TrendMacrolytics

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MARKET CALLS

Update to Our US Equity Forecast

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Donald Luskin

Why the bullish short term can only be so good, and why the bearish long term might only be so bad.

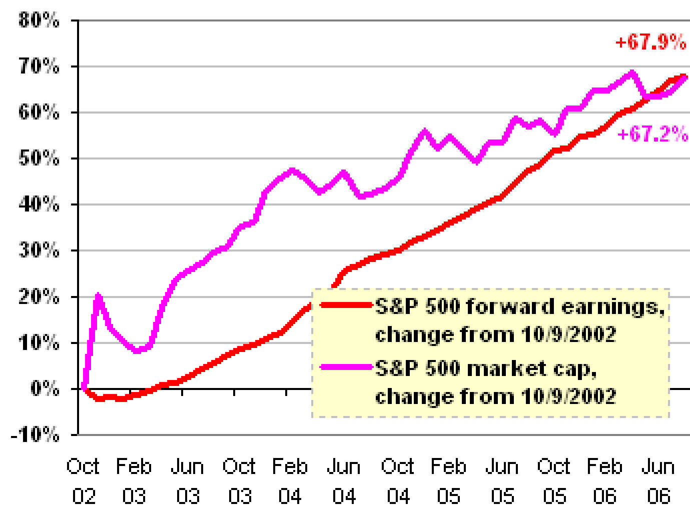
Update to strategic view

US STOCKS: We are moderately bullish in the near term, believing that stock prices will be dragged higher by continued robust earnings growth as the economy continues to expand. In the long term we are moderately bearish, expecting that aggressive Fed rate hikes will induce an earnings slowdown. But stocks are already so undervalued, they may be surprisingly robust to future risks.

[see Investment Strategy Dashboard]

Our forecast for US equities now comes in two stages. In the near term, we think stocks will grudgingly move higher as the Fed doggedly stays on hold even as the economy surprises on the upside and inflation pressures continue to mount. In the long term, the picture for stocks gets more problematic as the Fed resumes hiking interest rates, needing to move higher and more aggressively than it would have if it had not paused in the first place. But our long-term caution is tempered by a belief that stocks are already deeply undervalued.

NEAR TERM: STOCKS TRUDGE HIGHER For now, we stand by our original call that the decline that began in mid-May was a buying opportunity (see Investment Strategy Dashboard: US Stocks). We base this view on our belief that strong corporate earnings will continue as the economy keeps growing faster than the Fed expects. The Fed's downbeat top-down macro growth forecast is based on a model that expects a significant decline in consumption based on the rate hikes of the last two years, and high energy prices. Our model relegates consumption to a subsidiary role, and focuses instead on expectations for investment and production -- both of which we see as continuing to be quite strong. Thus we expect continued robust earnings growth, a view affirmed by the bottom-up Wall Street forward earnings consensus. One year ahead, S&P 500 earnings are expected to grow 16.9% versus trailing 12-month actual, and annualized month-over-month estimate upgrades are running at a16.4% rate. This forward-looking view on the macroeconomy sees no sign of a slowdown whatsoever. Note that while Wall Street analysts tend to err by consistently scaling their numbers too high, we have found that *given that bias*, changes in the direction of their forecasts have accurately called the last two recessions, both times approximately one year in advance (see "The Out-of-Consensus Consensus" June 26, 2006).



