Topical Study #77:
Half Full: Charts for Optimists

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- Introduction -

This chart book includes 16 charts that we believe are among the ones that make the most optimistic case for the economy and the stock market. We have used most of them in the past in our Morning Briefings and several are regularly updated in our Strategist's Handbook. Let's review them:

(1) Figures 1 and 2 show that financial and geopolitical crises usually tend to be bearish for the S&P 500 for a short time. However, more often than not, they present great buying opportunities. That's because worst-case scenarios, which become credible in the thick of the crises, rarely unfold. So relief rallies tend to follow the crises selloffs. Also the Fed tends to cut the federal funds rate and provide lots of liquidity in reaction to crises, which is the main reason why worst-case scenarios are usually averted.

(2) The Fed has responded to the latest credit crisis by lowering the federal funds rate from 5-1/4% to 2-1/4% (Figure 2). During March, the Fed shocked and awed the financial markets by introducing innovative new tools for injecting liquidity into the credit markets. On March 7, the Federal Reserve announced that it would initiate a series of term repurchase transactions that would facilitate funding of primary dealers' assets and that the volume of lending through the Term Auction Facility (TAF) would be increased. On March 11, the Fed introduced a Term Securities Lending Facility (TSLF) under which it would lend Treasury securities to primary dealers for longer terms than in the existing program and based on a broader range of collateral. On March 16, the Federal Reserve announced the creation of a lending facility to improve the ability of primary dealers to provide financing to participants in securitization markets. As a result, as shown in Figure 3, the Fed's outright holdings of US Treasury securities declined from $741 billion at the start of the year to $549 billion at the end of April.

(3) The Bush administration has started to send "economic stimulus payments" to taxpayers with the hope that they will revive consumer spending and overall economic growth. Figure 4 shows that a similar tax rebate in 2001 boosted real consumer spending by 7% during Q4-2001.

(4) Figures 5 and 6 show that liquid assets--measured as the sum of savings deposits (including money market deposit accounts) and money market mutual fund shares held by individuals and institutions--rose to a record $7.3 trillion in mid-April, up $1.2 trillion y/y. This increase was led by a $770 billion y/y increase in money market mutual fund shares held by institutions, A significant portion of these funds may have been accumulated by institutional investors to buy distressed assets when they decide that the time is right. When they do so, other investors may conclude that the time is right to buy stocks.

(5) Following the Fed's "shock and awe" actions during March, some investors seem to have concluded that now is the time to become less risk averse. Treasury yields have increased since then and credit quality bond yield spreads have narrowed, as shown in Figure 7. The S&P 500 Financials stock price index may also be bottoming, though it's too soon to be certain as shown in Figure 8. The stock market usually bottoms at the same time as Financials, which may have done so in March.

(6) Among the most widely cited risks to the economy is that the credit crisis will worsen if home prices continue to fall because they are so overvalued. Figure 9 shows the ratio of the S&P Case-Shiller National Home Price Index to national personal income on a quarterly basis. The average ratio is 1.20 from Q1-1987 through Q4-2007. Over this period, it fell to a record low of 1.00 during Q1-1998. It rose to a record high of 1.49 during Q3-2005. At the end of last year, it was back to normal, i.e., the average ratio. According to this measure, homes became increasingly undervalued during the first seven years of the 1990s. They returned to fairly valued by late 2002. They became increasingly overvalued through 2005. Now they are back to fairly valued.

(7) Contrary to popular belief, most of American household wealth isn't in real estate. Figure 10 shows that they have more in pension fund reserves, i.e., $12.8 trillion vs. $9.6 trillion in owners' equity in household real estate at the end of last year. They have another $10.4 trillion in corporate equities directly held plus mutual fund shares. Their IRAs, which are not included in pension fund reserves, totaled $4.2 trillion at the end of 2006.

(8) Figure 11 shows that the forward earnings of the S&P 500 peaked during the week of October 19, 2007 and was down only 4.5% by the end of April. During the previous profits recession at the beginning of the decade, the peak-to-trough decline was 17.5%. Back then, the peak-to-trough declines for the forward earnings of S&P 400 MidCaps and S&P 600 SmallCaps were 15.9% and 22.4%, respectively. So far, forward earnings have stalled for these two composites near last year's record highs. In other words, the profits recession isn't as broad this time, and it is almost entirely attributable to mark-to-market losses among Financials, losses that may be partially reversed later this year or in 2009.

(9) Stock valuation multiples have declined since the beginning of the decade, and are now relatively cheap. The P/Es of the S&P 500, 400, and 600 composite averages are in the low-to-mid teens (Figure 12).

(10) On an aggregate basis, rather than per share, S&P 500 earnings continued to rise to a record high of $697 billion in April, excluding the Financials sector, which fell by $75 billion from August 2007 through April of this year (Figure 13).

(11) While Financials aren't likely to boost S&P 500 earnings in the future as they did over the past several years during the heyday of securitization and structured derivatives, profits from overseas are likely to provide higher octane to profitability. Indeed, profits from abroad accounted for a record 33.3% of total corporate profits during Q4-2007 (Figure 14).

(12) Global economic growth may slow as a result of higher energy and food prices, but should remain resilient. Emerging economies have emerged: They are now big enough and growing fast enough to have a significant impact on global economic activity. Indeed, since the beginning of the decade through January of this year, OECD-30 industrial production is up 16.7%, while the output of the OECD-30 plus six major nonmembers (Brazil, China, India, Indonesia, Russia, and South Africa) is up 38.1% (Figure 15). There is plenty of global liquidity available to finance growth. International nongold reserves totaled $6.2 trillion in January, with emerging economies accounting for $4.7 trillion of this total (Figure 16). Of course, several emerging economies actually benefit from high food and energy prices, and should continue to grow rapidly.

