TrendMacrolytics

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MARKET CALLS

Return to Normalcy?

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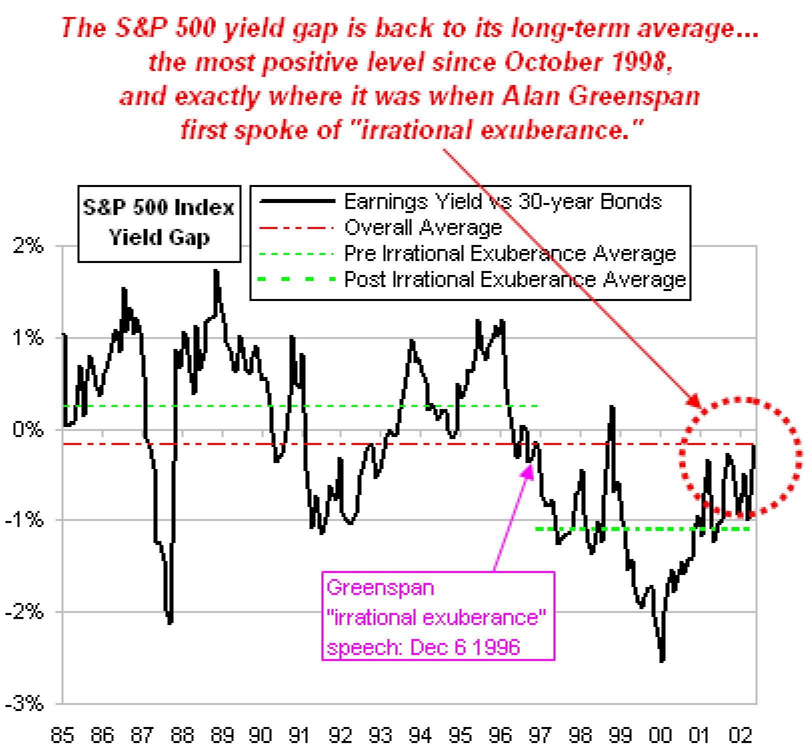
Donald Luskin

The equity market has finally returned to a normal level of earnings-based valuation... but what's normal? And will the earnings be there?

While the equity market has drifted lower, consensus earnings forecasts have drifted higher. Earnings up, prices down -- on the surface at least, it's been enough to move broad market valuations back to normal levels.

That surface may well be good enough for investors who have stayed out of the market due to valuation concerns and are eager to get back in. But beneath the surface there are important questions both about the likelihood of achieving the earnings that are being forecasted, *and* about what constitutes "normal" nowadays when it comes to valuation levels.



These questions are intertwined for us, because our measurement of valuation -- the "yield gap" -- is critically dependent on consensus earnings forecasts in the context of historical norms. We start by taking consensus earnings forecasts as a fraction of the market's capitalization: that gives us the "earnings yield" of the equity market. We subtract that from prevailing long-term bond yields, and call the difference between the two yields the "yield gap."

An abnormally *negative* yield gap (when the earnings yield of stocks is far *below* the income yield of bonds) means that stocks are relatively *over*-valued -- while an abnormally *positive* yield gap (when the earnings yield of stocks is *high*) means that stocks are relatively *under*-valued. Since the beginning of our data series in 1985, the average for the yield gap has been negative 0.17%, suggesting that investors, on average, have demanded a bit less earnings yield form stocks than they have income yield from bonds. That is precisely where the yield gap is today -- right on the long-term average.

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A return to normalcy may seem prosaic, but getting back to the long-term average yield gap is actually quite a feat for a market that has been richly valued -- at least by historical norms -- for a very long time. With the exception of only the two months of September and October 1998, the yield gap has been well below its long-term average for the 5-1/2 years since December 1996 -- which happens to be the very month **Alan Greenspan** made [his famous "irrational exuberance" speech].

But let's not leap to the conclusion that what I've called the "epoch of high valuation" is over. The long-term average to which the yield gap has returned *includes* the 5-1/2 years of post-irrational exuberance over-valuation, and is shifted lower as a result. If we consider the average yield gap *only up to December 1996*, we see a very different picture. The pre-irrational exuberance average is positive 0.3%, and we're still well below that level.

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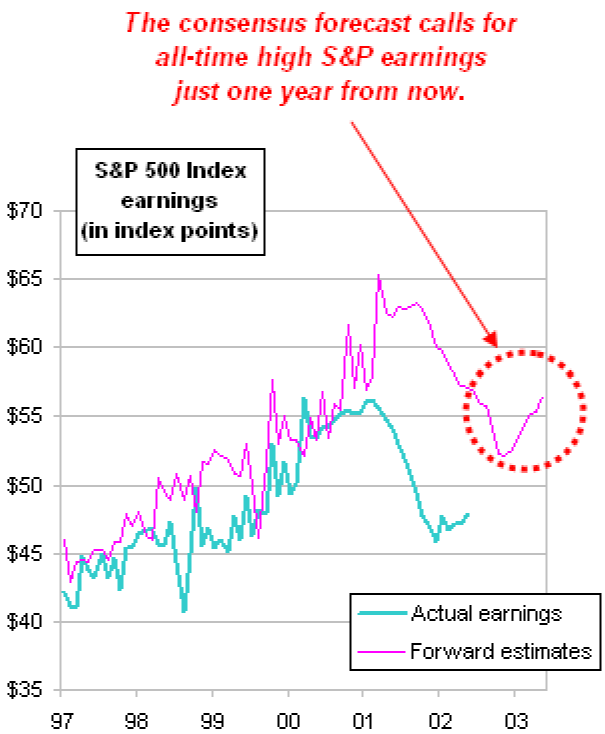
Against *that* norm the market remains over-valued. In fact, today's level of the yield gap -- even though it is precisely at the overall long-term average -- is right where it was when Greenspan warned of irrational exuberance.

