

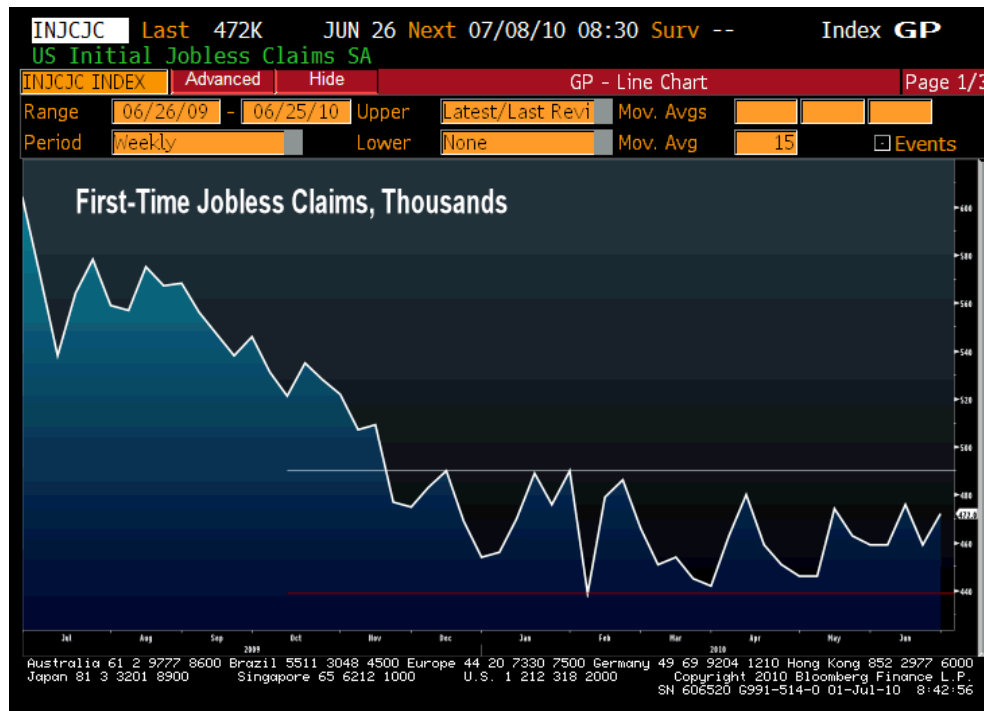
## MacroStrategy

July 1, 2010

### Slowdowns, Panics, Crashes & Other Observations

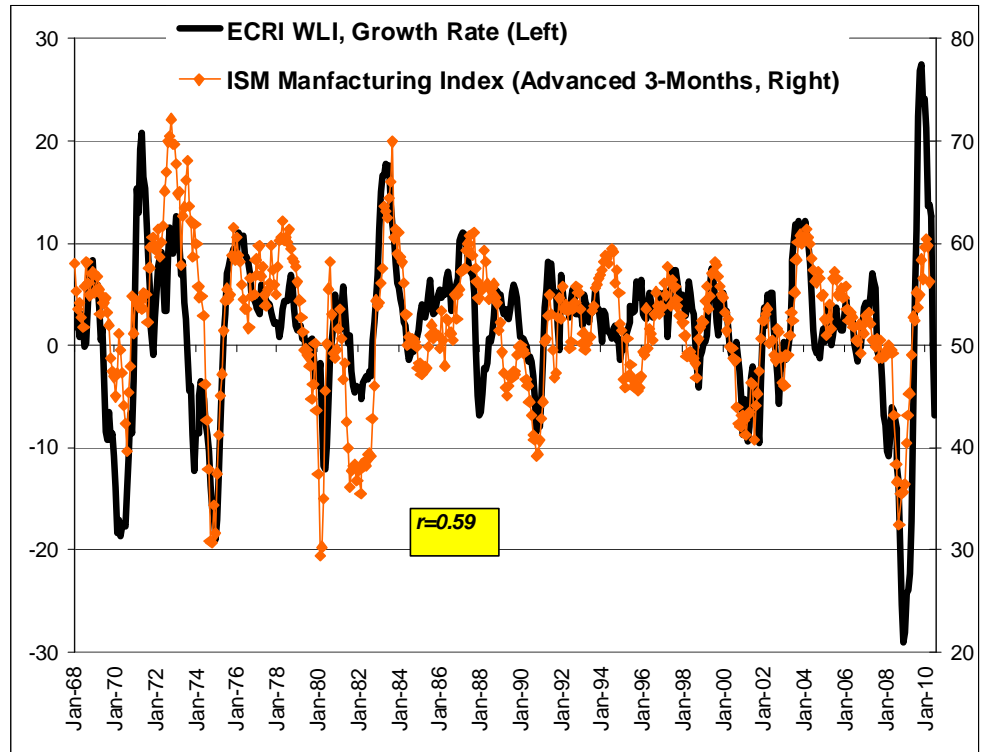
**Executive Summary:** To recess or not to recess, that is the question. Either way, we believe the stock market has essentially discounted a double-dip scenario, with our NIPA-based model showing a gap between equity earnings yields and corporate bond rates that rivals anything seen in nearly six decades. Even using a 10-year moving average for earnings (which implies a 13.4% decline in corporate profits from current levels), the S&P 500 has fallen to valuation levels *below* those seen at the market lows in October 2002, October 1990 and December 1987. We'd be more concerned if the credit markets were in worse shape. Yes, corporate spreads have widened, but all of the action has been in (declining) Treasury rates; corporate bond yields have been flat, unlike the situation in 2007-2008. Three-month dollar LIBOR has been in a flat to down trajectory since late May. Two-year swap spreads at 37 bps suggest that both the VIX and corporate spreads have overshot significantly to the upside (implying that equities are overshooting to the downside). The catalyst for today's slide appears to be the upward move in first-time jobless claims and the miss on the June ISM Manufacturing Index, although both were consistent with a continuing, albeit slower, expansion.

