Black Swan Capital

Currency Currents

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Quotable

"It is obvious that in 2009, because of its structure, Germany took a much bigger hit than France. It is hardly surprising that they would catch up faster, but that is only due to the fact that they went down farther."

Christine Lagarde, *France's Finance Minister, making excuses for why growth forecasts are being cut in France while German growth is exceeding expectations.*

FX Trading – Can stocks hang on?

A friend of ours forwarded on this chart from *The Economist* last week:

Our response: we think stocks are cheap relative to bond yields, but that doesn't mean stocks can't collapse. Super low yields say a lot about growth prospects ... and all the capital investment not made goes to bottom line.

His response: stocks could drop due to earnings weakness or general PE-multiple contraction. [It's funny how falling prices tend to create so-called PE multiple contractions; it's why we don't follow PEs too much.]

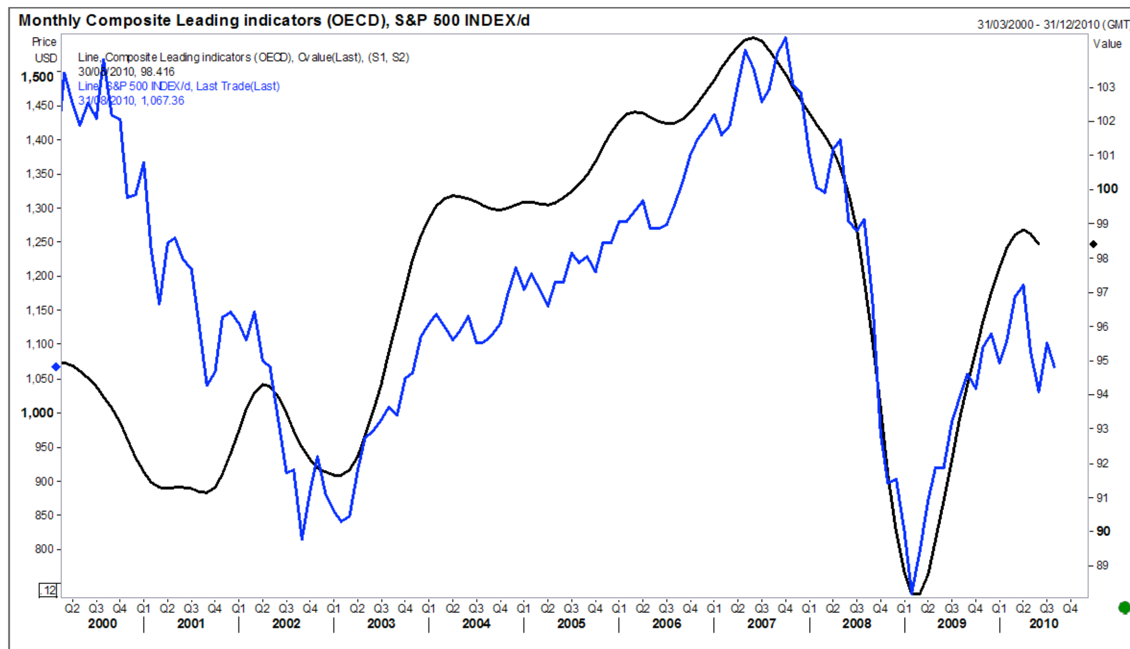
And here we are now with *The Wall Street Journal* piping in on the potential for earnings growth to slow:

> "What is occurring is practically a textbook slowdown: The stock market sells off, leading economic indicators roll over, economists mark down their growth forecasts, and earnings growth slumps. It is the speed of it all that is remarkable.
>
> ...
>
> "Moreover, stocks still may be overvalued. Barclays Capital notes the 15% earnings growth expected in 2011 is nearly triple what is expected for nominal GDP growth. Certainly, cost-cutting, fatter margins and foreign demand can help

profit. But Barclays reckons forecasts will moderate and predicts the S&P 500 will retest July lows before year-end as analysts mark down their views."

We recently talked about how seemingly vital it has become for policymakers to enact measures that are supportive of stock markets. We were reacting to Alan Greenspan's latest comments on the subject. *The Wall Street Journal's* comments imply the importance of a rising stock market in bolstering economic confidence at a time when the economy alone isn't worthy of such confidence.

Leading Economic Indicators (black) vs. S&P 500 (blue):



And we can look to these companies for another indicator of economic confidence ...

