Woe Is Us!
(1) The bull gets no respect. (2) Will the bull hit the wall or climb it if we fall off the cliff? (3) Why Bill Gross is wrong about the death of the equity cult. (4) Professor Gordon’s new normal on life support. (5) Was the old normal really abnormal? (6) The fourth industrial revolution. (7) Grantham’s Malthusian musings. (8) Reinhart-Rogoff again. (9) Bullish contrarians should be delighted. (10) Earnings outlook remains bright despite recent estimate cuts. (11) “Lincoln” (+ + +).

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Strategy. Pessimism is in fashion. Actually, it always seems to be in fashion, especially since the financial crisis of 2008. I’ve described the bull market in stocks since March 9, 2009 as "the Rodney Dangerfield of bull markets." It just gets no respect. As the saying goes, bull markets climb a wall of worry. There sure has been plenty to worry about for the past few years.

There still is plenty to worry about, including the fiscal cliff in the US, the Euro Mess (Greece over and over again, and Catalonia more recently), China’s leadership transition and economy, turmoil in the Middle East (Iran, Israel, Gaza, Egypt, Syria, Turkey, and all the rest), and the impact of the global slowdown on corporate revenues and earnings.

There has been lots of loud growling about the Endgame scenario by the bears since the start of the current bull market. Another popular refrain among the naysayers is that eventually policymakers will run out of road to kick the can down. Indeed, there may be a cliff at the end of the road at the start of next year.

With or without the cliff, there will continue to be the “new normal,” i.e., subpar growth for the foreseeable future, according to the pessimistic prognosticators. The phrase was coined and popularized by Pimco’s Bill Gross, who also recently predicted the death of the “equity cult.” A new variation of this theme, recently posited by Professor Robert Gordon and GMO’s Jeremy Grantham, is that we can look forward to zero growth forever. Let’s review:

(1) The cliff is near. The latest alarming discussion of the fiscal cliff appears in a report released yesterday by the White House. It is titled “The Middle-Class Tax Cuts’ Impact on Consumer Spending & Retailers.” The report was prepared by the National Economic Council and the Council of Economic Advisers. The fiscal cliff scenario outlined in this report is similar to the one updated at the beginning of the month in report issued by the Congressional Budget Office (CBO):

“Allowing the middle-class tax rates to rise and failing to patch the Alternative Minimum Tax (AMT) could cut the growth of real consumer spending by 1.7 percentage points in 2013. This sharp rise in middle-class taxes and the resulting decline in consumption could slow the growth of real GDP by 1.4 percentage points, which is consistent with recently published estimates from the Congressional Budget Office. Faced with these tax hikes, the CEA estimates that consumers could spend nearly $200 billion less than they otherwise would have in 2013 just because of higher taxes.”

This certainly isn’t a happy scenario. However, it isn’t apocalyptic either. It could trip up the bull. But will it lead to a bear market? More likely, in my opinion, the mild recession--predicted by both the White
House and the CBO if there is no deal to avert the cliff—might prolong and deepen the correction that started after the S&P 500 peaked at a cyclical high of 1465 on September 14.

Besides, going off the cliff might be good for us. It would be better not to do so since a deal among Democrats and Republicans to avert the cliff would almost certainly propel the S&P 500 to a new cyclical high, and maybe to a record high, as I expect. However, if the only way to cut the deficit is to raise taxes across the board and slash discretionary spending, then so be it. It won’t be the end of the world or the bull market, in my opinion.

(2) The old normal was abnormal. In his August Investment Outlook posted on PIMCO’s website on July 31, Bill Gross declared that the “cult of equity is dying.” That’s a late call since the cult has been mostly dying after flourishing during the 1990s, as evidenced by the secular downtrend in valuation multiples since 2000 (Fig. 1). The bull markets of 2003-2007 and since 2009 have been widely disparaged by perma-bears, including Mr. Gross, as cyclical rallies (“sugar highs”) in a secular bear market (Fig. 2). In any event, high-profile predictions such as this one by Mr. Gross often have been great contrary indicators. So far, so good.

However, it will be some time before we know for sure whether Mr. Gross will be proven right or wrong. The question for now is whether the logic of his argument makes sense. I don’t think so. He bases his pessimistic outlook for stocks on his view that “GDP growth itself is slowing significantly due to deleveraging in a New Normal economy.”