**First-time jobless claims rose 13K this week, to 472K, above consensus expectations.** The chart below shows the evolution of first-time claims over the course of the last year. In essence, claims have been trading in a fairly narrow range this year, although they are still down more than 20% from year-ago levels. What does this mean for the labor market? *Historically, a flat trend for jobless claims has been consistent with 3% real GDP growth and 130K monthly increases in private payrolls.* When claims have fallen 20% year to year (which is the case even with this week's upward drift), real GDP has tended to expand at a 5% rate and monthly private sector payrolls have tended to expand by 277K. We expect private sector payrolls to rise 150K in June, a modest rise, but an increase that would be above consensus expectations of only 110K on private payrolls. The overall

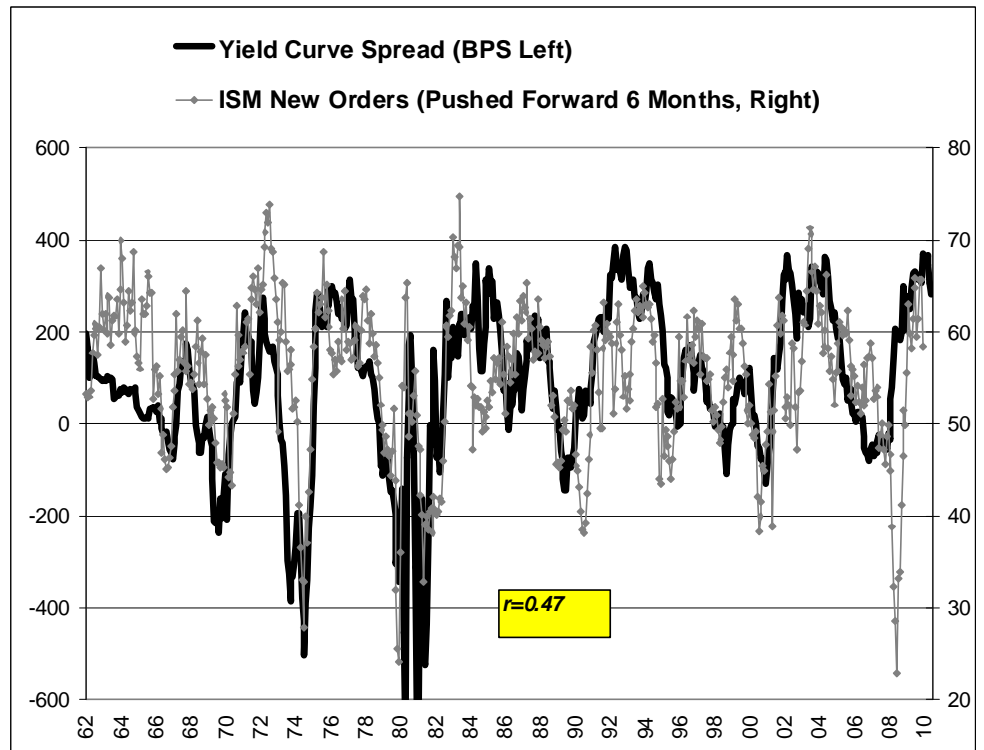


payroll number will probably fall 75-100K due to a roll-off of temporary census jobs.