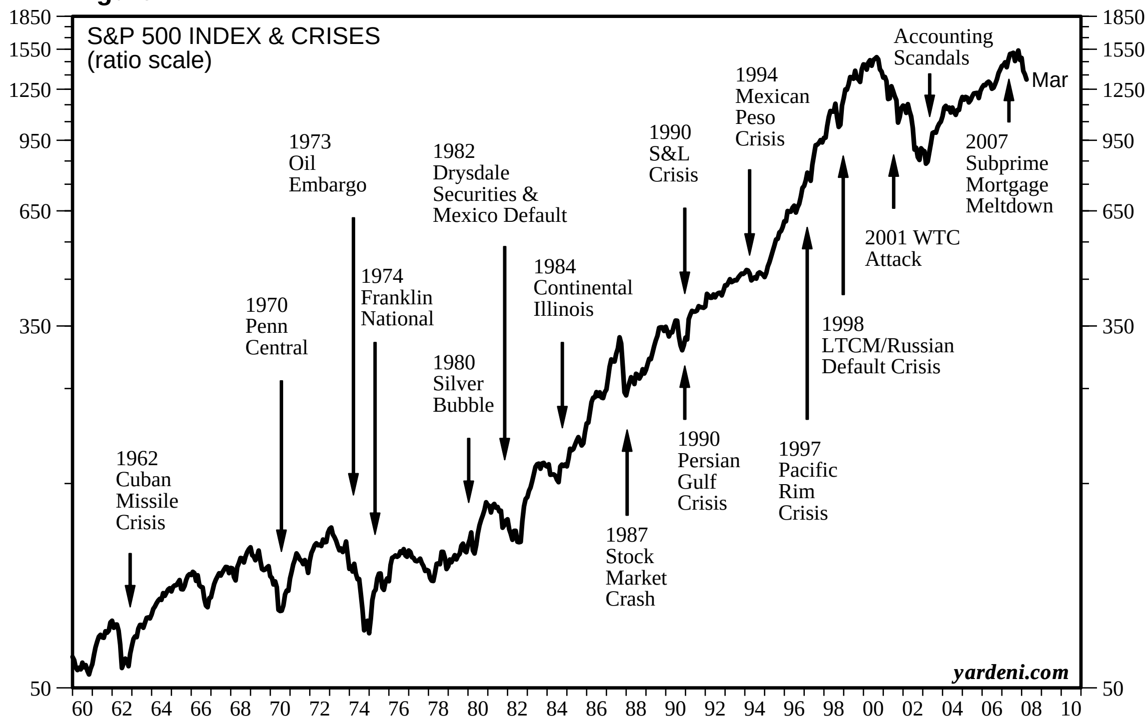
Needless to say, there are two sides to every story. The other side of this story is that the glass is half empty. The credit crisis may be abating, but it isn't over. Much depends on the performance of the economy. If the recession is long and deep instead of short and shallow, notwithstanding the monetary and fiscal stimulus, then the credit crisis will worsen again. There would be more delinquencies, foreclosures, and bankruptcies in this scenario, which will have a negative feedback effect on the real economy. Home prices would most likely continue to fall in this alternative scenario. High food and energy prices are sapping the real purchasing power of consumers not just in the United States, but around the world. For now, the Half Full scenario is the one that we think will prevail.

* * *

- Financial Crises -

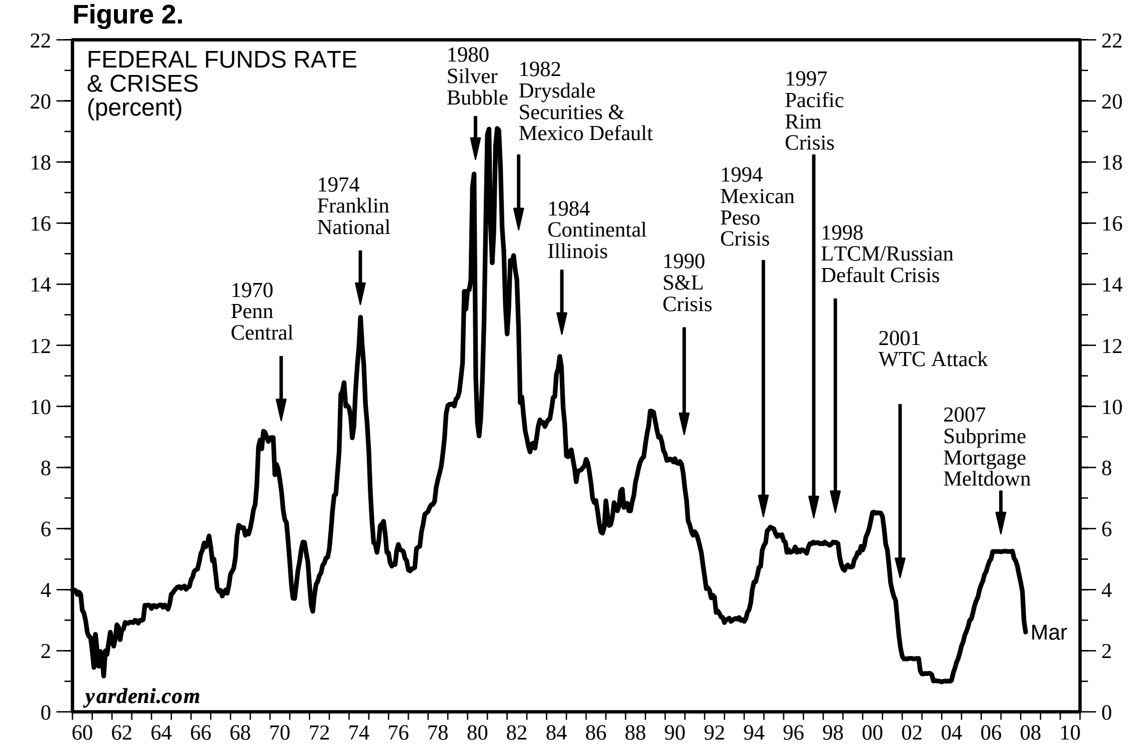
Are financial crises bullish? They frequently have been in the past as long as they don't cause a recession. They've been bullish because they often mark the end of Fed tightening and the beginning of an easing phase in monetary policy.

Figure 1.



Source: Standard & Poor's Corporation.

Figure 2.



Source: Board of Governors of the Federal Reserve System.

- Fiscal & Monetary Policies -

Figure 3.

The Fed has injected a great deal of liquidity into financial markets by agreeing to accept collateral from banks and nonbanks in exchange for its Treasuries on a short-term basis.