While economic growth has been subpar during the current economic expansion, corporate profits have been terrific. The cult of equity during both the current and the previous bull markets has actually been driven by CFOs (rather than individual and institutional investors) using some of their strong cash flow to buy back shares and increase their dividends (Fig. 3 and Fig. 4). I think they will continue to do so in 2013 and beyond because I expect that profits will continue to climb to new record highs.

Of course, that will be hard to do if the New Normal will be no growth at all in real GDP rather than subpar growth. That’s the dire long-term outlook for the US economy according to a widely discussed September study by Professor Robert Gordon of Northwestern University. It is titled, “Is US economic growth over? Faltering innovation confronts the six headwinds.”

The professor’s radical central premise is that the three industrial revolutions since 1750 might have fueled a “one-time-only” increase in standard of livings and productivity over the past 250 years. It really is a very interesting paper positing that smartphones and iPads won’t spur productivity as did innovations like the telephone, autos, electric lights, indoor plumbing, air conditioning, jets, and computers. On the contrary, he identifies six “headwinds” that are likely to keep economic growth close to zero for many years to come.

I’m not convinced. Gordon acknowledges that his analysis is US-centric. There are many emerging countries that have lots of catching up to do. As their standards of living improve, global trade will continue to expand, which will certainly boost growth in the US. He doesn’t acknowledge that there may be a fourth revolution underway in the US attributable to the abundance of cheap energy driven by new drilling technologies. In turn, cheap energy combined with cheap smart robots should revive manufacturing in the US.

One of Gordon’s six headwinds is “the plateau in educational attainment in the US reached more than 20 years ago.” He attributes much of this problem to “cost inflation in higher education, which has resulted in part from an arms-war-like explosion of expenditure by many universities, private and public
alike, to raise their league table ranking by building ever more lavish laboratory and athletic facilities.” That’s an excellent point. However, I can imagine a future where iPad-delivered courses dramatically reduce the cost of education.

Jeremy Grantham of GMO is in the same camp as Gross and Gordon. In his latest quarterly letter, dated November 2012, he writes: “The U.S. GDP growth rate that we have become accustomed to for over a hundred years—in excess of 3% a year—is not just hiding behind temporary setback. It is gone forever.” Grantham’s analysis tends to be Malthusian. He asserts that resource costs are rising faster than economic growth, thereby depressing it. Again, I’m not convinced.

(3) Is it different this time? The latest issue of Barron’s includes an interview with Carmen Reinhart and Kenneth Rogoff, the co-authors of This Time Is Different (2009). It’s already a classic, and is widely regarded as providing definitive historical proof that recessions caused by excessive debt are likely to be followed by very weak recoveries. Indeed, Rogoff is quoted saying, “In the advanced economies, think of trend growth being a percentage point lower for a decade or more, possibly even two decades more.”

The Reinhart-Rogoff thesis has been challenged by a few other economists. A recent example is a FRB Cleveland working paper by Michael Bordo and Joseph Haubich titled, “Deep Recessions, Fast Recoveries, and Financial Crises: Evidence from the American Record.” They conclude that “in general recessions associated with financial crises are generally followed by rapid recoveries. We find three exceptions to this pattern: the recovery from the Great Contraction in the 1930s; the recovery after the recession of the early 1990s and the present recovery. The present recovery is strikingly more tepid than the 1990s. One factor we consider that may explain some of the slowness of this recovery is the moribund nature of residential investment, a variable that is usually a key predictor of recessions and recoveries.” In recent months, housing construction has been showing lots of signs of rebounding finally.

John Maynard Keynes famously said that “in the long run, we are all dead.” This certainly seems to be the unhappy multi-year projections of Gordon, Grantham, Reinhardt, and Rogoff (GGRR). Of course, Keynes was arguing that waiting for market forces to get us out of deep recessions was madness. He advocated stimulative fiscal policies to revive growth. GGRR share a fundamentally pessimistic view that there isn’t much that either market forces or policymakers can do to revive economic growth. The good old days are long gone, and we will be dead before they make a comeback.

Again, I’m not convinced. Indeed, bullish contrarians should be delighted by the growing body of very well-reasoned and well-documented academic studies suggesting that the future is dark, which has become the conventional wisdom. We all know that “this will all end badly.” The surprise might be that the future is bright. Could it be that we are in the early stages of yet another great bull market in stocks, but are too depressed to know it? ‘Tis the season to be jolly.

