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# Monday Morning Musings

## From Five Degrees of Separation to Five Degrees of Suspicion

- Equities

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- **In early October 2011, five factors argued that markets were likely to trade higher.** In early 4Q11, the Five Degrees of Separation report (dated October 4, 2011), highlighted five different items as being indicative of a possible rally since the fears found in the market at the time did not line up well with the underlying data. Specifically, investor sentiment, equity market valuation, earnings estimate revision trends, the credit environment and Citi's Economic Surprise Index all supported appreciation even as recession fears were in full bloom following the ECRI prediction of a domestic GDP decline.
- **However, five indicators now are flashing reasons for concern about a correction.** The Economic Surprise Index appears to have peaked recently rather than having troughed which was the case in late 3Q11, the Panic/Euphoria Model is showing elevated levels of complacency now versus "panic" previously and earnings estimate revision momentum has not kept pace with stock price gains. In addition, margin pressures are becoming quite evident and Presidential election uncertainty is likely to become more crucial to the investment community as summer approaches, especially given a host of expiring tax cuts and government spending programs.
- **Possible catalysts for a market pullback include rising energy prices and the news of a second liquidity boost in Europe.** Another round of liquidity or monetary easing in the form of what is being dubbed LTRO II by the European Central Bank may generate a negative catalyst as markets consolidate on official launch of the program, after having run up on the expectation following the old Wall Street adage of "buying the rumor and selling the news." Moreover, greater attention is being paid to the rise in oil prices and more critically gasoline prices of late which could act as a drag on overall confidence (encompassing investors, corporate management teams and consumers).
- **Margin trends already are facing pressures and there is little reason to believe that will back off near term.** Various inputs argue for margins facing a more challenging future but it is not all bad in that profits may or may not be above trend. When reviewing the historical S&P 500 EPS trajectory, one can conclude that companies are over-earning their long term directional trend using a linear approach. In contrast, when considering a more geometric progression of earnings over time, corporates are somewhat under-earning their trend line. Hence, there is ample room for debate, but it is crucial to note that the credit backdrop does not intimate a looming recession with commensurate earnings collapses.
- **Some caution is warranted now even considering a more bullish full year view.** Citi's S&P 500 year-end target of 1,425 remains intact as outlined in late 2011, but with less than 5% upside from current levels over the next 10 months, it is a bit difficult to "pound the table" as near term signals argue for a more guarded view. With so much cash on the sidelines though, we remain buyers but choose to do such purchasing on weakness.

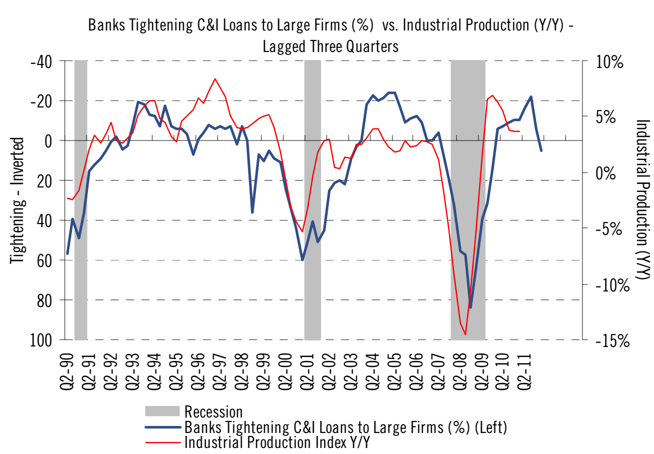
See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

# Things Are Different After a 25% Rally

In early October last year, we penned our “Five Degrees of Separation” report, noting several clear differences in the backdrop that argued forcefully for investors to get over their fears and buy equities. In particular, we noted a much better credit environment, a bounce off the lows of the Citi Economic Surprise Index, earnings estimates revision trends that had fallen back, despondent investor sentiment and compelling valuation. But after a very solid run over nearly five months now, conditions are not as supportive. Indeed, one can now cite the Five Degrees of Suspicion that may put a lid on incremental gains in the near term with catalysts that may include the news of a second LTRO (Long Term Refinancing Operation) out of Europe which many have credited with reining in the credit spreads for various countries across the pond and preventing a much more dire recessionary outcome there. However, markets have a tendency to run in anticipation of such events and then back off once the news is out there, as was the case with QE moves by the Fed in the US as well. Furthermore, gasoline price increases could be detrimental to investor psychology especially if consumers back off their spending patterns. Thus, we could see some endogenous catalysts for some market retrenchment without resorting to crisis triggers which might involve bank failures, the closing of the Straits of Hormuz and the like.

