MAJOR TOPICS: Another Lost Decade Ahead?

BULLET POINTS: (1) Losing decades. (2) Fed ready to lose half a decade. (3) Carmen Reinhart examines history of lost decades. (4) New Normal normally happens after financial crises. (5) It was the best of times for Emerging Markets. (6) Stocks may be the new bonds. (7) Growth and Value reunited. (8) A stylized model of the business cycle. (9) Inventories have plenty of upside. (10) Small business owners need customers, not credit. (11) Retailers may have some upside.

NOTICE: Our Morning Briefings are now available on FactSet.

I) STRATEGY: Temps perdu? Begun in 1909, Marcel Proust’s À La Recherche du Temps Perdu consists of seven volumes totaling around 3,200 pages (about 4,300 in The Modern Library's translation) and featuring more than 2,000 characters. Graham Greene called Proust the “greatest novelist of the 20th century,” and W. Somerset Maugham called the novel the “greatest fiction to date.” Proust died before he was able to complete his revision of the drafts and proofs of the final volumes, the last three of which were published posthumously and edited by his brother, Robert. If you don’t have the time to read it, Carla Bruni (Sarkozy’s wife) recorded a song titled Le Temps Perdu.

Will we lose another decade? Japan seems to have lost the last two decades and is working on a third one now. In the US, the DJIA has been lost for the past 10 years, generating a slightly negative return excluding dividends. Bonds have outperformed stocks for a few decades. In his insightful op-ed for the 8/31 FT, Bill Miller wrote: “Long-term Treasuries, as measured by the Barclays Capital Long Term Treasury Bond total return index, have beaten equities as measured by the S&P 500 in the year to date, and in the 3-, 5-, 10-, 15-, and 20-year time frames. It’s a tie at 25 years. More than 20 years of superior returns over stocks in an asset guaranteed by the US government seems to be sufficient to drive through the heart of the idea that you want stocks for the long term.”

Will the current decade get lost as well? Fed officials seem to have given up on about the first half of it. The New Normal was more or less endorsed in the minutes of the June 22-23 meeting of the FOMC: “Participants generally anticipated that, in light of the severity of the economic downturn, it would take some time for the economy to converge fully to its longer run path as characterized by sustainable rates of output growth, unemployment, and inflation consistent with participants’ interpretation of the Federal Reserve’s dual objectives; most expected the convergence process to take no more than five to six years.”
Pimco’s “New Normal” forecast has gained credibility based on some recent work by Carmen and Vincent Reinhart. Indeed, at the Fed’s annual conference at Jackson Hole last month, Carmen presented their joint research study on the 10-year after effects of major financial crises. (See link below.) In it, they examine 15 severe post-World War II financial crises in advanced and emerging economies and three synchronous global contractions—the Great Contraction after the 1929 stock market crash, the 1973 oil shock, and the 2007 US subprime collapse. They summarize their main results as follows:

1) Real per capita GDP growth rates are significantly lower during the decade following severe financial crises and the synchronous worldwide shocks. The median post-financial crisis GDP growth decline in advanced economies is about 1%.

2) In the ten-year window following severe financial crises, unemployment rates are significantly higher than in the decade that preceded the crisis. The rise in unemployment is most marked for the five advanced economies, where the median unemployment rate is about 5 percentage points higher. In ten of the 15 post-crisis episodes, unemployment has never fallen back to its pre-crisis level, not in the decade that followed nor through end-2009.

3) Real housing prices for the full period is available for 10 of the 15 financial crisis episodes. For this group, over an 11-year period (encompassing the crisis year and the decade that followed), about 90% of the observations show real house prices below their level the year before the crisis.

Well, isn’t that depressing? Why not just buy 10-year Treasury bonds yielding 2.5%-3.0% and come back in 10 years? Well, for starters, the past decade wasn’t all that bad for all stocks. I asked Joe to sort the 10-year returns (excluding dividends) of the major stock markets around the world. Over this period, the MSCI Emerging Markets Index is up 140.2%, led by Latin America with a spectacular gain of 302.0%. Emerging Asia was up by 113.1%. The DJIA was down 5.7%. The S&P 500 was down 24.4%, about half as bad as the Nikkei’s loss of 42.4%. MSCI Europe was down 27.5%, and MSCI EAFE was down 28.9%.

