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MACROCOSM

Yes, But…

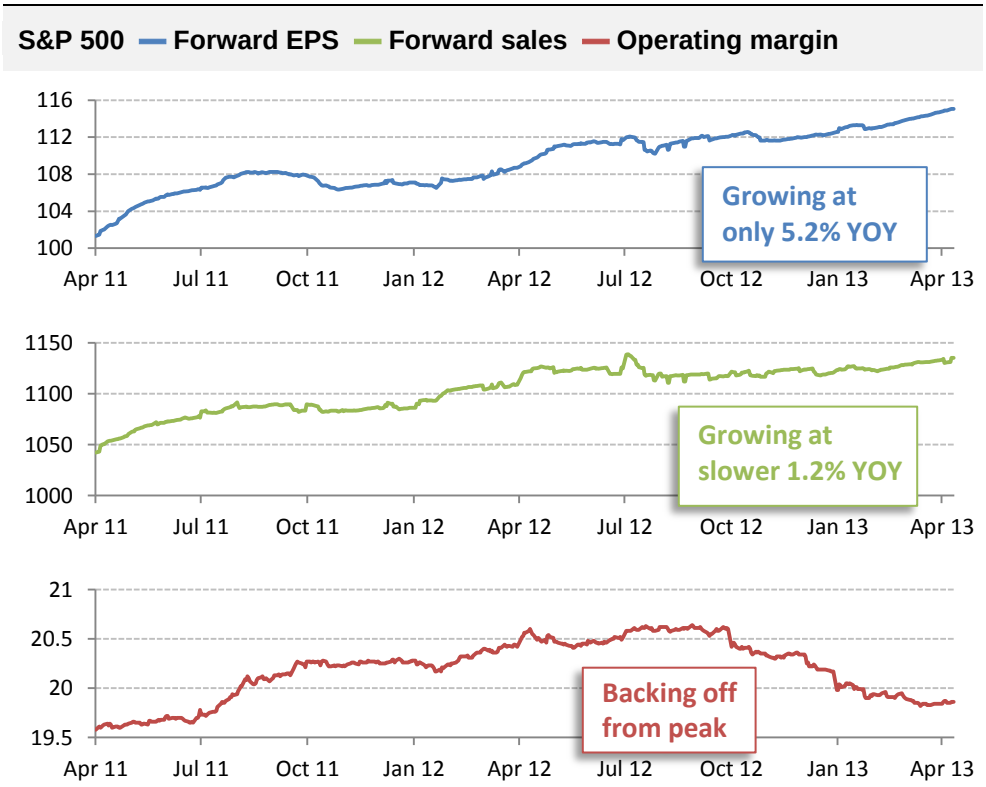
Thursday, April 11, 2013

Donald Luskin

US stocks still can't compete with Japan or the euro area on value or growth.

Bravo! Yesterday the S&P 500 finally made a new all-time intraday high, taking out the previous record on October 11, 2007. That makes an 11.3% gain year-to-date, not including dividends -- a better-than-average year's worth of growth already in a little more than three months. From here we're not bearish, but we remain as cautious and skeptical as we have all year, and for the same two basic reasons:

- ***Stocks are not a value proposition.*** The equity risk premium has almost entirely reverted to its crisis-era mean (see "The Incredible Shrinking Equity Risk Premium" February 21, 2013). That leaves stocks not *over*-valued, but exactly fairly valued. They are not remotely close to "crazy cheap" as we called them at the last bottom in this bull market (see "Europe Fails, US Stocks Flail" October 4, 2011).



Source: Bloomberg, TrendMacro calculations

Update to strategic view

US MACRO, US STOCKS, US BONDS, EUROPE MACRO, EUROPE STOCKS, EUROPE BONDS, ASIA MACRO, ASIA STOCKS: US stocks finally made new all-time intraday highs. We continue to be unenthusiastic rather than aggressively bearish. We see no reason in either valuation or growth prospects why stocks should move much higher. On the other hand, we still maintain that the euro area and Japan represent outright turnaround situations, from low bases. In the US, there's little scope for Treasury yields to fall, and rehabilitate the shrunken equity risk premium. In Europe, peripheral bond yields can continue to gradually decline -- and even if most of the gains here have been seen, versus the US they continue to be a total return play.

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- What could restore the value in stocks (other than prices falling)?
- Long-term yields (which are subtracted from the forward earnings yield to produce the equity risk premium) probably can't be expected to fall much from here, if at all.
- And it's unlikely that we'll be able to move the goal-posts for the equity risk premium by lowering the mean to which it is compared. With volatility in the vicinity of all-time lows and the forward price-earnings ratio at 13.9, there's not a great deal of room for improving risk-tolerance.
- A major inflection toward faster growth would do the trick in the best way, but…
- ***…stocks are not a growth proposition*.** Unless you want to take the stock market itself as indicative, there's just no evidence for an inflection to faster growth (see "New Highs, Same Old Cloudy Skies" April 1, 2013).
- Forward earnings are only growing at 5.2% year-on-year, and they are showing no particular sign of accelerating. If that rate continues for the coming year, then all else equal stocks will be 5.2% higher than they are today. That's the bull case, such as it is.
- Can the bottom line really grow at even 5.2% for the coming year? You'd never tell it from the forward *top* line, which is growing at only 1.2% year-on-year. Unless the *top* line grows, how much can the *bottom* line deliver? Operating margins are already falling substantially from peak (please see the chart on the previous page).
- Forward earnings are our very favorite growth indicator, and they are only pointing to more of the Not So Great Expansion after the Great Recession.
- Other favorite indicators are similarly unencouraging.
- Commodities prices are going nowhere (whether industrial ones like copper, or monetary ones like gold). The labor market continues to flail (see "On the March Jobs Report" April 5, 2013). The National Federation of Independent Business's Small Business Optimism Index is in an outright downtrend.
- Housing and energy production continue to improve, but in neither case has it been enough to move the needle on overall output in any visible way (again, see "New Highs, Same Old Cloudy Skies").

