TrendMacrolytics

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

MACROCOSM

Valuation Brinksmanship

Thursday, May 12, 2005
Donald Luskin

Stocks have pulled back from a value abyss -- shades of March, 2003.

Two weeks ago today the **stock market** quietly reached a landmark. At the close, it was virtually precisely as undervalued relative to **bonds** as it was on the very day of the bottom on March 11, 2003 (according to our model, which compares **forward consensus earnings** yields to the **long-term Treasury bond** yields). While still deeply undervalued today, stocks have pulled back at least a little from that extreme, a level that we regard as unsustainable. The **S&P 500** has risen 2.4% as of yesterday's close, while at the same time the long-term Treasury bond yield has risen 5 basis points. That's only a tiny down-payment. But separately and together, those moves are both in the direction of resolving the misvaluation between stocks and bonds -- though the conventional wisdom would argue that they shouldn't happen at the same time, since higher interest rates are supposedly bad for stocks. Cutting against the resolution of undervaluation, but supporting stock prices, is the fact that forward earnings continue to grow at a brisk pace, with the short term trend rate of **upward revisions** having turned higher over the last two weeks.

From the undervaluation extreme in March 2003, stocks began to recover once **Colin Powell** announced that the **US** was withdrawing its **UN Security Council** resolution authorizing action against **Iraq** -- thus ending a period of agonizing geopolitical uncertainty, and ultimately setting the political stage for the passage of the **2003 tax cuts** on **dividends** and **capital gains**. At the risk of reaching too far for an analogy, we can't fail to note that, two weeks ago, on the evening of the day that stocks closed at that same extreme level of undervaluation, **President Bush** announced in a prime-time press conference his support of **progressive price indexing** as a means of resolving **Social Security's** solvency problems. As a first approximation, it was good news for stocks that Bush's long-awaited solvency proposal was one that didn't include raising the cap on wages subject to the **payroll tax**.

But probably just as significant was Bush's statement the next day that **House Ways and Means Committee chairman Bill Thomas** would be taking an active role in crafting reform legislation, considering Social Security in the larger context of retirement and tax reform. Previously the House had not wanted to take the lead, only to have their work butchered in the **Senate**. And previously the **White House** had not been keen to have the strong-willed Thomas leave too deep a mark on its reform agenda. But desperate times call for desperate measures, and now Thomas is reform's best hope -- and the White House is lucky to have him. In another analogy to 2003, recall that Thomas was instrumental in getting Bush's proposed dividend tax cut enacted precisely because he put his mark on it, by partially transforming it into a capital gains cut. At first the White House vigorously fought Thomas's variation on their theme -- but in the end, Thomas's variation was key, in part because it welded onto what was seen as an idiosyncratic focus on dividends something that already enjoyed long-standing support among **Republican** legislators. Perhaps Thomas can do the same thing now with Social Security reform, putting what is seen by many in the House as a solution in search of a problem into the

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
704 552 3625

context of pro-growth tax-cuts which, after all, were at the center of Bush's electoral mandate. At the very least, after months of hearing Bush say that "everything is on the table" with respect to raising the payroll tax wage cap, it's a great relief to hear Thomas tell reporters about his strong opposition to that, and about his passion for making the 2003 tax cuts permanent. Perhaps Thomas's enthusiasm is contagious -- we're now hearing from White House sources that **Senate Finance Committee chairman Chuck Grassley's** reform proposal won't include any new taxes.

Bottom line: Stocks have pulled back from the valuation brink over the last two weeks, coincident with a lessening of the risk that Social Security reform will entail anti-growth tax increases. Other factors we are tracking have also improved at the margin over the same period. With **gold** and **crude oil** lower and the **dollar** higher, price signals suggest that **the Fed** is not pulling back from its rate normalization regime, thus keeping worst-case inflation scenarios off the table. Improvement in the inflation outlook makes it easier -- though less urgent -- for **China** to adjust its currency peg, thus making it more likely that protectionist legislation can be headed off. As these factors continue to improve, we envision an oxymoronic "U"-shaped inflection point, with the misvaluation between stocks and bonds being gradually resolved by both higher stock prices and lower bond prices. TM