**The [June ISM Manufacturing Index](#) missed consensus expectations, but the market seems to expect it to weaken dramatically more from here.** The June ISM Manufacturing Index came in at 56.2 vs. 59.7 in May; the consensus expectation was for a reading of 59. The largest component decline came from the prices paid index, which dropped to 57 from 77.5, thanks to the sharp fall in commodity prices. However, new orders, production backlogs, employment and exports all weakened from their levels in May. Nonetheless, a level of 56.2 on the ISM Manufacturing Index has historically been associated with about 4% real GDP growth. The market weakness likely is due to a pricing in of much weaker readings during the second half of the year -- perhaps below the 50 threshold. The ECRI's Weekly Leading Index (WLI) has declined at a rate that suggests the ISM could fall below 50 in the months ahead, but there have been times when it overstated future weakness (1987-1988, for example).

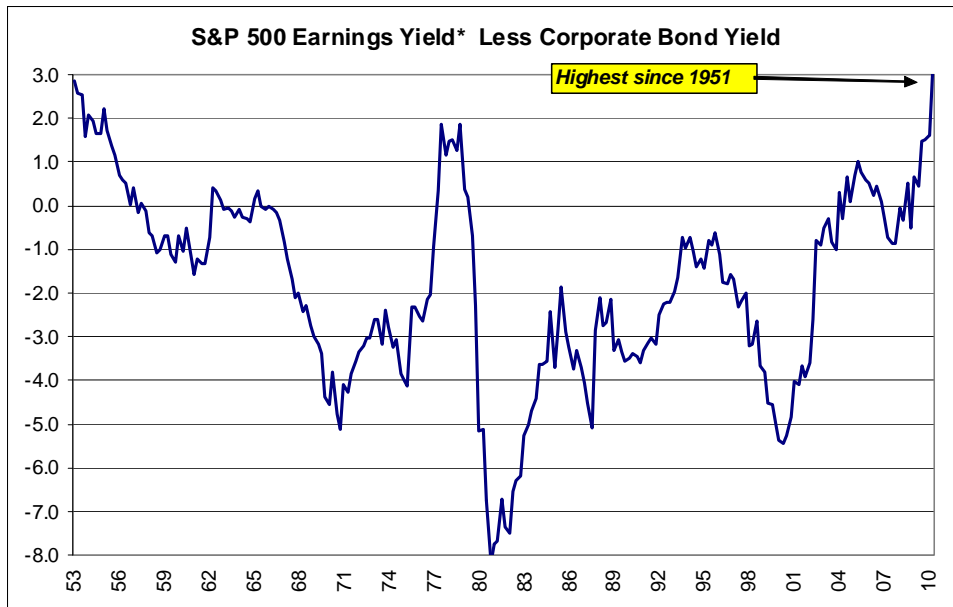


**The yield curve spread (which is not a component of the WLI) has compressed about 100 bps.** The last two times the yield spread flattened early into an economic expansion (with all the action coming from long rates) was in 2002 and 1993. In both cases, the economy slowed to a growth path of about 1.6% in real GDP terms, although no recession occurred and earnings continued to rise at a decent clip (corporate profits rose at a 9.5% pace in 1993 and at an 11.3%