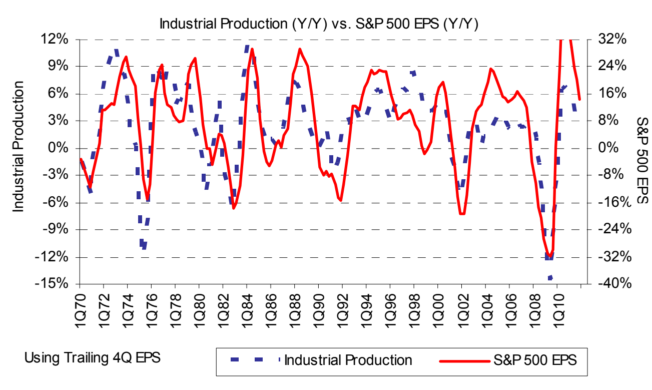
Yet, before focusing on the Five Degrees of Suspicion that suggest possible near term problems in markets, we should stress that our full year view remains unchanged as we still envision a 1,425 S&P 500 level by year-end, which puts us at the higher range of market strategists’ outlooks for 2012. Indeed, there are arguments to be made that it could go even higher though we would need some better sense of election outcomes and fiscal reform clarity to get on that bandwagon. Figure 1 shows that credit conditions still support the no US recession view (very unlike 2007-08’s trend) and thereby industrial activity over the next nine months should be able to sustain earnings (see Figure 2).

**Figure 1.**




Source: Haver Analytics and CIRA – US Equity Strategy

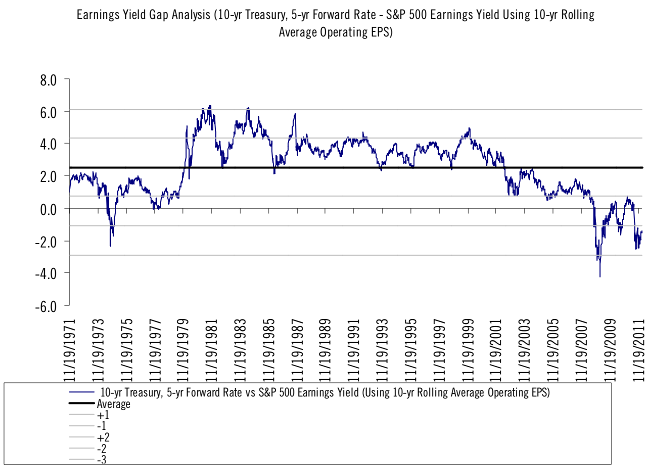
**Figure 2.**




Source: Haver Analytics and CIRA – US Equity Strategy

In addition, Figure 3 illustrates the earnings yield gap using cyclically adjusted (10-year rolling average) earnings and the five-year futures contract level for the 10-year Treasury yield, with current readings at two-to-three standard deviations below average. In the 46 previous such weekly occurrences dating back 40 years, investors made handsome money, on average, in more than 90% of instances both six and 12 months later (see Figure 4). As such, it is hard to get that bearish about the future barring exogenous shocks.

**Figure 3.**




Source: Haver Analytics and CIRA – US Equity Strategy

**Figure 4.**

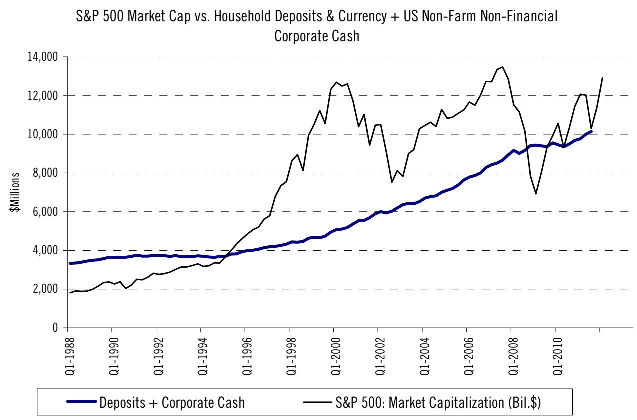
**Earnings Yield Gap Analysis (10-yr Treasury, 5-yr Forward Rate - S&P 500 Earnings Yield Using 10-yr Rolling Average Operating EPS)**