Past performance is no guarantee of future returns. A contrarian perspective suggests that stocks are overdue to outperform bonds. Or maybe, just maybe, stocks are about to become the new bonds! Have you noticed all the chatter over the past two days about technology stocks like Microsoft and Cisco finally increasing or actually paying some dividends? Doug MacKay, my former colleague at Oak Associates, and now proprietor of his own asset management firm, observes: “I suspect that more companies will do this type of thing and the result of it could help draw money away from the bubble in bonds and actually help stock prices in the future rather than hurt them under the common bearish interpretation that paying a dividend might mean that a company's growth years are behind it.”

No wonder that investors no longer see much difference between Growth and Value stocks. The forward P/E spread between the two narrowed dramatically over the past four years. During July 2000, Growth sold at a record high P/E of 40.9, while Value was only 15.3. Last month, Growth was down to 13.0, while Value was 11.2.
Tuesday’s FT reported on a JP Morgan study of ETFs of dividend yielding stocks, preferred shares, and convertibles. Since the beginning of 2009 net inflows have totaled more than $12bn. In August, $1.36bn moved into the sector—a monthly record.

* Lost Decade?: How has the S&P 500 performed compared to the rest of the world in the past ten years? It has been a lost decade. The S&P 500 is down 24.4% in the past ten years and ranks as the fourth worst performer among the 34 stock markets with data. The S&P 500 is also down 5.9% in the past two years, ranking 29th among the 38 stock markets. The S&P 500 is doing slightly better so far in 2010, ranking 27/38 and is up 0.6%. Emerging markets have beaten developed markets quite easily over these time periods too. The best performers in the past ten years: Peru (+1027.4%), Venezuela (+803.0), Indonesia (+630.8), Russia (+605.5), and Pakistan (+525.0).

* S&P 500 Growth vs. Value: Will Growth beat Value again in 2010? It had been a close race, but Growth is pulling ahead of Value now. Six of the nine S&P and Russell Growth indexes are ahead of Value so far in 2010, and seven of the nine Growth indexes are ahead of Value so far in Q3. The Growth indexes had generally outperformed Value in 2009 in a stunning recovery from the ashes of 2008. Value earnings gain beat Growth in 2009 due to a recovery from the Financials sector’s write-offs in 2008 and is expected to outpace Growth again in 2010. Growth forward earnings up again in August after falling in January for the first time in nine months, but Value earnings up for a fifteenth straight month. 12-month forward earnings growth for Value down to 25.0% in August from 29.6%, and Growth down to 15.4% from 16.5%. Forward P/E ratio for Growth down to 13.0 from 13.2, and Value fell to 11.2 from 11.4. Growth P/E rose to a 16.0% premium to Value from 13.6%, and is up from a record low 6.5% discount in October 2008. Growth PEG ratio (1.05) down from a 50-month high of 1.44 in September 2009, and Value PEG (1.06) down from a record high of 1.81 in February. Value PEG at an unusual premium to Growth PEG since late 2006, but at just 0.01 points now.

* S&P 500 LargeCap vs. SMidCap: Which Russell and S&P indexes are leading the way so far in 2010? They are all up again so far in 2010 after rising at a double-digit percentage pace in 2009, but MidCaps and then SmallCaps are ahead of LargeCaps. Here’s the 2010 score: S&P 400 MidCap (6.9%), Russell MidCap (6.8), S&P 600 SmallCap (4.5), Russell SmallCap 2000 (4.3), Russell 1000 LargeCap (1.0), and S&P 500 LargeCap (0.6). Twenty-four of the 30 sectors are up so far in 2010, down from the mid-April peak when 27/30 sectors were up. All 30 sectors rose in 2009 and all 30 sectors had fallen in 2008. Valuation mostly edged down for the three indexes last week, but is up from their recent cyclical lows in the summer. LargeCap valuation steady at 12.0 last week, MidCap down to 14.1 from 14.2, and SmallCap down to 14.7 from 15.0. LargeCap forward earnings is up in 71 of the past 74 weeks, but forward earnings momentum is down to 30.1% y/y from a record high of 38.2% in May, and forward earnings remains 11.2% below its record high in October 2007. MidCap forward earnings is 7.2% below its record high in July 2007, and SmallCap is 11.2% below its record high in July 2007.

