Economic Analysis

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The non-fab four

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Four things to address today

There are four things we want to address today. The new paradigm, valuation, February follies, and timing the end of the recession.

The new paradigm … ignore comparisons with the past

First, the new paradigm. What we're referring to here is the need for everyone to ignore comparisons with the past, if that past means the post-World War II era. As March draws to a close, we now head into the 17th month of the recession, which means that we have broken the peak duration of 16 months of the early 1980s and mid 1970s. And as we saw in the final revision to fourth quarter GDP last week, after-tax National Accounts profits collapsed at a 74% annual rate and are now down 36% year-on-year, both of which are unprecedented in the post World War II experience. As a share of GDP, profits are down to 6.6% but they usually bottom between 4% and 5% in a recession bear market. So, there is no question that there is still downside earnings risk ahead.

Valuation … market discounting a return to $70 earnings

That brings us to the second point, which is valuation. Back at the lows on March 9th, based on the relationship between the fair value P/E multiple and the real Baa corporate bond yield, the S&P 500 was priced for $55 on EPS, which may have been a tad too high from our vantage for 2009 but actually was not far off what we had been expecting to see in 2010. Fast forward to today, and the market is effectively discounting a return to $70 earnings, which is not only 75% above our forecast for 2009 but 30% higher than our forecast for 2010 (not to mention more than 10% higher than the usually bullish consensus forecast!).

February follies … this was no ordinary February

On the third point, for those who believe that we have hit some sort of inflection point on the economy because of the unexpected strength, all we can say is caveat emptor on any February data point that is seasonally adjusted, especially since this was no ordinary February. At 37 degrees, it was two degrees warmer than a year ago and four degrees balmier than it was two years ago.

Aggressive seasonal factors applied to February data

Meanwhile, in our detective work, what we found was that the commerce department applied the most aggressive seasonal factor ever to produce that 3.4% increase in February durable goods orders, and the seasonal adjustment for new home sales was also the strongest since 1982 (it's funny that nobody talks about how unfilled orders fell 1.3% in a possible sign that prior orders have been cancelled, or that median home sales deflated 2.9% MoM and a record 18% YoY in a vivid sign that there are still more sellers than buyers three years into this severe bear market in residential real estate).

Refer to important disclosures on page 3 to 4.

May see a reversal in the bullish data flow over the past month

The retail sales number in February in non-seasonally adjusted terms was the worst ever – a 3% decline actually, and yet again a strong seasonal adjustment factor made it look flat. So, we think if there is a risk to the market over the next month, it's the prospect that we see a reversal in this surprisingly bullish data flow over the past month.

End of negative GDP prints does not mean end of recession

The final point is on timing the end of the recession. It still looks as though real GDP is on pace for a 7.2% annual rate decline this quarter on top of the 6.3% contraction in the fourth quarter. This represents the worst back-to-back performance in fifty years. And, we are at -4.8% on real GDP for the second quarter. Now, while it is true that the statistical benefit of reduced inventory withdrawal and the fiscal stimulus will likely produce a positive GDP print in the third quarter, we doubt that the spurt will prove sustainable; nor are we certain that the end of the negative GDP numbers alone will be a flashpoint for the end of the recession.

Need to see personal income turn higher organically

What we do know is that all of the four ingredients that make up the recession call – industrial production, real sales, employment and real personal income excluding government transfers – are still in deep negative terrain. In fact, what was critical on Friday was the data-point on real personal income less government transfers. It fell 0.8% in February, which was the third decline in a row, not to mention the steepest slide through this recession. In a nutshell, personal income has to start to turn higher organically AND on a sustained basis to make the end-of-recession call.

Economy has to stand on its own without the help of Uncle Sam

In other words, the economy has to show that it has enough vitality to stand on its own two feet without the help of Uncle Sam. As an example, if you go back to the second quarter of 2008 when the federal government mailed out a record volume of tax rebates that boosted real disposable income at a whopping 10.7% annual rate, the comparable for what goes into the recession call – real organic income excluding government handouts – contracted at a 2.4% annual rate.

Premature to have the view that March was the bottom in equities

So, in our forecast, what is key is that there is no visible recovery in private sector GDP until we are into the first quarter of 2010. So, under the proviso that the market typically bottoms four months before the recession officially ends, we stick with the view that sometime in the fall continues to make the most sense in terms of timing the end of the bear market. At this point, it looks premature to have the view that March was the bottom, when it's perfectly conceivable that the recession officially won't be over for another 12 months.

We have good company, actually, as San Francisco Fed President Janet Yellen hinted as much in her speech to the New York Economics Club last week titled "The Uncertain Economic Outlook and the Policy Responses". To wit: "*But even so, the level of the unemployment rate would still rise throughout 2009 and into 2010. So, in this sense, the worst of the recession is not expected to occur until next year. And, even by the end of 2011, I would expect the unemployment rate to be above its full-employment level.*"

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