Donald Luskin, Chief Investment Officer
David Gitlitz, Chief Economist

MARKET CALLS

The Yield Gap – Sector by Sector

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Donald Luskin

Last week I discussed the yield gap -- the difference between the "earnings yield" of stocks (based on consensus forward estimates) and the income yield of the 30-year constant maturity Treasury bond. The yield gap is very negative now -- meaning that risky stocks yield far less than riskless bonds -- suggesting a tactical asset allocation opportunity to shift out of stocks and into bonds. This is especially true in the technology sector, where the yield-gap is at near-historic negative levels.

It is counterintuitive at first, but historically the yield gap has been negative on average -- since 1984 it has been -0.1% for the S&P 500 and -1.1% for the S&P Information Technology sector. How can risky stocks, on average, yield less than riskless bonds? It's simple: the earnings yield for stocks used in this calculation is based on forward estimates looking ahead just one year. Over many years -- certainly over the 30 years contemplated in the income yield of the long bond -- corporate earnings are expected to grow. This is true for all stocks, and all the more true for technology stocks.

One way to repair the seeming violation of common sense implicit in a negative average yield gap is to consider 5-year Treasury notes instead of 20-year bonds: there the average yield gap since 1984 has been a *positive* 0.4% for the S&P 500, and a less negative -0.6% for the S&P Information Technology sector. While looking at the yield gap that way produces more sensible historical averages, it overlooks an important opportunity offered in the market today.

The opportunity arises from the fact that forward price/earnings ratios for technology stocks are higher than they have ever been in history -- even higher than at the top of the so-called technology "bubble" in early 2000 (see "Vay Out of Vack, Even for a 'V'" December 10, 2001).

At the same time, long-term Treasury bonds have undergone a period of enormous volatility, leaving the yield-curve extremely steep and leaving real long-term yields at historic highs -- especially considering our expectations for continuing deflationary pressures. My colleague **David Gitlitz** has said for several weeks that the long bond is a "screaming buy." Look for a detailed report from David shortly, explaining exactly why this is so.

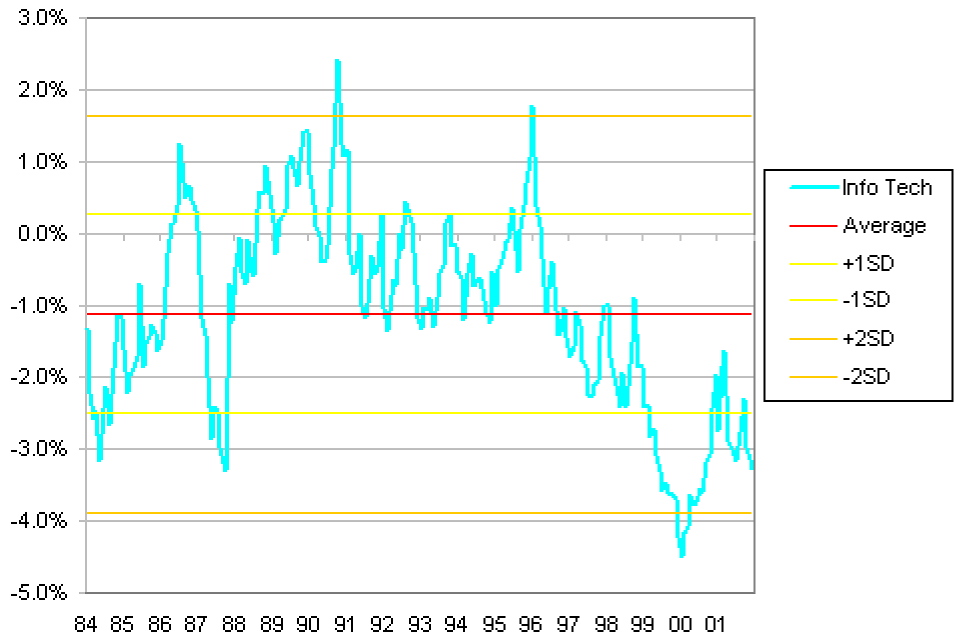
So by focusing on the yield gap between technology stocks and long-term bonds, investors have the opportunity to capture *not only* the extremely *high* valuation of technology stocks, but *at the same time* to capture the extremely *low* valuation of long-term bonds. This can be accomplished by a tactical asset allocation trade out of technology stocks and into long-term Treasury bonds.

