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MARKET CALLS

Mind the Gap

Wednesday, April 24, 2002

Donald Luskin

This morning we are reducing the commitment to the Model Position established on December 10, 2001, in which we suggested a tactical asset allocation move to buy long-term Treasury bonds and sell technology stocks. Our original call was motivated by the historically wide "yield gap" of 3.6% -- a gap between the earnings yield of technology stocks and the yield of long-term bonds that has only been wider on two occasions: just before the crash of 1987, and at the top of the so-called bubble in March 2000. We said at the time that such a wide yield gap represented a significant overvaluation of growth prospects, even in light of prevalent optimism about a "V" recovery in the broad economy (see "Vay Out of Vack -- Even for a 'V'" December 10, 2001).

Of course, since that time we have also argued consistently that hopes for a rapid and sustainable recovery were bound to be frustrated. As this vision has gradually begun to gain currency, the yield gap has narrowed. On February 4, with the yield gap at 2.99%, we suggested reducing the commitment to our asset allocation trade by 25% (see "On The Road to Equilibrium" February 4, 2002). Now, with the yield gap at 2.69%, we suggest reducing the commitment by another 25%, leaving only 50% of the original trade in place.

This position has been quite profitable. As of this writing, the cumulative gain, based on the initial value of the short side of the trade, has been about 33.5% on a cash basis. Since the position was initiated, the NASDAQ 100 is down 19.5%, while the total return of 30-year Treasury bonds has been 3.3%.

We continue to believe that the economy's ability to generate an earnings recovery in the technology sector is extremely limited, and that technology stocks remain overpriced. And technology stocks notwithstanding, we still maintain our bullish position on long-term Treasury bonds (see the Buy Bonds/Buy Eurodollars Model Position). That said, our quantitative measure of the relative valuation of technology stocks and long-term bonds -- the yield gap -- has pulled back now from the historically high levels where the position was initiated. So while the position and the basic market call remain in place, we suggest taking more profits off the table. TM

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