the economy's potential and actual production -- is as wide now as at the trough of most historical recessions, it is nevertheless considerably improved from where it began at the trough of the Great Recession.
- While there may still be a great deal of "slack" in the labor market thanks to millions dropping out of the labor force in the Great Recession and its aftermath, nevertheless the number of persons unemployed for less than 27 weeks is lower today than it was at the last business cycle peak in December 2007. By that narrow reckoning, at least, the US economy is at "full employment" (see "The Low Hanging Fruits of Our Labor" July 15, 2014).
- *In short, we are no longer in the basement. If we were to tip into recession, it wouldn't be falling out of the basement window. You'd feel it. It would hurt.*
- It might really hurt stocks, too. Not all recessions are associated with large bear markets (the two most recent ones were, but the

1990-91 recession was not).

- But if recession comes now, it will hit stocks after two years and nine months without a 10% correction, and at their highest valuations in the present bull market. *Indeed, for the S&P 500, the current forward PE ratio of 17.1 exceeds the 15.1 seen at the peak of the last bull market in October 2007. You have to go back 11 years, to March 2004 -- still in the shadow of the great overvaluation of 1998-2000 -- to see PE's like today's.*
- Oil has its role to play here. With the catastrophic drop of 54.85% in forward earnings in the energy sector since Q3 2014, the market cap of the sector has fallen only 13.2%. So the forward PE ratio of the energy sector has risen from 13.4 to 25.7. Take the energy sector out of the S&P 500, and the forward PE falls to 16.6. A small safety valve, to be sure, but it's a step in the right direction.
- The more significant safety valve is the equity risk premium (ERP) -- the spread between the forward earnings yield of the S&P 500 and the 30-year Treasury yield. PE's are an incomplete measurement of equity valuation, because they don't take into account neither inflation expectations nor competitive returns offered by less risky asset classes. The ERP takes all that into account, and thus offers a more nuanced valuation picture. Because 30-year Treasury yields are so low -- because inflation expectations have fallen, and for other reasons -- by this measure, stocks are not especially overvalued.
- As we predicted more than a year ago (see "Regime Change for Equities" November 26, 2013), the ERP has mostly stayed beneath its crisis-era mean -- as well it should: the global financial crisis is over. Is it below that mean today, though not as far below it as it was for the entire first half of last year, a year that proved to be rewarding for stocks (please see the chart below).



- Today's ERP of 3.03% makes stocks more attractive (relative to bonds, at least) than they were at the top in October 2007 (the ERP was 2.08% then), and the last time the forward PE was higher than today's, in April 2004 (the ERP was 1.00% then).
- Obviously, the flaw in this argument is that one can argue -- as many of our clients do -- that the ERP is giving a fundamentally faulty signal because long-term yields are falsely suppressed by the Fed, and now perhaps also by spillover from the European Central Bank's quantitative easing program that commences today.
- This is a debate that has raged for several years, ever since the Fed commenced its first Large-Scale Asset Purchases (LSAPs). We have maintained all along -- and given how stocks have performed over the LSAP years, we are glad we did -- that it doesn't matter that long-term yields are falsely low, if in fact they are (they might be that low anyway, without the Fed). Either way, stocks are objectively *more* attractive, all else equal, when the major asset class with which they compete is *less* attractive -- for whatever reason that may be.
- And to the extent that low long-term yields reflect quiescent inflation expectations, then so much the better for earnings quality.
- The risk, if in fact long-term yields are being falsely suppressed by the Fed, is that they will suddenly jump higher when Fed policy changes, driving the ERP lower, and taking away the *relative* valuation argument that has supported high PE's.
- Again, we are not convinced that long-term yields *are* falsely suppressed. But be that as it may, we are not worried that Fed policy is about to do anything to make them move a lot higher.
- For all the angst on Friday about the Fed's "liftoff" from zero rates in the wake of an upside surprise in jobs (see "On the February Jobs Report" March 6, 2015), we just don't see how a slight increase in the funds rate, nor its exact timing, matters to anything at all.
- To be sure, it would matter if it signaled a turning point in Fed policy toward an aggressive tightening regime. But we know for sure that it absolutely off the table. At the press conference following the December FOCM, Chair Janet Yellen couldn't have been more clear on that subject, telling a reporter, who asked about a repeat of the relentless "measured" march higher of the funds rate between 2005 and 2007, "I certainly don't want to encourage you to think that there will be a repeat of that."
- We know what Yellen's long-term vision is -- we call it the "Yellen Rule" (see "The Yellen Rule is Taylor Minus Two" May 19, 2014). It's those 38 words that have appeared verbatim in every one of her FOMC statements and congressional testimonies. Those 38 words are below, with the essence of the policy message called out in red.

> **The Committee currently anticipates that, even after employment and inflation are near mandate-consistent levels, economic conditions may, for some time, warrant keeping the target federal funds rate below levels the Committee views as normal in the longer run.**

* This means that if the Fed has anything to say about it, when the economy is back to normal, the funds rate will stay below normal -- so long term yields would presumably be higher than they are now, but then again growth would be a lot more vigorous (see "The Fed's Growth-Friendly 'Dot' Gap" September 19, 2014).
* *So the Fed will have raised rates, and yields will be higher -- but the Fed will not have "tightened."*
* In such a world we don't see why rising yields have to be incompatible with high PE's and rising stock prices -- after all, what could be better for stock prices and valuations than an acceleration in growth?
* For now, stocks are vulnerable to correction. Forward earnings ex-energy have stalled, stand-alone valuations are high -- and it's been almost three years since there's been a correction worthy of the name.
* But unless some kind of terrible non-linearity emerges from the distress in the energy sector, while we acknowledge the risk as the greatest in five years, we think it's unlikely that the economy will tip into recession. Indeed, if we can get through the minefield of this unique supply-drive oil shock, on the other side there is faster growth that will send the expression "new normal" to the same dustbin containing "peak oil."

Bottom line

S&P 500 forward earnings have rolled over since their peak at the beginning of Q4 2014 -- in the past this has been a reliable recession indicator. The drop in oil prices has been a shock to the US energy sector, which is radiating distress to the rest of the economy -- especially the consumer staples sector through the strength of the US dollar. We don't think the economy will tip into recession this year, but we think we're in a near-term minefield where the probability is higher than at any time since the end of the Great Recession. From here the economy has further to fall than it did in prior recession scares, with the labor market by some measures near full employment. Stocks appear richly valued in PE terms, but low long-term yields mean the equity risk premium remains wide. Fed "liftoff" won't spike long-term yields. Only a growth acceleration can do that, and in that world stocks will do just fine.