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MACROCOSM

Have We Suffered Enough?

Friday, February 26, 2016

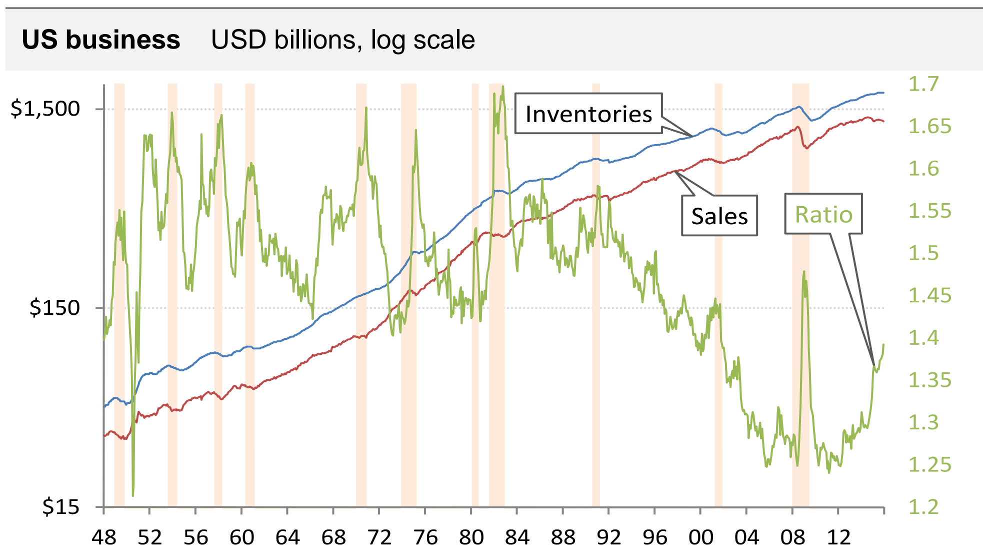
Donald Luskin

We're in recession, but we see "microgreens" pointing its end – and a bottom for stocks.

We predicted we'd be in a recession by now (see "Houston, You're the Problem" March 9, 2015), and we think we are. But we also predicted it would be a strange one – the first-ever caused by low oil prices, which means the same thing that caused it will cure it (see "2016: Two Charts, Six Words, One Man" December 31, 2015).

- *So it's no surprise to see mixed evidence of recession in the data – even within single data-sets.*
- Q4 2015 real growth of GDP was revised upward this morning to 1.0% from 0.7%. Great – but the entire upward revision is explained by growth in inventories. That simply means widgets produced in Q4 were unsold and warehoused, and won't have to be produced again in Q1 2016 (please see the chart below, and "Data Insights: A Few of Our Favorite Things" February 25, 2016). *The bleed-off of inventories now at record levels for this cycle will dim GDP growth for at least the next two quarters.*
- Labor market data is similarly mixed. In January the unemployment rate ticked down to a cycle low of 4.9%, but at the same time the rate of payroll growth was the worst for a January in five years (please see the chart on the following page, and "On the January Jobs Report" February 5, 2016).

US business USD billions, log scale



Source: US Census Bureau, TrendMacro calculations

Update to strategic view

US STOCKS, US MACRO, US FED, OIL, GOLD, US BONDS, COMMODITIES, FX, ELECTION MODEL: We think we're already in the first-ever recession caused by low oil prices, but evidentiary data are mixed. Q4 2015 GDP was revised upward this morning, but the revision was due entirely to inventory growth to record levels in this cycle, which implies slower growth in coming quarters as it gets worked off. January's labor data was mixed. Housing activity was week. But yesterday's strong cap goods orders point the other way. There are microgreens pointing this recession's end. We are encouraged by the 2016 rally in non-energy commodities, and now an incipient double-bottom in oil. China has stabilized its currency crisis, and the Fed is sidelined. Corporate spreads are still extreme, but gold keeps rallying, indicating no shortage of liquidity. After a post-crisis high equity risk premium two weeks ago, stocks have already had a bear market similar to the…

