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MARKET CALLS

A Little Problem of Reality

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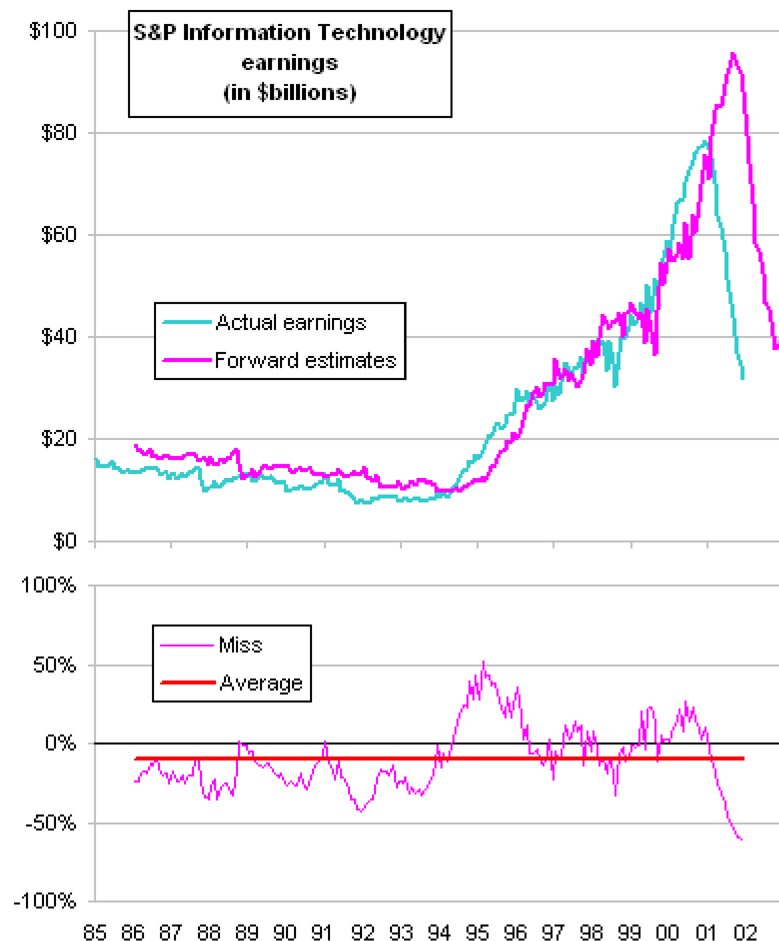
All it took to cure the market of its recession fears was for the **National Bureau of Economic Research** to declare that the recession had officially arrived. Ever since that happened on November 26, Wall Street economists immediately began to declare the recession to be over. It started with calls for a "V" recovery. Last Saturday ***Barron's*** ran an article calling -- with a straight face -- for a "super-V" recovery. What's next... an "ultra-V"... a "hyper-V"?

Now as January starts with a stock market surge, there's only one problem: *reality*. There are too many versions of it.



As of December 31, 2001; Source for earnings data: Morgan Stanley

One version -- reflected in price/earnings multiples of technology stocks -- has technology companies poised to make a "super-V" surge back to earnings levels similar to those achieved at the top of the market in March, 2000. But the *other* version -- reflected in somewhat more modest forward earnings estimates by Wall Street analysts -- has those same companies turning in a distinctly "mini-V" performance.

The same paradox exists in the broader market, but to a somewhat less egregious extent. Let's take a closer look, and see what it would take to reconcile these competing realities.

Looking at the world through the eyes of the analysts, we see consensus earnings forecasts that have only ticked up mildly, and only quite recently. For the S&P Information Technology sector, consensus forward estimates have only ticked up slightly over the last quarter -- October 2001's slight uptick was the first one at all since September 2000. November and December 2001 showed slight upticks as well, with the year-end consensus estimate logging in at $39.2 billion.

