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MACROCOSM

New Highs, Same Old Cloudy Skies

Monday, April 1, 2013

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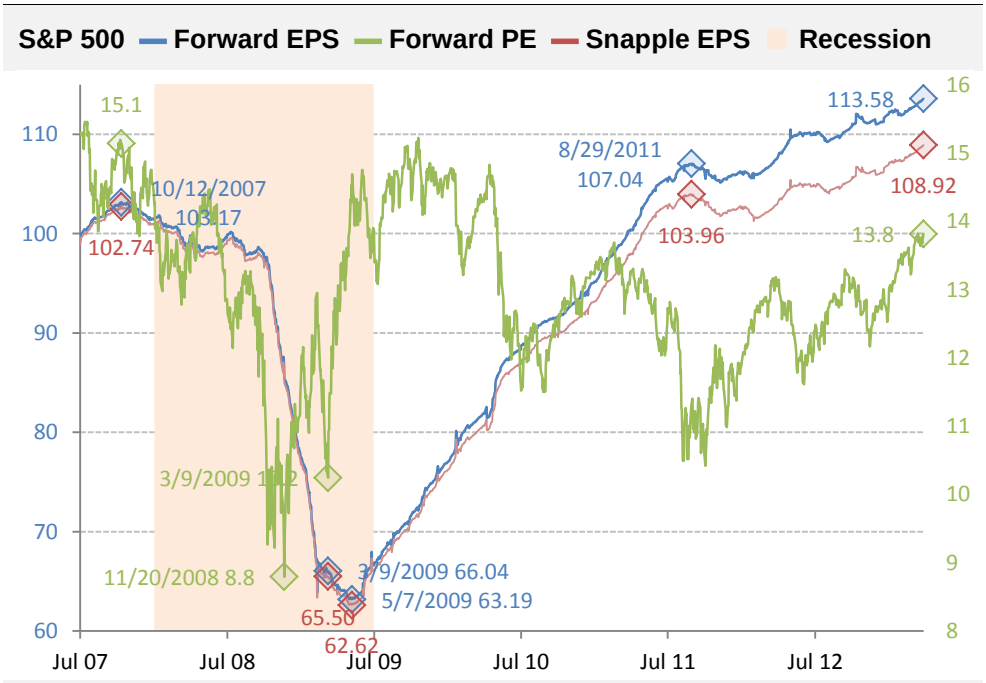
Slow earnings growth, energy and housing tailwinds, and a head-fake consumption spurt.

The S&P 500 drifted up at Thursday's quarter-end to notch a new all-time closing high. As we've been saying all year-to-date, "it feels like stocks want to keep melting up" (see "2013 Outlook: Think Globally, Shrink Locally" January 14, 2013). Our call early in March for a correction (see "The Crisis Score is Four for Four" March 4, 2013) has been met, at best, with a mere pause.

- On the face of it, why shouldn't stocks be at all-time highs? Forward earnings are. For that matter, they have been since May 2011 (please see the chart below). So all else equal, this is overdue.
- But that is too simple. For one thing, about half the gain in forward earnings can be attributed to a single company: Apple. But abstracting from that detail, as a general matter stocks are not priced only on earnings. Multiples reflect expectations for earnings *growth*. Right now forward earnings are growing only at a paltry 5.5% YOY rate, and the forward top line is growing at only 2.0%.
- Without an inflection toward higher growth, what is to drive the



Source: Zacks, Bloomberg, NBER, TrendMacro calculations

Update to strategic view

US STOCKS, US MACRO: Stocks closed the first quarter at new all-time highs, and we are skeptical that there's reason for them to go much higher, with forward earnings growth so slow. We are 13 years into a secular period much like the 16-year period between 1966 and 1982, when stocks went nowhere. Like then, the economy is held back by high energy prices -- and the much-vaunted technology revolution in domestic production has done nothing about that reality. We are not seduced by the spurt in consumption this quarter, seeing it as a temporary illusion based on extrapolating Q4-12's accelerated dividend and bonus payouts. And we don't see the housing recovery being sufficient to move the needle. At the same time, the equity risk premium has vanished, and risk has by no means gone away.

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present forward earnings multiple of about 14 back to about 15, where it was at the prior closing high in 2007? Indeed, the S&P 500 forward multiple did get back to 15 in October 2009 -- but that was when forward earnings growth was torrid.

- And even if the forward multiple for some reason jumped to 15 right now, that's would only be worth another 7% in stock prices. From there, we really couldn't expect more just from improving sentiment. Further gains would have to come from better earnings growth. Without that, what really would be a bull case for stocks achieving something better than about average total returns?

To be sure, average total returns -- from 1926, that's 9.9% per annum nominal, and 6.7% real -- would look pretty good right now.