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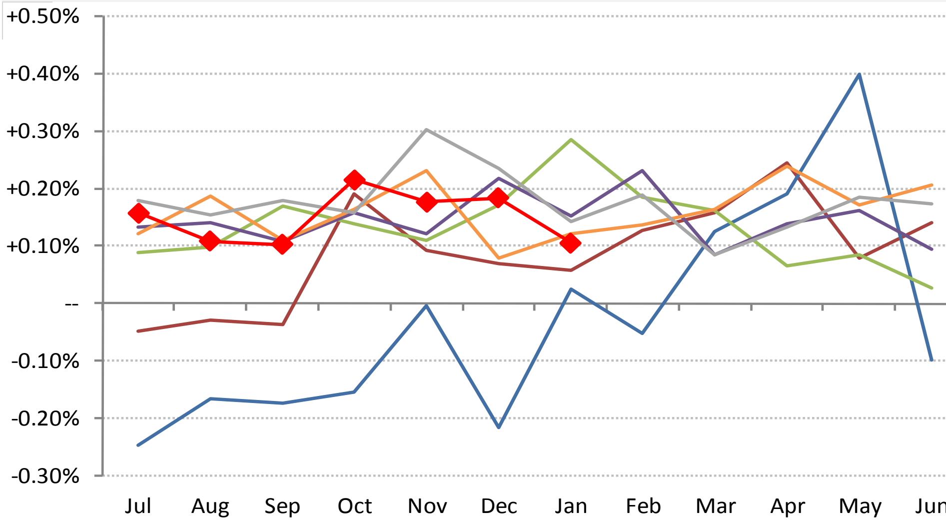
Monthly payroll growth after Great Recession, starting July

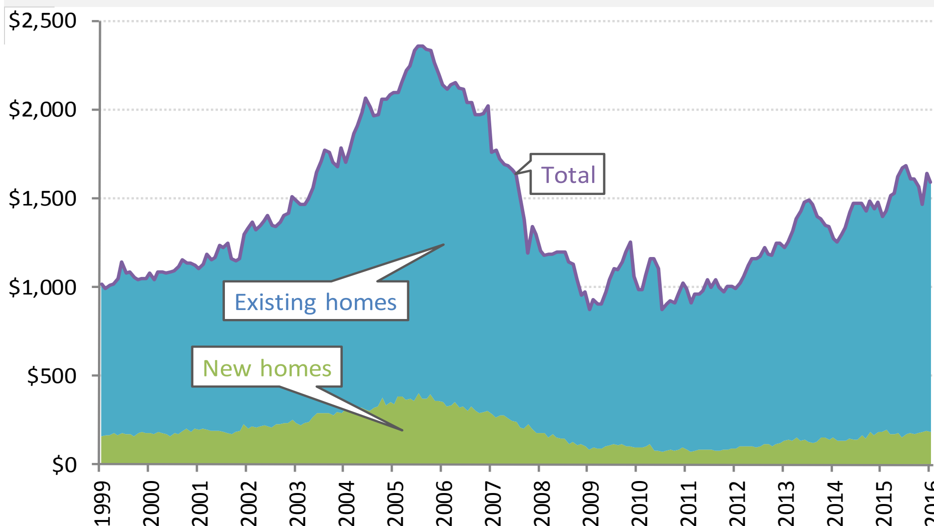
2009-10 | 10-11 | 11-12 | 12-13 | 13-14 | 14-15 | 2105-16



Source: BLS, TrendMacro calculations

- A surge in housing activity was a bright spot in December's generally weak data. It was not continued in January (please see the chart below). But on the plus side, for us, this critical sector remains within the context of a bull market.