Dividend growth has returned with the sharp recovery in corporate earnings. And that's a welcome change for investors who seek to capture yield with their stock investments. And while it's obviously a sign that corporate balance sheets are in decent shape, it may reflect badly on companies' expectations for the economy. They are taking their excess cash and funneling into their shareholders pockets, to keep them around. While we have seen investment bottom out, companies have not yet, to any meaningful extent, using that extra cash to invest in expansion.

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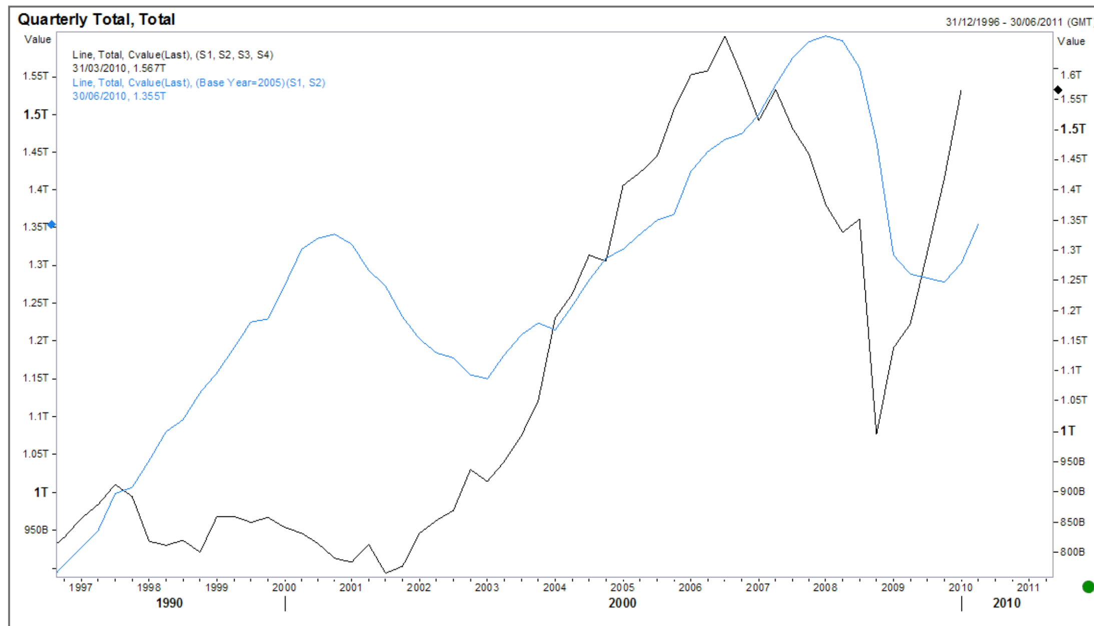
Corporate Profits (black) vs. Private Non-residential Investment:



This is what Morgan Stanley says:

> Longer term we believe the rise in the spread between dividend yield and real bond yields may represent a statement about the market's view on three things:
>
> 1) **An outlook for weak long-term earnings growth** that leaves a reduced possibility of P/E expansion, meaning that dividends have to be a dominant part of total returns. Historically a dividend yield of 2% would equate to a P/E multiple of nearly 17x (or alternatively a dividend yield near 3% supports the current market P/E of 14.5x). We do not think a 3% dividend yield is unrealistic. It would require the payout ratio to rise into the low 40% range – a move that would put it back close to the long-term average.
>
> 2) **A higher risk premium** (we estimate the implied ERP is now around 5.2%) that now needs to be compensated by a higher yield.
>
> 3) **Investors doubt that companies can be trusted to reinvest earnings and create value**. Companies are better off enhancing the payout ratio and returning money to investors, something we have yet to see in the current cycle.

As to the widening spread they mention, bonds are up big again today (yields lower) – that's saying something about how investors are viewing markets and the global