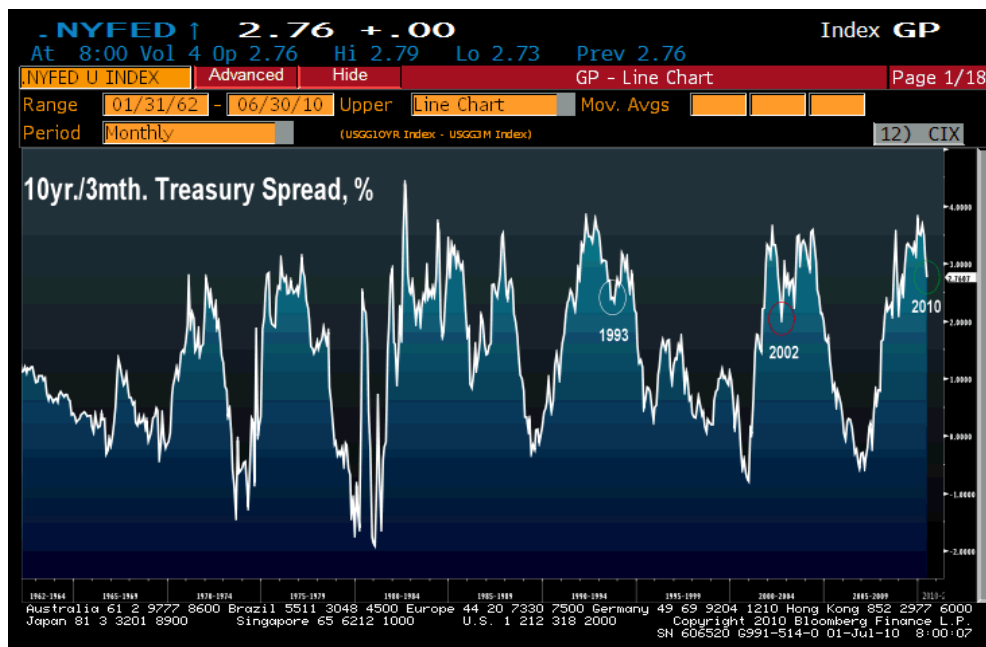
Source: Bloomberg; MKM Partners

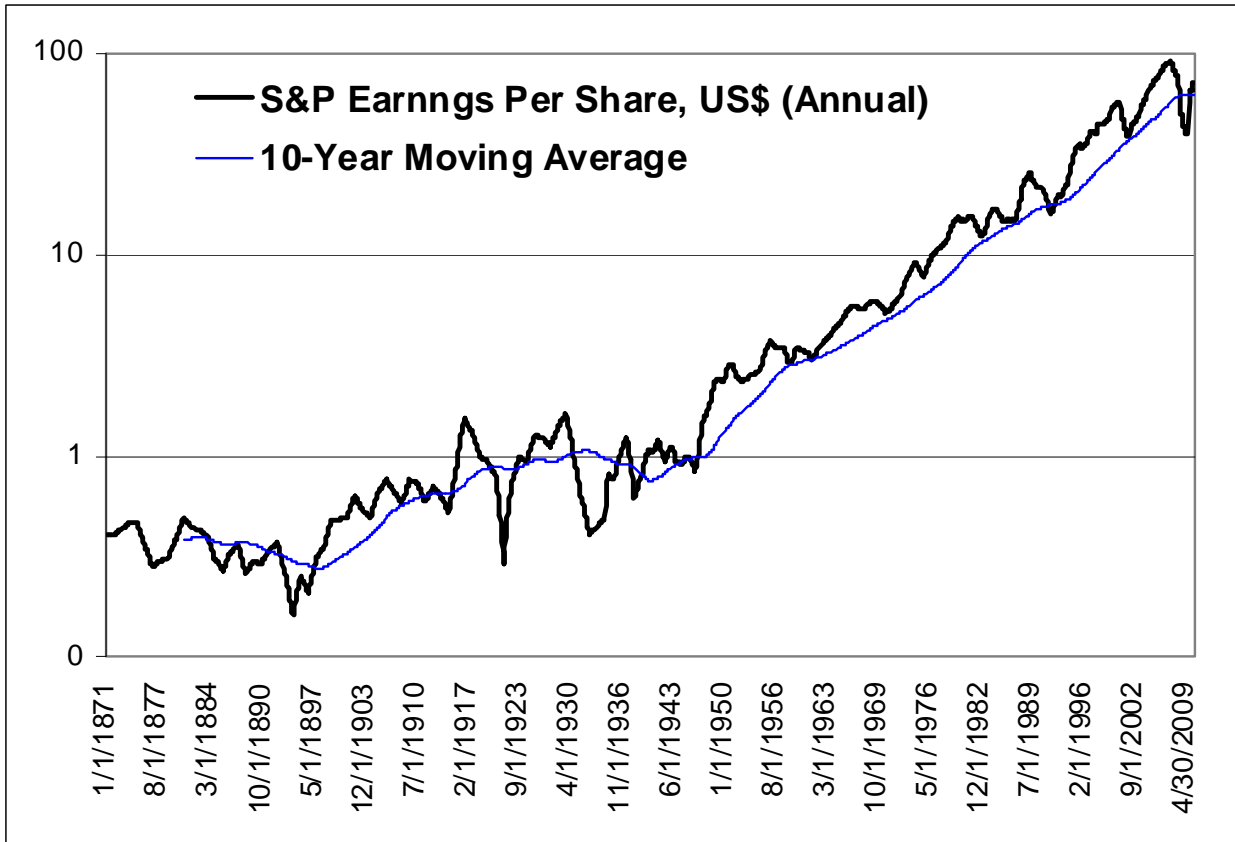
pace in 2002). The S&P 500 rose about 7% in 1993; it fell more than 30% in 2002, however. The [equity bears](#) believe it's 2002 all over again, but stock valuations are *much* lower today than they were then. Our NIPA-based profits data are at a level that corresponds to a market multiple of about 11x, which translates into an S&P 500 earnings yield of 9.1%. With corporate bond yields at 6.05%, the gap between the two is the largest in nearly six decades. In early 2002, the market was trading at a NIPA-based multiple of 22x, which equates to an earnings yield of 4.5%. With corporate yields above 8% in early 2002, that year looks like an inverse reflection of the current reality. For deep-value sticklers, stock valuations (based on a 10-year moving average for earnings) have fallen *below* the levels that marked the October 2002 and October 1990 lows, and are now about equal to the December 1987 lows, which were seen *after* the crash. We thus continue to believe stocks have overshot to the downside and that there is value in equities for investors with horizons beyond seconds, minutes, hours, days or weeks.