- From the previous peak on October 9 2007, five and a half years ago, the annualized total return for the S&P 500 has been only 2.3% nominal, and 0.3% real.
- From the only slightly lower prior peak on March 24 2000, almost exactly 13 years ago the annualized total return for the S&P 500 has been only 2.1% nominal, and a *loss* of 0.3% real.
- As we have been discussing in client meetings for several years, we think we are in a secular epoch much like the period from 1966 to 1982, when the Dow Jones Industrial Average (nobody tracked the S&P 500 then) couldn't get above the 1000 level (please see the chart below). In those 16 years there were great bull markets, as well as the "go-go years," the "nifty fifty," and the heyday of the "small stock effect." Peter Lynch and Warren Buffett had their best

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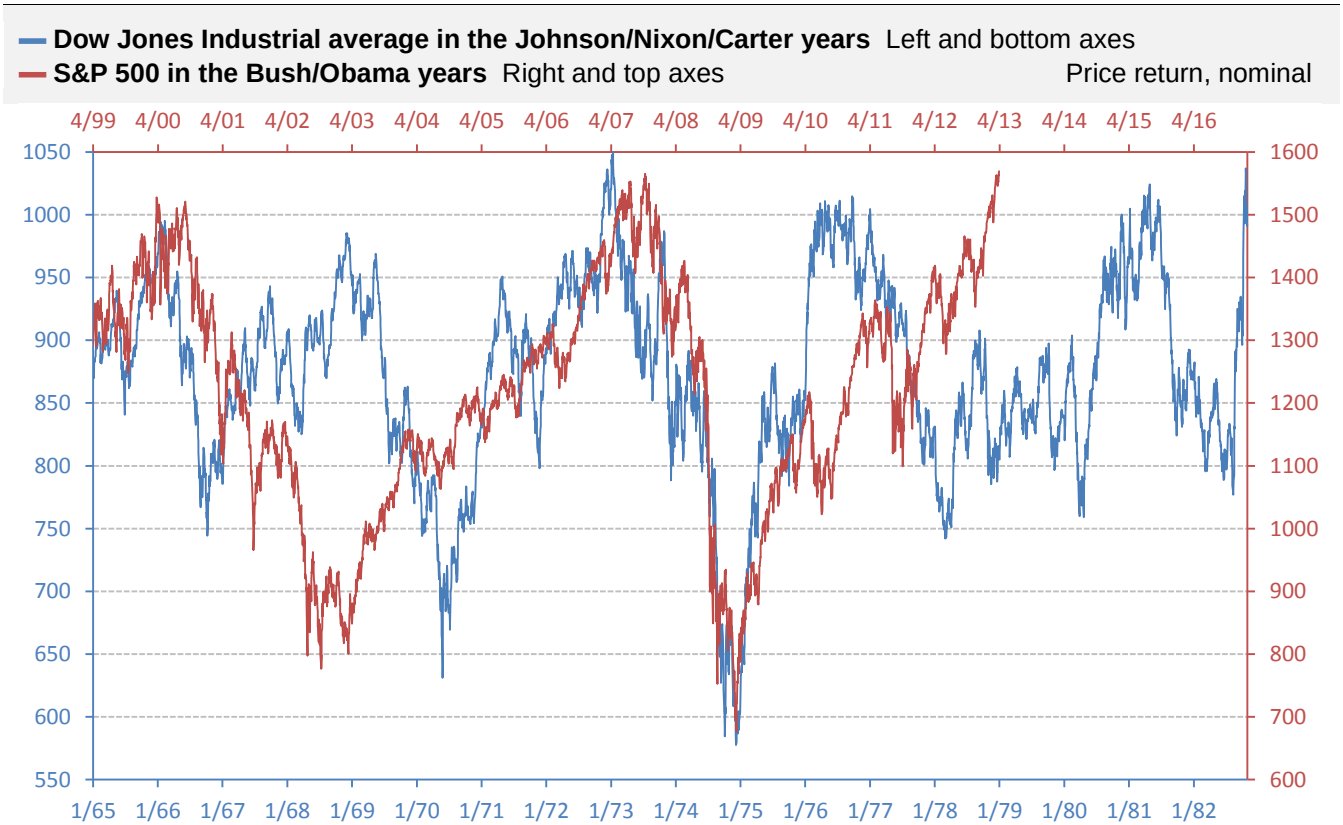


