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MACROCOSM

Back in the Hot Zone

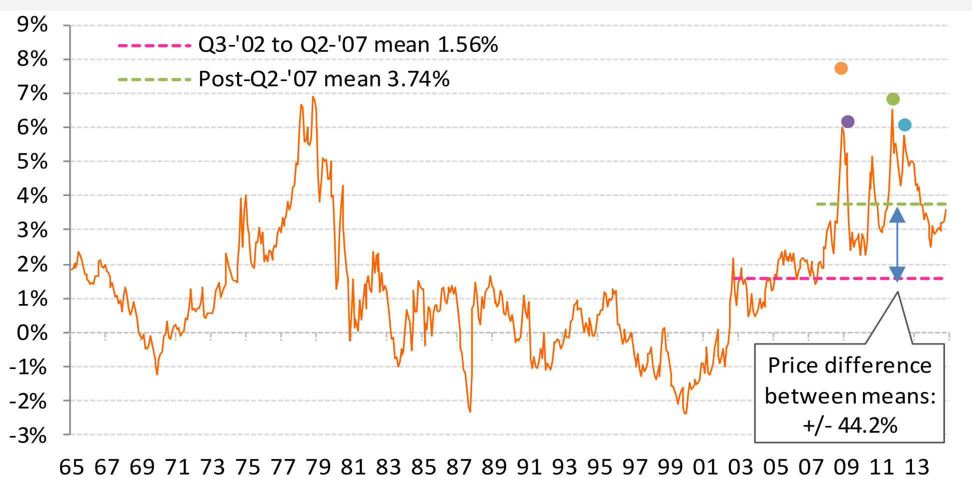
Friday, October 10, 2014
Donald Luskin

The equity risk premium has reverted to levels appropriate for a financial pandemic.

Stocks are in a correction, the third one this year. There still hasn't been a 10% correction for more almost two and a half years. We suppose this particular one was inevitable, after the mania atmosphere of the Alibaba IPO which came on the day of the S&P 500's all-time high close three weeks ago. For how small the correction has actually been so far, we're amazed at the depth of fear and pessimism we detect from clients and in the media.

- What's so remarkable about this correction is that it has brought the S&P 500 equity risk premium within a mere 20 basis points of its crisis-era mean (please see the chart below).
- In other words, stocks are priced as though we were still in the hot zone -- the expression containment experts use to describe areas contaminated by Level 4 biohazards like Ebola.
- The crisis era was a world of actual and potential financial contagion -- the world of the collapse of Lehman Brothers, AIG, Fannie Mae and Freddie Mac and the bail-out of the US banking system, the bail-out of five European countries and the rescue of the euro currency, and two near-defaults for the US Treasury.

S&P 500 equity risk premium, month-end and at yesterday's equity lows
Day peaks: • 11/20/08 • 3/9/09 • 10/3/11 • 6/1/12
Forward earnings yield minus 30-year Treasury yield



Source: Bloomberg, TrendMacro calculations

Update to strategic view

US STOCKS, US BONDS, OIL, US FED: This correction for stocks feels especially scary, despite how small the move has actually been -- we still haven't had a 10% correction in about two and a half years. The S&P 500 equity risk premium has reverted almost entirely to its crisis-era mean -- as though the world were as risky now as in the years of financial contagion. The specter of an Ebola pandemic, however remote, re-activates those fears. But the world is, in fact, less risky now, and the wide ERP mostly reflects overpricing in bonds. There's a "taper tantrum" going on, based on the incorrect beliefs that
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- The thrust of this correction has been a "taper tantrum," based on the widespread -- but mistaken, we think -- belief that the Fed is "tightening" (see "On the September Jobs Report" October 3, 2014") and that the ECB isn't doing enough to address its self-declared deflation crisis (see "No Way ECB QE" October 1, 2014). This all resolves into generalized fears of a global slowdown.
- But we think what's giving this correction its particular tinge of fear is Ebola. Once a mere gag-line when blue-skying about potential "black swans," a global pandemic is now an actual known possibility, however remote.
- The potential for contagion is never far from investors' minds now, so soon after the crisis era. So even the remote prospect of an Ebola pandemic has particular resonance, being the physical version of the financial pandemic we barely survived and are still recovering from. And as was the case with that financial pandemic, even successfully fighting an Ebola pandemic would have real costs -- experienced as frictions against free movement of persons and goods, and a general recoil from long-term and long-range economic activity.
- And there are other risks, too -- the Islamic State, Hong Kong protests set against the ever-present China crash narrative, and even the relentlessly negative cliffhanger Senate election now just a month away (see "Mid-term Cliffhanger" September 24, 2014).
- All that said, it's still a reach to say that the world today deserves the same risk premium as obtained, on average, during the deepest recession and worst financial crisis of any of our lifetimes.