* S&P 500 Technicals: How’s the technical picture looking for the S&P 500 and its 10 sectors? It’s better with the S&P 500 up 9.6% from the 2010 low of July 2 and no longer in a Death Cross; but we would be happier if it stayed above its 1025-1125 trading range and its 200-dma. At Tuesday’s close, the S&P 500 was trading 2.8% above its 50-dma, and 0.4% above its 200-dma, near the best readings since early August. The 50-dma is up sharply from a low of -8.9% on June 7, and the 200-dma is up from -8.2% on July 2. The S&P 500 traded above its 50-dma again on September 2, and moved above its 200-dma on September 13. For the S&P 500 to be in a Death Cross, its 50-dma must be lower than
the 200-dma, and both averages must be falling. It left the Death Cross on September 2 when the daily change in the 50-dma turned positive, but isn’t in a Golden Cross yet because the 50-dma is still 2.3% below the 200-dma. At Tuesday’s close, six of the 10 sectors were trading above their 200-dma, up from 2/10 on August 31. All 10 sectors were trading above their 50-dma, up from 2/10 on August 26. Eight of the 10 sectors have a rising 200-dma, and all 10 have a rising 50-dma. Here’s how the S&P 500 and its sectors are doing against their 200-dma and its direction: Telecommunication Services (+8.7%, rising), Utilities (4.1, rising), Materials (3.7, rising), Consumer Discretionary (3.6, rising), Industrials (2.6, rising), Consumer Staples (2.1, rising), S&P 500 (0.4, rising), Financials (-1.2, rising), Information Technology (-1.7, rising), Health Care (-2.0, falling), and Energy (-2.2, falling).

* **Fundamental Stock Market Indicator (weekly):** Is our Fundamental Stock Market Indicator (FSMI) still a good coincident indicator for the S&P 500? We think so. Our FSMI is the average of the Weekly Consumer Comfort Index (WCCI) and our Boom-Bust Barometer (BBB). It increased for the fifth straight week, jumping 3.1% during the week ending September 4 and 5.7% over the five-week period. That more than reversed the 4.8% drop during the previous three-week period. The BBB increased for the third straight week, up 2.7% during the first week of September, following gains of 1.3% and 0.8% the prior two weeks. It had dropped 3.9% over the prior three-week period when jobless claims jumped above 500,000. Now claims are down to 451,000. The BBB remains at a relatively high level. The WCCI was unchanged during the latest week, but still up 7 points the past 6 weeks, nearly reversing its recent 9 point drop. The FSMI remains volatile just below highs for this year.

* **Stock Market Sentiment Indicators:** Investors Intelligence Bull/Bear Ratio rose for the second straight week to 1.18 this week, after declining from 1.52 to 0.78 over the prior three-week period. The 0.78 reading was the lowest since March 24, 2009. Bullish sentiment rose to 36.7% from 29.4% two weeks ago, which was the least bulls since March of last year. Bearish sentiment fell to 31.1% from 37.7% over the two-week period, which was the most bears since late March 2009. The percentage of advisors predicting a correction fell to 32.2% this week after rising from 32.9% to 34.5% the previous week. The AAII Bull Ratio increased for the second straight week to 58.1% during the week ending September 10 from 29.5% two weeks ago. Bullish sentiment rose from 20.7% to 43.9% over the two week period, while bearish sentiment fell from 49.5% to 31.6%. In the futures pits, large speculators are more bearish on the S&P 500 than they are on the Nasdaq. S&P 500 Put-Call Ratio, based on 4-wa, fell for the fourth straight week, from 1.85 to 1.66 over the four-week period.

**II) US ECONOMY:** Recessions are usually caused by credit crunches; when credit conditions tighten unexpectedly and rapidly, consumer and business spending decline. The downturn is then exacerbated by inventory liquidation, which can only happen if production falls below sales. This simple progression makes a double dip a rare occurrence following a recession since the monetary authority tends to ease credit conditions dramatically during recessions. In addition, inventory liquidation tends to exaggerate the weakness of the economy. Indeed, it tends to end once businesses realize that they may have cut inventories too much as sales stop falling and start improving in response to easier monetary policies that are usually supplemented with stimulative fiscal policies. The resulting economic recovery then gets an initial boost from inventory restocking.
This stylized, old-normal business cycle mechanism seems to be in gear currently, notwithstanding the rants and raves of the Double Dip Doomsayers. Let’s review the latest data:

(1) Manufacturing and trade sales in the US have been on an upward slope since the latest cyclical trough during March 2009. They stalled in May and June, but edged up in July.

(2) Excluding petroleum shipments, business sales rose to a new cyclical high in July of $11.6tn (saar). That’s up 9.8% from last year’s low, and down 6.0% from the record high during July 2008, matching the best pace since October 2008.

(3) Excluding petroleum, both shipments of manufacturers and sales of wholesalers rose to new cyclical highs in July. Retail sales excluding gasoline and heating oil sales peaked during April of this year, and have stalled since then.