The idea is not to set up an "arbitrage" in which one shorts technology stocks and buys long-terms bonds, expecting to hold the trade for 30 years until the bonds mature. Rather, it is to exploit a tactical opportunity in which two separate markets have each gotten far out of whack with their own historical norms -- and with their normal relationship to each other. Such out of whack conditions sometimes have a way of repairing themselves very suddenly.

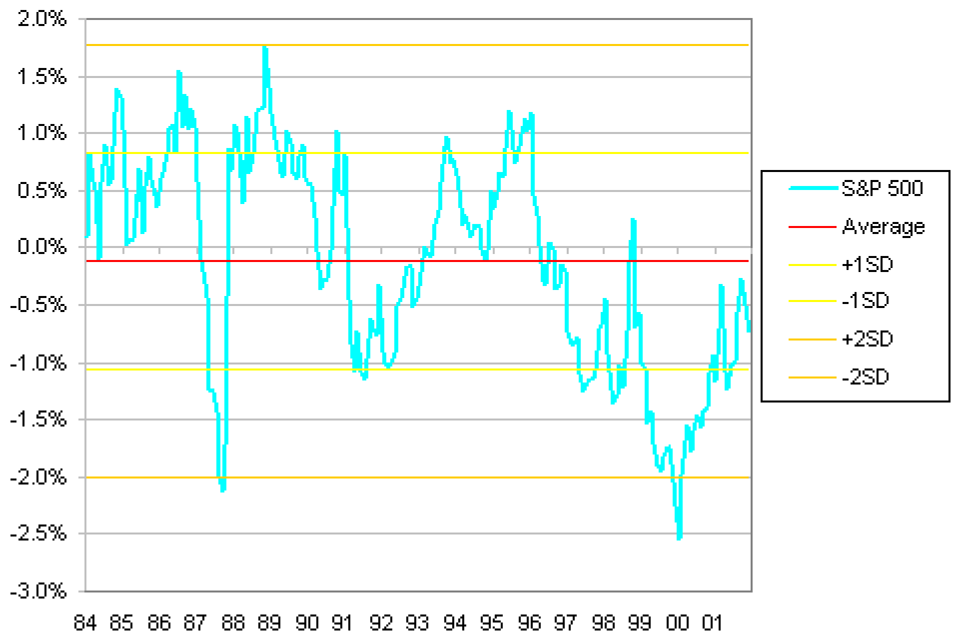
The chart below suggests the magnitude of the opportunity. For the S&P Information Technology sector, the yield gap today is even more negative than it was just before the crash of 1987, and only slightly less than it was at the top of the market in 2000. The only ways to rationalize the magnitude of the gap would be to imagine an upside earnings surprise or to imagine an inflationary surprise, materializing in early 2002 and only consistent with the most aggressive possible scenario for a "V" recovery from recession.

This chart, and the charts that follow, plot the monthly yield gap (the thick blue line) against its historic average (the thin red line). One and two standard deviations around the average are shown as thin yellow and orange lines, respectively.

Earnings yield/bond yield gap
Monthly, as of month-end November, 2001
Source for forward earnings: Morgan Stanley



A close look at the magnitude of the yield gap across the whole S&P 500 -- and sector by sector -- reveals that the most egregious out of whack condition in equities is displayed in technology stocks. The yield gap for the S&P *is* more negative than its historical average, and (simply for reference) is more negative than it was when **Alan Greenspan** first infamously used the expression "irrational exuberance" in December, 1996. This suggests that there is a minor opportunity to sell out of *extremely* overvalued technology stocks and replace that exposure with proxies for the *less extremely* overvalued broad market. But a sector-by-sector look will reveal more interesting opportunities.