Source: Bloomberg, TrendMacro calculations

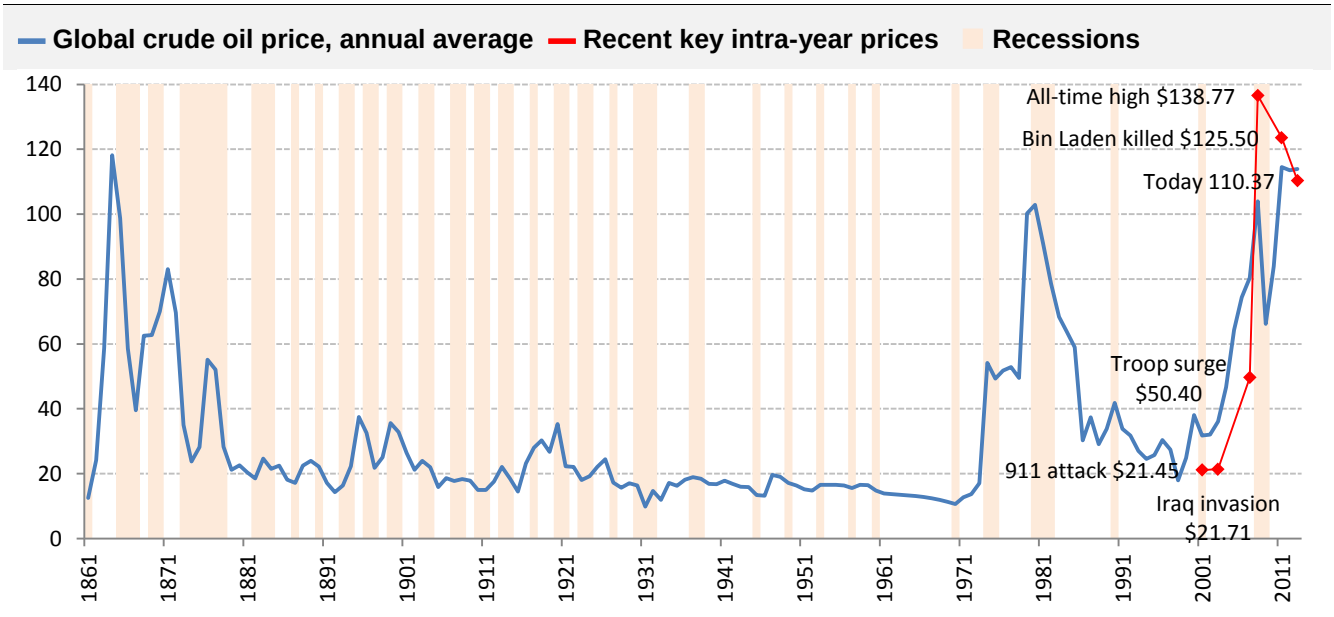
years of relative performance. So there were great opportunities then -- just as there are now -- in both stock selection and market timing. Yet *overall* stocks went nowhere. Dividend yields were higher then, so the average annual total return over about 16-1/2 years was 5.8% nominal. But inflation was higher then, too. The annual *real* total return was a *loss* of 1.1%.

- Those were the Johnson/Nixon/Carter years -- years of policy uncertainty, rising government spending, rising taxes, rising business regulation and rising energy prices. There are important differences, but much about those years reminds us of the present epoch -- the Bush/Obama years.
- Breaking out above the 1000 level on the Dow in October 1982, never to look back at it again, had to wait until the Reagan/Volcker policy-mix revolution of an anti-inflationary Fed accompanied by lower taxes and lower regulation -- and the end of a decade of recurring energy crises.
- We just don't see anything comparable at this point in the present epoch.
- Until further notice, S&P 1565 is the new Dow 1000.

Let us set aside for the rest of this report our broader subjective evaluation of the policy-mix then and now, and focus on three key objective macroeconomic factors that make us skeptical that stocks can substantively break out of the present secular trading range.