Yet here we are. And it's the exact opposite of what we'd expected for this year -- which was a gradual decline of the equity risk premium, in an objectively less risky world, back toward the mean that obtained before the crisis era began (please again see the chart below, and "Regime Change for Equities" November 26, 2013).

- If the ERP were at the pre-crisis mean, all else equal the stock market would be 44.2% higher (again, see the chart on the previous page). That logic was the core of our expectation for 2014 that stocks would make new all-time highs.
- And in that important sense we've gotten it right, despite the equity risk premium moving in the wrong direction. We've expected stocks would make new all-time highs, and they have.
- That part makes sense. Forward earnings are at all-time highs, and are growing robustly even as this business cycle matures (see "Earnings to the Rescue" May 12, 2014). Stocks simply reflect that, and the lower level of risk in the world, by sporting a 15.1 forward multiple -- not cheap, but not especially pricey either.
- Stocks are only one side of the equity risk premium -- bonds are the other. The ERP is the difference between the earnings yield of the S&P 500 -- currently 6.61% -- and the yield of the 30-year Treasury -- currently 3.07%. The gap between these two yields -- 3.54% -- is the premium investors demand for taking the risk of equities, versus that of Treasuries.

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[About us]

Recommended Reading

"In 1976 I discovered Ebola, now I fear an unimaginable tragedy"
Interview with Peter Piot
by Rafaela von Bredow and Veronika Hackenbroch
The Observer
October 4, 2014

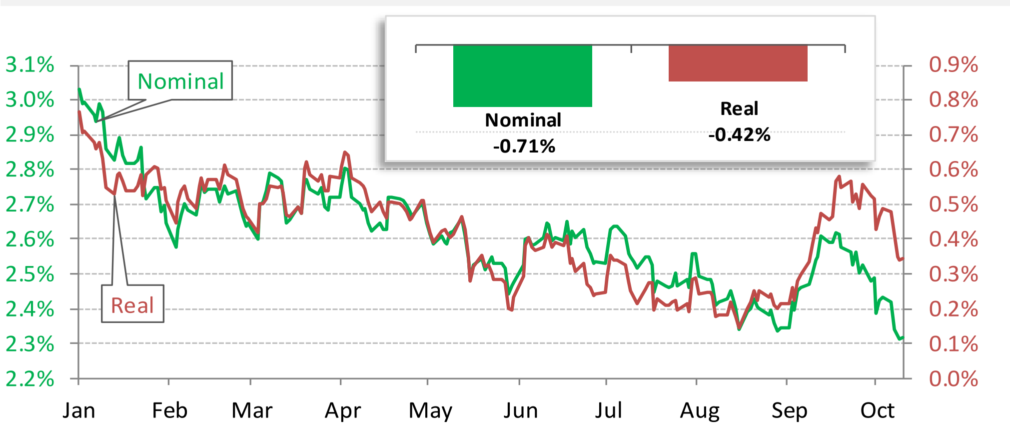
Richer (and Holier) Than Thou? The Effect of Relative Income Improvements on Demand for Redistribution
Mounir Karadja, Johanna Möllerström and David Seim
Research Institute of Industrial Economics
Working Paper No. 1042
September 20, 2014