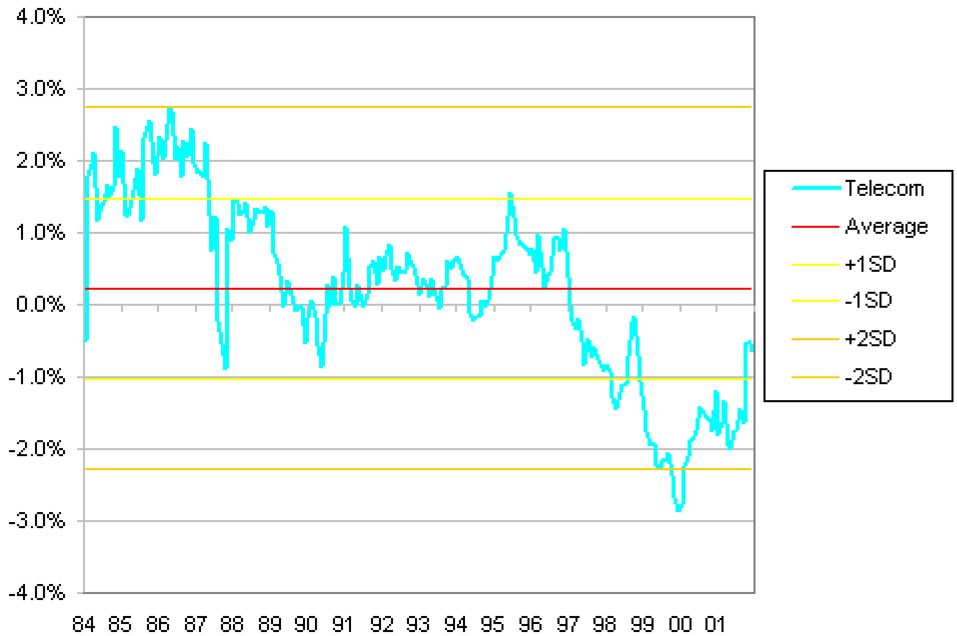


Now let's look sector by sector, and find the opportunity to shift out of technology where the yield gap is most negative, toward the sectors where it is most positive. Such an opportunity is agnostic as to which yield gap is "right," if either of them even are. It simply takes cognizance of the fact that technology stocks are way out of whack with their *own* norms, and that another sector may be way out of whack with *its* norms -- but in the opposite direction. On a relative-performance basis, such an opportunity will very likely be profitable whenever the two sectors agree on a common amount to be out of whack. It is not required that either of them ever get back into whack -- they simply have to be the *same amount out of whack*, or at least closer than they are today

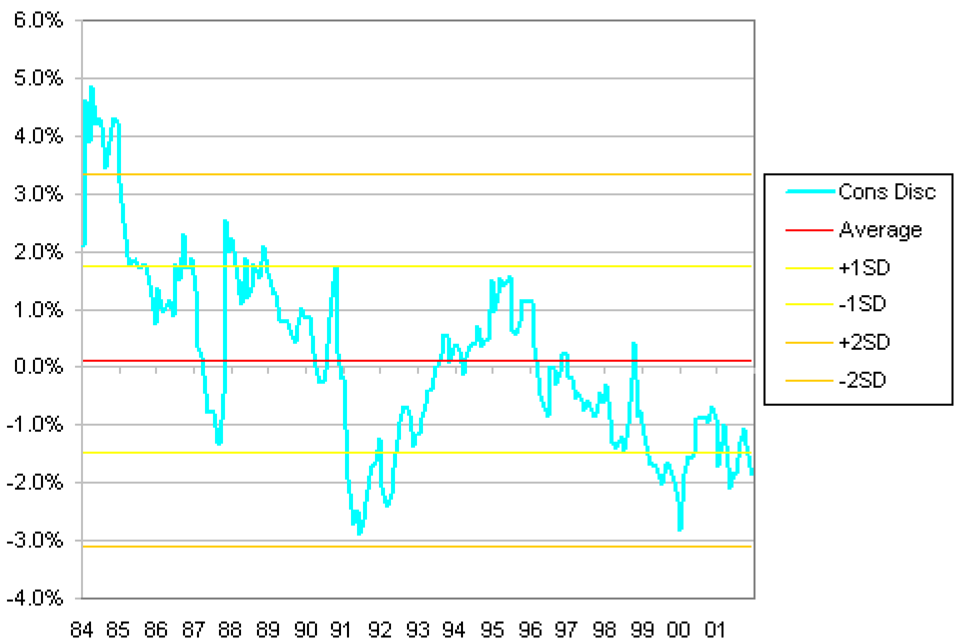
Of course, when comparing the yield gap of one equity sector to another -- or to the broad market -- we are, in essence, simply comparing forward price/earnings ratios. The special analytical power of the yield gap comes into full force when comparing stocks and bonds. But nevertheless, it is a powerful cognitive tool that helps us look at conventional data in new ways -- by adjusting the raw level of p/e's for the competitive background of riskless long-term interest rates.