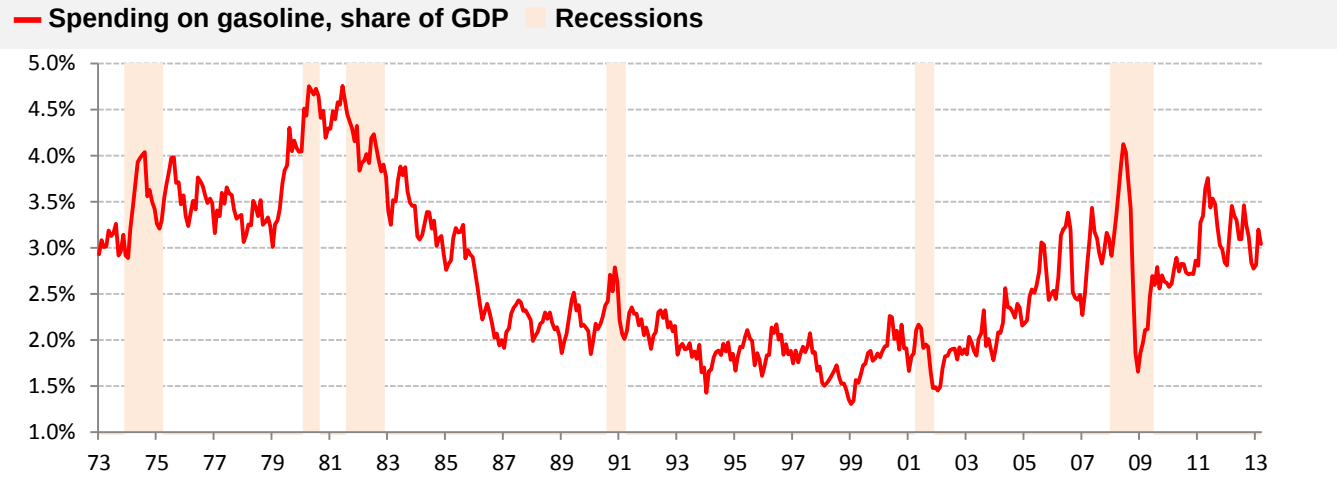
First, a critical secular similarity between the 1966-82 and the 2000-present epochs is the persistence of high energy costs.

- Yes, we know all about the technology revolution in domestic production. Yet the reality is that real global crude oil prices are close to all-time highs (please see the chart below).



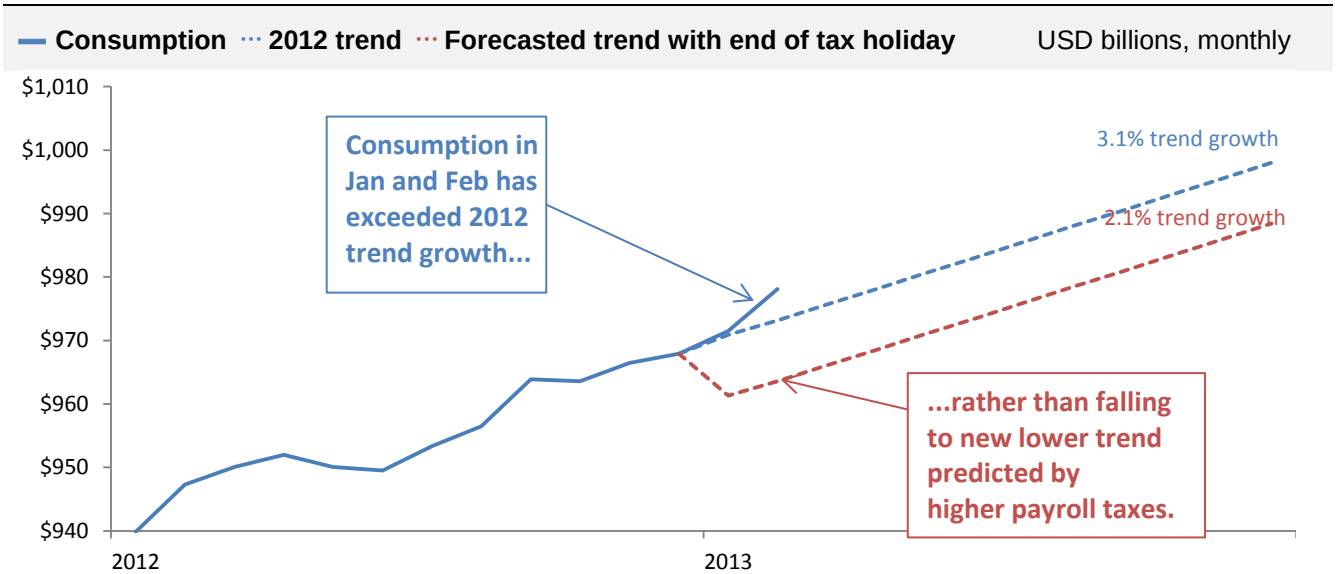
Source: BP, BLS, NBER, Bloomberg, TrendMacro calculations

- And yes, we know all about the energy efficiencies the US economy has invested to achieve. Yet the reality is that gasoline consumption now absorbs more than 3% of GDP (please see the chart below). This level is the lower bound of the range seen in the energy crisis years in the 1970s and early 1980s. To be sure, it is no "energy shock." But it is well above the range experienced in the years of strong earnings growth in the rest of the 1980s and the 1990s. At this level it is a growth inhibitor.



