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MACROCOSM

Today and 1987: Ominous Parallels? Part 1

Thursday, May 25, 2006

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Some macroeconomic variables are parallel to 1987, but markets are totally perpendicular.

The steep stock market correction of the last two weeks has prompted some market commentators and several clients to note that the economy and the markets today look ominously like they did in 1987, the year of the great crash. There *are* a number of similarities -- a new Fed chairman, a cooling housing market, rising interest rates, rising inflation, rising commodities prices, rising trade deficit, and a falling dollar. We have actually noted some of these similarities ourselves over the last two years, drawing an analogy between the current rate-hiking cycle and the one that began in late 1986, both following sharp rallies in the price of gold and other commodities, and both leading to flare-ups of reported core inflation. That said, while there are certainly similarities between then and now, we don't subscribe to the view that the economy or the markets are pointed toward some sort of crash. We would interpret that view as no more than the latest rationale for the same misplaced anxiety that has dogged the economy and the markets since this expansion and this bull market began three years ago.

Update to strategic view

STOCKS: Despite some similarities between today's macro environment and that of 1987, the stock market could hardly be positioned more differently. Then it was at record levels of *over*valuation relative to bonds, while now it is at near-record levels of *under*valuation. A 1987-style stock crash at this time is not in the cards.

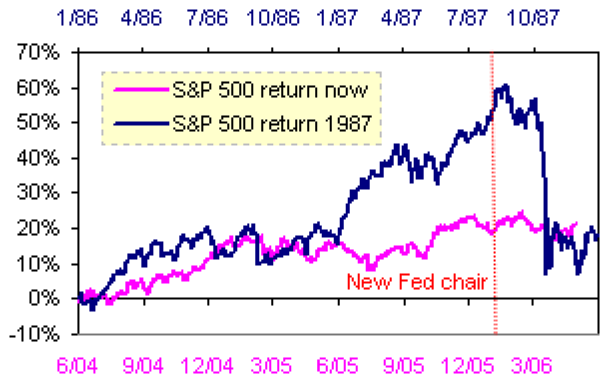
BONDS: The same is true for bonds, but in reverse. If there is a crash coming, it will be in bonds.

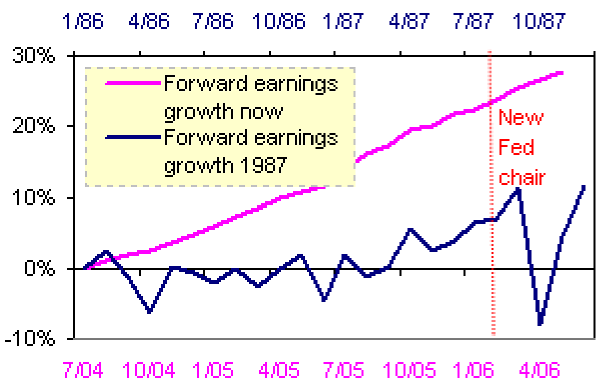
In this report we will look at the growth environment of 1987 and after, and at the way stock and bond markets were positioned and valued. In a follow-up report next week, we will look one by one at the macroeconomic variables at play in 1987 and today, focusing on parallels in the risks of inflation and restrictively high interest rates.

1987 WAS GOOD TIMES What's the fuss about in the first place? Other than the October 19 stock market crash, it's not clear what is supposed to be so bad about 1987. If now is indeed like 1987, that may well be *a good thing.* Growth during 1987 -- and after -- was volatile quarter-to-quarter, but robust. Annualized quarterly GDP growth in 1987 averaged 4.5%. The stock market crash in the fourth quarter seems to have had even less impact on subsequent economic performance than Hurricanes Katrina and Rita have had recently. Quarterly annualized growth in 1988 averaged 3.7%. Over the nine quarters following 1987, growth averaged a respectable 3.3%.

Growth didn't get into trouble until 1990, following the Fed's move to extremely high interest rates in late 1989. The inflationary precursors of those rates were present in 1987 -- and similar precursors are present today. As we will discuss in Part 2 of this report, that similarity is the only really ominous parallel between 1987 and today. But just as was the case then, it took time for those precursors to mature into clear and present dangers -- and until they did, there remained significant gains to be had in the economy and in stocks.

