TrendMacrolytics

Donald Luskin, Chief Investment Officer
David Gitlitz, Chief Economist
Thomas Demas, Managing Director

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Just Chute Me

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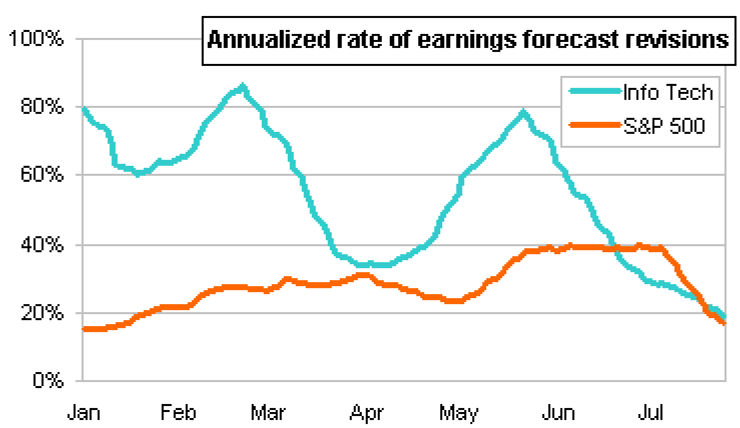
Donald Luskin

Over-excited fantasies have elevated risk premiums at the bottom of the trading range.

As the equity market tests the bottom of this year's trading range, the tone has turned to something between defeatism and paranoia. But when a week begins with reports that parachutists have been spotted dropping into **Boston** near the site of the **Democratic National Convention** (it turned out a security official misidentified a loose tent-flap), we can have fair confidence that sentiment can't get much worse for a while. That suggests that the bottom of this year's trading range -- or something close to it -- is likely to hold.

The S&P 500 is now off only 4.8% from its year-to-date highs of February 11. This small loss belies how much the equity risk premium has actually expanded. We can see it clearly using our equity valuation model, which compares the yield of long-term Treasuries to the consensus forecasted earnings yield to approximate the equity risk premium. The model shows that that the 41 basis point rise in interest rates since February 11 should have produced a 7.0% drop in the market. If rates had stayed unchanged, the sharp rise in consensus earnings forecasts would have caused the market to gain 11.7%, rather than lose 4.8%. With changes in rates and earnings taken together, the market should be *up* 3.9% year-to-date. Yet it's not -- because the risk premium has dramatically expanded. If rates and earnings had stayed unchanged, the expansion of the risk premium, by itself, would have caused the market to drop 9.0%. It's only the fact that earnings have grown so much faster than interest rates that the market's year-to-date loss has been held to only 4.8%.

Speaking of earnings, we think the recent hand-wringing about slowing earnings growth is overdone, but we don't quite put it in quite the same class as parachute rumors. There's no doubt that the rate of estimate revisions has slowed, and that this reflects to some extent the prevailing mood of gloom and doom. But it *had* to slow in any event. At 16.9% now, the annualized rate of month-over-month revisions for the S&P 500 has fallen sharply from the unsustainably high near-40% level where it had held steady from late May to early July -- yet it's still higher than the 15.1% rate where it began the year, and not much lower than the point-estimate one-year forward growth consensus of 17.7%. The numbers just don't show anything really wrong with earnings. Yes, the conventional wisdom now embedded in trading chatter is that guidance has been disappointing. But now that's become a standard complaint every earnings season -- and it's no coincidence that it



http://www.trendmacro.com
don@trendmacro.com
dgitlitz@trendmacro.com
tdemas@trendmacro.com

