

MACROCOSM

Regime Change for Equities

Tuesday, November 26, 2013

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The mean equity risk premium will shift lower -- which says that stocks are still cheap.

US equities have broken out of the 13-year trading range that we've called "the Bush-Obama years." *We think this symbolizes a fundamental shift in the investment environment, analogous to the breakout in late 1982 from the 16-year trading range we've called "the Johnson-Nixon-Carter years" (please see the chart below).*

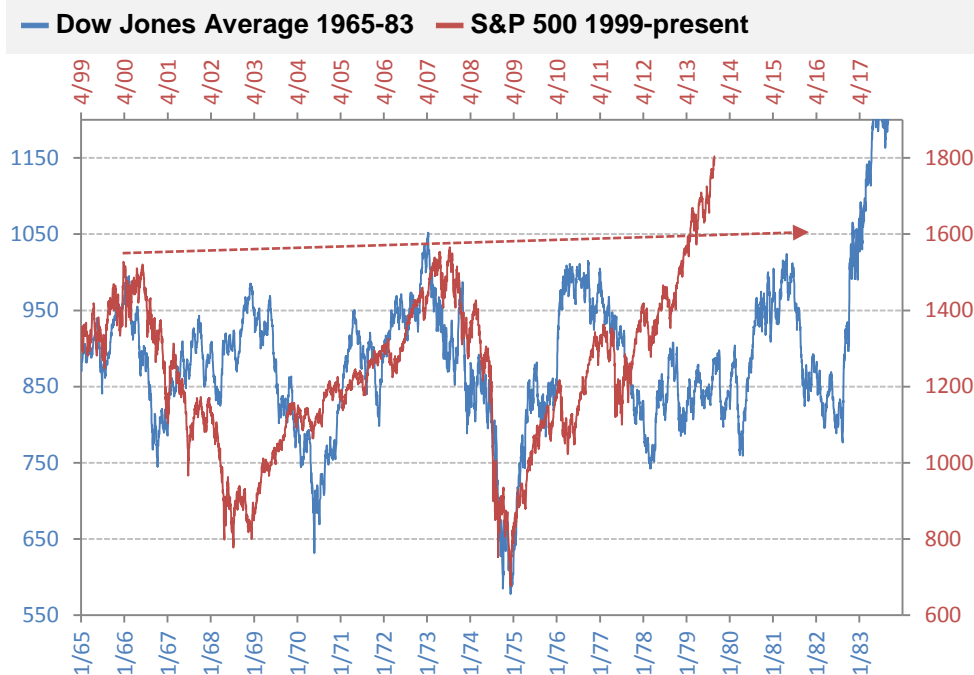
- Such analogies only go so far. We're not saying that now, like then, we are about to embark on a tripling of stock prices over the coming eight years.
- But we do think 2014 will be a strong year for stocks.
- One immediate objection is that 2013 will be the fifth year in a row of positive total returns for equities -- so intuitively, it may seem unlikely that it could be followed by a sixth.
- But in fact, using monthly data since 1900, almost three-quarters of the 236 streaks of five consecutive winning 12-month periods for

Update to strategic view

US STOCKS, US BONDS:

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Source: Bloomberg. TrendMacro calculations

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stocks have been followed by a sixth, with the average total return in the sixth year of 13.1%.