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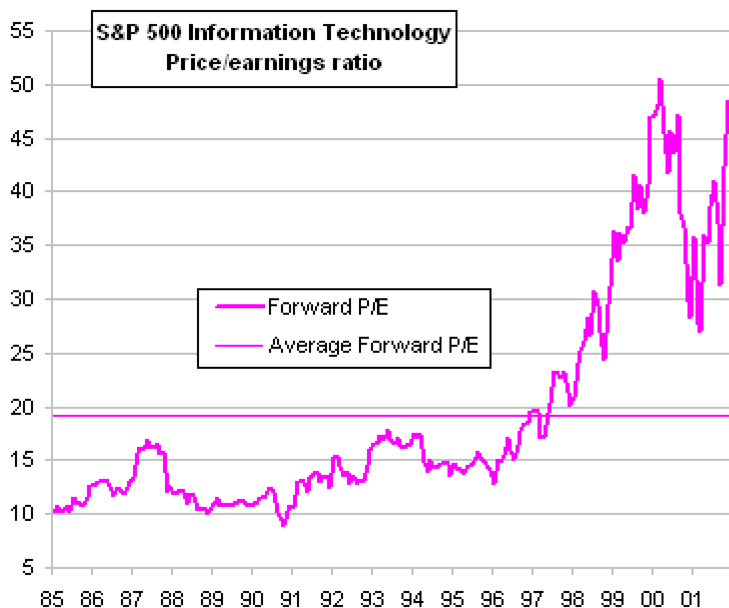
The upper panel of the chart on the previous page plots forward estimates -- the thick pink line -- versus the actual trailing 12-month earnings that were achieved one year later (the thick blue line). The year-end estimate of $39.2 billion is a beefy 22.5% increase above year-end's actual trailing 12-month earnings of $32.0 billion. It's a V, but it's a "mini-V."

The bottom panel of chart is the analysts' report card. It shows the gap between their forecasts and the actual earnings that developed a year later -- that's the thin pink line (rose-colored, like the analysts' glasses). On average, actual earnings have come in 10% below the almost perpetually too-rosy estimates -- the average is the thick red line on the chart.

But last year's forecast for $88.2 billion takes the booby prize. The actual earnings of $32.0 billion represents a 60% shortfall versus the consensus estimate, the worst downside surprise ever.

The essence of the conflicting realities we face today is: for technology companies to produce the kind of earnings implied in their prices today, the economy is going to have to produce the kind of "super-V" recovery the most optimistic pundits are ranting about. That's what it will take, because what is needed to justify today's prices is the greatest *upside* earnings surprise ever.

I say that because, even if we grant that the technology sector can deliver every penny of that $39.2 billion forecast for next year, that still leaves the S&P Information Technology sector index with a year-end forward price/earnings ratio of 47.0, very nearly the highest in history. The only higher reading was in the previous month, November 2001, and for three months at the peak of the so-called "tech bubble" in the first quarter of 2000.



The chart at left shows it all. It's very clear that technology stock prices are listening to the most optimistic "super-V" fantasies -- and not to the Wall Street analysts and their own less hysterical (but still very rosy) version of reality.

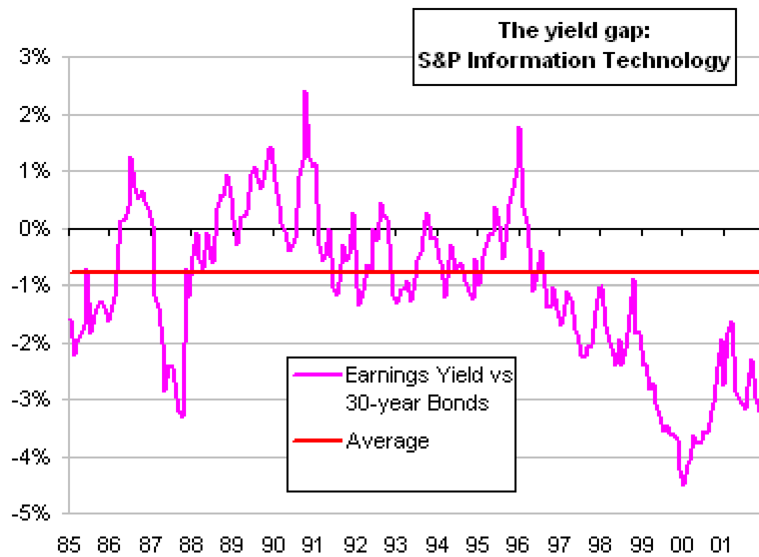
What kind of upside surprise would it take to prove today's stock prices right? Well, we could ask what kind of earnings technology stocks would have to book this year to bring their price/earnings ratio in line with the post-1985 average of 19.2.

