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MACROCOSM

New Dynamics for Equities

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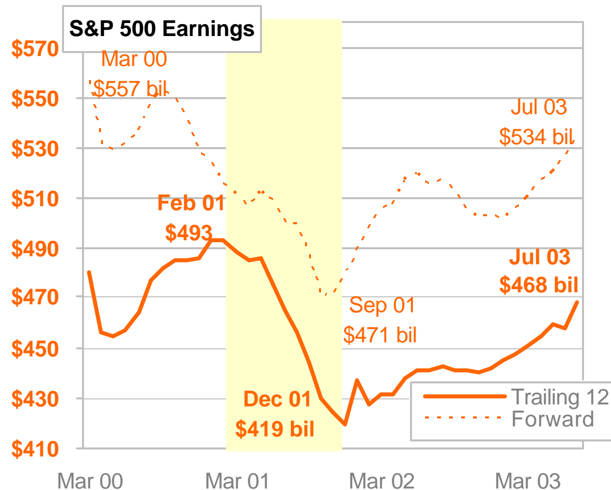
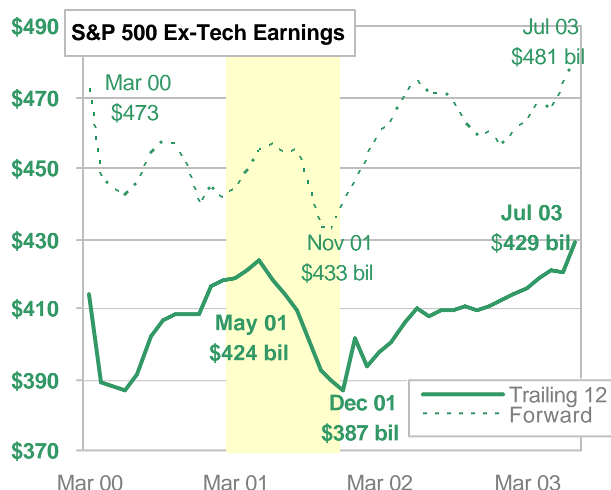
Earnings recovery is solidly in place, but stocks will have to adapt to a new era of fair valuation.





July was a watershed month for the stock market -- though perhaps you'd never know it, for how little prices changed overall. The S&P 500 passed a critical earnings milestone, and -- probably not entirely coincidentally -- is undergoing a phase-shift in valuation at the same time.

The 8-month period in 2001 now defined by the **National Bureau of Economic Research** as the last recession (the shaded portion of the charts at left) corresponds almost perfectly to the period of in which S&P 500 earnings fell 15%, or $74 billion. Since the earnings trough in December 2001, the S&P has gradually regained two thirds of its lost earnings, or $49 billion.

But if the especially hard-hit Information Technology sector is excluded, the S&P 500 has now completely recovered back to peak earnings -- and beyond. Peak trailing 12-month earnings of $424 billion were recorded by the S&P 500 ex-Tech in May 2001. Last month they surpassed that, at $429 billion. Consensus year-forward forecasted earnings have also now broken out to new highs, at $481 billion, suggesting an earnings growth rate for the coming 12 months of 12.1%.

Compared to the earnings that were measured and forecasted in 2001 (when nobody was worried about earnings quality), *today's* earnings are, in many ways, of much higher quality (yet now, everybody's grousing about earnings quality). Critics complain that today's earnings are the product mostly of cost-cutting, but the fact is that leaner meaner production platforms represent sustainable structural profitability. And critics worry about **Enron**-style accounting gimmicks inflating earnings, yet surely *today's* earnings are at least *relatively* honest compared to those of two years ago (for example, more and more large companies -- such as **Microsoft** and **General Electric** --

explicitly report costs of equity-based executive compensation). And nobody ever seems to mention that *more* of today's earnings will get to shareholders on an after-tax basis, whether through dividends, interest, or capital gains.

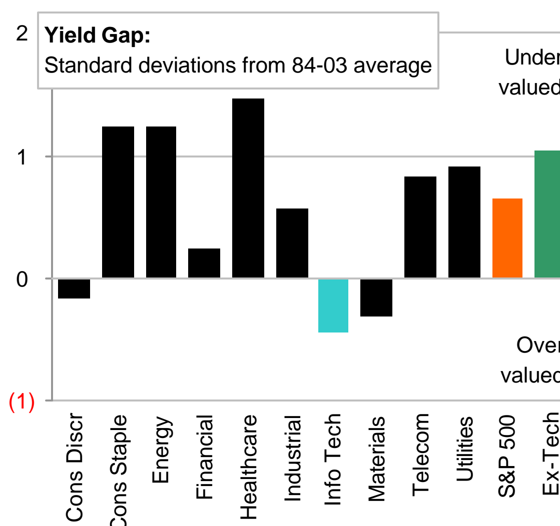
Stocks seem to have been indifferent to the earnings recovery reaching this important watershed in July -- as stocks have also seemed to ignore the flow of generally good economic data releases in the last two weeks. This is because, as we wrote last week, stocks have had to absorb a very rapid run-up in long-term Treasury bond yields, which negatively impacted the discount rate at which future earnings streams are discounted in today's stock prices (see "A Phase-Shift in Valuation" July 28, 2003). That this could happen without an outright stock market collapse is testimony to the fact that this increase in yields is not about inflation, and not about Fed tightening -- but about accelerating economic growth rates (see "The Great Unwinding" July 31, 2003). At the same time, it is evidence of recovery of the market's willingness to bear risk. Combined with the recovery in stock prices from the March lows, the result has been a dramatic compression of the equity risk premium -- the difference in the expected return of stocks over that of bonds, which compensates stock investors for bearing higher risk.