On the other hand, if we calculate the yield gap *only after December 1996* -- which results in an average of negative 1.1% -- then the market appears under-valued. Judged against the norms of the "epoch of high valuation," the market is cheap. Indeed, it appears about as *under*-valued today as it was *over*-valued in March 2000.

There's another issue that throws today's apparent normality into question. Regardless of which norm you prefer -- long-term, pre-irrational exuberance or post-irrational exuberance -- the level of the yield gap today that gets measured against that norm depends on today's consensus earnings forecasts. And even in a world in which Wall Street analysts have been chastened both by a bear market and class action lawsuits, those forecasts may be too optimistic.



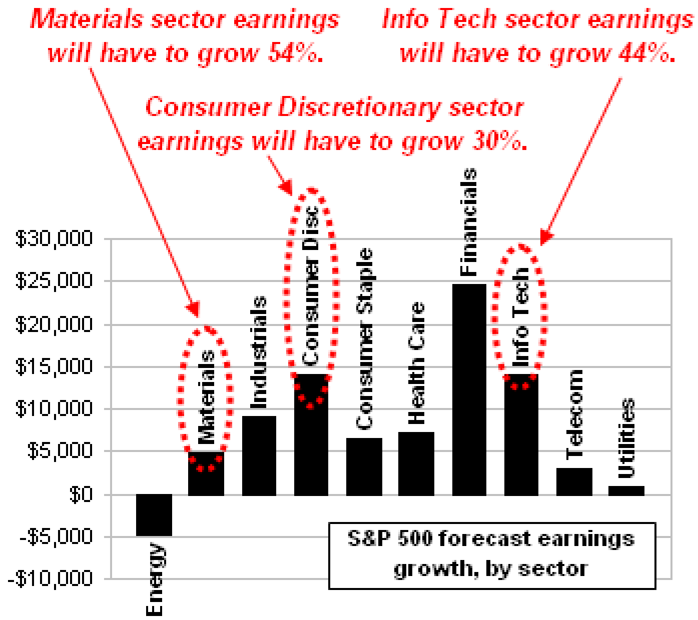
At 56.5, the consensus 12-month earnings forecast for the S&P 500 has now, for the first time, climbed back above its pre-September 11 level of 55.8. In fact, it's now the highest it has been since June 2001, when it weighed in at 56.8.

The current consensus of 56.5 -- that's measured in S&P 500 index points, and is the equivalent of $518.2 billion -- represents a new all-time record high for S&P earnings. It is higher than the 56.3 achieved in the 12 months ended March 2000, and it's a jump of 18.0% -- or $79.2 billion -- over the most recent trailing 12 months.

Can the market make that jump -- from recession back to peak earnings in less than a year from now? It's not impossible on the face of it -- there have bigger jumps in a single year's time on several occasions over the last couple decades. But a detailed look at where the earnings growth is forecasted to come from this time -- sector by sector -- suggests that some skepticism may be in order.

Almost one third of the $79.2 billion of forecasted earnings growth -- by far the largest single chunk -- is expected to come from the financial sector. Its large expected contribution to overall earnings growth in dollar terms is, in part, due to the fact that this sector represents the largest fraction of the index's capitalization weight, at almost 20%. Nevertheless, it is forecasted to grow its earnings at 23% year-over year -- very ambitious for a sector facing what are today stagnant markets and dangerous credit and litigation issues.

The next two largest chunks are expected to come from the information technology and consumer discretionary sectors, forecasted to grow 44% and 30% year-over-year, respectively. Today most technology companies are saying that they have no earnings visibility out more than a single quarter, and those few that have dared to forecast a year out sure aren't saying anything about 44% earnings growth. And with consumer spending having stayed reasonably intact so far through the present recession, it's difficult to see where the consumer discretionary sector is going to find 30% earnings growth.



Although the total dollar contribution will be small, the most aggressive growth percentage growth forecast is for the materials sector, expected to grow earnings at 54% year-over-year. Oddly, this ambitious forecast may be among the most realistic. With earnings dependent on prices of basic commodities, the materials sector will be an early beneficiary of easing deflationary pressures. Stock prices seem to agree with this assessment: the forward price earnings ratio for the materials sector is 21.4 -- hardly princely in the grand scheme of things, but far above this sector's normal forward p/e of 13.6. These stocks are already priced for *a lot* of deflation relief.

Deflation was a key causal factor in the devastation of earnings across all sectors, as **Trend Macrolytics chief economist David Gitlitz** has repeatedly warned over several years. Now, the process of deflation relief -- signaled by the consolidation of gold's rally well above $300 -- will play a critical role in any broad earnings recovery. Its effect on the materials sector is only a down-payment on a long, complex and risky process.

It's not at all clear that deflation relief will be sufficient to power the S&P's forecasted $79.2 billion in earnings growth over the coming twelve months. But it's a real positive for a market that has gone a very long time without any real positives. And with valuations starting to get near some version of normalcy, we may be approaching a time when we can start getting interested in stocks again. TM