TrendMacro Housing Transaction Value Aggregate USD billions



Source: NAR, US Census Bureau, TrendMacro calculations

- Conversely, CAPEX was very weak in December, and recovered significantly in January (please see the chart on the following page). But this sector remains, to our eye, within the context of a bear market of almost two years.
- Purchasing manager indices have been coming down for almost two years, like CAPEX, peaking when oil did in June 2014. The ambiguity here is that while the ISM Manufacturing index has been

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... average in recessions. The major risk is that the double-bottom in oil doesn't hold. The black swan remains the increasingly likely nomination of Donald Trump.

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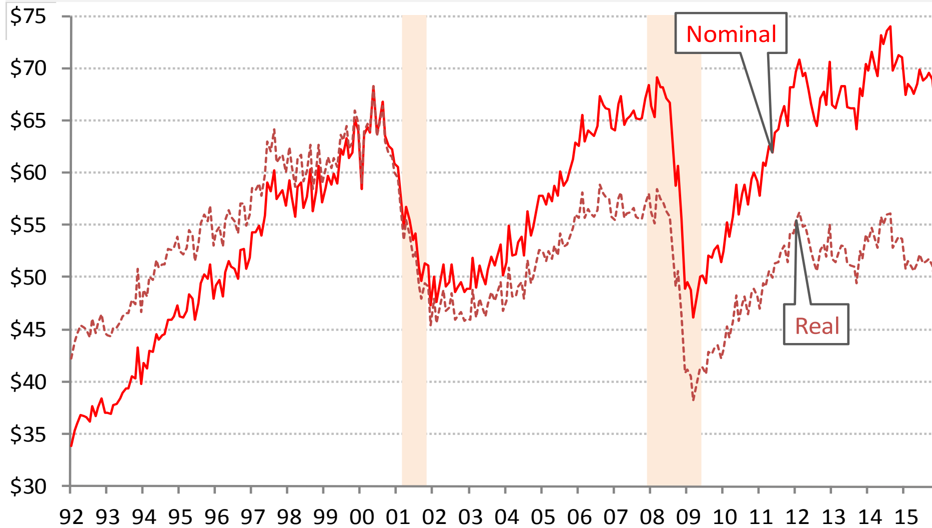
[About us]

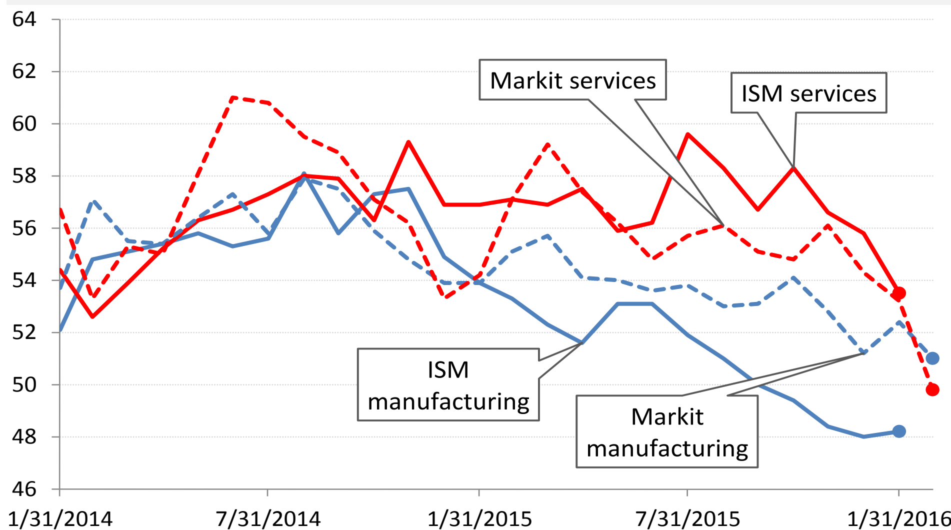
New orders, non-defense capital goods ex-aircraft USD billions



Source: US Census Bureau, BLS, TrendMacro calculations

below 50 – signaling contraction – for four months, the ISM Non-Manufacturing (services) index has remained above. Yesterday's "flash" services PMI from Markit suggests that February's index might finally make the plunge (please see the chart below).