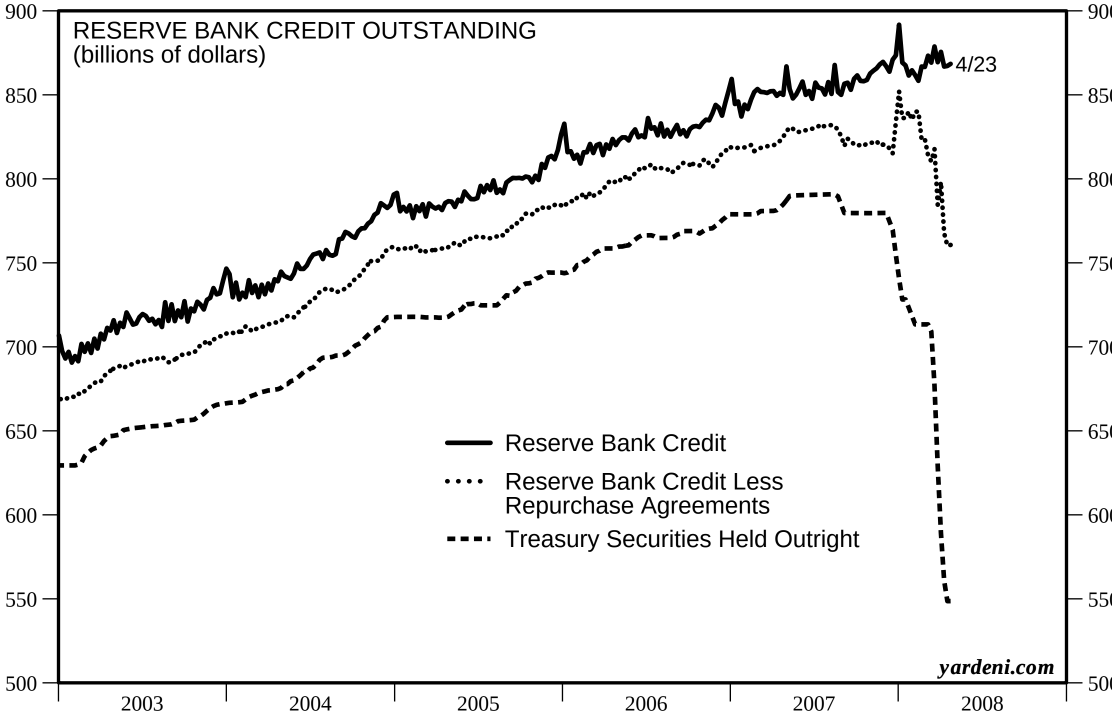
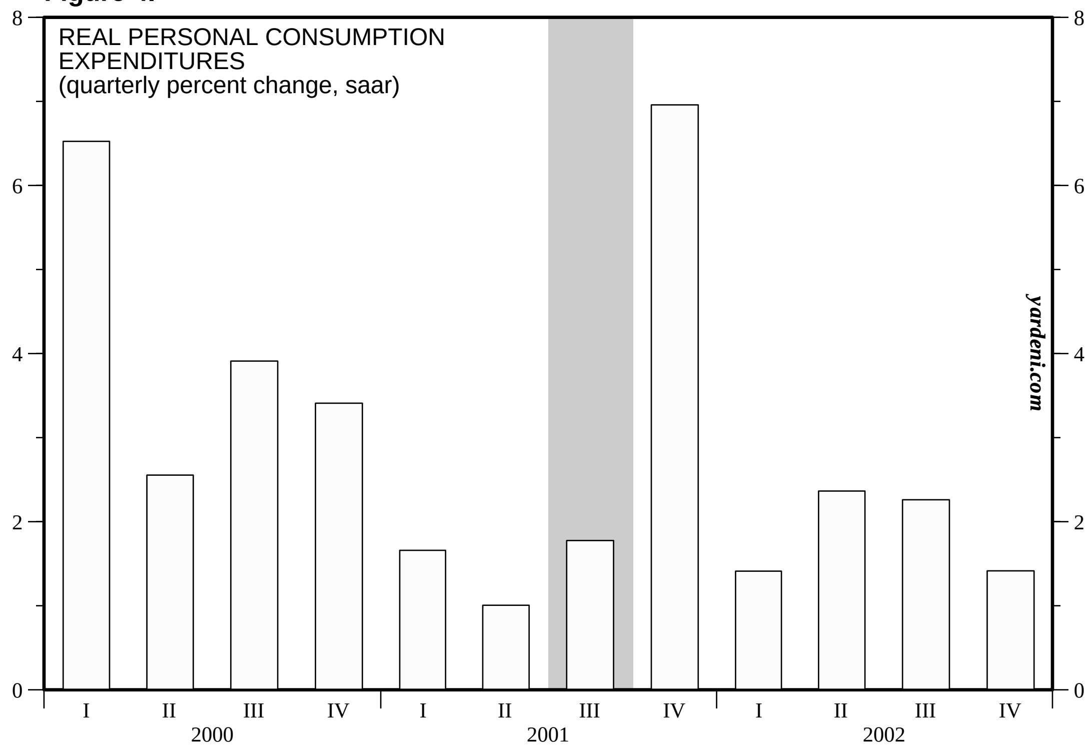


Figure 4.

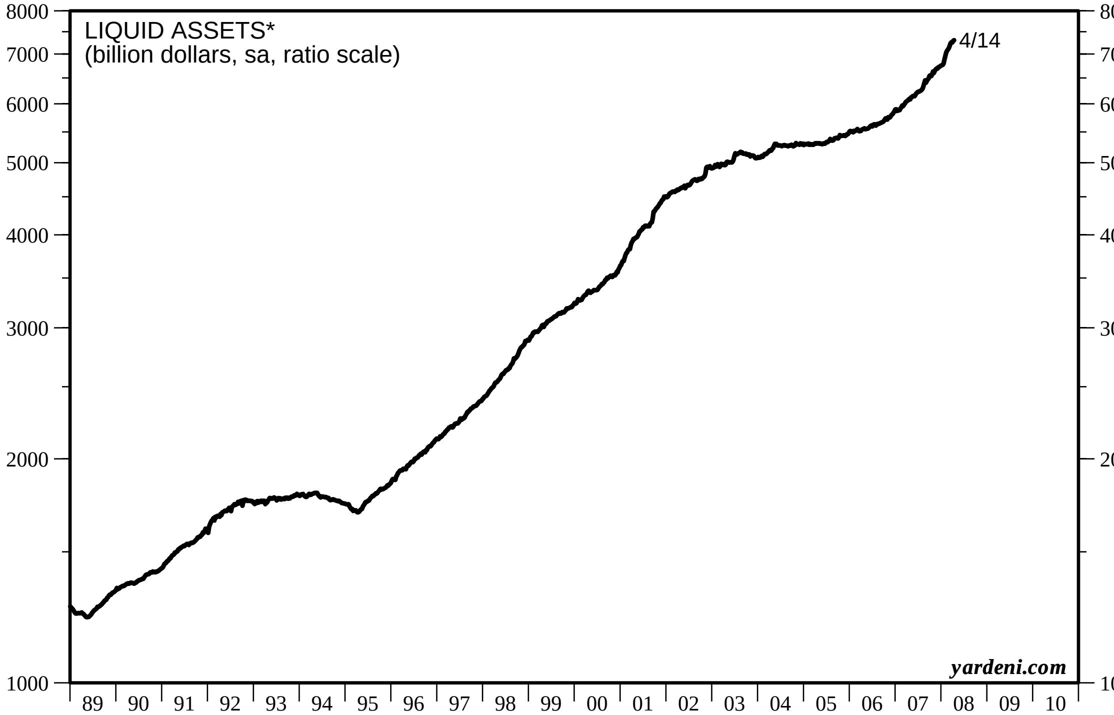
Tax rebates provided a big boost to Q4-2001 consumer spending. "Economic stimulus payments" likely to boost Q2-2008 and Q3-2008.