What we find is that those sectors that can be interpreted as the *most cyclical* -- and the most in a position to benefit from the materialization of today's exaggerated hopes for a "V" recovery -- are generally the ones with yield gaps more *negative* than average. Conversely, the ones that can be interpreted as *staples* -- and least in a position to benefit from "V"-mania -- are the ones with yield gaps more *positive* than average. The staples, therefore, are the ones to consider as candidates for sector allocation trades against the technology sector.

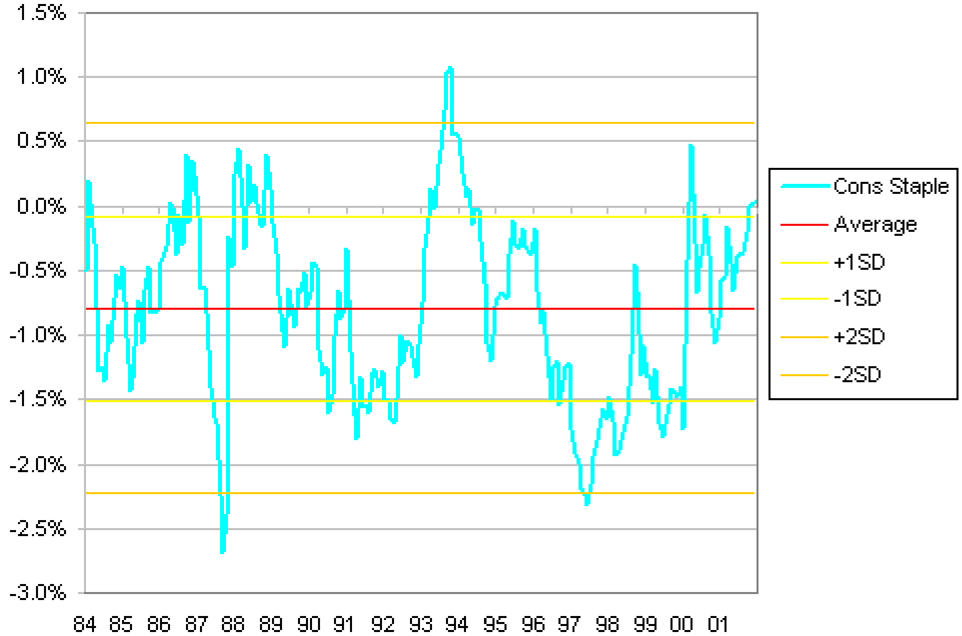
Telecom is in the cyclical camp, and it's about the same amount out of whack as the broad market.



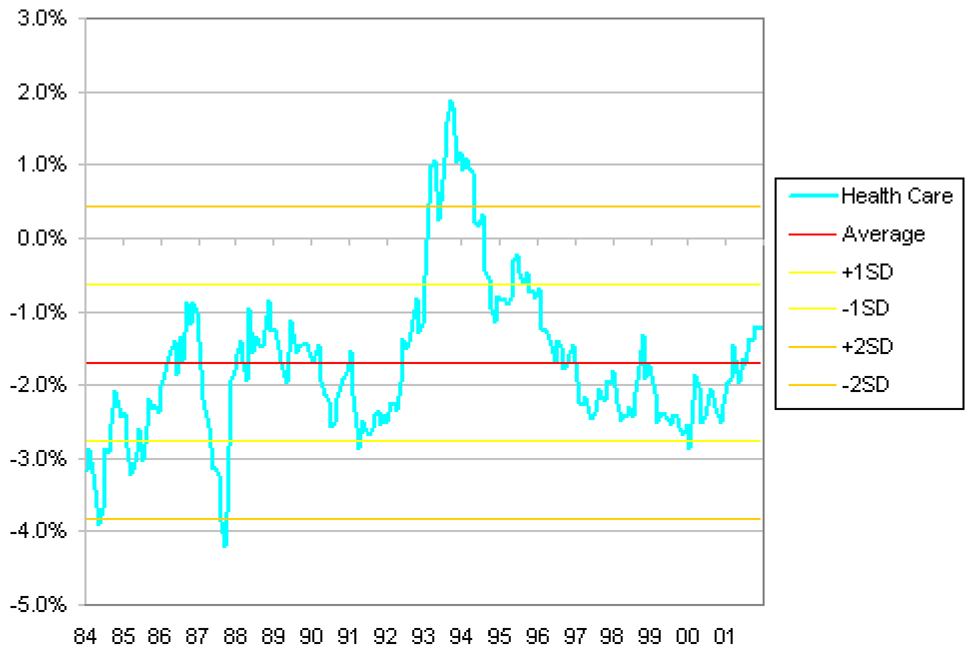
Consumer Discretionary is considerably more out of whack than the broader market, and indeed it closely resembles Information Technology. This should be no surprise, considering that this sector is especially sensitive to hopes for a cyclical recovery -- just like tech.