Obama Factor in 2014 Vote Similar to 2010
Gallup Politics
October 3, 2010

[Reading home]

- *If (a) there is nothing exceptional about the way stocks are valued, and if (b) the world today is not in fact as risky as it was, on average, during the crisis era, then it must be the case that bonds are overpriced.*
- We've been saying so for quite some time, and we still think so -- though we must admit markets have made us wrong on that.
- We recognize that there are any number of structural explanations for it -- appetite for duration by certain institutional investors, buying by foreign official institutions, arbitrage against exceptionally low sovereign yields in Europe, and lately, surely a bit of a liquidity squeeze as investors park funds withdrawn in a hurry from PIMCO funds formerly managed by Bill Gross.
- We think the core explanation for such low Treasury yields is that the bond market is making a sensible first-order response to the arrival of what we call "the Yellen Rule" -- the promise that policy rates will be permanently below normal, even when the economy is at maximum performance (see, among many, "The Yellen Rule is Taylor Minus Two" May 19, 2014). Yellen is promising lower than expected discount rates for all future coupons and maturity payments -- so the present value of bonds must rise.
- But there are second-order effects, too. Today's bond prices, while appreciating the arithmetic, don't seem to recognize the reflexivity implicit in "the Yellen Rule." Lower Treasury yields -- something the Fed was never really able to engineer with all its Large-Scale Asset Purchases (LSAPs) -- will themselves feed back into faster growth and higher inflation.
- Or perhaps today's bond markets just think "the Yellen Rule" will be yet another Fed policy failure -- and why not, considering that while LSAPs were invaluable in liquefying the world banking system through the crisis years, they never had any demonstrable direct effect on inflation or growth.
- Year to date, that's the way the bond market has voted -- the 71 bp decline in the 10-year yield can be explained two-fifths as a diminution of inflation expectations, and three-fifths as a diminution of growth expectations (please see the chart below).
- We don't think that's the right call. Monetary policy above the zero-