US purchasing managers indices



Source: ISM, Markit, TrendMacro calculations

We think the balance of evidence points to being in our expected recession – yes, a strange one, an ambiguous one, and a mild one. But here we are. So now we have to look to its eventual end.

- We are seeing one "green shoot," or at least a microgreen: the action in oil and commodities so far during the New Year. As we noted last week, while global stock markets have been in severe corrections and equity risk premia have risen to levels not seen in

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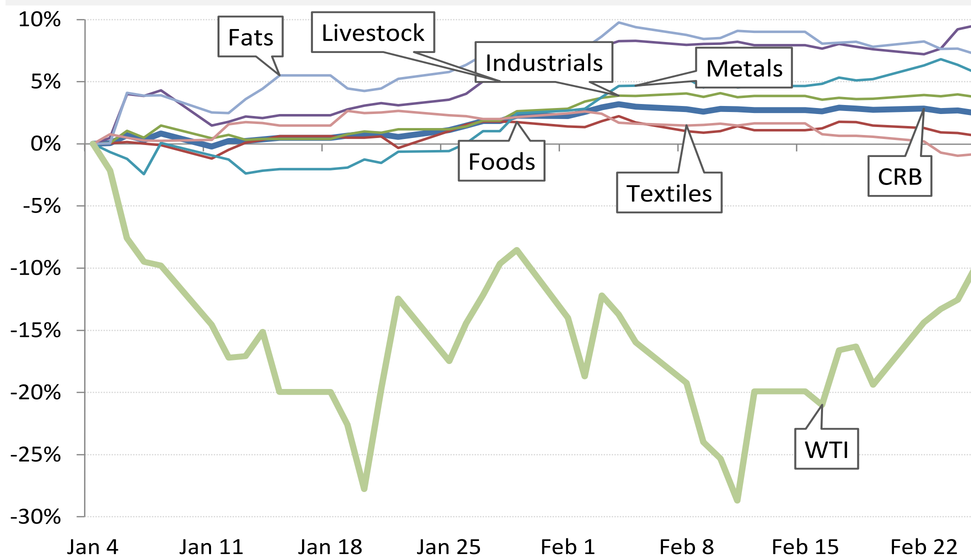
almost three years, non-energy commodities have been stealthily rallying. Among the CRB Spot indices, at this point only the textiles sub-index is lower year-to-date (please see the chart below).

- The upside drift in non-energy commodities may be small, but it is notable considering the extreme downside move that crude oil has made in the New Year (again, see the chart below). This is an encouraging "decoupling" – after almost five years in which oil and all other commodities have been in lockstep to the downside.

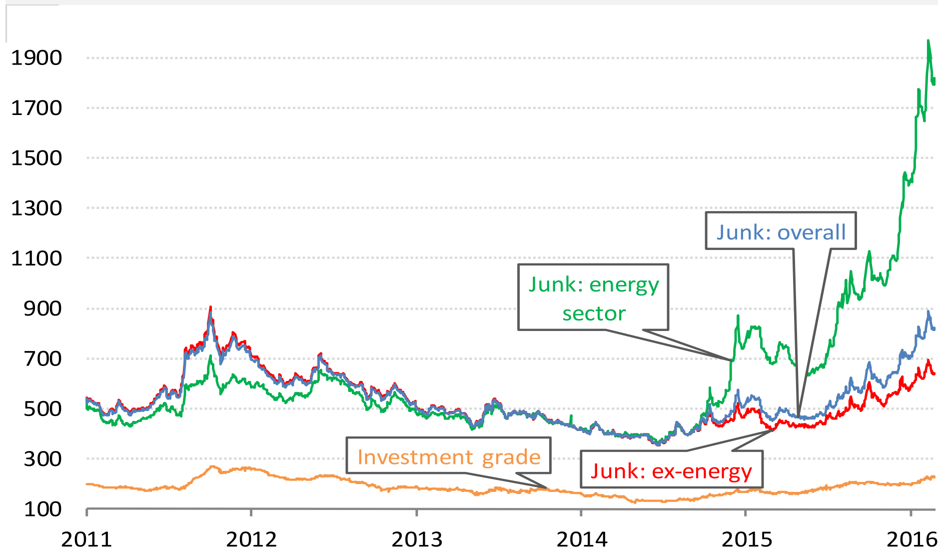
CRB Spot Commodities Index versus crude oil Cumulative gain in 2016