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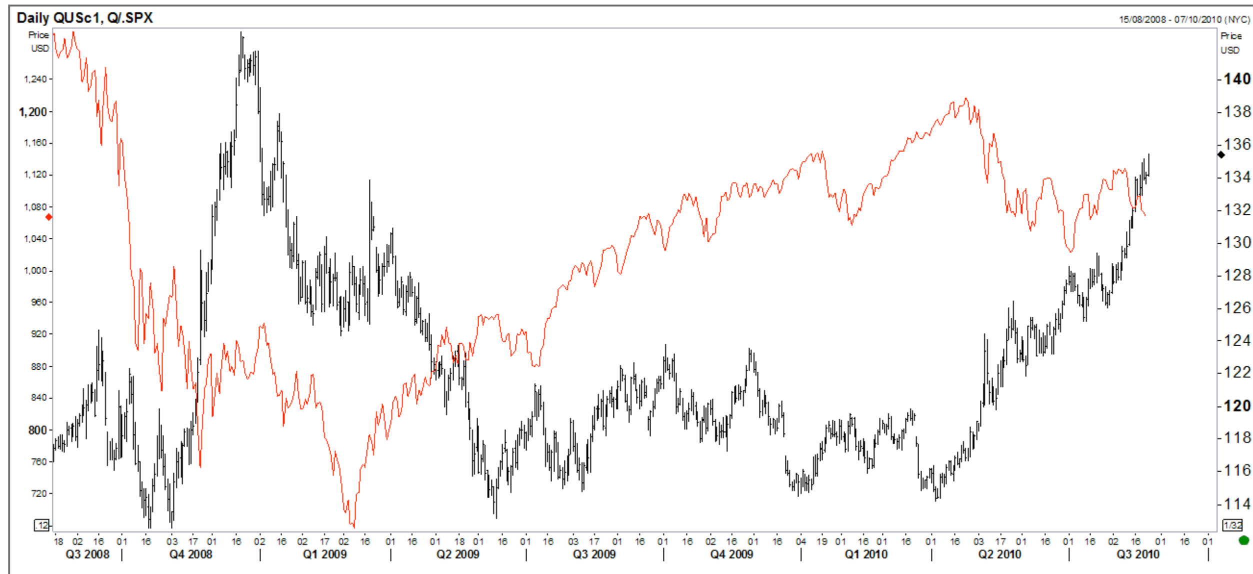
economy. We're entering 2008 crisis territory on 30-year bonds. Can stocks hang on in such an environment of investor and corporate caution?

US 30-Year Bond Futures vs. S&P 500 (red): bonds have jumped well ahead in this mostly negative correlation; time for stocks to play catch-up with a swift drop? (Additional analysis in today's Chart Library)



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Leading the Way to Lower Highs, Lower Lows: An Opportunity!

You're probably well aware of the correlation between major asset classes by now. And that goes to the same risk-on, risk-off trading theme that's been driving capital flow.

The rally in stock markets through the month of July meant a similar rally in currencies, at the dollar's expense. We called the beginning of the correction back in June when we alerted our Currency Investor members to exit a position that profited from a weaker euro. That trade netted a very nice gain. Since then we've been waiting for signals that the correction has come to an end, that the euro would resume its decline. We seem to have reached that point.

Sentiment has shifted back into bearish territory ... and the major global risks have not been addressed to any meaningful extent. A new, deep move lower in the euro could be triggered by a coming collapse in stocks. A failed test on the S&P 500 of critical

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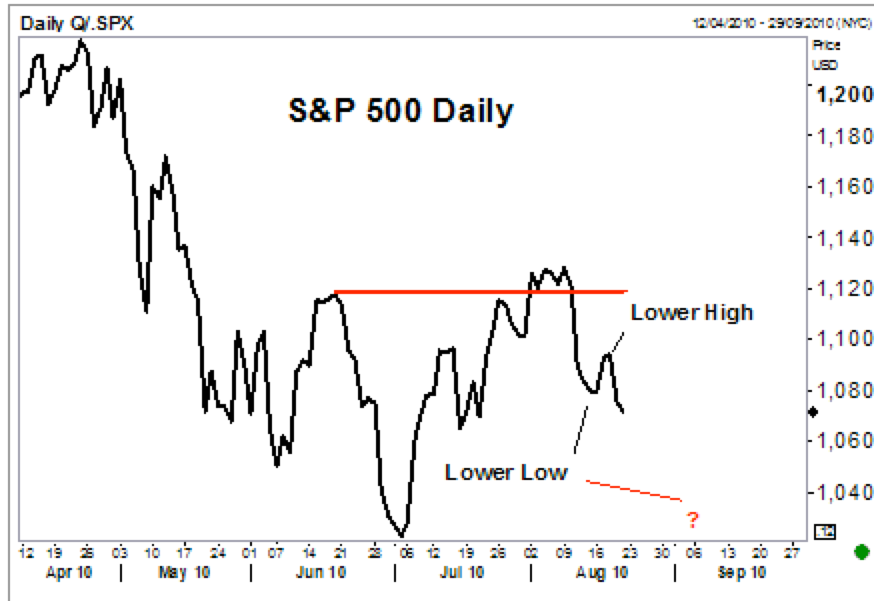
resistance has been followed by a lower low and a lower high – the markings of a downtrend in the making. Will you be ready to play it? Will you know how?



Currency Investor.

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