Source: EIA, NBER, Bloomberg, TrendMacro calculations

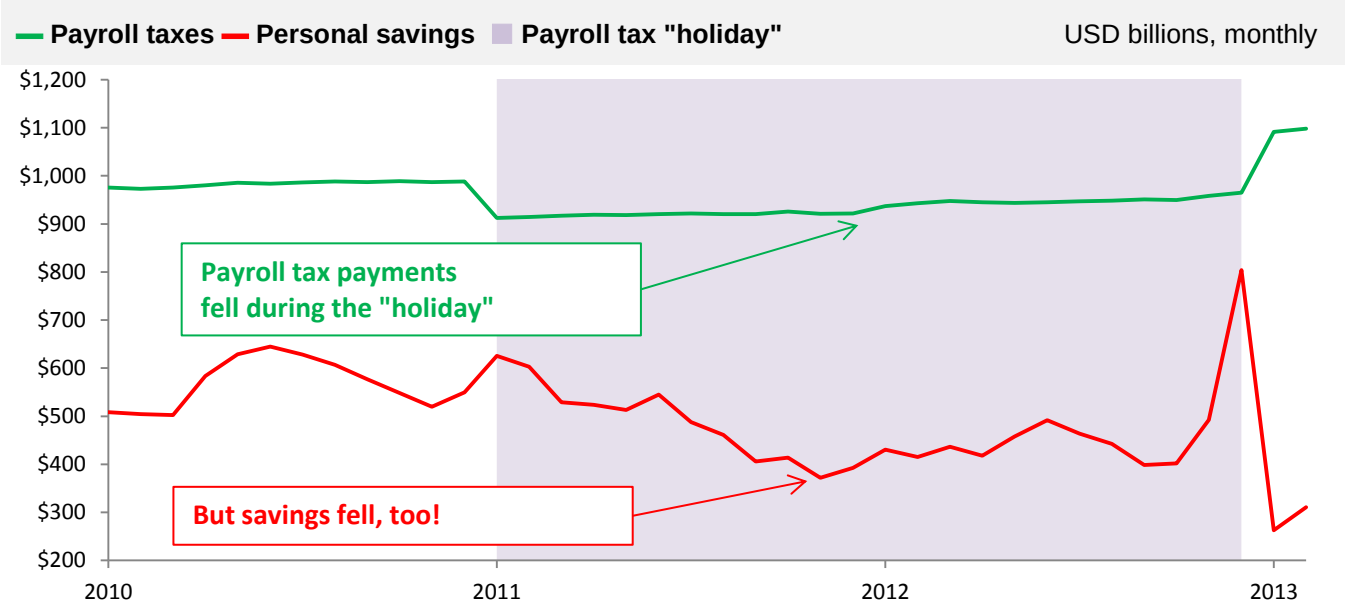
Second, we are not persuaded that the spurt so far this year in personal consumption portends sharply higher GDP growth than we've experienced so far in this Not So Great Expansion. The spurt starkly flies in the face of our expectation that the demand-side effects of the end of the payroll tax "holiday" in January's American Taxpayer Relief Act should suppress consumption growth (please see the chart below, and "Tax Hikes Have



Source: BEA, TrendMacro calculations

Consequences" January 2, 2013).

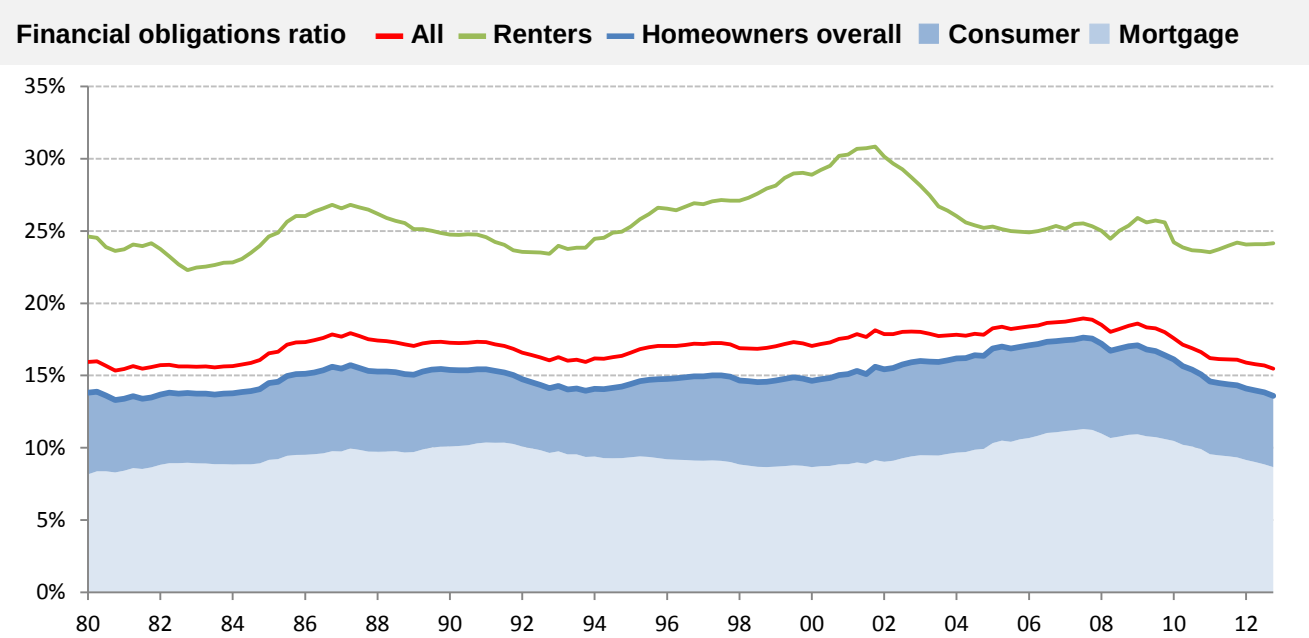
- As a result of the spurt, some economists are now expecting real GDP growth 2013 to come in around 3%, after a three years with a 2-handle. Maybe, but don't forget that 3% growth -- about the average over the last several decades -- doesn't even begin to close the enormous output gap left by the Great Recession.
- Be that as it may, how are we to explain the strong consumption growth we have seen in 2013? Is it, perhaps, the triumph of Milton Friedman's "permanent income hypothesis" -- which holds that consumption doesn't vary perfectly with income, because consumers smooth their spending in good times and bad in line with longer term income expectations?
- Could be, but the data doesn't confirm it. During the two years 2011 and 2012 in which consumers paid lower payroll taxes, personal savings *went down*. So it appears consumers did not bank the reduction in payroll taxes as the hypothesis predicts (please see the chart below).