(4) Business inventories hit a cyclical low last September and have increased nine of the past ten months through July. July’s 1.0% increase was very strong, bringing inventory levels back up to $1.38tn. However, that was only 4.0% off last year’s bottom, and still 11.1% below the record level of $1.55tn during August 2008. During July, inventories rose 1.0% at factories, 1.3% at wholesalers, and 0.7% at retailers.

Figure 38 in our *High Frequency Economic Indicators* handbook shows the relationship between business inventories and short-term business borrowing, which is the sum of commercial and industrial loans and nonfinancial commercial paper. It certainly explains why banks aren’t lending to businesses. They don’t need the money to finance inventories at this point of the business cycle. While inventories are recovering, they remain relatively depressed. Furthermore, the inventory cycle tends to lead the borrowing cycle.

While data are available on inventories held by different industries, none are available by size of companies. We do know from the ADP monthly survey that small businesses with fewer than 50 employees accounted for 45% of private sector payrolls during August. We know from the monthly survey conducted by the National Federation of Independent Business that small owners remain depressed, but not so much about the availability of credit as the weakness in their sales. A net 12% reported loans harder to get than in their last attempt, one point lower than July. Overall, 91% of the owners reported all their credit needs met or they did not want to borrow, unchanged from July. Only 4% cited financing as their top business problem.

“What businesses need are customers, giving them a reason to hire and make capital expenditures and then they may have the need to borrow to support those activities,” said Bill Dunkelberg, NFIB’s chief economist. “Washington doesn't seem to understand this. Their proposals to improve the economy typically focus on easing credit conditions or giving businesses incentives to spend. These policies are unlikely to help most small businesses whose main problems remain poor sales and uncertainty over the economy.”

*US Business Sales:* How are business sales? They were back up in July after taking a breather in May and June. Manufacturing & Trade Sales (MTS) rose 0.7% in July, following declines of 0.5% and 1.2% in June and May, respectively, the first losses since
Q1-2009. MTS turned positive on a y/y basis for the first time in a year during November 2009, and rose 9.2% y/y in July, not far from April’s 13.1% rate, which was the strongest performance since the spring of 1984. Excluding petroleum products, sales were up 7.9% y/y, holding around 5½-year highs. Inflation-adjusted MTS rose for the fourth time in five months, up 0.5% in June and 1.7% over the five-month period. These sales were 5.8% above June 2009 low. The inventories-to-sales ratios remain very low, with the nominal ratio ticking up to 1.26 in July from a record low of 1.23 in April, and the real ratio edging up to 1.33 in May from a two-year low of 1.32 in April.

* US Retail Sales: Will the consumer continue to spend? We think so, though spending is likely to remain subdued until job growth improves. Retail sales rose 0.4% in August, following a 0.3% gain in July. That followed back-to-back declines of 0.3% and 1.0% the prior two months. Special factors boosted sales during Q1, borrowing from Q2 sales. Now Q3 sales are on the rise, but at a slower pace than at the beginning of the year. August sales were 8.4% above December 2008 low and only 4.3% below its record high in the fall of 2007. Eight of the 13 major categories showed gains last month, led by gasoline service stations, and grocery and clothing stores.

* US Business Inventories: Will inventories boost real GDP again during Q3? Maybe. Finished goods inventories at the factories and among distributors rose for the seventh straight month in July, jumping 1.0%, the biggest one-month gain since July 2008. It compares with an average monthly gain of 0.8% during Q2. The inventories-to-sales ratio remains low, which implies continued inventory rebuilding. Nonfarm business inventories contributed 2.57pps to Q1 real GDP growth and 0.55pps to Q2. It could add to growth again this quarter, but still too early to tell.

* NFIB Small Business Survey: What’s the message from small business owners? Their business remains depressed. “Small business owners are expecting sub-par growth in the second half of 2010,” said Bill Dunkelberg, NFIB’s chief economist. “Consumers are pessimistic, business owners are pessimistic and Washington’s leadership has been unable to inspire any confidence in the future.” The Small Business Optimism Index (SBOI) rose for the first time in three months, edging just 0.7 points in August to 88.8, only 8.7 points above its all-time low.