Source: Bloomberg, TrendMacro calculations

- Such a "decoupling" could imply that – finally – the oil price is reflecting its own unique supply-driven dynamics, without the implication that those dynamics reflect (or cause) economic damage elsewhere.
- *At the same time, oil itself seems to have put in a double-bottom, in the face of bad news* *from inventories*, *from the industry* *and* *from OPEC*. *That's what we were looking for at the first bottom in that potential double-bottom – to get all possible bad news out* (see "Oil: Priced for Perfection in an Imperfect World" January 20, 2016).
- *If the recessionary effects of too-low oil prices have just about run their course – and oil prices themselves are bottoming – then we have the basis for the end of this recession.*
- For us the signal of confirmation that the worst is really over will be the narrowing of corporate spreads from their current critical levels, driven by extreme distress in the energy sector (please see the chart on the following page).
- We are hopeful on this because of the behavior of another microgreen – the fact that gold has rallied almost 16% in the New Year while corporate spreads have blown out.
- As we mentioned two weeks ago (see "Will Yellen Get Trumped?" February 11, 2016), we believe gold acts as an indicator of expected liquidity conditions. In the post-Lehman TARP-fiasco environment in 2008, gold crashed along with everything else while

US corporate bonds: spread to Treasuries



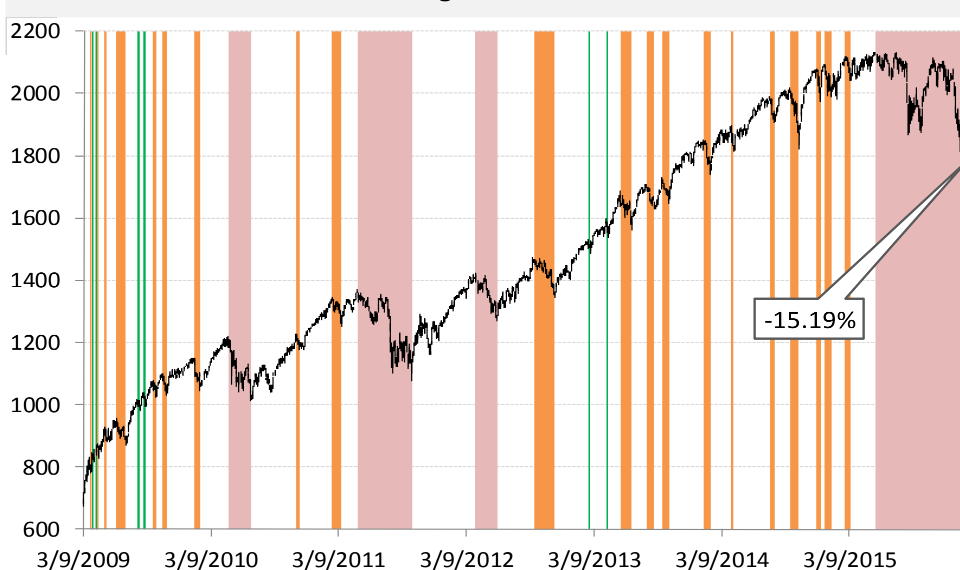
Source: BAML, Moody's, TrendMacro calculations

liquidity dried up. It was then the first risk-asset to recover as the Fed made its first tentative steps to restore liquidity, bottoming well before stocks or any other risk-asset.