Source: BEA, TrendMacro calculations

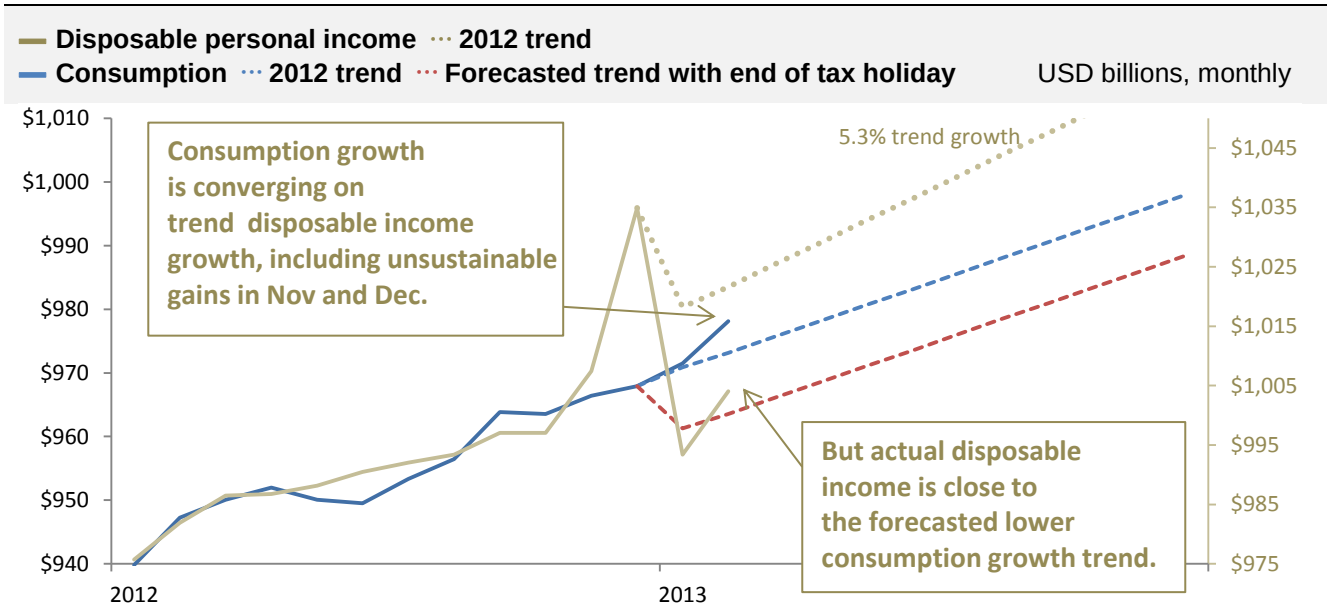
- An exception is the large increase in personal savings in November and December 2012. This is explained by a corresponding increase in personal income -- driven by accelerated dividend and incentive compensation payments designed to get ahead of expected high tax rates in 2013 (see "On Q4 GDP" January 30, 2013).
- With that effect washed through, personal savings is now the lowest since December 2007, the very peak of the prior debt-fueled business cycle. To be sure, at this point US households don't have to deleverage like they did then. That work is substantially done (please see the chart on the following page). But now the bulk of consumers are facing household income lower even than at the trough of the Great Recession -- and stagnating

there. They don't have recourse to credit cards and home equity lines of credit as they once did. We don't see how further consumption growth can be fueled by further dis-saving.