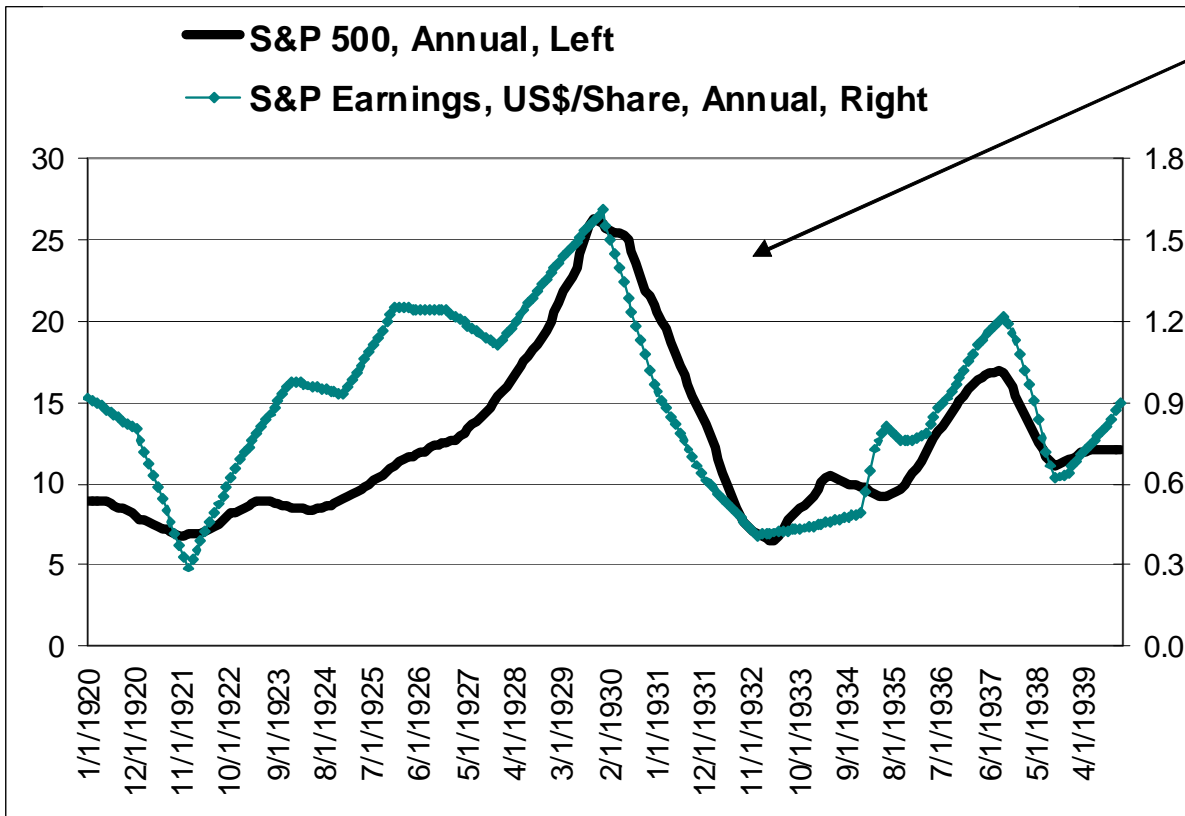
Source: Bloomberg; MKM Partners

\*Earnings yield based on NIPA-equivalent S&P operating earnings with 1988 as a base year





Source: Robert Shiller; MKM Partners



Markets tend to move with earnings; this was true even in the 1920-1939 period....

Source: Robert Shiller; MKM Partners

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