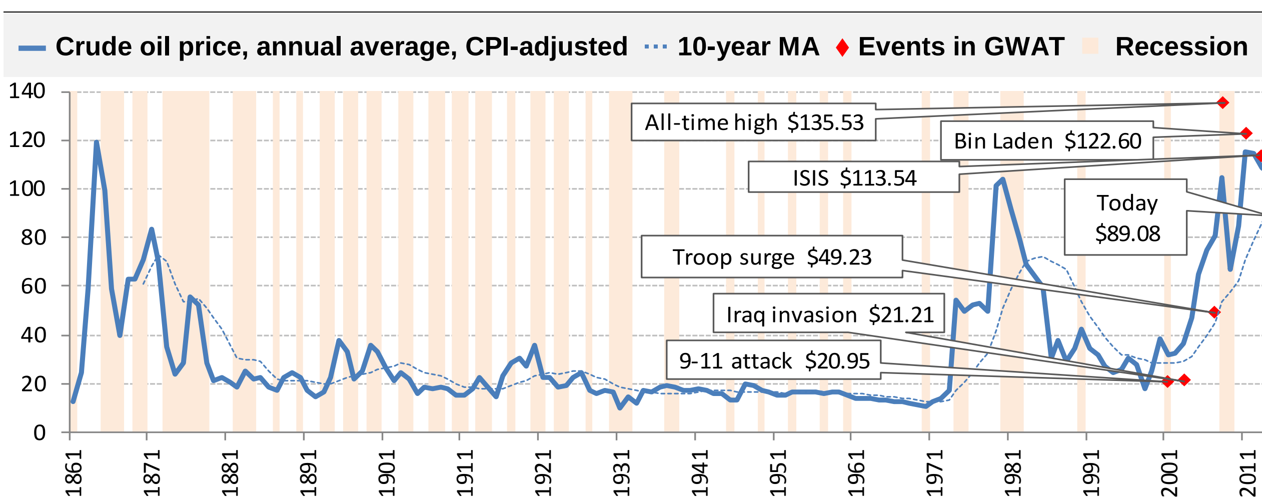
— 10-year yields ■ Change from year-end



Source: Bloomberg, TrendMacro calculations bound can be far more effective then below it -- but it's going on six years since anyone has had a chance to see that. Memories are short -- especially the memory of the bond market, which historically has been a terrible predictor of both inflation and growth (see "Attack of the 15 Basis Point Deflation Monster" September 2, 2014).

At the same time, in this pessimistic sentiment environment, the sharp drop in crude oil prices is being interpreted as a signal of slowing growth and incipient deflation. We don't think that's the right call, either.

- In the spirit of rounding up the usual subjects, we have to at least ask whether it signifies slowing growth in China. Perhaps, but slowing growth *per se* doesn't necessarily mean lower demand, just a slower rate of demand growth. And we are unaware of any data that shows falling consumption or import volumes.
- And stagnant growth in Europe? That's not exactly a new factor in the oil market.
- Evidence of deflation? Yes, but not necessarily anything beyond the simple computational truth that falling oil prices lead to lower inflation. In fact, last month's US personal consumption expenditures price index printed negative month-over-month because of it. Perhaps that should command a drop in the inflation premium in bonds. But that's a far cry from concluding that falling oil prices are evidence of a relapse into monetary deflation.
- Instead, we believe that the rapid and massive advances in technology -- horizontal drilling and fracking -- have induced a benign supply shock. *That is, the gusher of North American shale oil has risen to the level where it has finally outrun demand in the Not So Great Expansion following the Great Recession.*
- *This is not a development to be feared, but rather to be welcomed.*
- We have argued that record high oil prices in 2008 were as much a trigger for the Great Recession as the post-Lehman banking panic.
- In the aftermath, oil prices have remained high -- on a 10-year moving average basis, adjusted for inflation, they have been the



Source: BP, Bloomberg, BLS, NBER, TrendMacro calculations highest in history for the last four years (please see the chart on the previous page, and "The Stench of CrISIS" June 25, 2014).

- *The present drop puts world oil prices below the inflation-adjusted 10-year moving average for the first time since 1999 (again, please see the chart on the previous page). How is that not overwhelmingly positive?*

Obviously we don't know where this correction will end. But we do believe it is just a correction, not a cyclical turning point. And as we face the various crises of the moment, whatever happens, stocks come into it with two cushions against extreme further downside.

- An equity risk premium priced for a world of intense crisis -- when in fact the world is less risk than that -- means that investors can earn outsized relative performance, at least in terms of accreted earnings, and probably in terms of actual total returns.
- At the same time, sharply falling oil prices are very growth-positive. Demand-driven oil price declines are zero-sum games, equilibrium-seeking structures in which lower prices revive demand, which then just drives prices higher again, which lowers demand. But price declines driven by supply shocks are positive-sum games, in which new energy -- literally and figuratively -- is introduced into the economy, allowing a new and higher growth equilibrium to eventually be reached.

Bottom line

This correction for stocks feels especially scary, despite how small the move has actually been -- we still haven't had a 10% correction in about two and a half years. The S&P 500 equity risk premium has reverted almost entirely to its crisis-era mean -- as though the world were as risky now as in the years of financial contagion. The specter of an Ebola pandemic, however remote, re-activates those fears. But the world is, in fact, less risky now, and the wide ERP mostly reflects overpricing in bonds. There's a "taper tantrum" going on, based on the incorrect beliefs that the Fed is "tightening," and that there is a deflation crisis in Europe. Falling oil prices are mistakenly cited to demonstrate this risk, when in fact they reflect a benign supply-shock. That, together with a wide ERP, puts a cushion underneath extreme further downside in this correction.