* Shaded area indicates 2001 tax rebates.
Source: US Department of Commerce, Bureau of Economic Analysis.

- Liquid Assets -

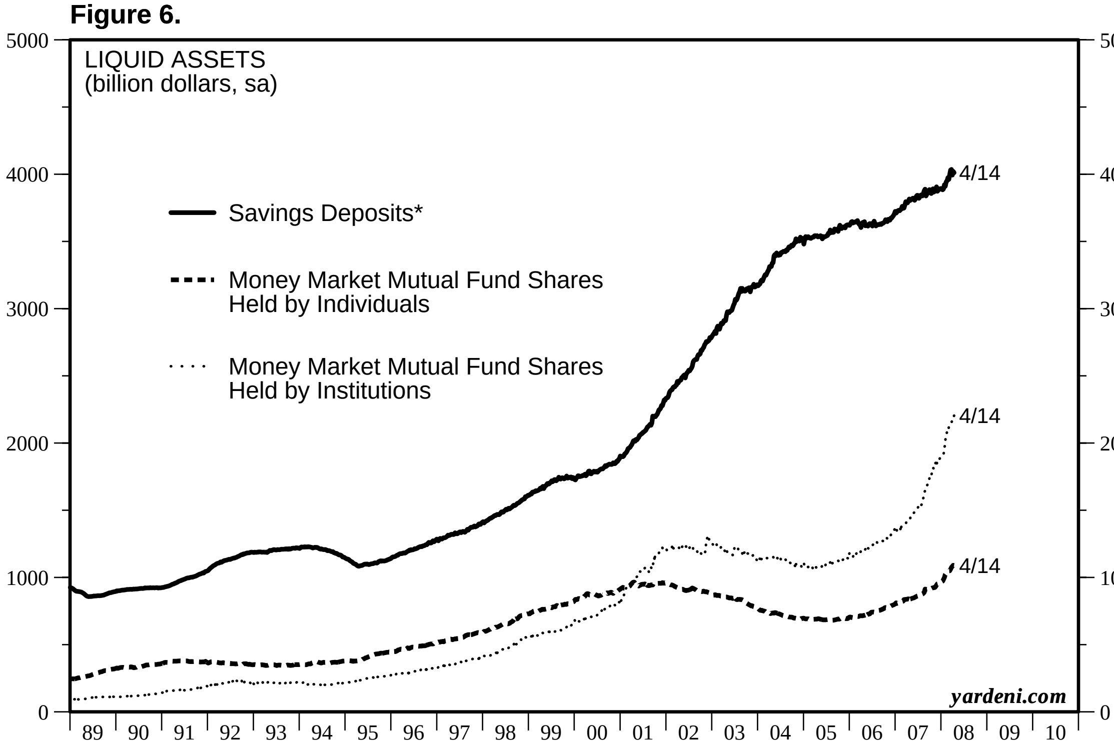
Figure 5.



* Total savings deposits (including money market deposit accounts) plus total money market mutual funds held by individuals & institutions.
Source: Board of Governors of the Federal Reserve System.

Liquid assets at record high of $7.3 trillion, up $1.2 trillion y/y, led by MMMF held by institutions.

Figure 6.

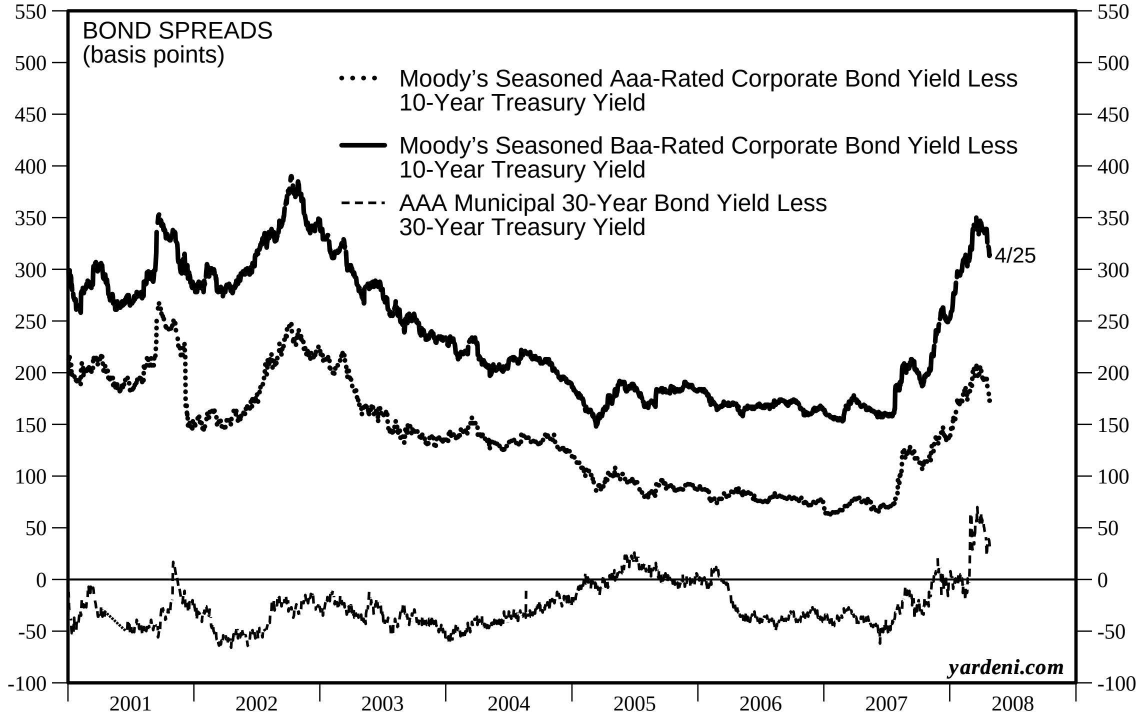


* Including money market deposit accounts.
Source: Board of Governors of the Federal Reserve System.

- Credit Quality & Financials -

Credit quality bond yield spreads may have peaked in mid-March.

