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Earnings Surprise

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In a pessimistic and politicized world, stocks are just barely beginning to reflect the macro positives.

Which world would you prefer -- today's, or that of five years ago? The world of a little more than five years ago was a world in which the major threats we face today were simply not in our awareness. No one was substantively worried about **terrorism**, long-term **government fiscal insolvency**, high **interest rates**, or competition from **China** and **India**. The **equity risk premium** was the lowest in two decades. In the world of today, on the other hand, our noses are rubbed daily in worries about all those things, and the equity risk premium is the *highest* in two decades. To put a fine point on the **equity valuation** difference implied in that swing from lowest to highest risk premium, consider that **S&P 500 market cap** is 11% *lower* today than it was then, while **earnings** are 32% *higher* -- and those earnings are *more* honestly reported and *less* heavily taxed.

So here's your choice: the world *then* of high equity valuation and no awareness of the challenges soon to come, or the world *now* of low stock valuation and substantive engagement with those challenges? Sure, there were unique fast-money opportunities five years ago, and it would be great to be able to go back in time and have another swing at them. And everything just *felt better* then. But if the question is about choosing an environment in which investment risks are well understood and fully compensated, then there's really no choice at all -- *today*'s world wins hands-down. In fact a case could be made that today's world is the perfect equity investment environment. It's a world of low **taxes on capital**, low interest rates, low **inflation**, low **volatility** and robust **earnings growth** -- all set against an equity risk premium that implies **stock prices** are about 45% undervalued versus historical norms. And all the bad news is out -- can there possibly be a crisis, calamity or catastrophe about which teeth are *not* already gnashing?

In this kind of world, surprises are on the upside -- but when they come, they don't get no respect. Consider this week's announcement by the **White House Office of Management and Budget** that a massive upside surprise in **tax revenues** has served to reduce this year's **federal budget deficit** down to levels at or below historic **US** norms as a fraction of **GDP**, and below current levels for most other **developed economies**. The announcement was remarkable, first, for the extent to which the higher revenues were indeed a surprise -- if this were a public company's earnings we were talking about, it would be nothing less than a blow-out. **Corporate** tax revenues came in 17.4% higher than forecasted just six months ago -- according to White House sources, that's almost twice the average surprise over the last dozen years. Revenues from **social insurance** taxes came in 2.6% higher than forecasted -- and that's *more than five times* the historical average surprise. The announcement was also remarkable for the sheer *magnitude* of revenue growth, surprise or no surprise. **Individual income tax** revenues in 2005 will be up 15% year-over-year; corporate revenues will be up

40%; and social insurance revenues will be up 8%. All three exceed even the best years in the booming 1990s.

A sign of today's rampant pessimism -- and the political agenda that in part motivates it -- is the way this good news has been denied in some quarters. Keying off **Goldman Sachs** research, economist and **liberal** pundit **Paul Krugman** wrote in the ***New York Times*** this week that this revenue growth was "just a blip" because it was not reflected in payroll taxes, which derive from sustainable core **employment** levels -- those revenues "aren't showing any big pickup," he said. The reality is that their present 8% year-over-year growth is the greatest since 1989. That's a "big pickup." Why deny it? Because it's part of the evidence that **President Bush's 2003 tax cuts** have triggered a broad-based and diversified **economic recovery** manifested in employment growth, **personal income** growth, corporate earnings growth, and shrinking deficits -- just when the **extension** of those tax cuts is being debated by **Congress**. The tax revenue surprise has enhanced the chances of that extension, and that's very bullish for the economy and for stocks -- and very threatening to the president's political opposition.

Bottom line: Improved prospects for extension of the 2003 tax cuts are a major positive for stocks and the economy. Beyond that, the news about the surge in payroll tax revenues should put to rest the myth of the **jobless recovery** -- and it should prove in dollars and cents that the **payroll jobs statistics** have been systematically undercounting employment growth. And other positive **economic data** this week should drive a stake through the heart of this year's **"soft patch"** and **"slowdown"** fears -- fears which we have staunchly opposed all year. Against this background, stocks have grudgingly trudged higher, just as we have said they would. Yet as earnings grow and interest rates stay low, stocks continue to accrete value in the form of the equity risk premium (see "The King of Carry Trades" June 14, 2005). Surely it's not as much fun as counting your winnings in March 2000, but we continue to think that today's investment environment should be seen as extraordinarily favorable for strong-handed contrarian investors willing to buy stocks cheap in the face of very well-aired risks. TM