Having spent the better part of the last year with an historically wide equity risk premium, we are now back to approximately to normal levels for the S&P 500 overall. In other words, having been deeply *under*valued, the S&P 500 is now finds itself -- suddenly -- essentially *fairly* valued. That means a cushion against bad news is now gone, and advances in the light of good news will now have to be earned the hard way. So stocks may have to spend a little while here adapting to this new reality.

To put it in human terms, consider **PIMCO's** bond guru **Bill Gross**. Last September he was calling for "Dow 5000." Back then the bull case was a sure-thing bet against Gross's abject fear. In his latest commentary, Gross suggests "the assumption of low, single digit returns for the next decade." So now the bull case faces a higher bar -- now all it has to bet against is good old fashioned pessimism.

But by no means is that to say that equities cannot advance substantially here as accelerating economic recovery takes hold. From here, though, the gains will come from changing *return* expectations, not from changing *risk* expectations. Yes, it was nice when we could expect gains to come from *both*. But the good news is that return expectations are more likely to improve when the economy is not artificially held back by abnormally high risk aversion.

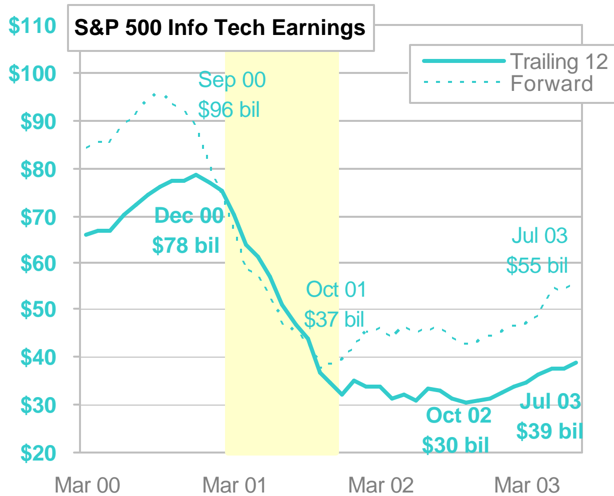
The S&P 500 may be about fairly valued *overall* now, but there are interesting valuation distinctions between sectors. We can see this by using our Yield Gap metric -- the consensus forecasted "earnings yield" of stocks minus the yield of long-term Treasury bonds -- as a proxy for the equity risk premium overall, and for each sector.



The sector-by-sector Yield Gap reveals that Information Technology is now somewhat *over*valued (its Yield Gap is below its historical norm), but to nowhere near the extent achieved at the market top of 2000. When the Tech sector is stripped out of the S&P 500, the remaining S&P Ex-Tech is revealed to be notably *under*valued, although to nowhere near

the extent achieved at the market bottoms of October 2002 and March 2003.

The degrees of under- and overvaluation here are not so extreme as to suggest a high-probability trade across sectors (we've learned over and over that simple models like this only work really well at extremes). If anything, these relative valuations may simply suggest that investors are discounting a rapid catch-up earnings recovery in the tech sector.



In the recession, tech sector earnings topped out first, fell further, bottomed later, and have recovered less than for the S&P 500 overall. But while tech has recovered less of the total earnings it lost, it has recovered far more in percentage growth terms per unit time from the trough: 30% above a trough reached 10 months ago for tech, as opposed to 11% above a trough reached 20 months ago for ex-tech. And tech was the fastest growing single GDP spending category in the second quarter, up 16% on an annualized basis.

In talking to clients about these things, we are sometimes embarrassed to be misunderstood as die-hard tech bulls, when to be anything of the sort nowadays is seen as a confession that one learned nothing from the so-called bubble. Well, nobody at TrendMacro is irrationally exuberant, or expects that we'll see NASDAQ 5000 any time soon. But to put tech permanently in the investment penalty box is a mistake. The reality is that technology and overall economic growth exist in a virtuous circle that was broken in 2000, and is now in the process of being re-established.

With the deflationary monetary errors of 1999 and 2000 now reversed, the economy is in a position to gradually pick up the pieces and get on with valuable technology adoption that was artificially and unnecessarily diverted. The incentives for investment and risk-taking implicit in the tax cuts enacted two months ago will speed up the process. TM