TrendMacrolytics

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MACROCOSM

Climbing the Wall of Self-Loathing

Tuesday, May 18, 2004

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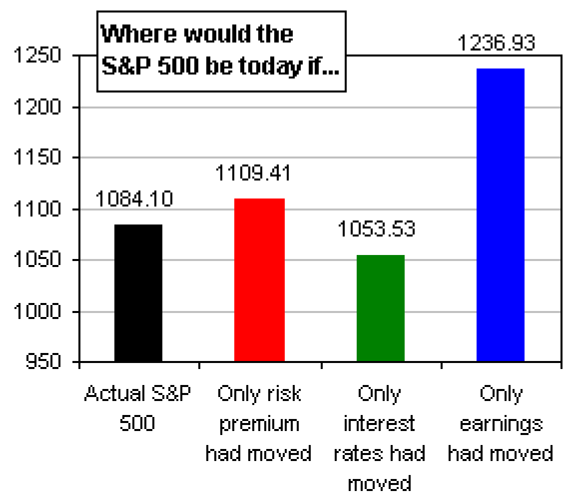
With the world supposedly falling apart, why isn't the market more scared?

Recent events in **Iraq**, and the apparent inability of presidential candidates of either party to articulate a compelling leadership position about them, have resulted in national mood of morbid introspection and self-loathing -- a malaise, if you will (oops... wrong president). In markets, the mood has morphed into a profusion of economic doomsday fantasies so numerous that they are beginning to collide with each other. As one example among many, should we fear that **China** is headed for a depression that will kill global growth, or that China is growing so fast that it will consume all the world's oil?

Considering the anecdotal abundance of doom-and-gloom sentiment, it is remarkable that equities haven't performed worse than they have. From the high water mark of February 11, the S&P 500 is down 6.4%. That's the biggest correction in a year, and only time will tell if it's over at this point -- but so far, at least, it hasn't been an especially large or violent move. It would seem that the market must be seeing something good to offset the negatives that dominate the headlines.

The underlying forces are not complicated, and a pure valuation analysis easily explains it. Equities have been dragged down by a rising equity risk premium and by rising long-term interest rates. But at the same time they have been supported by rapidly rising expectations for future earnings. Here are the numbers:



Since the highs of February 11, the equity risk premium (the amount by which the forward earnings yield of stocks exceeds the Treasury bond yield) has risen 24 basis points. This move is proportionate in every way to moves in other measures of expected risk, such as the CBOE Volatility Index (VIX). *If this were the only factor at work, the S&P would have fallen only 4.6% instead of 6.4%.*

Long-term Treasury yields have risen 54 basis points. *If this were the only factor at work, the S&P would have fallen 9.0% instead of 6.4%.*

Consensus bottoms-up expected earnings have risen by 6.8%. *If this were the only factor at work, the S&P would have risen 6.8% as well, instead of falling 6.4%.*

The interplay of these forces explains why we've been saying for so long that investors should

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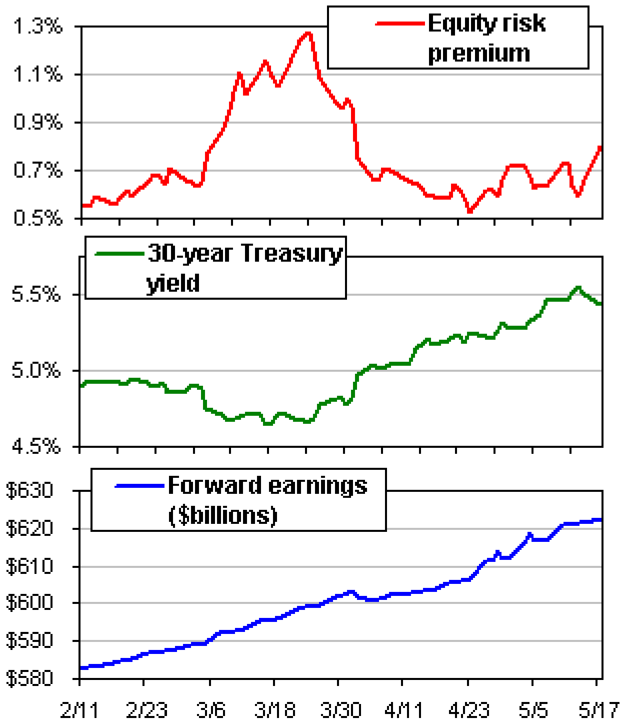
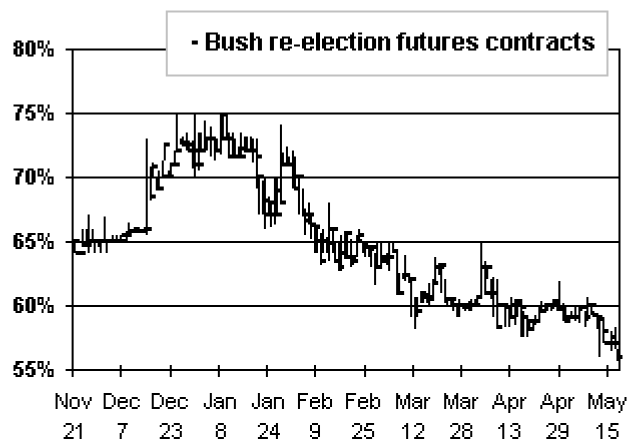


