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MACROCOSM

The King Is Dead, Long Live the King

Monday, July 9, 2007
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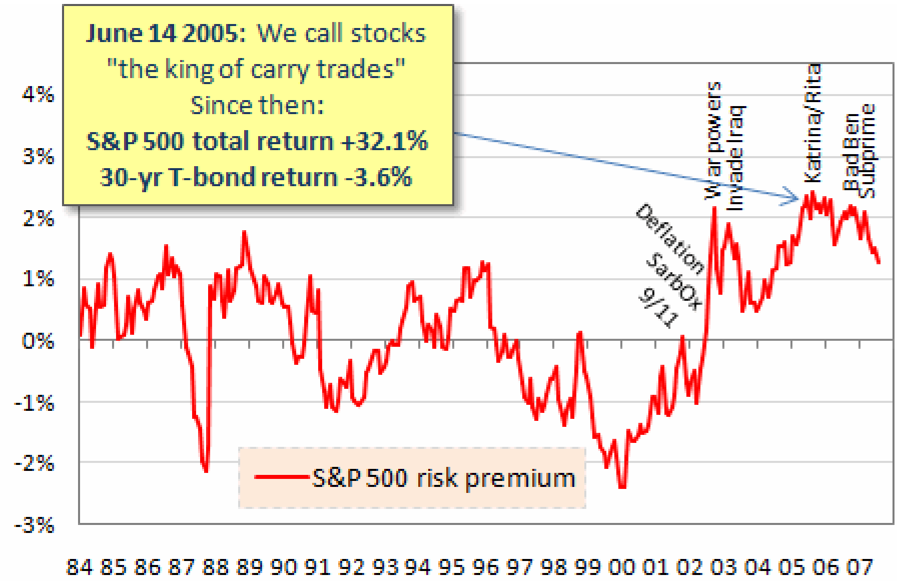
Stocks are no longer insanely cheap relative to bonds. They're just wildly cheap.

A little more than two years ago the equity risk premium -- the forward earnings yield of the S&P 500 minus the 30-year Treasury yield -- broke into record high ground, above the record set at the panic bottom of October 2002. We declared stocks to be "the king of carry trades," and said the best macro trade in US markets was to short-sell long-term Treasuries and reinvest the proceeds in stocks (see "The King of Carry Trades" June 14, 2005). We were right. Since then, the S&P 500 has returned 32.1% including dividends, and the total return of 30-year Treasuries has been a loss of 3.6%.


June 14 2005: We call stocks "the king of carry trades" Since then: **S&P 500 total return +32.1%** **30-yr T-bond return -3.6%**

As shown in the chart above, there is a series of negative news events that would seem to explain the dynamics of the equity risk premium. First, the long "irrational exuberance" period characterized by a persistently low risk premium ended in 2001 and 2002 with the 9-11 terrorist attacks, the enactment of Sarbanes Oxley and the Fed's declared concern with "deflation." The recent period of a persistently high risk premium was kicked off in 2002 and 2003 by the run-up to the

Update to strategic view

US STOCKS: As recession fears have receded and long-term interest rates have risen, the equity risk premium has pulled back from its elevated levels of the last two years. It is still higher than it has been at almost any time prior to 2002. Stocks still represent a significant bargain in relation to bonds -- so carry trades such as private equity transactions continue to be attractive, and may now grow in frequency as market participants gain confidence in earnings, and look to the end of an era of anomalously low financing costs. We expect stocks to continue to be gradually lifted on the rising floor of growing earnings.

[see Investment Strategy Dashboard]

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invasion of Iraq. The record peaks in the equity risk premium of the last two years are associated with Hurricanes Katrina and Rita in 2005, Ben Bernanke's rough start as Fed chairman in 2006, and the subprime mortgage crisis of earlier this year.

But all this is secondary to a much more fundamental explanation -- low interest rates. Since June 2005 when we called stocks "the king of carry trades," the 30-year Treasury yield has risen 85 basis points, from 4.43% to 5.28%. *This entirely explains the contraction of the equity risk premium from June 2005 to today.* In other words, it we were to plug today's bond yield into the equity risk premium model as it stood two years ago, the result would almost precisely match today's risk premium. The fact that the market capitalization of the S&P 500 has risen 27% since June 2005 has nothing to do with it -- because that was offset by forward earnings, which grew by almost the exact same amount as the market cap. That means the forward earnings-yield of the S&P 500 (or, equivalently, the forward price-earnings ratio) hasn't changed over two years. To put it another way, in terms of the valuation of earnings, stocks are no richer than they were two years ago, despite having risen to all-time highs, and despite the contraction of the equity risk premium. All that has changed is bond yields.

So all that worrisome news of the last several years wasn't keeping stock prices low. Just the opposite, it seems. Since the double-bottom of October 2002 and March 2003, stocks have marched steadily higher as earnings have risen, without so much as a 10% correction and with only minor variations in broad-market multiples. Instead, the effect of all that bad news has been to keep bonds expensive (and, concomitantly, yields low), in mistaken anticipation of a recession and Fed rate cuts. *That* created the record high equity risk premium. Now recession fears and Fed rate cut expectations have receded, and bond yields have risen toward more normal levels, so the equity risk premium has commensurately contracted.

All this means that, during the recent period of a persistent record-high equity risk premium, stocks haven't really been cheap, *per se* -- rather, they've been cheap *relative to bonds*. That's equivalent to saying that it's been possible for corporate earnings to be financed at historically low interest rates. So it should have been no surprise to see the surging volume of private equity transactions over the last two years. Private equity is, in its essence, nothing but the financing of earnings with low interest rates -- exactly the carry trade we talked about two years ago.

Though the equity risk premium has contracted, the "king of carry trades" is by no means moribund. To be sure, it's not as extraordinarily compelling as it was two years ago when the equity risk premium was at record highs. It's tempting to correlate this fact with the financing challenges now reportedly facing some private equity deals. But we expect that once the market gets beyond the recent small spasm of risk aversion triggered by the latest round of subprime problems, sensible deals will continue to get done (see "The Subprime and the Banal" June 25, 2007). And there should still be plenty of sensible deals. Even with the recent contraction in the equity risk premium, today it still higher than at any but a tiny handful of moments from 1984 to 2002 (the entire period for which we have data, prior to the onset of the recent epoch of persistently high risk premium), which includes the LBO boom of the mid- to late-1980s.

And considering that the availability of ultra-cheap debt financing of the last two years was enabled by mistaken recession fears, the cessation of those fears should lead to bolstered confidence in earnings growth that can offset some of the rise in interest rates. In fact, with increased confidence in the economy, interest rates will be expected to rise further -- that could set off a stampede of private equity deals designed to absorb the enormous funds that have been raised before the equity risk premium vanishes altogether.

BOTTOM LINE: As recession fears have receded and long-term interest rates have risen, the equity risk premium has pulled back from its elevated levels of the last two years. It is still higher than it has been at almost any time prior to 2002. Stocks still represent a significant bargain in relation to bonds -- so carry trades such as private equity transactions continue to be attractive, and may now grow in frequency as market participants gain confidence in earnings, and look to the end of an era of anomalously low financing costs. We expect stocks to continue to be gradually lifted on the rising floor of growing earnings. ▶