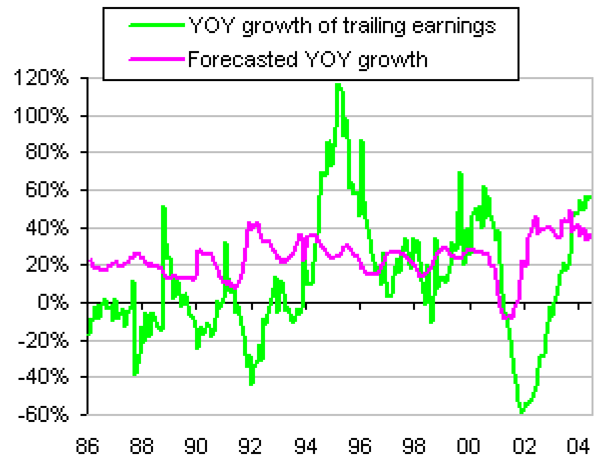
Offices:
Menlo Park CA
Parsippany NJ
Charlotte NC

Phone:
650 429 2112
973 335 5079
704 544 6900

started with the passage of **Sarbanes Oxley**. So we see it as more an opportunity than a threat that our valuation model shows the S&P 500's risk premium to be so steep as to imply a one-year forward earnings growth rate of *negative* 3.1%.

The drop in the annualized rate of consensus earnings forecast revisions for the S&P Information Technology sector has been even more dramatic -- from a peak of 86.3% in February, down to 18.5% today. But the chart on the previous page suggests that this may be very much a seasonal artifact: the rate seems to trough at the onset of each quarterly earnings season. And yes, so far year-to-date -- despite the seasonal cyclicality that is so apparent -- the rate has been trending lower. But this has to be put in the context of the astonishing (and mostly unappreciated) earnings recovery that the Information Technology sector has experience over the last two years. Trailing 12-month operating earnings for the sector troughed at $30.4 billion in October 2002 -- the same month the NASDAQ hit bottom, and ten painful months after overall S&P 500 earnings had troughed in December 2001. Today trailing earnings stand at $58.7 billion, practically a double in 21 months, and all without anything that any tech company CFO has ever dared to characterize in an earnings conference call as a full-on tech recovery (we're *still* waiting for that PC replacement cycle).

Wall Street has pretty much gotten it right. The one-year-forward growth consensus turned higher in October 2001, precisely one year before actual earnings turned higher. By June 2002, the consensus growth rate was the highest ever -- 46.3%. That call was a little early, and -- amazingly enough -- a little conservative. By November 2003, actual earnings growth exceeded that forecast, and it continues to exceed it today, at 56.6%. This is no bubble -- but growth like that still won't last forever. Recovery matures into expansion. Indeed the one-year forward earnings consensus is now down to 35.9%, and that will probably drift down over time.



But as we pointed out last week, tech stocks have taken the brunt of the gloom-and-doom this year-to-date, and are now uncharacteristically cheap in relation to the consensus earnings forecast (see "Tech: A Trading Value Play" July 20, 2004). The risk premium in the Information Technology sector implies earnings growth of 19.6%. That's too big a gap from 35.9%, considering how very widely discussed the risk of a tech earnings wreck has been lately. And it leaves the tech sector about as undervalued as it's been at any time since 1996, with the exception of the bottom in October 2002.

That is, unless you think that the current economic expansion is going to completely unravel. We've often pointed out the risks to continued expansion this year -- the risk that **Bush's** pro-growth tax cuts get repealed, and the risk that **the Fed** lets inflation run rampant. But those are still just risks, and for the moment all the underpinnings of the expansion remain in place (see "No Bail-Out for Bonds" July 13, 2004). A growth plateau here, maybe. A great unraveling, not.

In one of a series of meetings with investors in **Cincinnati** this week, we were asked "What's the true out-of-consensus view now?" My colleague **David Gitlitz** immediately replied, "That we're still in an economic expansion." He meant it as a joke, but his quip nevertheless has the ring of truth. In a time of parachute rumors, stocks -- especially technology stocks -- are priced to reflect bad news that isn't really happening. It's getting near time for the equity markets to move back up through the year's trading range. Especially tech. TM