| | S&P 500 Forward Return | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | 3-mth | 6-mth | 12-mth | 3-mth | 6-mth | 12-mth | 3-mth | 6-mth | 12-mth |
| | -3 StDevs and Below | | | -3 StDev to -2 StDev | | | -2 StDev to -1 StDev | | |
| Average | 13.3% | 27.1% | 43.7% | 7.9% | 20.1% | 24.0% | 0.1% | 1.7% | 8.5% |
| Median | 17.3% | 30.8% | 44.0% | 8.9% | 21.6% | 24.9% | 2.1% | 3.2% | 10.3% |
| Total | 9 | 9 | 9 | 58 | 46 | 46 | 219 | 218 | 193 |
| % Up | 78% | 100% | 100% | 83% | 91% | 96% | 60% | 61% | 87% |
| %Down | 22% | 0% | 0% | 17% | 9% | 4% | 40% | 39% | 13% |
| | -1 StDev to Average | | | Avg to +1 StDev | | | +1 StDev to +2 StDev | | |
| Average | 0.6% | 0.4% | 1.6% | 3.4% | 6.8% | 11.9% | 0.0% | 1.0% | 6.5% |
| Median | 1.0% | 1.2% | 4.9% | 3.4% | 6.8% | 13.3% | 0.3% | 2.6% | 8.2% |
| Total | 649 | 649 | 648 | 868 | 868 | 868 | 271 | 271 | 271 |
| % Up | 57% | 57% | 61% | 71% | 76% | 78% | 55% | 58% | 62% |
| %Down | 43% | 43% | 39% | 29% | 24% | 22% | 44% | 42% | 38% |
| | +2 StDevs and Above | | | Random Outcomes | | | | | |
| Average | 3.5% | -1.2% | 9.0% | 1.9% | 3.8% | 8.0% | | | |
| Median | 4.4% | -1.5% | 9.7% | 2.3% | 4.2% | 9.6% | | | |
| Total | 11 | 11 | 11 | 2085 | 2072 | 2046 | | | |
| % Up | 64% | 45% | 82% | 64% | 66% | 72% | | | |
| %Down | 36% | 55% | 18% | 36% | 34% | 28% | | | |

Source: Haver Analytics and CIRA – US Equity Strategy

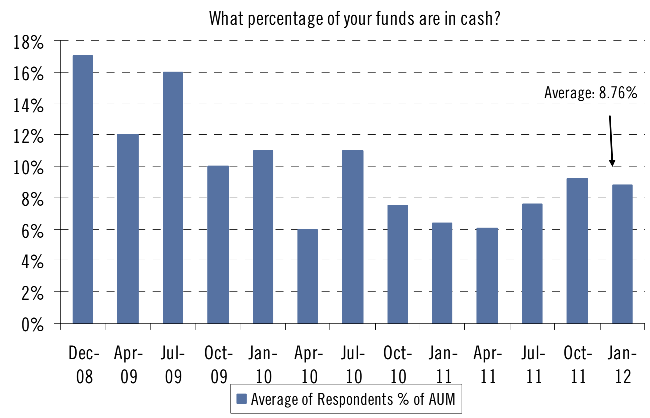
Indeed, one of the most exciting elements for equity market support is the very large amount of cash sitting on the sidelines. If we add the amount of cash held by corporations and US households, one can see that there is more than $10 trillion of theoretically available investable assets (earning very little thanks to Fed policy) compared with a $13 trillion equity market value (see Figure 5). And, this does not include cash held by pension, mutual and hedge funds which spiked somewhat based on our January survey of institutional investors (see Figure 6). Accordingly, while a short term pullback seems very plausible as we are about to explain, it is also unlikely for that downdraft to be of the 10%-20% ilk and more like a 5% consolidation.

**Figure 5.**




Source: Haver Analytics and CIRA – US Equity Strategy

**Figure 6.**



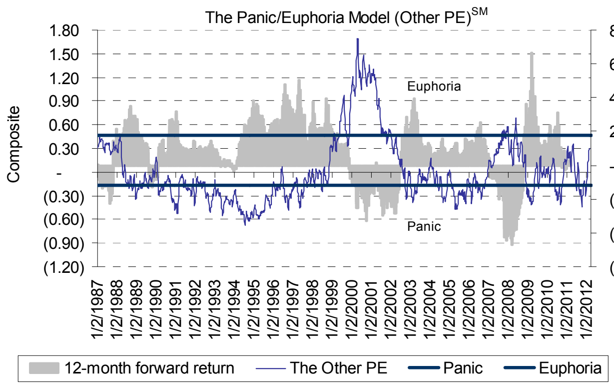

Source: CIRA – US Equity Strategy

## The Five Degrees of Suspicion

Investor sentiment is no longer depressed based on our proprietary Panic/Euphoria Model (see Figure 7) and has approached complacency readings commensurate to the data seen last April/May when equity indices topped out. Moreover, the Cyclical Expectations Model has taken a step down over the last couple of weeks