- And while we're looking at hopeful signs, let's throw in that China seems to have mastered it currency crisis (see "Yuan Direction" February 16, 2016), and the Fed's "liftoff" regime seems to be indefinitely sidelined (again, see "Will Yellen Get Trumped?").

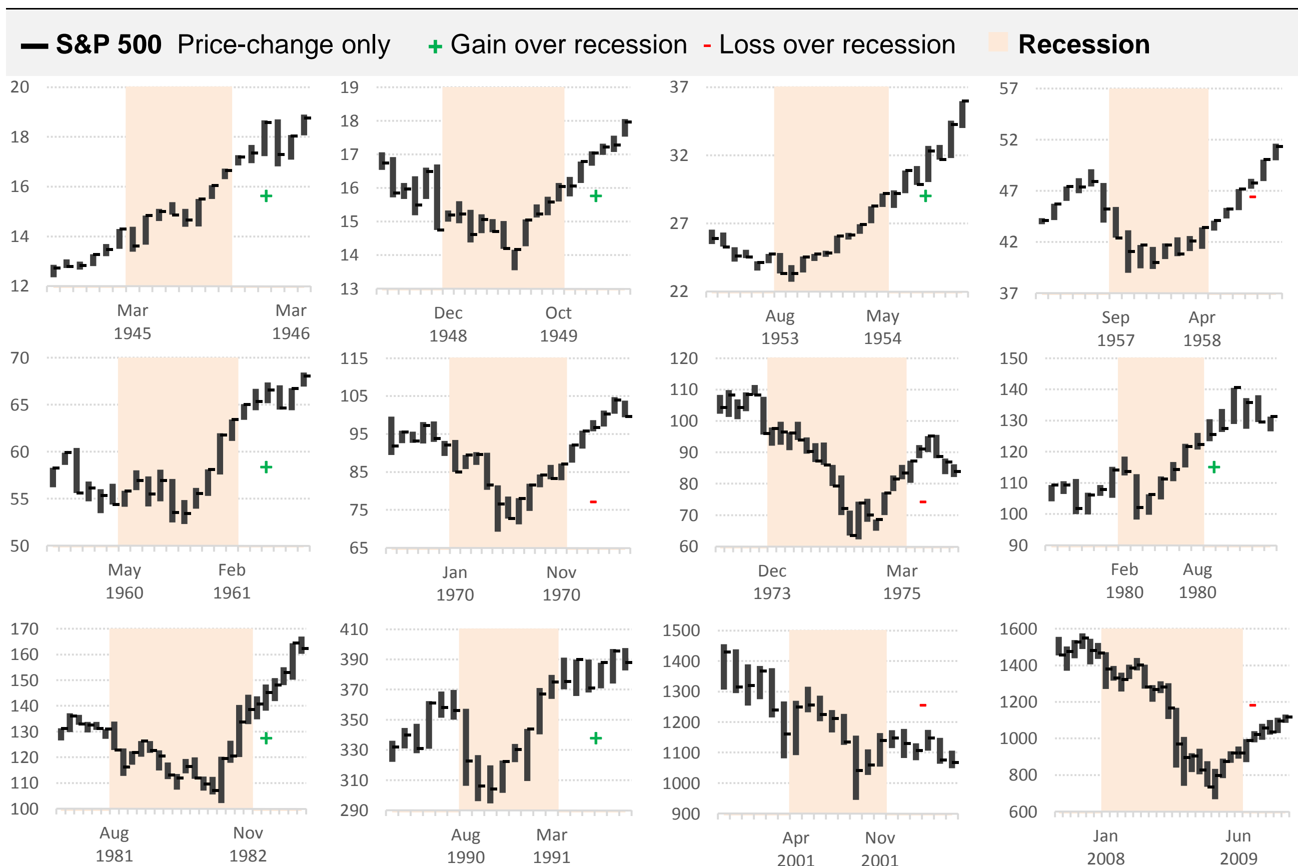
In this guardedly optimistic framework, the 15.19% correction we've seen in US stocks – from the highs last May to the lows on February 11 – is a sufficient bear market for this mild recession (see the chart below).