Source: Federal Reserve, TrendMacro calculations

- The best explanation for the spurt in consumption is the accelerated dividend and incentive compensation payments made late last year. Consumption is converging on trend growth in disposable personal income -- an impossible 5.3% rate -- *as though those payments were recurring* (please see the chart below). They are anything but -- in fact, they borrow against 2013.

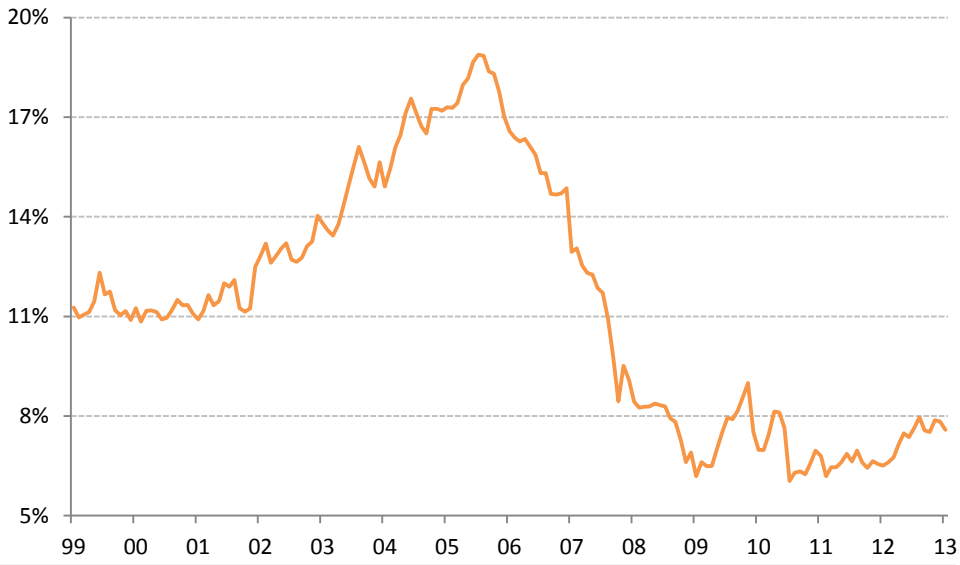


Source: BEA, TrendMacro calculations

Third, we caution against becoming too enthusiastic too early on housing as a source of macroeconomic reinvigoration. To be sure, there is a housing turnaround underway (see "It's Okay You Didn't Build That" July 20, 2012), and there are many ways investors can profit from it. But if the question is whether housing has recovered enough to start making an important contribution to overall GDP growth, we think the answer is: not yet.

- Remember, housing by almost any measure has already been improving for at least two years. Yet the last two years have seen subpar growth. This means that the *degree* of housing improvement we have seen so far has been *insufficient to move the needle* of the overall economy.
- The best way to see this is with TrendMacro's Housing Transaction Aggregate -- which measure the total turnover each month in homes, both new and existing. The Aggregate has been below 8% of GDP for five years (please see the chart below). Before the housing bubble, it was consistently above 11%. We are not likely to get back to the bubble levels in the high teens during our lifetimes, if ever -- but at 8% of GDP housing transactions are too small to create sufficient wealth effects and multipliers to close the output gap.