STOCKS ARE EARNINGS-DRIVEN The market is on guard for faster-than-

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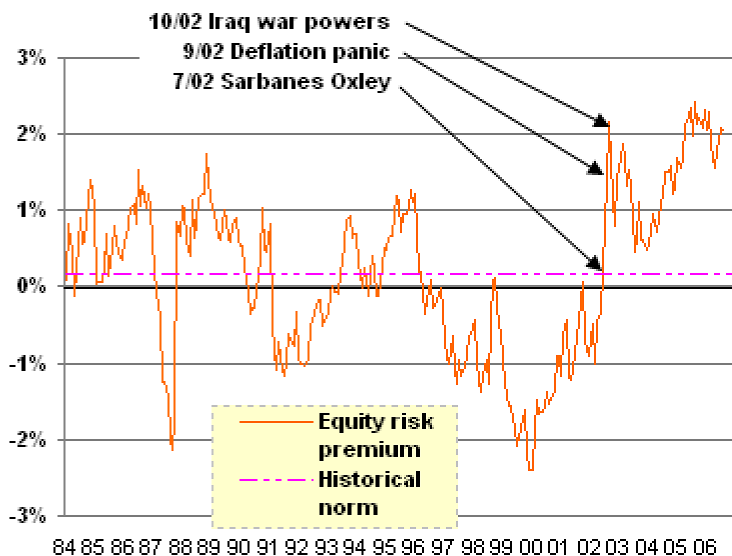
expected growth taking a "data-dependent" Fed off pause. But for the moment the Fed is acting more as though it is "model-dependent" -- and data or no data, the Fed's model is calling for a "moderating" economy. As the Fed keeps itself on pause, stock prices should be dragged higher by the earnings growth we expect. We see very little room for negative shifts in sentiment to potentially offset earnings growth as a driver of stock prices -- because sentiment is so terribly negative already. Since the day the present bull market began, at the bear market bottom on October 9, 2002, forward earnings have grown 67.9%. But S&P 500 market capitalization has grown only 67.2%. Thus sentiment -- as reflected by earnings multiples -- is actually slightly worse today than it was at the very bottom of the second longest and second steepest bear market in history. So for the near term, until we can see that the Fed is being forced by events and its own errors to commit to expansion-killing rate hikes, we think an earnings-driven stock market will trudge higher.



WHY IS SENTIMENT SO NEGATIVE? Based on our model of the equity risk premium -- which looks at the relationship of S&P 500 market cap to forward earnings and long-tern Treasury yields -- stocks have been undervalued now for four years. Stocks were still slightly overvalued relative to historic norms immediately after the terrorist attacks of September 11, 2001. It seems that three other factors have had greater impact. Stocks moved from slightly overvalued to slightly undervalued in July, 2002 -- the month that Sarbanes Oxley was enacted. They became extremely undervalued in September 2002, when the minutes of that month's FOMC meeting show the Fed first became concerned with the risk of monetary deflation, and the need to combat it by "unconventional means." Stocks reached their nadir of undervaluation in October 2002 on the very day that Congress passed a joint resolution authorizing the president to use military force in Iraq. Since then, all three of those factors have become expensive and risky quagmires, each in its own way -- and according to our model stocks have remained persistently undervalued, often at levels rivaling the worst seen in 2002. With these factors in place, it seems the best that stocks can hope for is just what they've gotten these last four years: to track earnings higher.

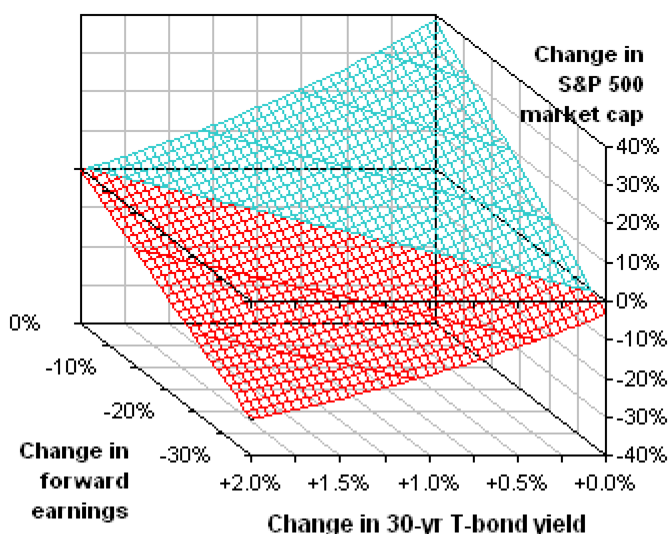
LONG TERM: STOCKS HIT A SOFT WALL We believe that upside surprises in both growth and inflation will take the Fed off pause at some point, probably by the end of the year. The aggressive rate hikes that will be required then to rein in inflation will lead to a substantial economic slowdown, which will undermine the earnings growth that has supported stock prices. But with stocks already deeply undervalued, it's not clear that stock prices have to fall commensurably with earnings -- the bear market may be a shallow one. When the economy pays the price for the Fed's inflationary error that became inevitable in 2002 (when it first started worrying about a deflation that no longer existed), stocks will no longer need to accrue a "loss reserve" for that factor. The equity risk premium could then return to more normal levels, and the era of deep undervaluation would end. That said, other factors of unknown relative importance, such as Sarbanes Oxley and Iraq, would remain in play.