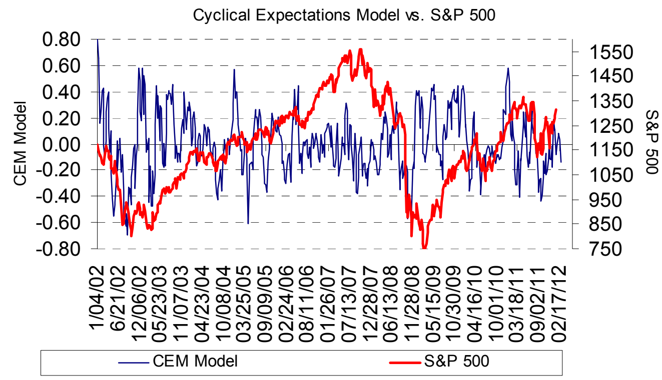
arguing for some near-term market weakness (see Figure 8). Thus, sentiment is more of a drag than a support mechanism even as money flows have not been that hefty.

**Figure 7.**




Source: CIRA – US Equity Strategy

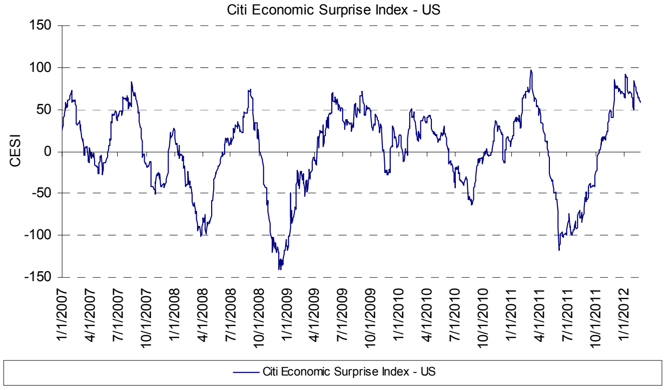
**Figure 8.**




Source: Haver Analytics and CIRA – US Equity Strategy

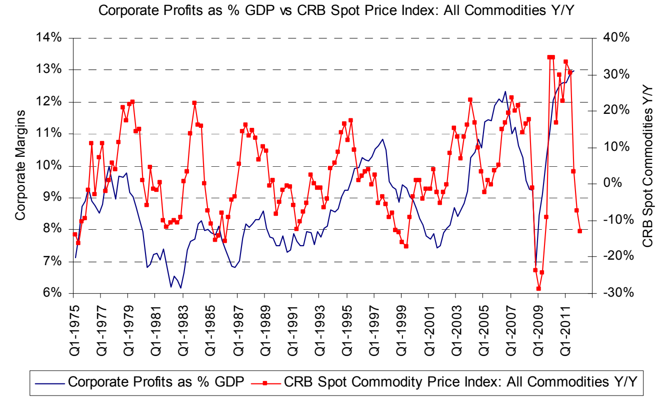
Probably the more worrisome signs may be coming from Citi's Economic Surprise Index which appears to be rolling over (see Figure 9) and margin pressures are building including weakness in commodity prices that directionally move in sync with margins, somewhat non-intuitively (see Figure 10). Furthermore, we suspect that more uncertainty with respect to the upcoming US Presidential/Congressional elections will develop in the next few months, especially as investors begin to consider the reality that tax cut and spending programs will expire at the end of 2012 alongside the sequestration process that will account for 3.4% of GDP in 2013 if nothing gets enacted. We would further point out that who wins the elections will probably have inordinate influence on the direction of four areas of the market (financials, health care, energy and defense) that collectively account for nearly 40% of the S&P 500's market cap. As such, one has to recognize that some near term market performance risk is increasing.