S&P 500 corrections from new highs ■ >3% ■ >5% ■ >10%



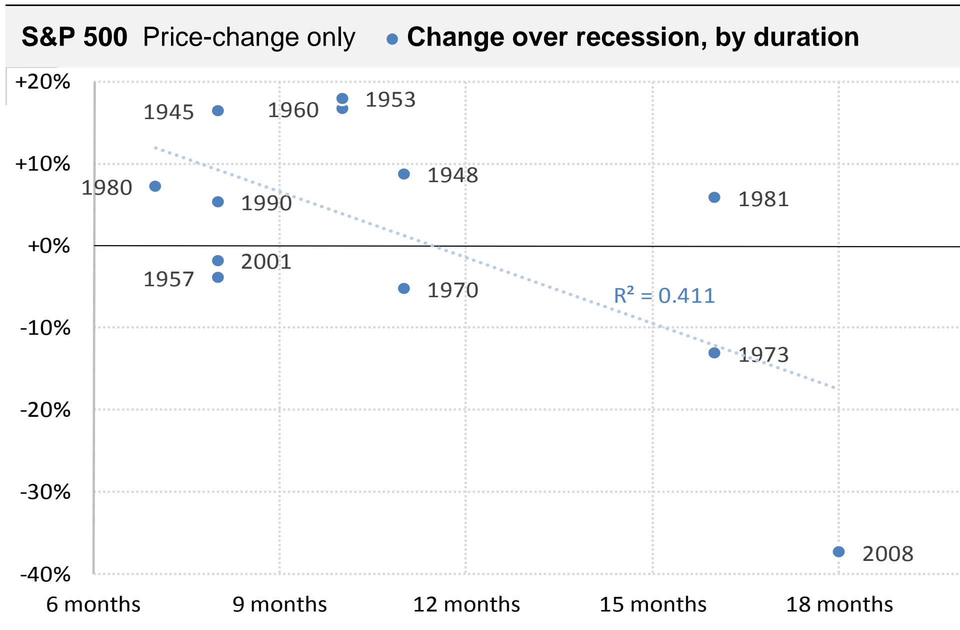
Source: Bloomberg, TrendMacro calculations

- The current correction was sufficient to take the S&P 500 equity risk premium to new post-crisis highs – making, as we said at the time, the most compelling value case for stocks in almost three years (again see “Will Yellen Get Trumped?”).
- The current correction is already the longest one since the present bull market began in March 2009, if not quite the deepest (that distinction belongs to the 21.58% decline that ended in October 2011 after the S&P US debt downgrade).
- The present 15.19% correction, excluding dividends, is about average for a recession bear market. From business cycle peak to recession bear market trough for all 12 post-war recessions (excluding 2008 – more a financial crisis than a recession), the S&P 500 has lost on average 15.6%. Including 2008, it’s 18.9%.
- Typically, stocks bottom well before the official recession trough – indeed, perhaps before the recession is even officially recognized. Apparently forward-looking securities are able to envision the end of the recession long before lagging economic indicators prove it (please see the chart below).
- On average over the 12 post-war recessions excluding 2008, stocks actually *gained* 4.9% from business cycle peak to recession trough. Including 2008, the average gain is 1.4%.
- The gain or loss for stocks is highly correlated to the duration of the recession. That is, longer recessions are associated with losses –



Source: Bloomberg, NBER, TrendMacro calculations

and larger losses – and shorter recessions are associated with gains – and larger gains (please see the chart below).