But these are brave times -- even the S&P 500's current p/e of 21.9 is higher than *that*. It seems almost ludicrous to expect a correction back to such a strict norm.

And indeed, as we've discussed here before, today's low interest rates *do* justify higher-than-normal price/earnings ratios (see "Vay Out of Vack -- Even for a 'V'" December 10, 2001; and "The Yield Gap, Sector by Sector" December 19, 2001). One simple and powerful way to adjust p/e's for interest rate changes is to compute the "yield gap" -- the difference between the forward "earnings yield" on stocks, and the income yield on bonds.

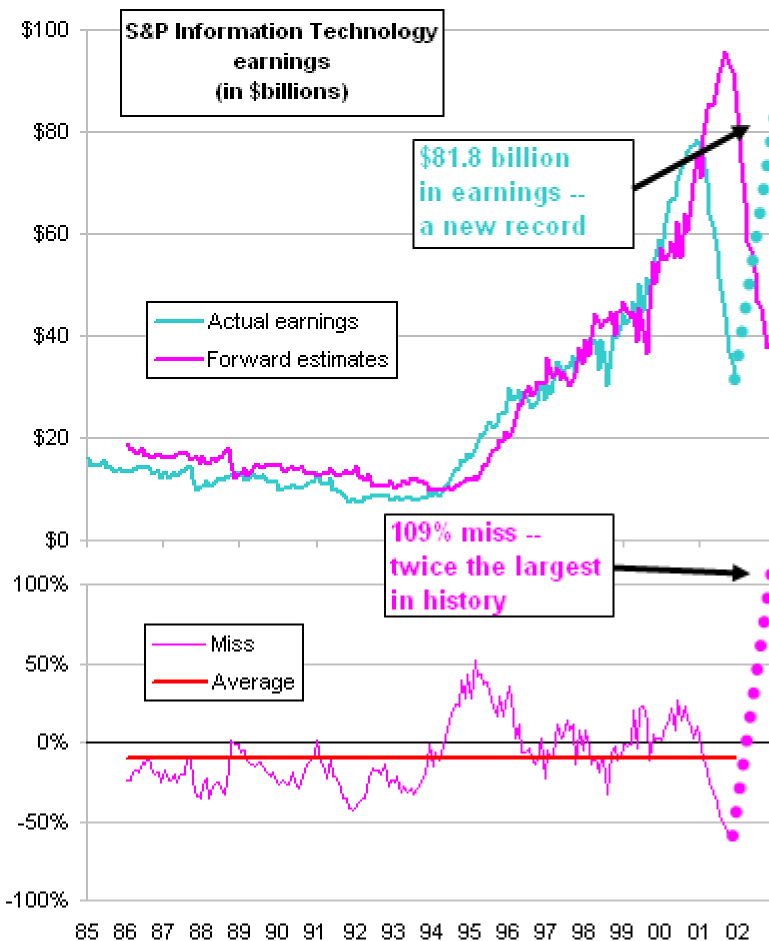
As the chart below shows, the yield gap for technology stocks versus 30-year Treasury bonds is typically negative, averaging -0.9% post-1985 (the thick red line on the chart). It's negative --

even though bonds are riskless and stocks are risky -- because stocks are presumed to have earnings growth potential that will make up for the yield gap over time.



The yield gap month by month is the thick pink line. Today it is at -3.4%, an extreme reading to be sure. That's about the same level it attained briefly just before the great stock market crash of 1987, and attained for somewhat longer at the top of the market in 2000.

Because the yield gap takes interest rates into account, we can justifiably ask what kind of upside earnings surprise would be required to move the market back to the post-1985 average of -0.9%. It's a simple calculation: you just keep increasing the earnings estimate until you find the amount that produces an earnings yield exactly 0.9% less than the current yield on 30-year Treasury bonds.