expect a "buyable dip" when it becomes obvious that **the Fed** is about to begin raising interest rates. The logic is that underlying values are approximately maintained long-term in the trade-off between higher interest rates and higher expected earnings. The buying opportunity arises first, when rate increases (which move in Fed-drive jumps) get ahead of earnings growth (which accretes smoothly) -- which is where we are now. Second, the widespread fallacy that rising rates will squelch the economic expansion (when in fact, they will prolong it by dealing head-on with the risk of incipient inflation) drives a temporary expansion in the equity risk premium -- which is *also* where we are now.

The fly in the ointment of course, is knowing exactly *what* is behind changes in the equity risk premium. If it's just misplaced worries about transitioning from a hyper-accommodative Fed to a normal Fed, then this dip is indeed buyable, and recapturing that 4.6% loss in S&P 500 driven by the risk premium's increase since February 11 -- and more -- should be in the bag. But it could be *anything*. After all, the equity risk premium is an all-inclusive term in valuation models that stands for all possible explanations that link earnings and interest rates to stock prices. For example, the equity risk premium went through a mini-"bubble" in March, perfectly corresponding to the period when Treasury yields hit their lows. Perhaps investors were seeing some special risk at that time (logically, it could have been inflation risk) -- but more likely the equity risk premium was simply discounting the very temporary nature of those low bond yields.



Today's equity risk premium is not especially high by historical standards, at eight tenths of one standard deviation above the average of the last 20 years. On the one hand, that means it's certainly *not* driving the kind of compelling value play today that we saw in October 2002 and March 2003 when it was making all-time highs. But on the other hand, the fact that the equity risk premium is *not higher* today suggests that we do *not* face the kind of critical macroeconomic risks that were in play at those two key inflection points, despite the heavy negativism in the environment. We do not face the possibility of catastrophic policy error, because -- despite voters' apparent hunger for gestures of leadership -- no particular policy decisions are in play. Of course, by the same token we don't face the prospect of a brilliant policy breakthrough. Instead, at the moment it appears we face a dull, grinding six months of self-loathing while we march toward elections that are looking increasingly like a toss-up. The **Bush** re-election futures contracts traded online at **Tradesports.com** are making new lows, heading toward 50/50. Hopes that Bush's pro-growth tax cuts will be extended beyond 2008 will just have to wait and see.

The good news is the old Chinese proverb in reverse: may you live in uninteresting times. While the depressing political wars drag on in the media foreground, in the real-life background the economy continues to quietly expand, and corporate earnings continue to quietly soar -- with annualized S&P 500 consensus forecast earnings upgrades running now at an annualized rate above 30%. That's a peak rate -- it won't last. But it implies tremendous self-sustaining momentum in the economy. Sadly, it could be even better if there were more certainty that Bush's tax cuts would be extended. But for now, until and unless there emerges a clear and present threat to the expansion, the stock market's going to have a hard time going much lower based on nothing more than doomsday fantasies. TM