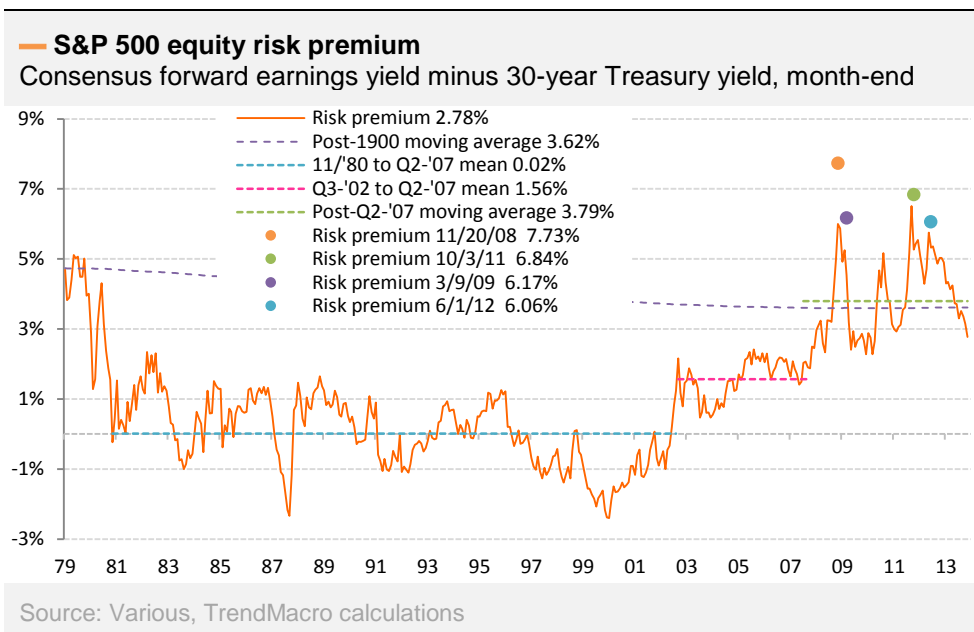
We're not basing our expectations on chart-reading or statistics about past returns. The change symbolized by the breakout on the chart is the result of three very substantive developments in the economic environment: the end of the era of global financial contagion; the containment of radical anti-growth politics; and the consequent liberation of technologies that can end the era of the highest oil prices in history (see "[A Major Upgrade to our Strategic Outlook](#)" September 12, 2013).

For equities, these changes operate through several intertwined channels.

- *There is now objectively less risk in the world. In response, investors will gradually become less risk-averse.*
- *This will lead to faster economic growth, and both top-line and bottom-line growth in earnings. It's too early for it to show up in the data yet, but it will come.*
- *It will also lead to higher bond yields, as the need for safe-haven investments recedes, and bonds have to compete for capital in a faster-growing world.*
- *Every one of these factors points in the same direction: to a new, lower expected mean equity risk premium.*

The S&P 500 equity risk premium (ERP) has been narrowing for the past year and a half (please see the chart below, and "[The Incredible Shrinking Equity Risk Premium](#)" February 21, 2013). Earlier in the year, before we had sufficient evidence to support our current more optimistic outlook, we saw this as nothing more than the usual mean-reversion for the ERP. All it meant was that stocks were no longer cheap (see "[What the ERP Isn't Telling Us](#)" May 15, 2013).

But now we think something more is happening. We think the mean itself is



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shifting lower, so the ERP now has an entirely different mean to revert to. If that judgment is correct, then stocks are still cheap.

- We know that the S&P 500 ERP is reliably mean-reverting, and so is capable of driving high-performance asset allocation strategies that choose between stocks and bonds as the ERP oscillates around the mean. But we also know that the mean itself changes from time to time, forming durable "regimes" that last many years, but then suddenly shifting to a new durable regime.
- After stocks broke out of their 16-year trading range from 1966 to 1982, one of those regime changes occurred in the ERP. After many years at a very high level, the ERP suddenly fell to about zero starting in November 1982 -- just as Ronald Reagan was elected president. This would prove to be a durable regime lasting two decades (please see the dotted blue line in the chart on the previous page).
- That regime ended in the third quarter of 2002, with the passing by congress of the [Sarbanes Oxley Act](#), marking the end of a quarter century of deregulation; Ben Bernanke's ["helicopter speech,"](#) marking the end of two decades of disinflation; and the passing of the [Authorization for Use of Military Force Against Iraq Resolution](#), signaling the end of a decade and a half of world peace and low oil prices. A new ERP regime began then, at a higher level. It was to last for about five years (please see the dotted pink line in the chart on the previous page).
- *That* regime ended in July 2007, as the crisis era of financial contagion began. The mean ERP for the ensuing crisis era was far higher than the prior two regimes (please see the dotted green line in the chart on the previous page). It was similar to the mean ERP from 1900, a century-plus that included the traumas of two World Wars and the Great Depression (please see the dotted purple line in the chart on the previous page). During the crisis era, there were individual days in which the ERP rose to pathologically high levels not seen since for more than a half-century (please see the four dots in the chart on the previous page).
- *Now, with even the possible default on US Treasury debt we experienced last month unable to even modestly destabilize world markets* (see ["On the Shutdown and Debt Limit Deal"](#) October 17, 2013), *the crisis era is over -- so the crisis era mean is no longer relevant.*