**Figure 9.**




Source: Bloomberg and CIRA – US Equity Strategy

**Figure 10.**

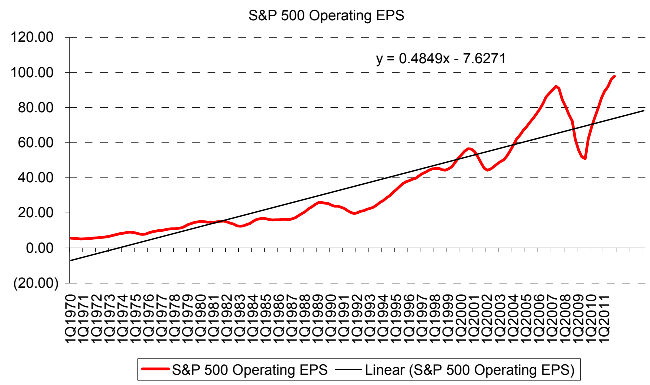



Source: Haver Analytics and CIRA – US Equity Strategy

## The Earnings Trajectory

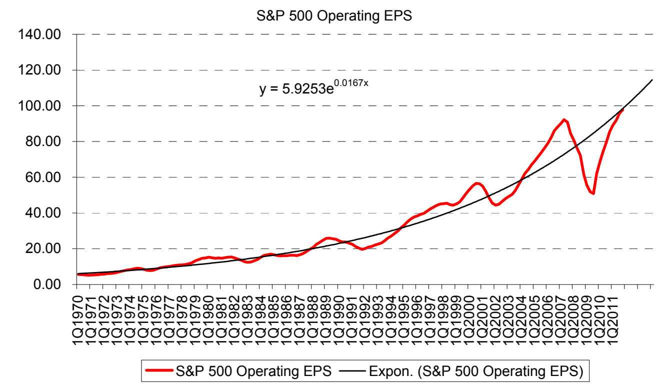
One area that many investors are struggling with is the corporate profit margin issue and how it affects earnings. Indeed, margins are quite wide and reflect several issues including the depressed level of labor cost when there is weak hiring and large swaths of unemployed people holding down wages. In particular, there is a view that corporations are over-earning their trend as seen in Figure 11. However, Figure 12 would argue something a bit different using a more geometric progression of earnings over time. Thus, we can see why so many investors are squabbling over this directional concept. As long as the economy does not tank, it is hard to contend that profits will plunge, in our opinion.

**Figure 11.**




Source: CIRA – US Equity Strategy

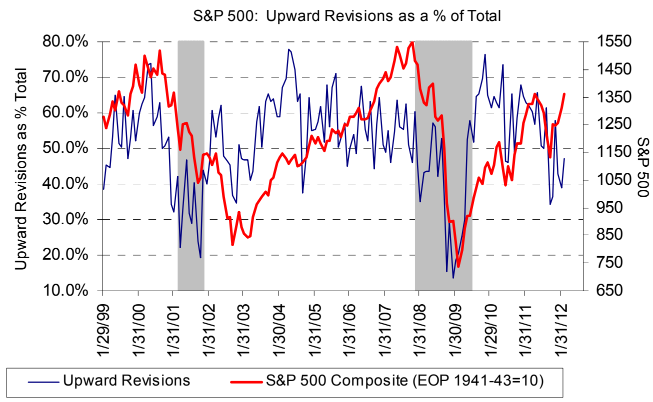
**Figure 12.**




Source: CIRA – US Equity Strategy

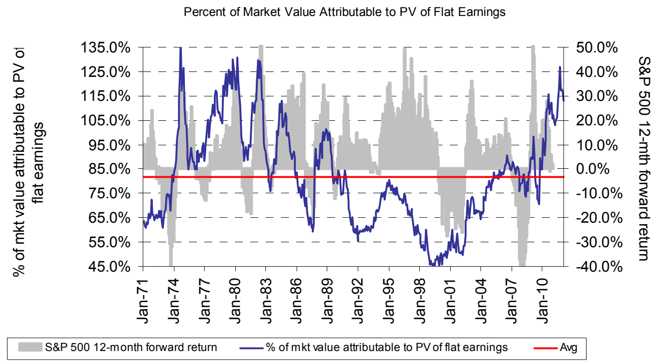
Earnings estimate revision momentum has improved a bit of late but does not appear to us that a major updraft is likely to support the stock price surge (see Figure 13) given economic challenges in the US (from still high unemployment and elevated gasoline prices) as well as in Europe. More critically, investors do not even believe their own forecasts of 2012 earnings growth since the present value of flat earnings held flat to forever is currently valued at about a 13% premium to the current S&P 500 index price (see Figure 14). Therefore, the market is implying an earnings decline of a fairly meaningful magnitude since the average present value of no growth would be at a 20% discount to the S&P 500 level. In the past, this kind of outlandish divergence has led to major advances in the subsequent 12 months. Hence, while we harbor near-term concerns, our longer-term view remains fairly optimistic for US equities.

**Figure 13.**




Source: FactSet and CIRA – US Equity Strategy

**Figure 14.**




Source: Haver Analytics and CIRA – US Equity Strategy

# Appendix A-1

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