**III) FOCUS ON S&P 500 DISCRETIONARY RETAILING INDUSTRY**

(overweight): The stock price index for the overweight rated Consumer Discretionary Retailing industry is down 14.5% from its bull market high in late April, but has risen 3.5% ytd and is trading back up to its rising 200-dma again. Forward earnings have been edging out of a V-shaped recovery recently, but rose for a seventeenth straight month in August to a 32-month high. Consensus annual earnings forecasts are increasing for the first time since 2004, but the estimates for 2010 and 2011 edged lower again in August. Analysts expect earnings to increase 19.7% in 2010 and 15.4% in 2011 after falling for three straight years through 2009. The forward P/E rose to 14.1 in August from a 17-month low of 13.7, and is trading at a higher 18% premium to the market. The profit margin was up for a fourth straight quarter in Q1 to a seven-quarter high of 4.1% from 3.9%, and should continue to rise in Q2.

* Apparel Retail (overweight): Overweight rated Apparel Retail’s stock price index is down 18.0% from a 10-year high in late April, but is the fourth best performing Retailer with a gain of 10.1% ytd. Forward earnings fell 0.3% m/m in August from a record high in July, but is up 22.6% ytd. Analysts expect earnings to rise 22.6% in 2010 and 11.1% in 2011, but lowered their earnings forecasts slightly again in August. NERI down to 0.7% in August from 18.8% and from a record high of 61.3% in May, but is fifth highest
among the 14 Retailers, and positive for fifteen straight months. Valuation down to a 17-month low of 12.2, and at a lower 1% premium to the market. The profit margin was up to a five-year high of 6.1% in Q1.

* Department Stores (overweight): The stock price index for overweight rated Department Stores is down 23.2% from its bull market high in late April and has fallen 5.4% ytd, but is up 131.6% from an 18-year low in November 2008. The earnings recovery appears to be slowing, and forward earnings fell in August for the first time in 17 months. Consensus forecasts for 2010 and 2011 also fell again in August, and analysts now expect earnings to rise 25.1% in 2010 and 15.3% in 2011. The forward P/E rose to 11.9 from a 20-month low of 11.7 in July, but is now trading at a higher 1% discount to the market. NERI was down to -14.3% in August from 17.7% and negative for the first time in 16 months, and fell to ninth best among the 14 Retailers.

* General Merchandise Stores (overweight): Overweight rated General Merchandise Stores is down 7.4% from its bull market high in late April, but is up 14.2% ytd, and is the third best performer among the 14 Retailers. It also still has a rising 200-dma, one of just six Retail industries meeting that standard. Forward earnings usually rises steadily for this Retailer, and was at a record high again in August. However, consensus forecasts for 2010 and 2011 were mixed in August, and analysts now expect earnings to rise 18.8% and 13.0%, respectively, versus a gain of 13.4% in 2009. NERI was down to -0.7% in August from 19.7% and a record high of 59.8% in May and negative for the first time in 17 months, but was still sixth best among the retailing industries. P/E up to 12.5 from a 17-month low of 12.0 in July, but relatively steady since the bull market began. It’s trading at an unusually low 5% premium to the market, but is improving recently.

* Hypermarkets & Super Centers (underweight): The stock price index for underweight rated Hypermarkets & Super Centers has been relatively steady since 2008, but is still down 1.6% ytd and trading below its now falling 200-dma. Forward earnings up to a record high again in August, but is probably rising too slowly during this bull market for investors who are seeking outsized returns. Analysts expect earnings growth of just 10.1% in 2010 and 9.6% in 2011, and raised their consensus forecasts slightly for both years during August. Valuation steady at a record low of 12.8 in August, and was at a relatively low 6% premium to the market. The profit margin was steady at 3.1% in Q1, but is still among the lowest of the Retailers.

* Specialty Stores (market weight): Market weight rated Specialty Stores is down 17.0% ytd, and is the worst performer of these Retailers. It’s down 23.1% from its bull market high in late April and trades 11% below its falling 200-dma, among the worst readings for the Retailers. This index is heavily weighted with economically sensitive office supply retailers and the earnings recovery has been slower than for other Retailers. Earnings are expected to rebound 26.5% in 2010 and rise 22.8% in 2011 after falling for two straight years through 2009. NERI fell to 6.9% in August from 12.0%, but was third highest among the Retailers. The industry’s P/E was steady at 14.4, but is still trading at a relatively high 20% premium to the market. The profit margin rose to a six-quarter high of 2.8% in Q1, up from a record low of 2.4% in Q3-2009.

IV) UPDATES & LINKS: We have updated High Frequency Economic Indicators, Analyst's Handbook: Retailers, Valuation Briefing Book, and Investment Style Guide on our website. Questions, comments, downloading problems: vardeni_requests@yardeni.com or call 480-664-1333. Morning Briefing with links, Printer Friendly Morning Briefing (PDF format).
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