TrendMacro Housing Transaction Aggregate, share of GDP

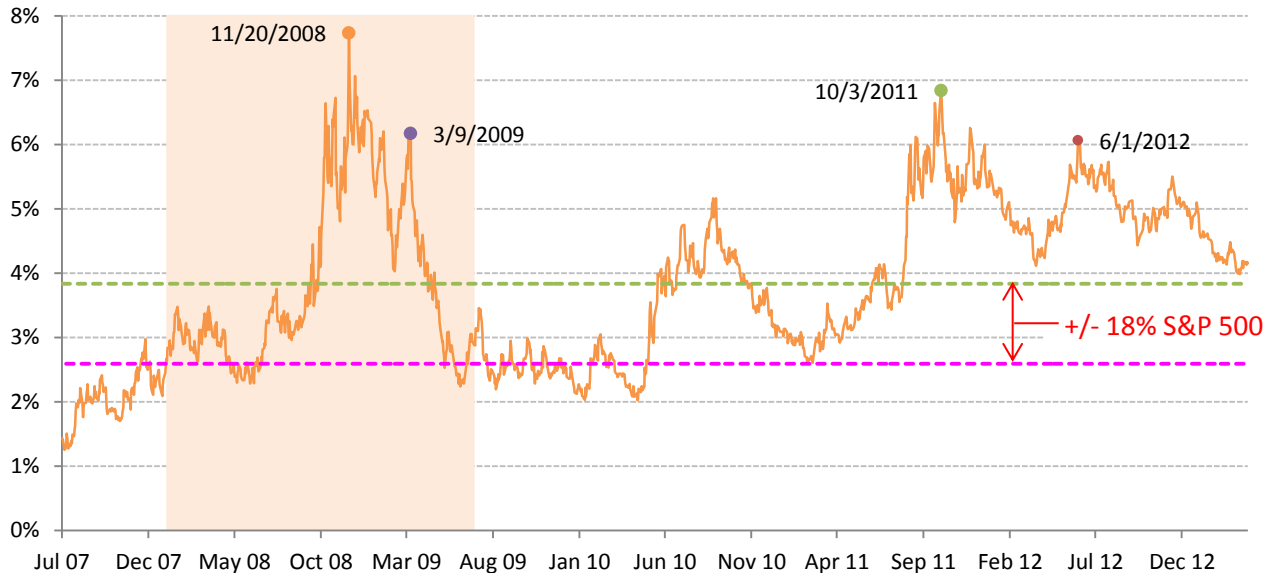


Source: NAR, Census Bureau, TrendMacro calculations

None of this is meant to be a bear case against the economy or equities. It is only to say we are still stuck in the Not So Great Expansion. And with stocks at all-time highs, we don't see the fuel for stocks to continue to go up as they have.

- And once again (see "The Incredible Shrinking Equity Risk Premium" February 21, 2013), while we don't see *growth* as the fuel, neither do we see *value*.
- With stocks at all-time highs on the heels of a 42.8% rally (excluding dividends) over the last 18 months, with forward earnings having grown only 6.4% over the same period (and growing now at an annual rate of only 5.5%), and with long Treasury yields 34 bp higher, the equity risk premium has almost entirely reverted to its crisis-era mean (please see the chart below).

S&P 500 equity risk premium **Crisis era mean, post 7/1/07** **Post Q3-02 mean** **Recession**
Consensus 365-day forward earnings yield minus 30-year Treasury yield



Source: Bloomberg, NBER, TrendMacro calculations

- This indicates to us that stocks have gotten about all they are going to get from the sheer relief of the US economy having not fallen *all* the way off the year-end fiscal cliff, and of dodging the three other Washington-driven dates with destiny in the first quarter (again, see "The Crisis Score is Four for Four"), or from the lessening of systemic risks from Europe and China (see "Oh What a Relief It Is" January 23, 2013).
- So for the equity risk premium to fall below the mean, there would have to be an inflection higher in forward earnings growth. We're not seeing anything like that at all in the consensus numbers. And we see no reason to expect it, given the macro background -- for reasons discussed already, and others as well.
- That said, if investor sentiment continues to improve, then it's possible that we should think of the true mean equity risk premium being somewhat lower.
- Suppose the equity risk premium were to revert to the mean that has obtained since Q3-02. That point in time was when sharp shifts in monetary and regulatory policy -- and congressional

approval of the invasion of Iraq -- came together to inflect the equity risk premium to a new secularly higher level above where it had been throughout the 1980s and 1990s. But *that* mean was not as high as the even higher mean that has obtained since the onset of the financial crisis in mid-2007. Reversion to that lower mean, all else equal (that is, assuming Treasury yields stay low), would improve equity valuation by about 18% of market cap (again, please see the chart on the previous page).

- But we just aren't ready to say a secular drop to a lower mean equity risk premium is in the cards. We're still in the Not So Great Expansion in the wake of the Great Recession -- uncharted territory with the unprecedented combination of a persistently high output gap and low output growth, and with continuing threats of anti-growth tax, monetary and regulatory policy.
- We still think systemic risk in Europe is actually quite low, though Cyprus is now bringing euro area bank stability bank into question (see "Regime Change Comes to Euro Policy" March 28, 2013). So even this pillar that could potentially support improving sentiment seems somewhat shaky.

Bottom line

Stocks closed the first quarter at new all-time highs, and we are skeptical that there's reason for them to go much higher, with forward earnings growth so slow. We are 13 years into a secular period much like the 16-year period between 1966 and 1982, when stocks went nowhere. Like then, the economy is held back by high energy prices -- and the much-vaunted technology revolution in domestic production has done nothing about that reality. We are not seduced by the spurt in consumption this quarter, seeing it as a temporary illusion based on extrapolating Q4-12's accelerated dividend and bonus payouts. And we don't see the housing recovery being sufficient to move the needle. At the same time, the equity risk premium has vanished, and risk has by no means gone away.