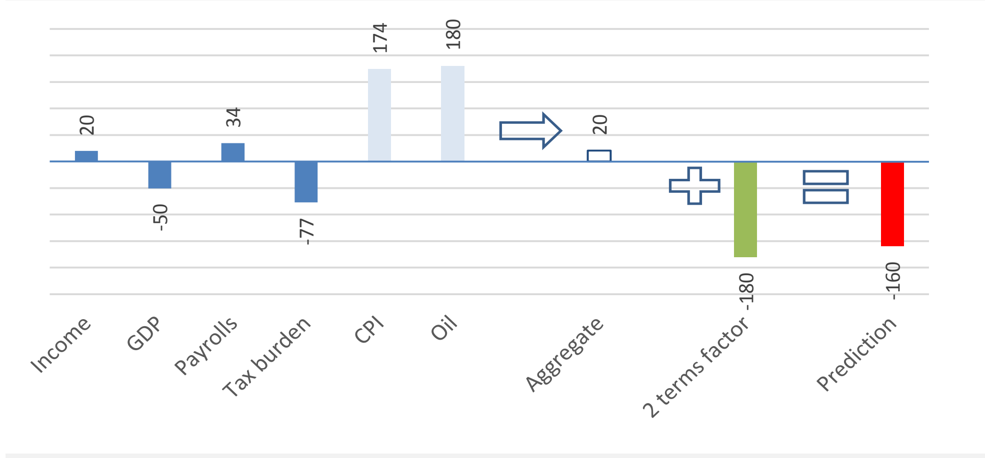


Source: Bloomberg, NBER, TrendMacro calculations

__The oil price is the key variable going forward – it has been throughout this cycle, and still is. If we're right that it has bottomed, then some close version of our guardedly optimistic scenario will play out. We've suffered enough. If we're wrong about oil, then all bets are off.__

The other big uncertainty is the upcoming US presidential election. The gradual onset of this unique recession has tipped the election in favor of the GOP. Our election model – which correctly predicted Obama's 2012 win within four Electoral College votes (see "On the 2012 Election" November 7, 2012) – is now predicting that a generic GOP candidate will win by 160 Electoral College votes (please see the chart below).

TrendMacro 2016 US presidential election model
Electoral college margin for incumbent party candidate



Source: Various, TrendMacro calculations

- *We can see just how much macro data has deteriorated by comparing today's model prediction of a GOP win by 160 Electoral College vote to that of last July – a hanging-chad margin of only 21 Electoral College votes, virtually a tie.*
- *Now, though we are looking across the valley now to the end of this recession, we think it will continue to play out in lagging macro data for another quarter or two, and this will only move the model more in favor of the generic GOP candidate.*
- *The problem is that Donald Trump is anything but a generic GOP candidate.*
- As we have been saying for months, Trump is not going away (see "Trumped!" December 14, 2015). As should now be clear to everyone, he very may very well be the GOP candidate.
- This raises major black-swan issues whether he wins the presidency or loses it (again, see "2016: Two Charts, Six Words, One Man").
- And we may be one top-secret e-mail away from some form of chaos on the Democratic side, and perhaps a third party candidacy.
- We like the microgreens we see. But it's still going to be an interesting year.

Bottom line

We think we're already in the first-ever recession caused by low oil prices, but evidentiary data are mixed. Q4 2015 GDP was revised upward this morning, but the revision was due entirely to inventory growth to record levels in this cycle, which implies slower growth in coming quarters as it gets worked off. January's labor data was mixed. Housing activity was week. But yesterday's strong cap goods orders point the other way. There are microgreens pointing this recession's end. We are encouraged by the 2016 rally in non-energy commodities, and now an incipient double-bottom in oil. China has stabilized its currency crisis, and the Fed is sidelined. Corporate spreads are still extreme, but gold keeps rallying, indicating no shortage of liquidity. After a post-crisis high equity risk premium two weeks ago, stocks have already had a bear market similar to the average in recessions. The major risk is that the double-bottom in oil doesn't hold. The black swan remains the increasingly likely nomination of Donald Trump.