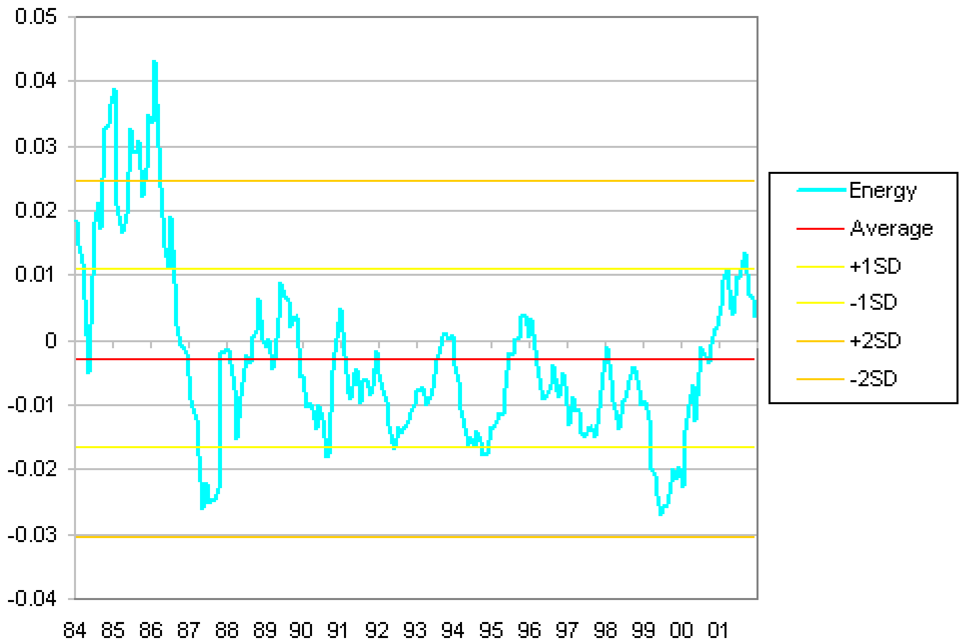
As we might expect, Consumer Staples shows the converse pattern. It is about as out of whack on the positive side as Consumer Discretionary is on the negative side. This sector is the best single candidate for a tactical sector allocation trade against technology stocks.



