TrendMacrolytics

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MARKET CALLS

Don't Blame the Long Bond!

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OTHER REPORTS ON "THE YIELD GAP"

A Little Problem of Reality
January 4, 2002

The Yield Gap, Sector by Sector
December 19, 2001

Vay Out of Vack -- Even for a "V"
December 10, 2001

For the last several weeks I've been talking about how equity valuations have gotten way ahead of already optimistic analysts' earnings growth estimates -- especially in the technology sector. At the same time, 30-year Treasury bonds are yielding above 5.5% in an environment with virtually no inflationary pressures.

That puts the stock market and the bond market into significant disequilibrium, which can be quantified by measuring the "yield gap" -- the difference between bond yields and the "earnings yield" of stocks. The more negative the yield gap, the less stocks pay in uncertain earnings in relation to what bonds pay as guaranteed income. Of course stocks offer earnings growth prospects, so a negative gap is no surprise. But the more negative the gap, the less competitive stocks are in an efficient market.

Today the yield gap is at levels of negativeness seen only rarely, and historically associated with stock market tops. For the S&P 500, the yield gap to 30-year Treasuries has averaged -0.2% since 1985. Today it is at -0.9%. For the S&P Information Technology Index, the yield gap has averaged -1.1%. Today it is at -3.4%.

A fair question about using the yield gap as a measure of disequilibrium is whether it may be merely an artifact of today's unusually steep yield curve. The yield curve itself is in a form of disequilibrium now (see the Trend Macrolytics report "Following the Curve" by **David Gitlitz**, December 21, 2001), and that would cause the yield gap to appear especially negative when measured against the long end of the curve.

So perhaps stocks aren't really so overvalued. Perhaps the yield of the long bond is just too high. Let's apply a few common-sense acid tests, and see if we can find out which market is to blame for the present disequilibrium. Let's start by looking at how the yield gap looks across the Treasury curve.

	Yield gap as of 12/31/2001	Yield gap post-1985 average	Standard deviations from average
S&P 500			
Vs 30-year	-0.9%	-0.2%	0.8x
Vs 10-year	-0.5%	0.1%	0.6x
Vs 5-year	0.2%	0.4%	0.2x
S&P Info Tech			
Vs 30-year	-3.4%	-1.1%	1.7x
Vs 10-year	-3.0%	-0.8	1.5x
Vs 5-year	-2.3%	-0.5	1.2x

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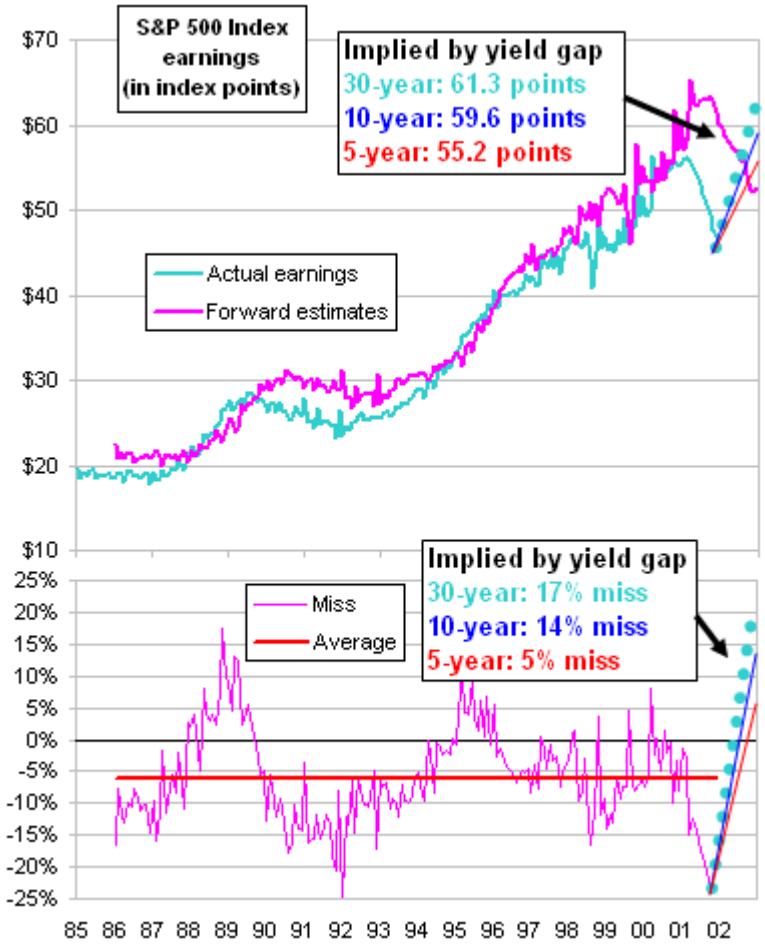
Indeed, the yield gaps for 5-year and 10-year Treasuries are less outrageously out of whack than the yield gap for 30-year Treasuries. In fact for the S&P 500, the 5-year yield gap is only 0.2 standard deviations from the post-1985 average. But for the Information Technology sector, even the 5-year yield gap -- while a big improvement from the 30-year -- is still 1.2 standard deviations from the average.

This evidence suggests that the long end of the Treasury curve is in greater disequilibrium than the short end, and it confirms that the disequilibrium is greater in Information Technology than across the broad stock market. But there is nevertheless a pervasive disequilibrium between *all* stocks and the *entire* yield curve.

There are other tests we can apply to confirm this intuition. For example, we can determine what level of earnings that stocks would have to deliver to justify today's prices. In other words, how much above today's estimates would 2002 earnings have to be to bring the yield gaps back to their historical norms? And how different would 2002 earnings have to look depending on whether we measure them against 5-year, 10-year, or 30-year Treasury yields?