Earnings. Now let’s shift our temporal focus from the long term to the short term. Below, Joe provides an update on the latest consensus earnings estimates. The good news is that industry analysts may be ready to take a rest over the rest of the year after cutting their S&P 500 earnings expectations during October’s Q3 earnings season. They continued to lower their estimates for Q4 during the week of November 22, but they did less of that for the four quarters of next year (Fig. 5 and Fig. 6).

Their 2013 estimate edged down last week, but should start to stabilize around $113 through the end of the year and until the next earnings season during January (Fig. 7). For industry analysts, the long term is 2014, and their estimate for that year edged up to $127 last week, a projected increase of about 12%
y/y. So while forward earnings are showing signs of stalling recently, they should be moving to new highs again if 2014 estimates hold up (**Fig. 8**). (To receive updates of our **Earnings, Revenues, & Valuation: S&P 500/400/600**, click **.**)

**Movie.** “Lincoln” (+ + +) (**link**) is a great film about a great president. Directed by Steven Spielberg, it is based on the book by historian Doris Kearns Goodwin titled, “Team of Rivals: The Political Genius of Abraham Lincoln.” Torn between ending the civil war or ending slavery, Lincoln pursues the latter course. Daniel Day-Lewis deserves all the credit he has already received for his outstanding performance in the leading role. One of the insights of the film is that Congress was just as corrupt back then as it is now; politics was just as dirty.

**CALENDARS**

**US. Tues:** Durable Goods Orders Total & Ex Transportation -0.8%/-0.4%, Consumer Confidence 72.8, Richmond Fed Manufacturing Index -8, S&P Cash-Shiller HPI 0.4% m/m/2.9% y/y, FHFA House Price Index 0.5%, Bernanke, Lockhart. **Wed:** New Home Sales 387k, Beige Book, Pianallto, Tarullo. (Bloomberg estimates)

**Global. Tues:** China Leading Index, China Industrial Profits, UK GDP. **Wed:** Germany Headline & EU Harmonized CPI 2.0%/2.1% y/y, Japan Retail Trade. (DailyFX estimates)

**STRATEGY INDICATORS**

**S&P 500/400/600 Forward Earnings & Valuation (**link**):** Forward earnings rose for a second consecutive week for LargeCap and MidCap; SmallCap’s was up for the first time in three weeks. LargeCap’s forward earnings is 0.5% below its recent record high, MidCap’s is down 0.5%, and SmallCap’s is down 1.0%. Forecasts continue to fall for Q4, but analysts still expect single-digit percentage y/y growth--with LargeCap’s and SmallCap’s growth rising versus Q3 (to 4.7% from 1.3% and 7.9% from 6.9%, respectively) and MidCap’s slowing (to 6.0% from 10.1%). P/Es for all three rose for the first time in three weeks, but have toppled from mid-September’s multi-month highs: LargeCap’s to 12.5 from a 16-month high of 13.1, MidCap’s to 14.3 from a 17-month high of 14.8, SmallCap’s to 14.8 from a 14-month high of 15.6.

**S&P 500 Sectors Quarterly Earnings Outlook (**link**):** Earnings revisions for Q4 have lightened considerably since the Q3 earnings season began to wind down. Q4 consensus forecasts edged lower last week for 8/10 sectors and held steady for two sectors (Consumer Staples and Health Care). Since September 27, these forecasts have risen for two sectors and fallen for eight. The strongest sectors are Telecom and Energy, with their Q4 forecasts having risen 5.1% and 3.7% since September 27, respectively. Materials, Tech, and Industrials are the weakest; their Q4 forecasts have fallen 15.4%, 9.4%, and 7.2%, respectively. Before Hurricane Sandy hit the East Coast, the Q4 forecast for Financials had been up 2.3% (third best at the time). It’s down 6.1% since then, and now ranks 7/10--with a 3.6% decline since September 27.

**ECONOMIC INDICATORS**

**Dallas Fed Manufacturing Index (**link**):** Dallas region activity has been stalling as the company outlook worsens; November marked its first negative reading since April. The production index, a key measure of manufacturing conditions, remained positive in November for a twelfth month, though it has slipped far since the June cyclical peak (to 1.7 from 15.5). General business activity index was back in negative territory (-2.8), fluctuating around zero the past four months. The new orders index improved to 0.4 from a recent low of -4.5; shipments were also near zero (0.9). Labor indicators were mixed:
Employment rose (from 5.2 to 6.7); hours worked deteriorated (to -7.1, a three-year low). The future general business activity index (-5.3) plunged below zero; indexes for future manufacturing activity remained well above despite declines.

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