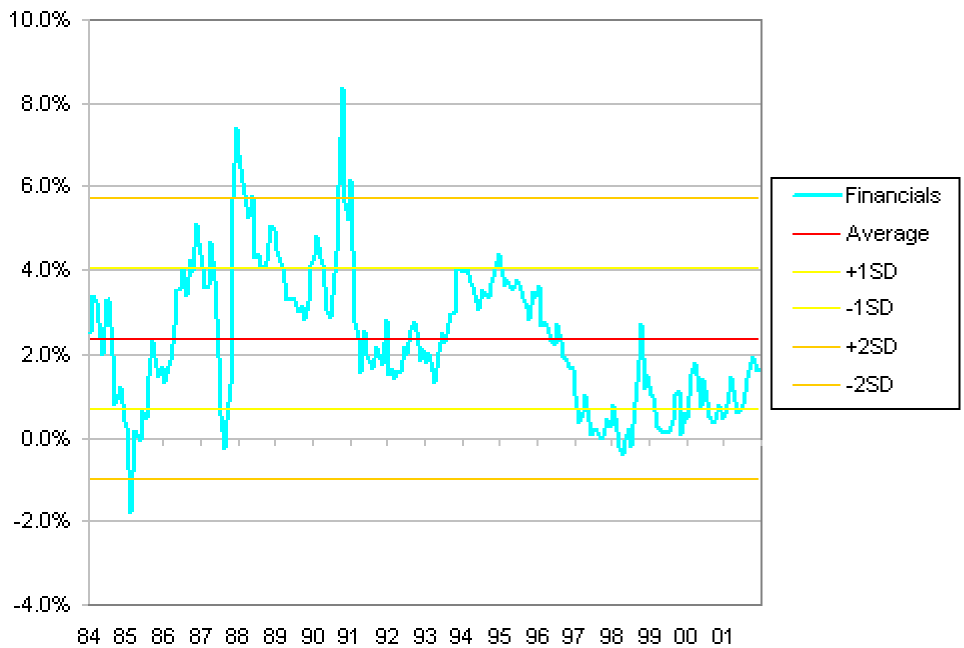
Health Care, another staples sector, reflects a yield gap that is more positive than average, although only slightly.



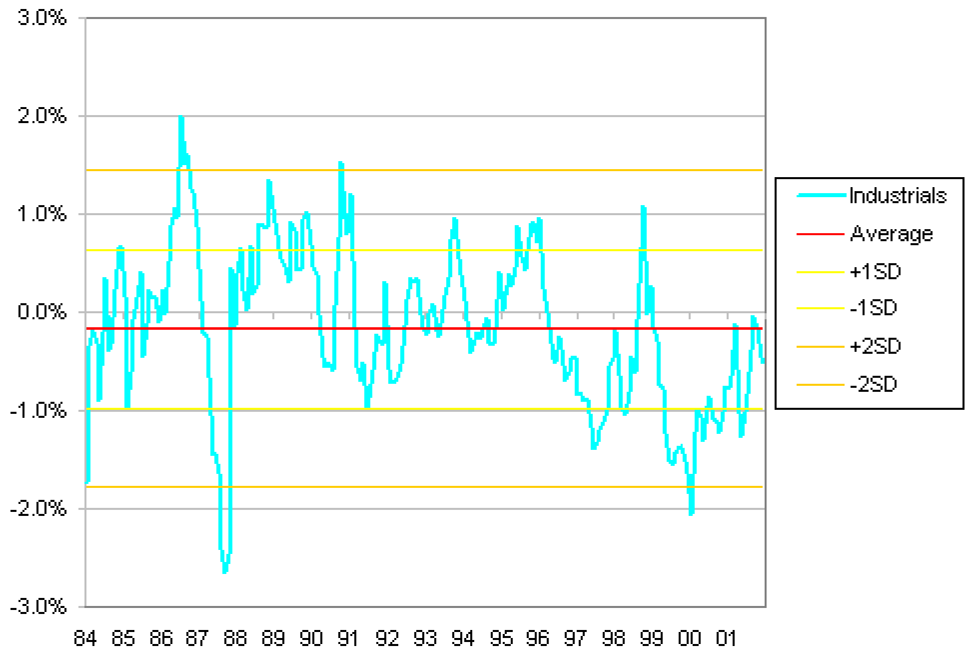
Energy is similarly out of whack on the positive side, perhaps reflecting its staples status, or perhaps expectations for a continuing trough in the price of oil.



