MARKET CALLS

Dam Lies?

Wednesday, July 17, 2002
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When the Treasury Undersecretary says the market is overvalued, you'd better listen -- because the Bush administration is making it so.

Thanks to our friend **Brian Wesbury**, the chief economist for **Griffin, Kubik, Stephens & Thompson**, for sharing a real gem yesterday in a his daily commentary. Wesbury says that **Deputy Undersecretary of the Treasury Kenneth W. Dam** was quoted last Friday in the Australian press saying that "the historical valuation for S&P-type stocks is about 14 times earnings, and we are apparently a lot higher than that."

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Just what is this statement supposed to mean -- this vapid, superficial cliché about the stock market that sounds like something Dam picked up from a personal investing column in an in-flight magazine -- uttered in the midst of a full-blown crisis of confidence with the markets making new lower-than-post-911 lows? Is it supposed to be comforting? Is it supposed to say we don't need to listen to what the collapsing stock market is telling us, because it's so overvalued?

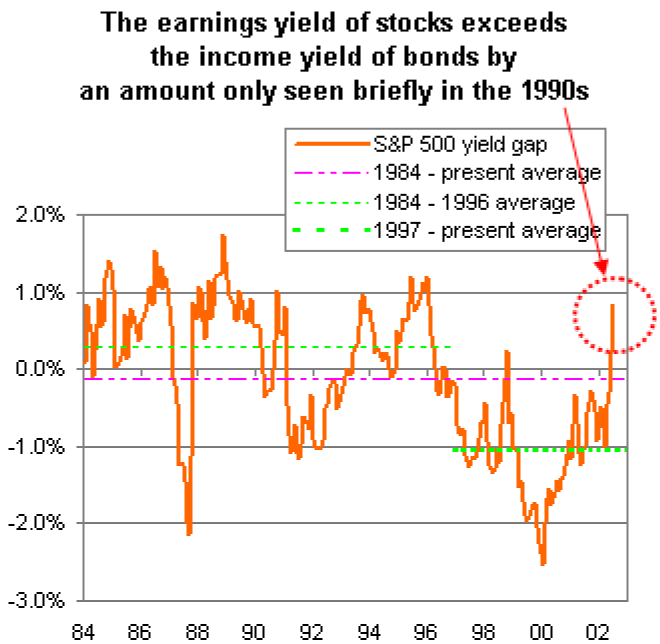
If we *did* have to listen to the market, we'd hear it telling us that Washington's feeding frenzy to punish "corporate crooks" is imperiling the prospects for economic recovery and expansion. Stocks staged their biggest rally in weeks Monday afternoon when over-reaching options-expensing provisions were blocked from the **Senate's** bill, and it seemed that reconciliation with the milder **House** version would slow down the witch-hunt a bit. But then yesterday, the market's attempt to hang on to Monday's recovery collapsed when the House rushed through amendments to its version, toughening it beyond even the Senate's version's already tough terms.

Dam's remark -- and that he made it to the press at a time like this -- tells you everything you need to know about the **Bush** administration's utter haplessness in the economic sphere. It's almost enough to make you nostalgic for **Bill Clinton** and **Robert Rubin**, who at least were said to listen to the bond market.

Paradoxically, Dam's remark can be true simply because of that fact that he says it. If the Bush administration keeps making every politically expedient policy mistake in the book -- from Dam's statement to steel tariffs to the present *jihad* against business -- then the market is indeed overvalued. If the Bush administration keeps heading down this slippery slope, then almost *any* price will be too much to pay for stocks.

Yet, abstracting from the risks that the Bush administration is itself creating, Dam's statement about valuations is utterly wrong -- the market is, in fact, *undervalued.* Even **Alan Greenspan** has stopped worrying about what he once called "irrational exuberance," calling it in his Senate testimony yesterday "a once-in-a-generation frenzy of speculation that is now over."

Look at our measure of equity valuation, the "yield gap" -- the amount by which the consensus forecast earnings yield of stocks exceeds the yield of long-term Treasury bonds. The higher the yield gap, the more stocks are promising relative to bonds -- and the more stocks are undervalued. This valuation metric is superior to simple price/earnings ratios because it scales earnings expectations to the competitive riskless rates available contemporaneously.