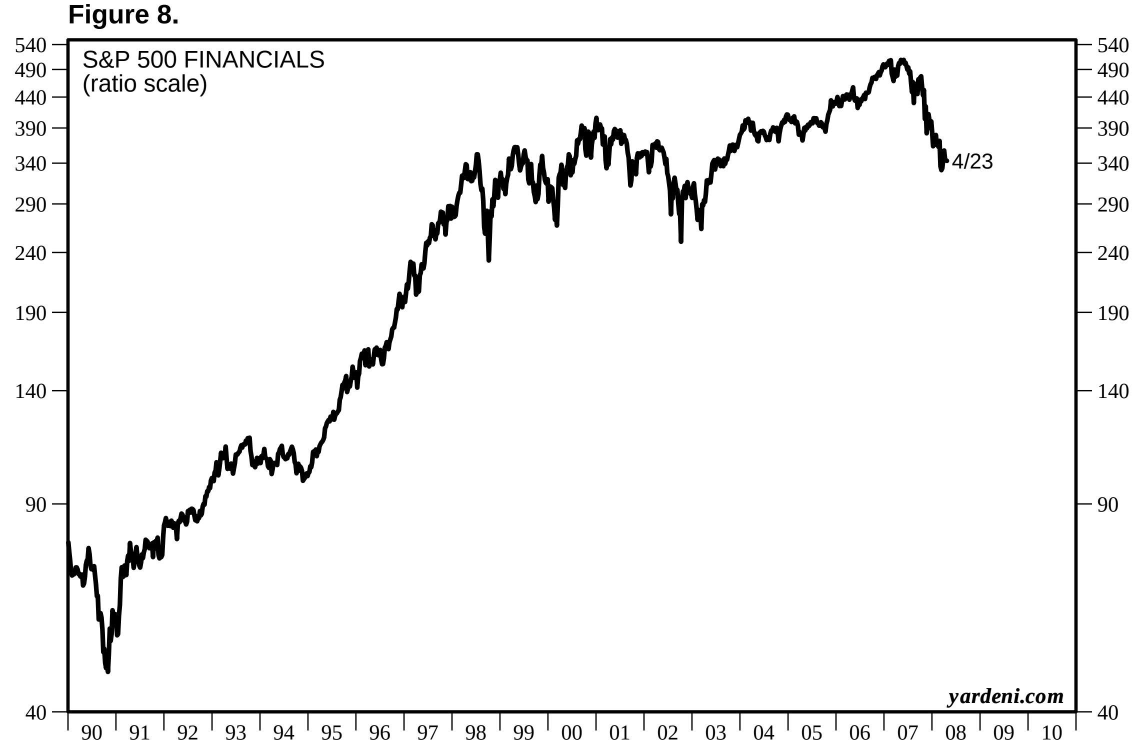
Figure 7.



Source: Board of Governors of the Federal Reserve System.

Financials may be bottoming.

Figure 8.

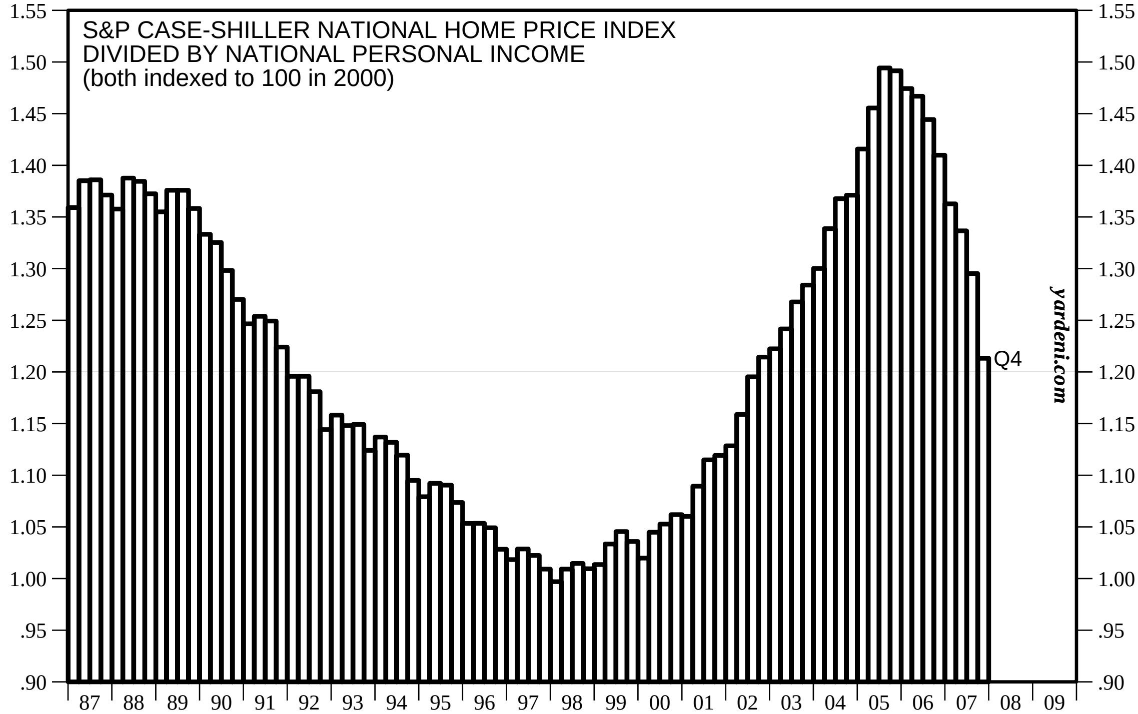


Source: Standard & Poor's Corporation.

- Home Prices & Wealth -

Relative to personal income, home prices are back to normal.