Are stocks at new all-time highs telling us simply to ignore all this stuff? We think not. At the scariest moments for stocks over the last few harrowing years we've used these and similar macro indicators to avoid selling bottoms. Today, none of them is screaming at us to sell this top. But none of them is saying very loudly to get in, either.

Obviously we've been less bullish than we should have been so far this year. But we've not been bearish -- only unenthusiastic. That's because we have had the fundamentally positive conviction that US stocks deserve a relief rally, a step-function to higher prices recognizing that 2013 will be less systemically risky than any of the last five years (see for example, among many, "Oh What a Relief It Is" January 23, 2013).

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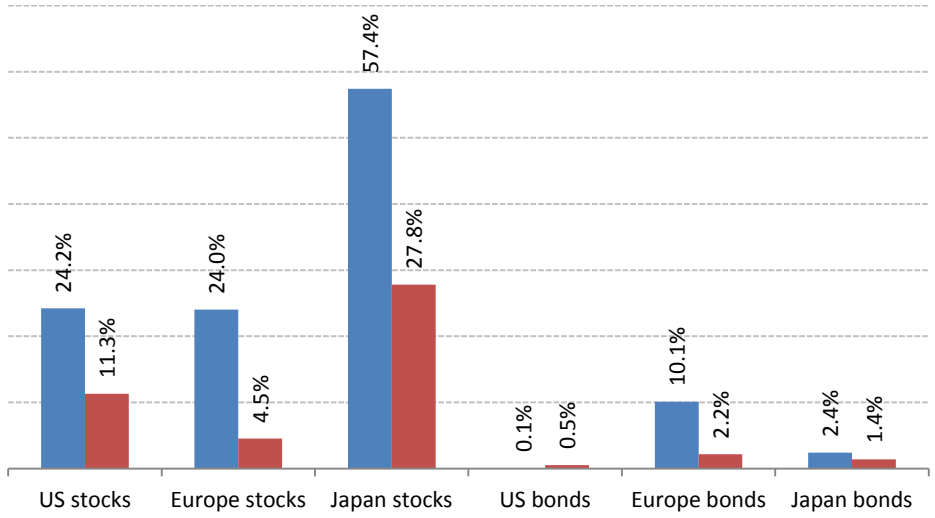
[About us]

- But we continue to think that US stocks won't be the primary beneficiary (see "2013 Outlook: Think Globally, Shrink Locally" January 14, 2013).
- US stocks -- and government bonds too, for that matter -- continue to be relative poor performers for the most part (please see the chart below).

Relative performance Stocks: dividends not included Bonds: Total return

From June 30 2012 bottom in US stocks **YTD 3013**



Source: Bloomberg, TrendMacro calculations

- We continue to think that the euro area has turned the corner -- an outright turnaround from the edge of disaster. Recession may linger in the periphery, but the preconditions for a major recovery from a low base have been established.
- The Cypriot banking crisis only proves that the euro area is now robust to threats that would previously have been dangerously destabilizing (see "Dubious Timing, Obvious Truth" March 28, 2013).
- That crisis put a serious dent in the powerful bull market in peripheral euro area stock markets -- but for peripheral bonds it was barely an interruption. Make no mistake about it, we still very much like peripheral equities as an aggressive turnaround play. But we like peripheral bonds even more. This posture comes straight from the wisdom of the equity risk premium model. As we noted near the very worst moments for the euro area (see "It Only Feels Like Blood in the Streets" December 1, 2011), the negative premium in peripheral nations like Spain and Italy has shown that while stocks are attractive turnaround plays, bonds are the better risk-adjusted values.
- Japan, thanks to radical reflationary policy from a newly awakened central bank, is another major turnaround opportunity (see "On Kuroda and Iwata at the BOJ" February 25, 2013 and "On the April BOJ Policy Meeting" April 4).
- So the best case for the US is somewhat faster growth, and we see no evidence that we are going to get it. That is supposed to

carry stocks even higher than all-time highs, beyond even where they already are.

- At the same time the euro area and Japan are outright turnarounds, where there are solid reasons to speculate on a substantive growth acceleration. And no one is going to accuse euro area or Japanese stocks of being at all-time highs.

Bottom line

US stocks finally made new all-time intraday highs. We continue to be unenthusiastic, rather than aggressively bearish. We see no reason in either valuation or growth prospects why stocks should move much higher. On the other hand, we still maintain that the euro area and Japan represent outright turnaround situations, from low bases. In the US, there's little scope for Treasury yields to fall, and rehabilitate the shrunken equity risk premium. In Europe, peripheral bond yields can continue to gradually decline -- and even if most of the gains here have been seen, versus the US they continue to be a total return play.