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MARKET CALLS

On the Road to Equilibrium

Monday, February 4, 2002

Donald Luskin

OTHER REPORTS ON "THE YIELD GAP"

Don't Blame the Long Bond
January 7, 2002

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 almost two months now we've been saying that technology stocks and long-term Treasury bonds are in extreme disequilibrium relative to their historical value norms. They still are in disequilibrium -- so we still believe there is an excellent tactical asset allocation opportunity to sell tech stocks and buy long bonds. However, since we first pointed out that opportunity on December 10 (see "Vay Out of Vack -- Even for a "V" December 10, 2001), the disequilibrium has become less extreme -- and, as a result, the tactical asset allocation trade is profitable on both sides. We now suggest taking a little off the table, reducing the size of the tactical asset allocation trade by 25%.

On December 10 the forward price/earnings ratio of the S&P Information Technology sector was 50.0, for an "earnings yield" of 2.00%. With the long bond yielding 5.58%, the "yield gap" between the two markets showed an extraordinary reading of negative 3.58% -- more negative than in October 1987, and almost as negative as at the top of the so-called tech bubble in March, 2000.

Now, as of the close on February 1, the forward price/earnings ratio for tech stocks has fallen to 43.8%, for an earnings yield of 2.28%. This drop in p/e is due to changes in both the numerator and the denominator -- forward earnings have been revised upward by 6.0%, and tech stock prices have fallen by 7.1% (as measured by the NASDAQ 100 Index). At the same time, the long bond's yield has fallen to 5.40%, for a gain in the long bond of 3.5% (as measured by the 30-Year Treasury futures contract).

That means that the yield gap has narrowed from negative 3.58% to negative 3.12%. That is still an unusually negative value, and it suggests that the tactical asset allocation trade continues be a promising position. But any position based on a temporary market misvaluation should be scaled to the size of that misvaluation. As the misvaluation is repaired the position should be reduced.

So for the purposes of our own scorekeeping, we will be reducing the position by 25% today -- and booking a gain on both sides.

One never knows exactly why equilibrium finally reasserts itself after there has been a disequilibrium (or, for that matter, why the disequilibrium existed in the first place). But here are some thoughts on this particular case.

We initially suggested that the extraordinarily high valuation assigned to technology stocks was a bet on a "V" recovery, or even a "super-V." But as earnings season has played out, it has become increasingly difficult for equity investors to build the "V" case from the bottom up -- the best most companies have been able to do is forecast flat results. So even while the

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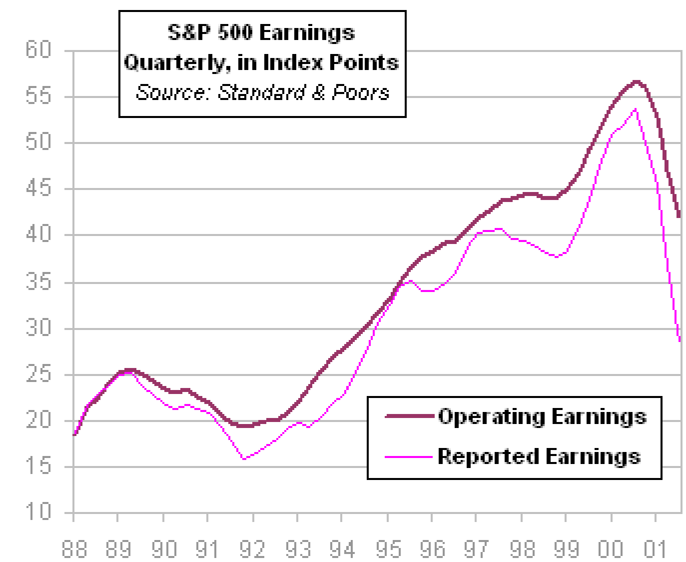
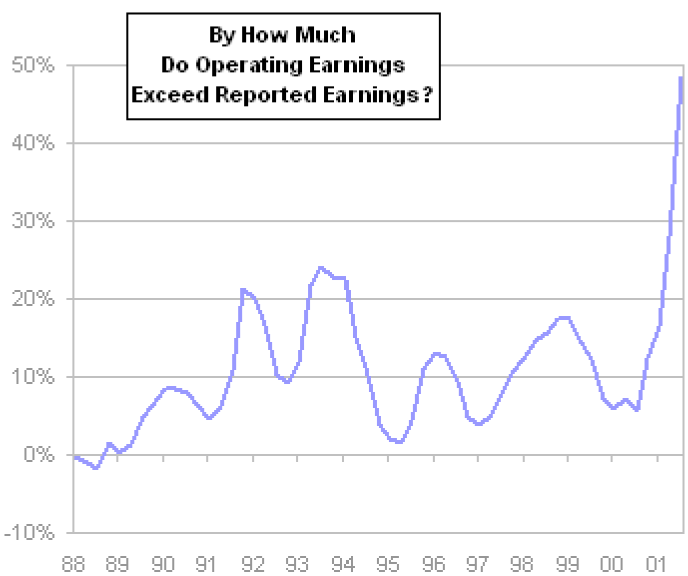
macroeconomic forecasters have turned up the volume on their "super-V" forecasts, equity investors have learned one stock at a time that it isn't going to be so easy.

Another factor weighing on equity valuations has been the **Enron** scandal. Even as forward earnings have been revised higher, it is difficult to justify a high multiple to those earnings when trust has been eroded, even though investors surely do not expect that very many companies have practiced the kind of deliberate fraud of which Enron is accused. Nonetheless, the Enron affair has attracted new scrutiny to the way that "operating earnings" or "pro forma" earnings are presented as distinct from "reported earnings." Enron or no Enron, with companies like **JDS Uniphase** and **AOL/Time Warner** taking good-will write-offs each one of which is large enough to whack 10% off S&P 500 total earnings, questions of protocol are going to get asked.

Today there seems to be a widespread belief that earnings reporting has become increasingly dishonest, with more and more categories of losses getting defined out of operating or pro-forma earnings. One report typical of this belief calculated that for the first three quarters of 2001, "the one hundred companies that make up the NASDAQ 100 reported $82.3 billion in combined *losses* to the **Securities and Exchange Commission** (SEC). For the same period, these companies reported $19.1 billion in combined *profits* to shareholders via headline, 'pro forma' earnings reports..." It concluded that, "These findings are a sad commentary on the state of financial reporting in the United States."





We may indeed wish that reporting companies drew less self-flattering distinctions about what should go into operating or pro-forma earnings. But at least their GAAP earnings reports are filed with the SEC and are there for all to see -- except in the presumably exceptional cases of the Enrons of the world.

And while it's true that in 2001 the dollar gap between reported earnings and operating earnings was the largest in history, it can all be explained by a handful of truly exceptional and well-publicized events -- for example, almost half the gap described in the quotation above is attributable to JDS Uniphase's write-off. Other than that -- a symptom of the once-in-two-generations boom-and-bust cycle we're going through -- there really is no discernable long term trend toward a widening gap between reported and operating earnings. The charts on this page make this quite clear.

On the bond side of the tactical asset allocation trade, we would argue that yields have come down as investors have begun to recognize opportunity in the highest real yields in living memory -- set against a background of deflationary momentum that will make it difficult for the **Fed** to hike interest rates as rapidly as they otherwise might.

Disappointment in the vigor of recovery, some measure of skepticism about earnings reporting, and continuing deflation -- these are all ideas with legs. They should continue to drive disequilibrium back toward equilibrium. Already it would appear that the worst of the disequilibrium is behind us. TM