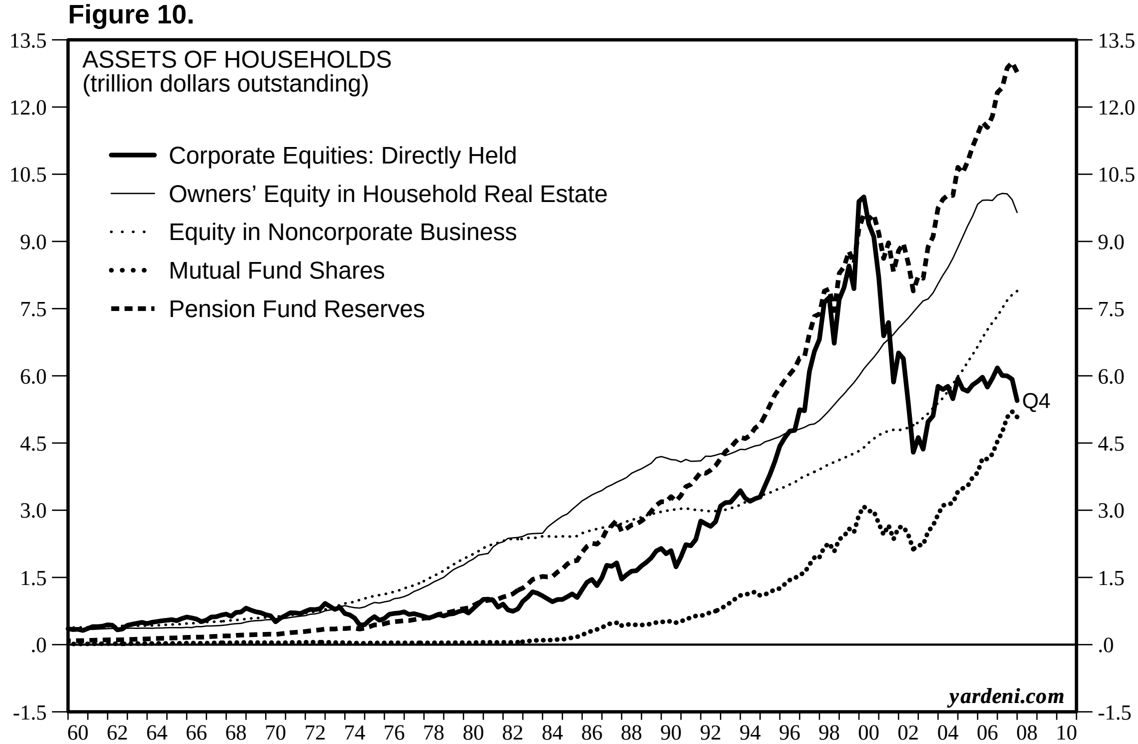
Figure 9.



The vertical line is the average for the periods shown in the chart.
Source: Bureau of Economic Analysis and S&P Case Shiller

US households have a diversified portfolio of assets.

Figure 10.

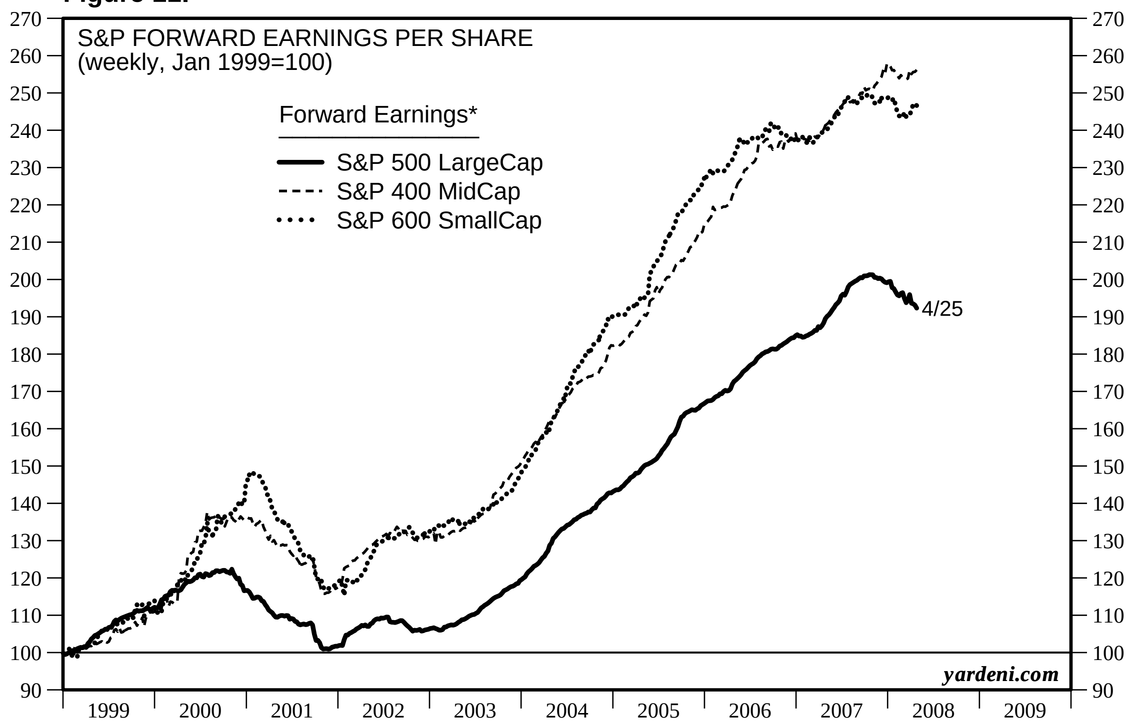


Source: Federal Reserve Board Flow of Funds Accounts.

- Earnings & Valuation -

Forward earnings holding up remarkably well for MidCap and SmallCaps. Weakness in S&P 500 forward earnings mostly due to Financials.

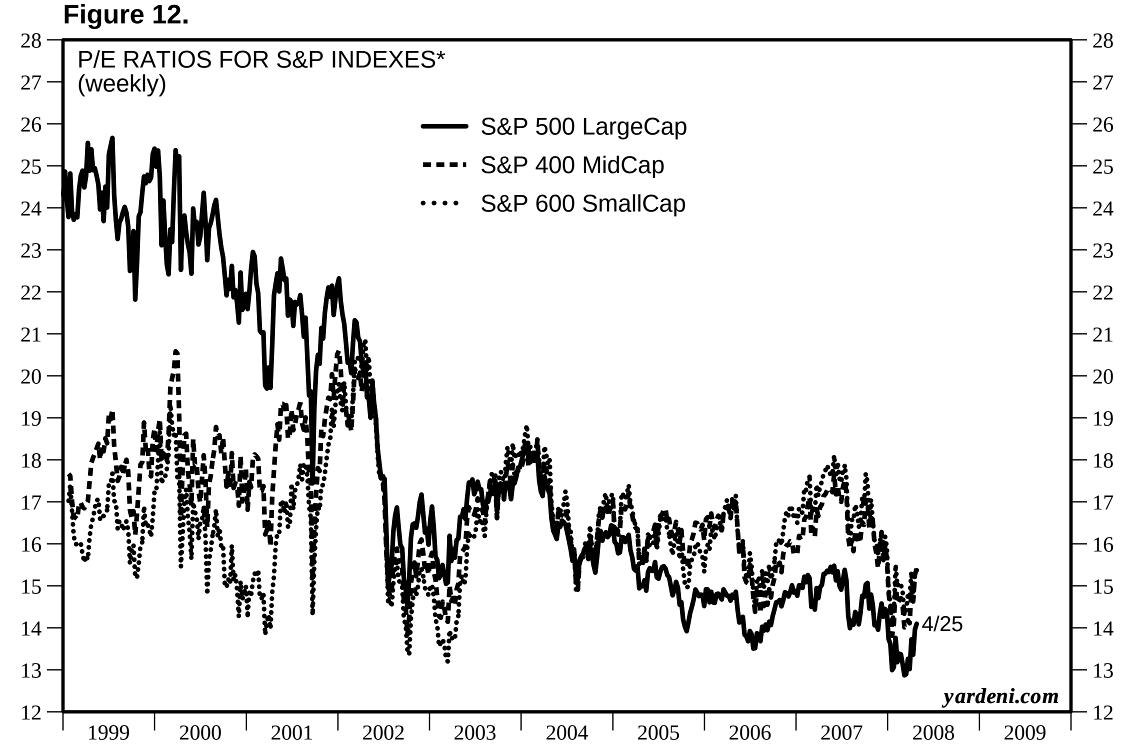
Figure 11.