For the S&P 500, record trailing 12-month earnings of 56.3 were attained in March 2000. 2001 earnings were 45.8, and consensus for 2002 is 52.5, up 15%.

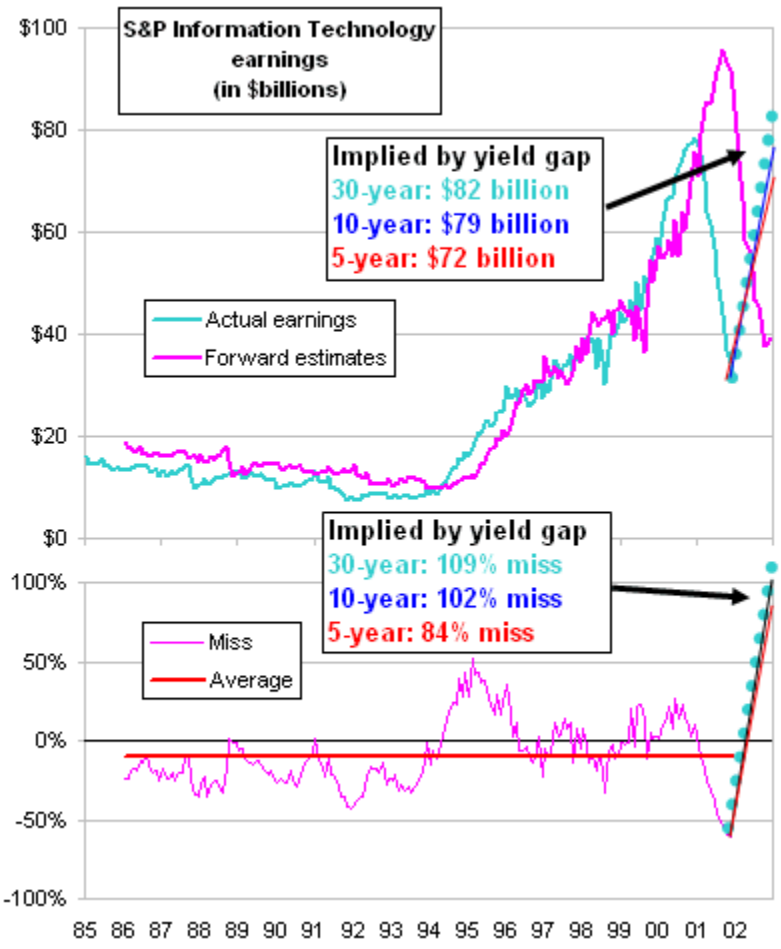


To bring the 30-year yield gap back its historical norm, it would require 2002 earnings of 61.3. That's higher than the record level, a 34% jump over 2001, and 17% higher than the consensus. A miss that size would be 3.0 standard deviations from the average miss of -6%.

For the 10-year yield gap, it would require 2002 earnings of 59.6. That's still higher than the record level, 30% above 2001, and 14% higher than the consensus. It's a 2.6 standard deviation miss.

For the 5-year yield gap, it would require 2002 earnings of 55.2. That's *not* a new record. But it is still 20% above 2001, and 5% higher than the consensus. It's a 2.6 standard deviation miss.

For the S&P Information Technology sector, record trailing 12-month earnings of $78.4 were attained in December 2000. 2001 earnings were $32.0 billion, and consensus for 2002 is $39.2 billion, up 23%.



To bring the 30-year yield gap back its historical norm, it would require 2002 earnings of $82 billion. That's higher than the record level, a 156% jump over 2001, and 109% higher than the consensus. A miss that size would be 5.6 standard deviations from the average miss of -10%.

For the 10-year yield gap, it would require 2002 earnings of $79 billion. That's still higher than the record level, 148% above 2001, and 102% higher than the consensus. It's a 5.3 standard deviation miss.

For the 5-year yield gap, it would require 2002 earnings of $72 billion. That's *not* a new record. But it is still 126% above 2001, and 84% higher than the consensus. It's a 4.4 standard deviation miss.

Face it: it would take a super-hyper-ultra-mega-gonzo-"V" recovery to make *any* of those earnings numbers in 2002. It's not just the long bond, and it's not even just Information Technology, even though that's where the disequilibrium is most extreme. Across stocks, and across the curve -- even comparing the S&P 500 to 5-year Treasuries -- it's just not going to happen. An earnings surprise like this is simply a bridge too far.

Now let's perform this test in reverse, and try to close the yield gaps from the opposite direction. Let's assume that earnings come in for 2002 exactly as expected by the analysts. How much would bond yields have to come down to restore the yield gaps to their historical norms?

Here are the bond yields that would be required to achieve that.

	Yields at 12/31/2001	Required given S&P 500 consensus	Required given Info Tech consensus
5-year Treasuries	4.4%	4.2%	2.6%
10-year Treasuries	5.1%	4.5%	2.9%
30-year Treasuries	5.5%	4.7%	3.2%

For the S&P 500, the required declines in yields for all three maturities are easily conceivable. In fact, these are all yields that have been seen within the last three months or so. But for the Information Technology sector, the required moves down in yields are far more difficult to imagine. And it's not just 30-year yields. Sure, it's tough to imagine the long bond yielding 3.2%. But is it all that much easier to imagine 5-year Treasuries yielding 2.6%?

Yes, the yield curve is steep. And yes, we believe that long-term Treasuries represent a special value now.

But don't just blame the long bond for the disequilibrium we are seeing. This crime isn't being committed by a lone gunman. This is a conspiracy. Stocks and bonds -- broadly -- are out of whack with each other, across stocks and across bonds. And that disequilibrium means a major tactical asset allocation opportunity. TM