What will the new mean be in the post-crisis era? We won't know for sure for years, but for now even an approximation of the new regime will be very useful in making tactical judgments.

- *We are going to posit that the mean after the crisis era will be the same as the mean before it* (again, please see the dotted pink line in the chart on the previous page).
- Holding forward earnings and Treasury yields constant, that implies a 22.5% gain in the S&P 500. (Note: in client meetings over the last month we have been using 30% as an approximation; that has

fallen to 22.5% almost entirely due to rising stock prices -- that is, the expectation is already being fulfilled.)

- We expect Treasury yields to rise. *If the 30-year yield rises by 50 bp, that trims the mean-reverting gain in the S&P 500 to 12.1%.*
- But we also expect forward earnings to rise, as indeed they virtually always do other than during recessions. *Even anemic 7% growth in forward earnings -- what we've had for the last year, which is far lower than usual -- would restore the mean-reverting gain in the S&P 500 to 19.9%.*
- 10% growth in forward earnings -- still below historical standards -- would more than entirely offset a 50 bp rise in yields.

As we've talked to clients about this, we aren't getting a lot of push-back. But most find our outlook quite aggressive, and tell us it is far more optimistic than they are generally hearing.

- Indeed, it feels difficult to believe that, after all this time, the global economy can pull itself out of what we've always called the Not So Great Expansion following the Great Recession -- what others have called, with their own different paths of reasoning, the "new normal."
- Expressions like these are useful for simply encapsulating a complex state of the world. But by giving that state a nickname, it potentially becomes in one's mind an actual entity with a life of its own -- when, in fact, it is only a pattern, recognized and named. Naming the pattern tends to excite the cognitive bias that any state that has persisted for a certain length of time is, *ipso facto*, permanent. The expression "new normal" does this deliberately, and in an especially strong way.
- But a "normal," new or old, is just a regime -- a set of conditions which, by their very nature, are dynamic. When those conditions change sufficiently, the regime changes.
- Regimes are durable, in part because they contain positive feedback loops reinforcing them -- cycles both virtuous and vicious.
- The "new normal" has been driven by vicious cycles, fueled by the objective risk of financial contagion interacting with the subjective reality of high aversion to that risk.
- If the risk of financial contagion is over, that will usher in a virtuous cycle in which risk aversion becomes risk tolerance. As that lowers equity risk premia, it lowers the cost of capital -- and that enables faster growth.
- Again, we haven't seen it yet in the data. We don't have a point-forecast for exactly when we will. But we think it will at least begin sometime next year. With an historic output gap remaining after four and a half years of weak recovery, growth could be faster than anyone now expects.

Bottom line

Stocks have definitively broken out of the 13-year trading range we have called the "Bush-Obama years." This symbolizes regime change -- a

fundamental shift in underlying conditions: the end of financial contagion, radical anti-growth politics and record high oil prices. The expected mean equity risk premium should now fall to where it was before the global financial crisis, implying 2014 gains for US stocks of more than 20%, even as bond yields rise. ▶