* 52-week forward consensus expected operating earnings per share. Time-weighted average of the current year's and next year's consensus forecast. Source: Thomson Financial.

Forward P/Es are relatively low.

Figure 12.

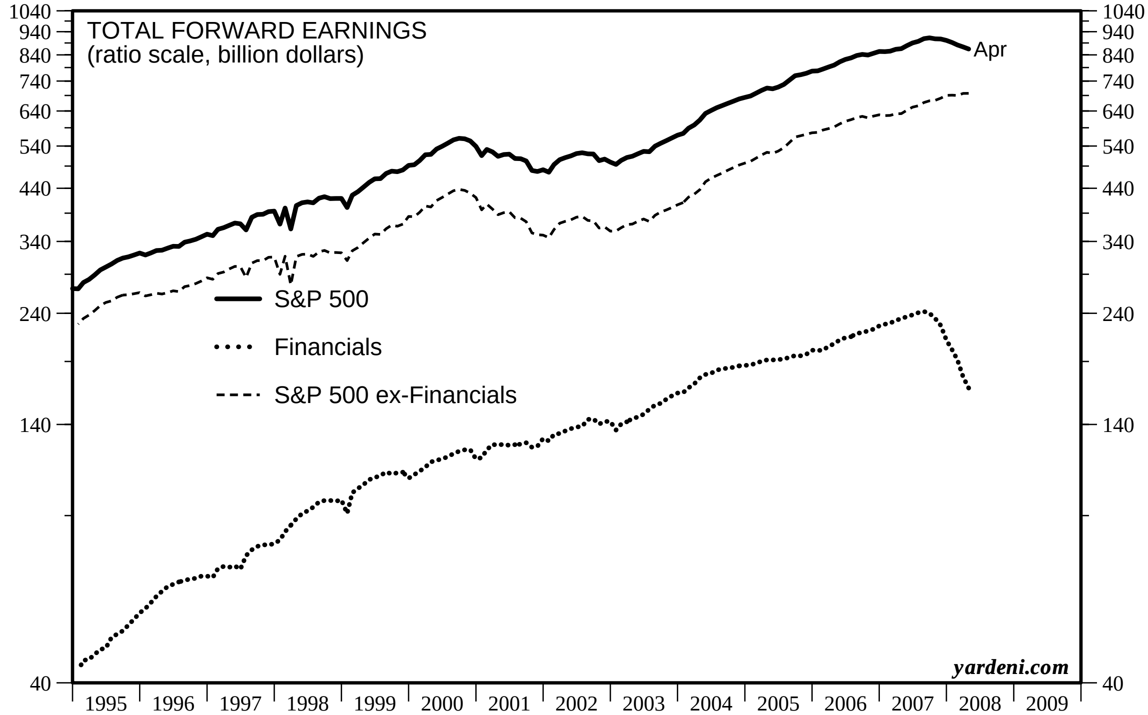


* Price divided by 52-week forward consensus expected operating earnings per share. Source: Thomson Financial.

- Earnings -

Excluding Financials, S&P 500 forward earnings remains on uptrend.

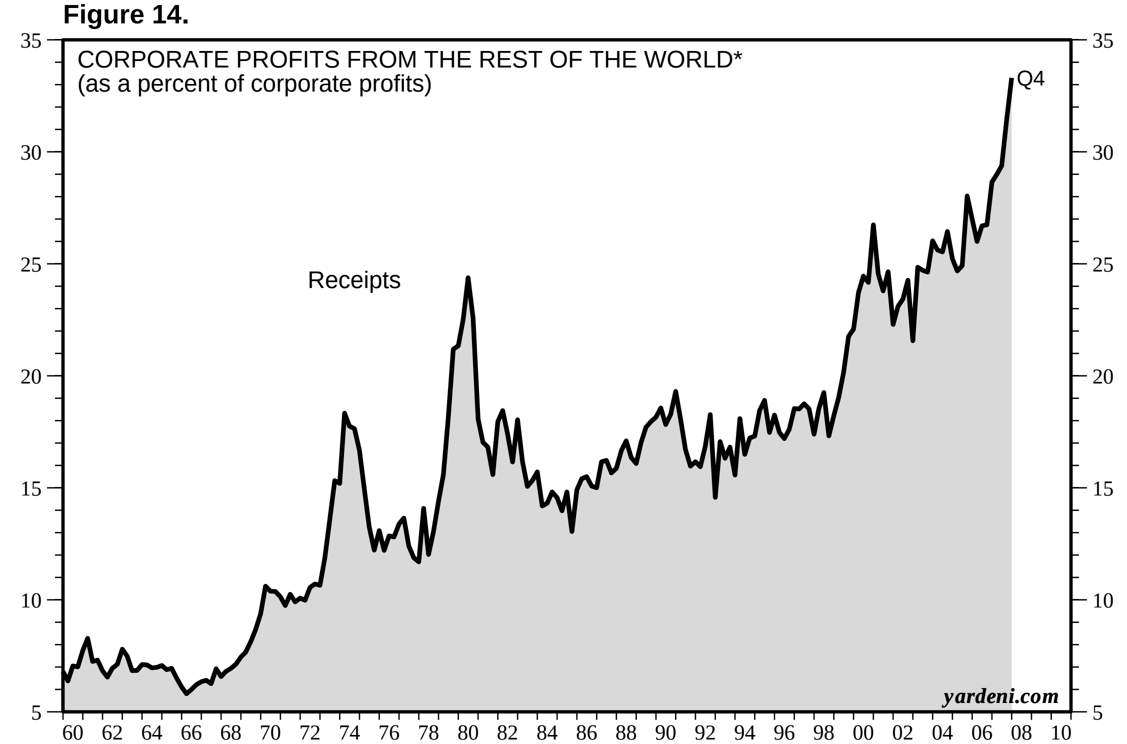
Figure 13.