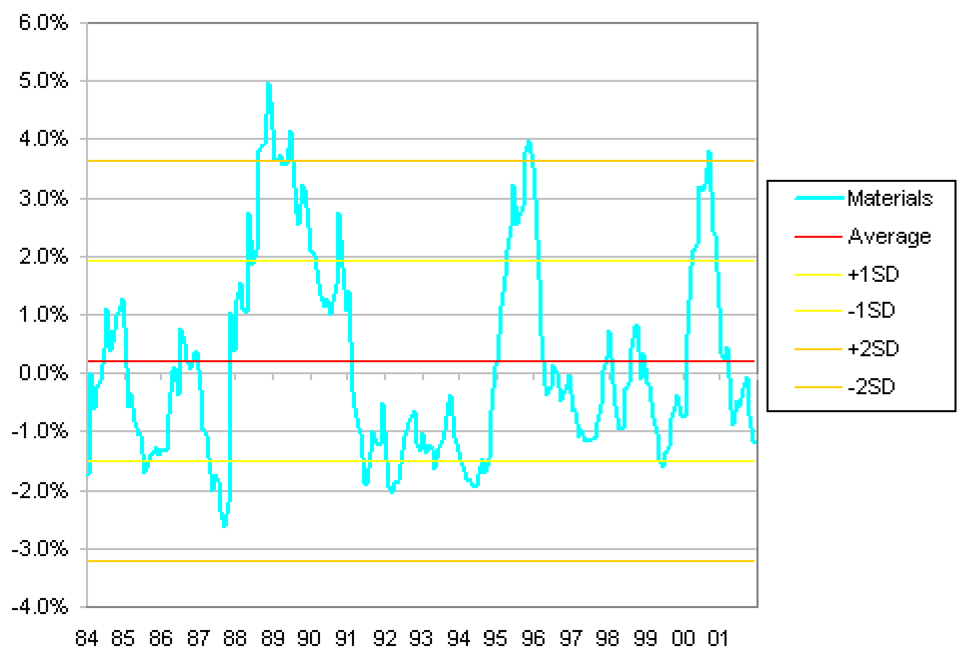
Financials are close to their average yield gap, tending only slightly to the negative.



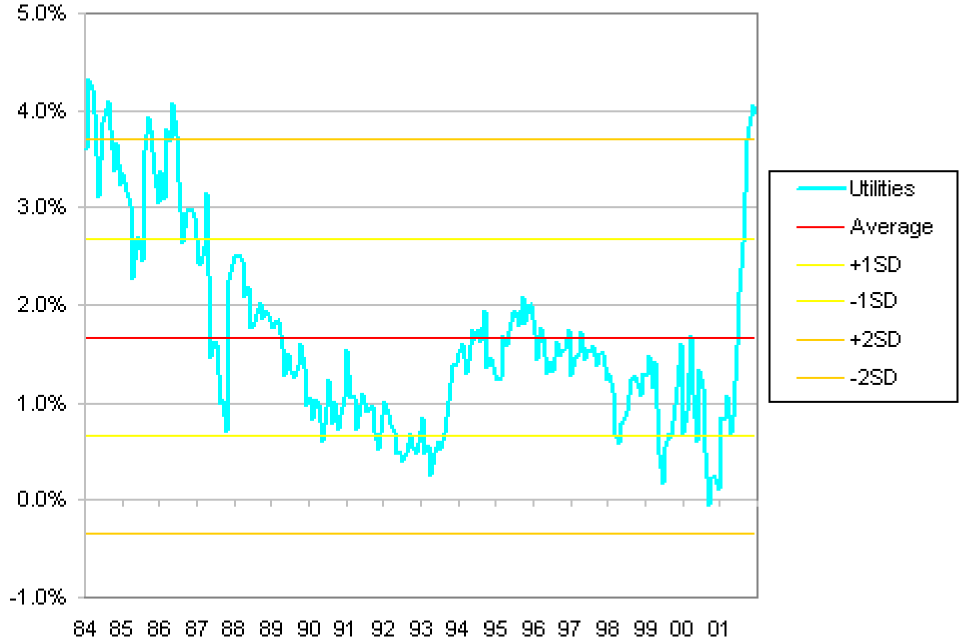
Industrials are also just slightly more negative than average.



Materials are somewhat more negative with respect to their average than the Industrials, perhaps reflecting expectation that basic commodities prices will rebound when the economy recovers.



The Utilities Sector is skewed by instability in the sector induced by the troubles at Enron. This should be regarded as a "special situation" outside the scope of quantitative analytical concepts such as the yield gap.



The bottom line: the most compelling trade is still sell technology, buy long Treasury bonds. *Both* sides of that trade are significantly out of whack -- each on its own, and both in relation to each other -- and all at historic levels.

But for investors who wish to confine their trading to the world of equities, and wish to exploit the temporary overvaluation in the technology sector, the best single sector allocation trade would be to sell technology and buy consumer staples. TM