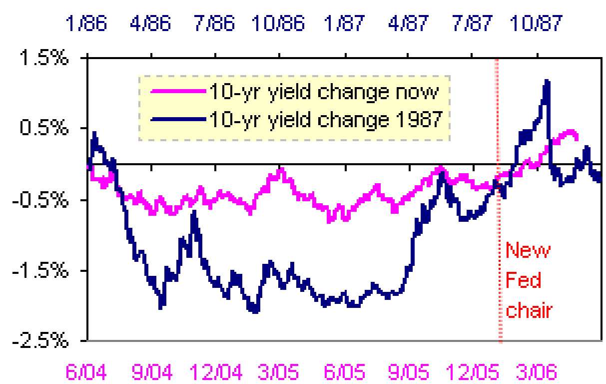
NO PARALLEL IN MARKETS The behavior of relationships between markets in 1987 could hardly be more different from those of today. Abstracting from the correction of the last two weeks, stocks have performed well -- but unspectacularly -- from their lows last October. But before the crash of 1987, stocks experienced a substantial speculative run-up. At the high reached on August 25, the S&P 500 had gained 38% year-to-date (not including dividends). The chart at right reveals the striking difference in S&P 500 returns, then and now. The two years 1986 and 1987 are charted with a dark blue line on the top date axis; the analogous two years today, aligned by the date on which the new Fed chairman assumed his duties then and now, is charted with a pink line on the bottom date axis.

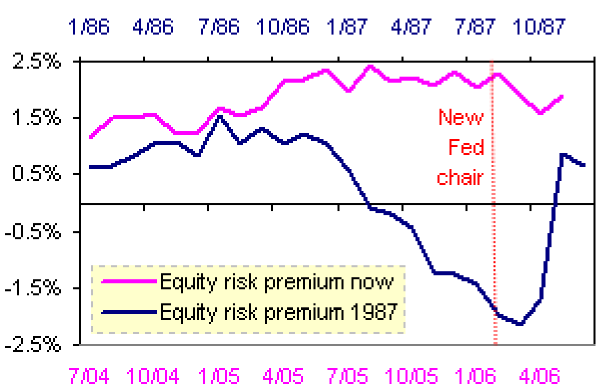




The chart at left, constructed the same way, shows the growth in S&P 500 consensus forward earnings, then and now. The speculative run-up in stocks can be seen as a disproportionate response to an acceleration in earnings growth that began in early 1987. But similar growth rates have been produced with remarkable consistency for the last two years, and stock returns have not even managed to proportionately track it.

The chart at right shows the cumulative change over the timeframes viewed in the 10-year Treasury yield, then and now. In 1987, yields rose dramatically -- by exactly 300 basis points year-to-date through the day before the stock market crash. At that point long-term government bond holders were looking at catastrophic year-to-date losses of greater than 10%, including income. By comparison, this year's back-up in rates is mild -- now only 113 basis points from the lows of last June.





The chart at left integrates the information in the previous three charts in the form of the equity risk premium -- defined as the amount by which the consensus forward earnings yield of the S&P 500 exceeds the yield of 30-year Treasuries. A high value implies a large equity risk premium, when investors demand that the earnings yield strongly exceed the bond yield, to compensate for taking the relatively greater risk of stocks. A low value implies a small or negative risk premium, when investors are willing to accept a smaller earnings yield -- *in extremis*, even one lower than the bond yield -- despite the greater risk of stocks. Before the crash in 1987, with stock prices rising faster than forward earnings, and bond yields rising at the same time, the equity risk premium fell to near-record lows (exceeded subsequently only briefly at the top of the "bubble" market of 1999 and 2000). Remember, this was the era in which institutional investors, especially large pension plans, embraced the then-new tools of quantitative investment management -- such as "portfolio insurance" -- as panaceas that would enable them to bear higher equity exposure with supposedly no greater risk. In stark contrast, now, such investors are sadder, wiser, and more averse to equity risk. With stock prices not having kept up with forward earnings growth, and bond yields still low, the equity risk premium is close to record highs. Last October it was literally at record highs, even higher than on the days of the panic bottoms in October 2002 and March 2003.

BOTTOM LINE: In a nutshell, stocks now are just about as *under*valued (relative to bonds and forward earnings) as they were *over*valued before the stock market crash of October 19, 1987. Considering that the crash occurred in the absence of a palpable macroeconomic catalyst -- and, indeed, that economic performance for more than two years to come was quite strong -- one has to conclude that the crash was virtually entirely a function of valuations. So if the macroeconomic environment of 1987 is parallel to that of today -- yet, at the same time, valuations are entirely different -- the idea of a 1987-style stock market crash today is virtually off the table as a possibility, barring some unforecastable catastrophe such as a massive terrorist attack.

That said, today's extreme *under*valuation of stocks logically implies a commensurate *over*valuation in bonds. Given that, and as we will see when we look closer at the macroeconomic parallels, if anything, a 1987-style crash today is more likely to occur in the bond market, not the stock market.