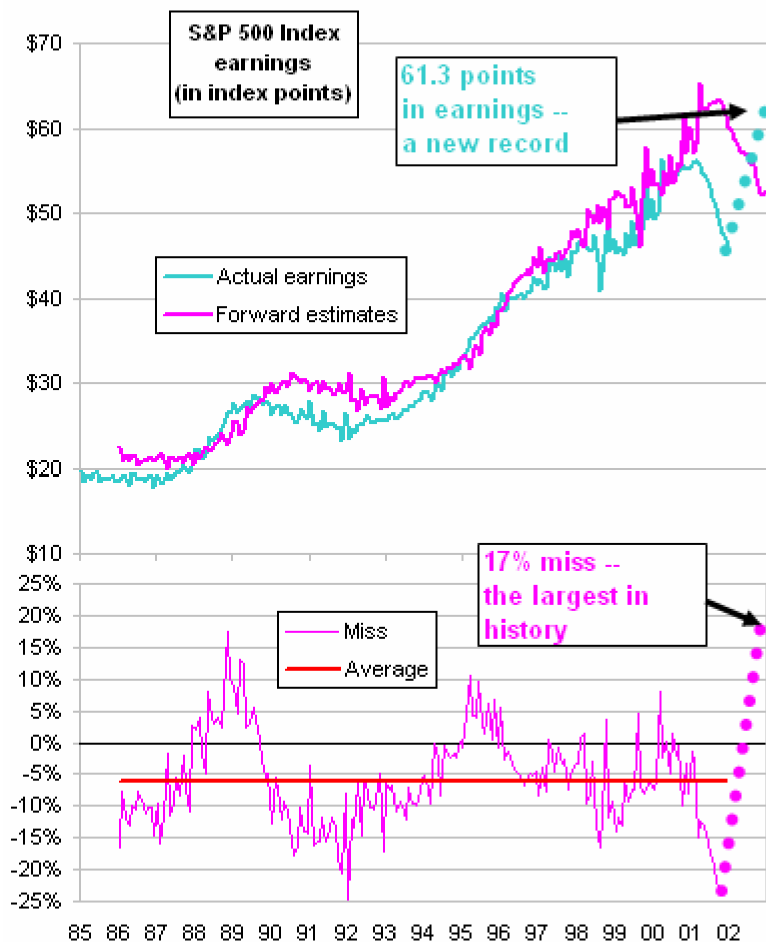


If you've been paying today's prices for technology stocks, you just might find the results of this calculation -- the amount of upside surprise that's *really* required to justify the price you paid -- *somewhat*, well... surprising. Just take a look at the chart at left.

The calculation shows that today's stock prices are discounting for $81.8 billion in earnings -- the best year in the history of the technology sector. And today's prices are calling for a 109% upside surprise -- more than twice the biggest upside surprise there's ever been.

The situation is similar for the S&P 500. For earnings to catch up with today's prices enough to bring the S&P's yield gap back to *its* post-1985 average, earnings will have to set a new record at 61.3 index points. The consensus now is 52.5, already a 14.6% sequential increase over 2001's actual earnings of 45.8. To hit 61.3, earnings would have to grow 33.8% --

and that would mean a new record for upside surprises – a miss of 17%. While this is undoubtedly asking a lot, at least the required surprise is only slightly higher than the one registered coming out of the recession of the early 1990s. At least the required surprise isn't *twice the largest one in history* as it is for the technology sector.



It's tough to be anything less than wildly bullish right now, especially after the big days on the NASDAQ that have opened the New Year. Sometimes I feel myself getting V-ness envy.

But then I look at these charts. And I remind myself that *even if* the wildest "super-V" fantasies come true -- *if stocks come back to their long-term average yield gap at the same time, then prices will be exactly the same as they are today.*

Or to put it another way: *stock prices already generously discount a very, very robust and rapid recovery.* You just aren't getting paid to make that bet at this point. To win it, *not only* does some form of this massive upside earnings supply have to materialize, *but in addition, valuations have to stay at these high levels or higher.*

Oh -- and if that isn't already enough to make you stop and think, here's one more thing. All the ravers calling for a "super-V" reality are also saying that interest rates are going to move a lot higher in the process. If that happens, it will put even more pressure on already high multiples.

And *that* will put all the more pressure on the real world to catch up with the "super-V" fantasies. When the only tangible signs of recovery to be seen objectively are that some indicators that had been in free-fall have stopped falling, it's going to be a stretch even to get the real world to cooperate to the extent of delivering the 22.5% earnings growth for technology companies -- and 14.6% for the broad market -- that the analyst consensus is hoping for. Personally, I'll be delighted with *that* reality. TM