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MARKET CALLS

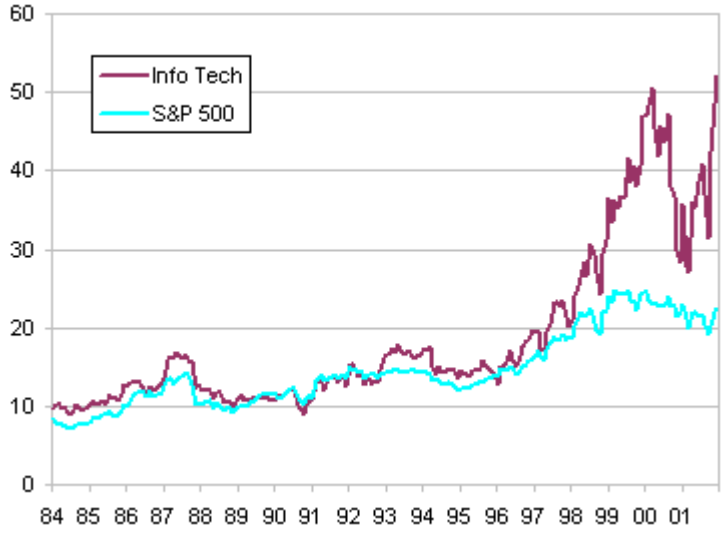
Vay Out of Vack – Even for a "V"

Monday, December 10, 2001
Donald Luskin

Stock markets have rallied with force and fury from the panic bottom of September 21 -- very few periods in market history have shown such steep and rapid advances. Yet, paradoxically, for all that, the markets have really only recovered to the levels where they were a mere four months ago -- and *those* levels were discounting the recession we most assuredly are in.

But -- again paradoxically -- though we can regard the recovery as only modest in that it has only restored the market to recent recessionary levels, the current price-earnings multiple of 52.2 for technology stocks is higher than the "bubble" levels that prevailed when the NASDAQ was at 5000. The p/e for the broader market -- 22.4 for the S&P 500 -- hasn't made new highs, but it has sharply recovered and remains above historical norms. It's worth at least an historical note that the S&P's p/e was only about 15 when Alan Greenspan first infamously used the expression "irrational exuberance" in 1996.

Forward P/E multiples:
S&P 500 and S&P Information Technology Sector
Monthly, as of month-end November, 2001
Source for forward earnings: Morgan Stanley



It's true that when we adjust today's high p/e's for today's low interest rates the needle on the valuation meter stops spinning wildly, and no longer signals code blue in the boiler room. But it's close.

For technology stocks, forward "earnings yields" are now more than 3% lower than the yield on 30-year Treasuries. That's not quite a record spread -- it was worse early last year when the

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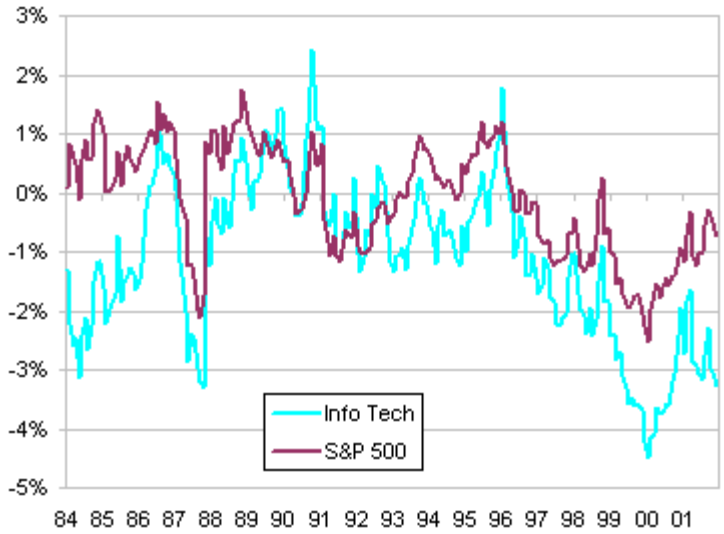
NASDAQ was at 5000. But that's the *only* time it's ever been worse. Right now it's at about the same level where it -- briefly -- flashed just before the stock market crash of October, 1987.

The spread for the S&P 500 is also negative, but not as dangerously negative as it is for technology stocks. But remember, these charts were drawn with month-end November data. They are even worse now, with stocks having rallied and long rates having risen.