The yield gap yesterday stood at 0.83%. That puts is about as richly in favor of stocks as it has been at any time during the 1990s. It is 1.02 standard deviations above the average since 1984, the period for which consistent data exists. In other words, stocks have only been cheaper about 15% of the time over the last 18-1/2 years.

Compared to the average from 1997 through the present -- the great bull market years following Alan Greenspan's December 1996 speech in which he first warned of “irrational exuberance” -- the market is a screaming pound-the-table buy. In this 6-1/2 year period, the yield gap *has never been higher than it is right now*. Nor has at ever been *as extreme in any direction* as it is now -- it is further from the average in the direction of *under*valuation than it was in the direction of *over*valuation at the blow-off top in March 2000.

That said, compared to the average from 1984 through 1996 -- before the era of “irrational exuberance” -- the market is *still* undervalued, but less extraordinarily so. It is 0.58 standard deviations from the average, which means that stocks have been cheaper about 28% of the time.

Any value analysis such as the yield gap is implicitly a bet on "reversion to the mean" -- the assumption that norms that have obtained in the past will continue to obtain in the future. Looking at three different means -- 1984 through present, 1984 through 1996, and 1997 through present -- offers a choice of norms: a long-term one, and two sub-periods representing two distinct growth regimes. Which norm you pick would be based on your forecast for growth in the future.

And any analysis such as the yield gap is always subject to its inputs being wrong. Of course we hope it is the market price that is wrong -- and we'd like to see that error corrected by the market price rising sufficiently to return the yield gap to one of its historical norms. But higher bond yields or lower earnings growth forecasts could also do it. We can easily compute what level of changes in all three inputs would be required -- doing so is an important credibility check for the market's apparent undervaluation. The table below shows all the "what ifs."

		To bring yield gap back to average		
	Today	**1984 - present**	**1997 - present**	**1984 - 1996**
S&P 500	901	17%	9%	44%
Bond yield	5.45%	+95bp	+188bp	+54bp
Forecast earnings growth	17.90%	0.2%	-17.3%	7.9%

- Holding bond yield and forecast earnings growth constant, the market could rise anywhere from 9% to 44% to become normally valued.
- Holding the market level and earnings growth constant, bond yields could rise from 54 to 188 bps for the market to become normally valued.
- Holding the market level and the bond yield constant, earnings growth could come in anywhere between 7.9% and a *decline* of 17.3% and the market would still be fairly valued.

But there is one other risk in this assessment of the market's undervaluation. It is the risk that all three norms are wrong, that there is another mean to which valuation will revert. The data we have looked at -- from 1984 to present -- represents the modern age of the American economy, reflecting the pro-growth monetary, fiscal and regulatory policies have obtained, more or less, throughout the period. But there *have* been less fortuitous times. I don't have the data to compare today's yield gap to the average yield gap of the 1970s, an era of catastrophic policy mismanagement. But it's a cinch that stocks today would look expensive measured against that norm.

Since stocks are cheap by all *modern* norms, it can only be the norms of the 1970s or other similarly adverse periods that Dam has in mind when he says that stocks are overvalued. Does Dam really believe that the economic quagmire of the 1970s is the true mean, and that we are destined to revert to it? Is anything else only a temporary aberration, or what Bush himself called an "economic binge" in a speech on Monday? Is Dam telling us to expect of the Bush administration no better than wage and price controls, 90% tax rates, stagflation and over-regulation? Well, by saying that stocks are overvalued today, that is precisely what Dam is telling us to expect.

And there is the bet that investors are being asked to make right now. Do you believe Dam or don't you? In 1999 Alan Greenspan said he'd break the back of "irrational exuberance" -- it was the wrong thing for him to do, but he said he'd do it and then he did it, and woe to investors who didn't believe him. Every economic policy step that the Bush administration has taken this year is telling us clearly that they either don't value economic growth, or that they have no idea how to engender the preconditions for it. The Bush administration isn't listening to the market, but the market is beginning to listen to the Bush administration.

Policy errors take time to accumulate, and there are many opportunities to correct them along the way. And as the market's undervaluation today shows, an awful lot of error has already been discounted. We continue to be comfortable hedging our bets -- sticking with our relatively unaggressive Model Positions in equities -- a small long position in the S&P 500, and a small short position in the NASDAQ 100 (against a long position in long-term Treasuries). TM