RETURN TO NORMALCY? What might happen to stocks if, once the Fed's inflationary error has been made, the equity risk premium returns to historical norms? Under our simple model, a return to normal levels would occur when S&P 500 market cap, interest rates, and forward earnings come into historical equilibrium. Simplistically, from today's extreme levels, that suggests some combination of (1) higher market cap, (2) higher interest rates, and (3) lower forward earnings. In the last two decades the risk premium has moved back to normal from levels indicating extreme undervaluation five times. It is instructive to see what combination of factors accounted for those moves.

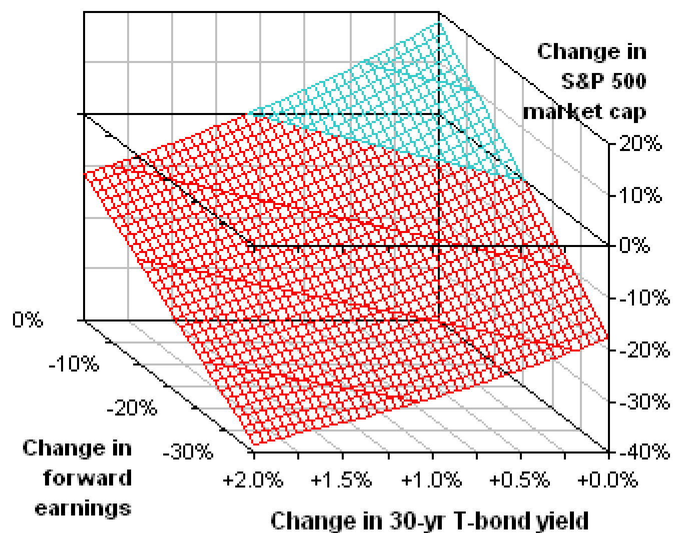
	Change in long-term Treasury yield	Change in market cap	Change in forward earnings
Nov 84 to Feb 85	-9 bps	+10.8%	-1.7%
Jul 86 to Feb 87	+27 bps	+19.3%	+0.8%
Nov 88 to Apr 90	-26 bps	+17.0%	-5.2%
Oct 90 to Feb 91	-83 bps	+21.5%	-6.8%
Nov 95 to Apr 96	+75 bps	+9.3%	+0.8%
Average	*-3 bps*	*+15.6%*	*-2.4%*

The only factor in common to all five events is that market cap went up. Die-hard technicians may also wish to note that all but one of the five events began in either October or November, and all five events ended in either February or April. But with respect to earnings and interest rates, there is no consistent pattern at all.

THE SHAPE OF OPPORTUNITY SPACE Under our long-term scenario for a more aggressive Fed, we fully expect higher long-term interest rates and a drop in forward earnings. Holding the equity risk premium constant, those two factors would -- by construction -- dictate lower stock prices. But as the periods from November 1988 and October 1990 demonstrate, stock prices can rise *provided that the equity risk premium falls*. In other words, positive shifts in sentiment can trump negative shifts in factors. The complex chart at right shows the range of possible outcomes for stock prices, assuming that the equity risk premium fully returns to normal levels. The best outcome is if yields and earnings do not change at all, in which case stock prices would rise 38%. Any combination of higher yields and lower earnings make the outcome worse -- but the equity risk premium is so large today, stock prices are robust to serious negatives. For example, with the equity risk premium at normal, interest rates could rise 100 basis points *and* earnings could fall 14%, and stock prices would be unchanged.



However, if we *don't* assume that the equity risk premium returns fully to normal levels, the possibilities are less comforting. If the risk premium only falls by half from its current elevated levels, then in the best outcome (if yields and earnings do not change at all), stock prices would rise 18%. But then stock prices would be far less robust to higher rates and lower earnings. If, as in the earlier example, interest rates were to rise 100 basis points and earnings fall by 14%, stock prices would be 13% lower.



BOTTOM LINE: Strategically, we are moderately bullish in the short term, and moderately bearish in the long term. Tactically, the game hinges on timing the shift from the former to the latter. The art of it will be to anticipate just when the Fed will ultimately cave in to mounting evidence of continuing growth and mounting inflation. The longer it takes, the better the short term will be for stocks -- and the worse will be the long term, as the Fed will have fallen further behind the curve and will have to be that much more aggressive. TM