Earnings yield/bond yield gap:
S&P 500 and S&P Information Technology Sector
constant maturity 30-year Treasury bond yields
Monthly, as of month-end November, 2001
Source for forward earnings: Morgan Stanley



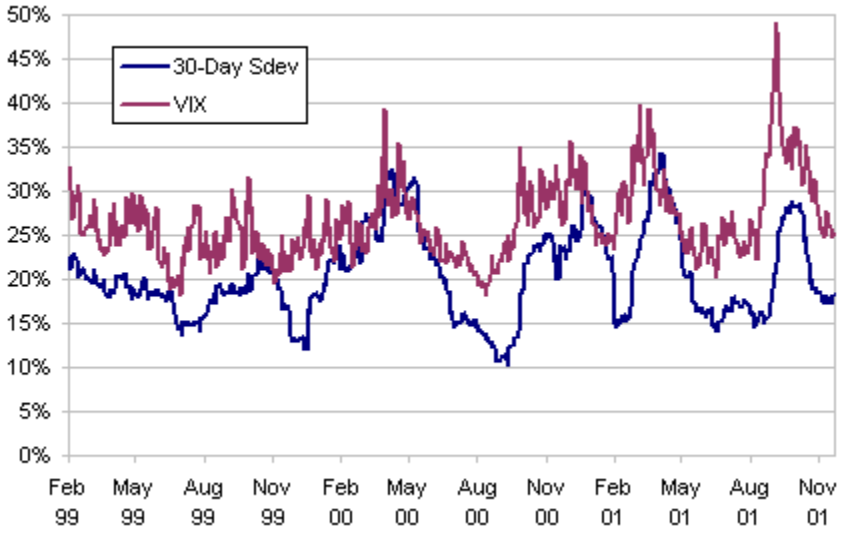
This means that stocks -- especially technology stocks, but to some large extent stocks in general -- are way out of whack with respect to bonds. Stocks are riskier than bonds, yet today they yield far less in risky earnings than bonds do in guaranteed income. And that's a paradox that will soon have to be resolved.

One way for it to be resolved would be for stocks to "grow into their multiples." We can tell ourselves that investors trying to catch cyclical lows in the stock market are used to paying *seemingly* high multiples as stocks begin to discount the large earnings gains that can be made in the first stages of a recovery. But the p/e multiples we're looking at here are based on *forward* earnings estimates which, presumably, already have a hefty helping of anticipated recovery baked in -- Wall Street analysts (especially technology analysts) have never been known to be an especially pessimistic lot.

That means that for stocks to grow into these multiples tech companies are not only going to have to meet estimates -- they are going to have to beat them by a mile. The "our business is stabilizing" and "we're on track" and "orders are looking more linear" routines aren't going to make it. Even **Intel's** conference call last Thursday night in which they reaffirmed at the high end of revenue guidance and guided the range slightly higher wasn't enough to do anything but get a couple percent shaved off the stock price on Friday. Tech stocks are priced for the "V" recovery to be a real va-va-va-voom -- and so far there's really just no sign of that.

Another way for the paradox of the negative stock/bond yield spread to be resolved is for stocks to be far less risky in the future than they have been in the past. This is suggested today by large declines in both *observed* levels of stock price volatility and *expected* levels of volatility implied in options prices. Neither of them is showing absolute extreme low readings, but both are definitely at the low end of their cyclical ranges. If history is any guide, we should expect volatility to *increase* from here, if anything -- which would disappoint investors who had counted on low risk to justify high prices.

S&P 500 volatility
Annualized daily standard deviation, rolling 30-day intervals
Option-implied volatility from CBOE Volatility Index
Daily as of Friday, December 7, 2001



Yet another way for the negative stock/bond yield paradox to be resolved is for there to be an outbreak of inflation. That would both pump up the nominal level of earnings, and explain today's high bond yields. The problem with this is that the US economy is still wrestling with the very opposite -- monetary *deflation* -- and we see no substantive indicators that this is about to be reversed anytime soon.

So if we rule out rapidly escalating earnings; drastically lowered risk for stocks; and inflation -- that only leaves three other possibilities. Stock prices have to come down, bond prices have to go up, or both of the above.

No matter which way it breaks you want to be out of the most vulnerable overpriced stocks and into bonds. And *even if* the coming earnings season is full of lots of "V"-ish earnings surprises, the asset allocator who sold stocks here is hedged to some degree because of the great extent to which surprises are already anticipated in stock prices. Similarly, there's a lot of cushion in a long bond yielding over 5.5% in a world in which there is not even the slightest sign of inflation (see today's "One Wild Ride" by David Gitlitz).

I'm as delighted as anyone to see recovery in markets so soon after the tragedy and dislocation of the September 11 terrorist attacks. But that doesn't change the fact that markets have gotten themselves way out of whack. This is yet another opportunity arising from the crisis. TM