* Using consensus 12-month forward earnings forecasts.
Source: Thomson Financial.

Profits from overseas accounting for greater share of total profits.

Figure 14.

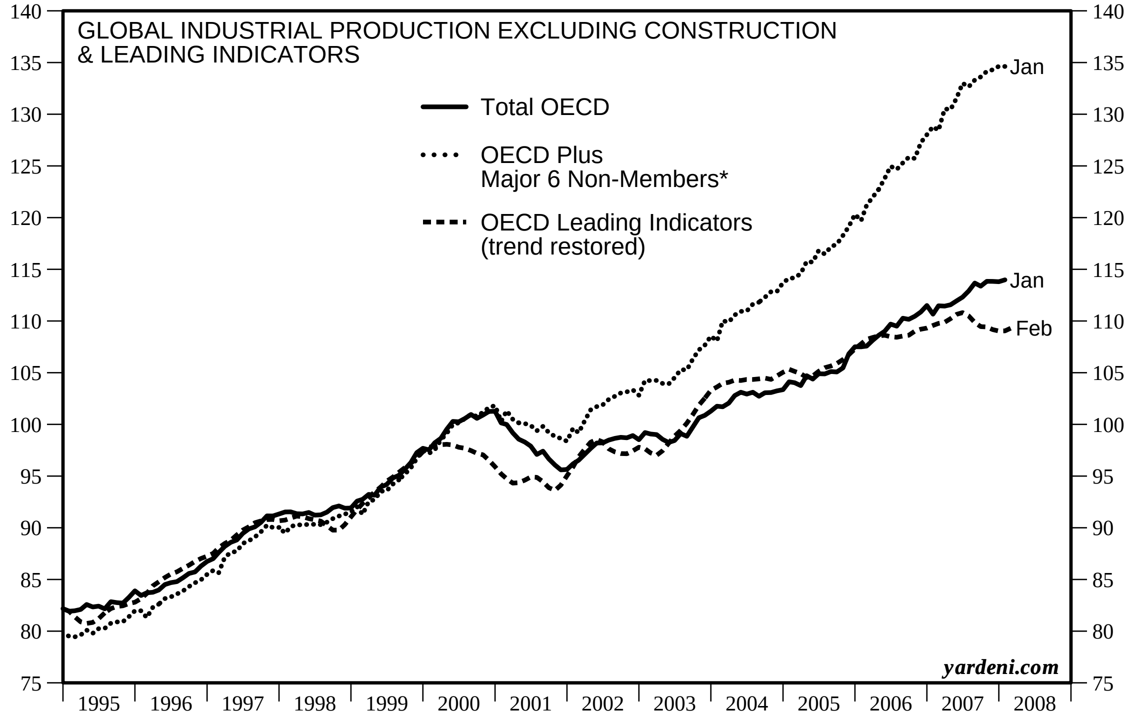


Source: US Department of Commerce, Bureau of Economic Analysis.

- Global -

Global industrial production growing rapidly.

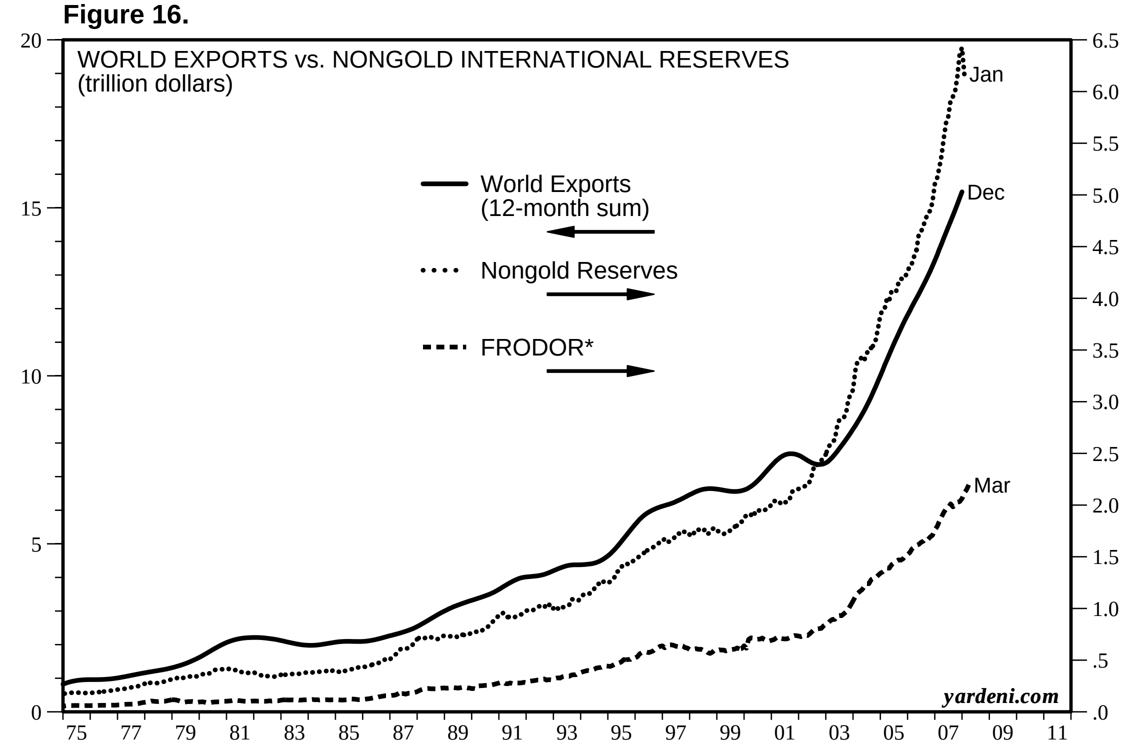
Figure 15.



* Includes 30 OECD countries plus Brazil, China, India, Indonesia, Russia, and South Africa.
Source: OECD

World exports and international reserves growing rapidly.

Figure 16.



* Data from 1952 to 1996 are foreign official assets held at the Fed in US Treasuries. From 1997 to the present, data are marketable US Treasury securities held by the Fed for foreign and international accounts. Data from 2000 onward include Federal agency securities.
Source: International Monetary Fund and Board of Governers of the Federal Reserve System.