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NY Minutes: Valuation and Deflation -- No Elation

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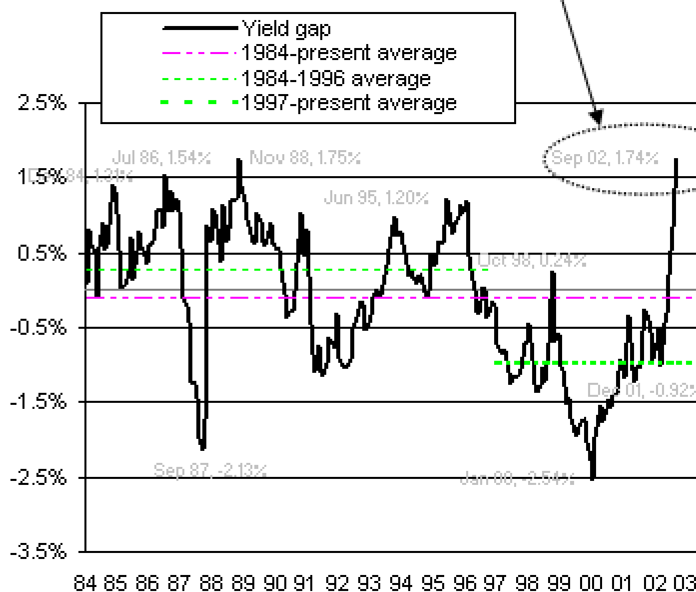
We didn't meet one bull on Wall Street last week, yet equity values are attractive and deflationary pressures are under control.

After meeting with senior-level portfolio managers in New York last week, the enormous volatility that continues to prevail in US equity markets seems entirely fitting.

The fifty or so managers that we met with is too limited a group to serve as a statistically valid sample, but the cross-section of views we encountered is probably not atypical of broad market sentiment. Arrayed on a continuum from extremely pessimistic to cautiously optimistic, there were no outright bulls. Even the optimistic ones were marked by a striking lack of confidence, with perceived risk factors ranging from continuing deflation to the consequences of the corporate accounting scandals, with growing doubt about the economic competence of the Bush administration thrown in.

The earnings yield of stocks exceeds the yield of long-term bonds by more than at almost any other time in 18-1/2 years



Our view is that while none of these risks is inconsiderable, the market already appears to have discounted for the worst, presenting a risk premium in broad market valuations that establishes the foundation for solid returns provided the worst is avoided. It's not a perfect investment environment to be sure -- but for the first time in a long time, investors are being compensated for bearing risk.

Oddly, just when market valuations have become attractive, we sensed in our New York meetings a near-universal skepticism about quantitative equity market valuation models. That should be no surprise -- most quant value models are screaming "buy" now, yet the most bullish investors we talked to were only "cautiously optimistic."

Our simple "yield gap" model of US equity valuation is, indeed, screaming "buy." This is a simple model that plots the amount by which the forward earnings yield of stocks exceeds the income yield of long-term Treasury bonds. But we were told by the investors we visited that their more sophisticated quant value models were telling them the very same thing: stocks are very cheap.

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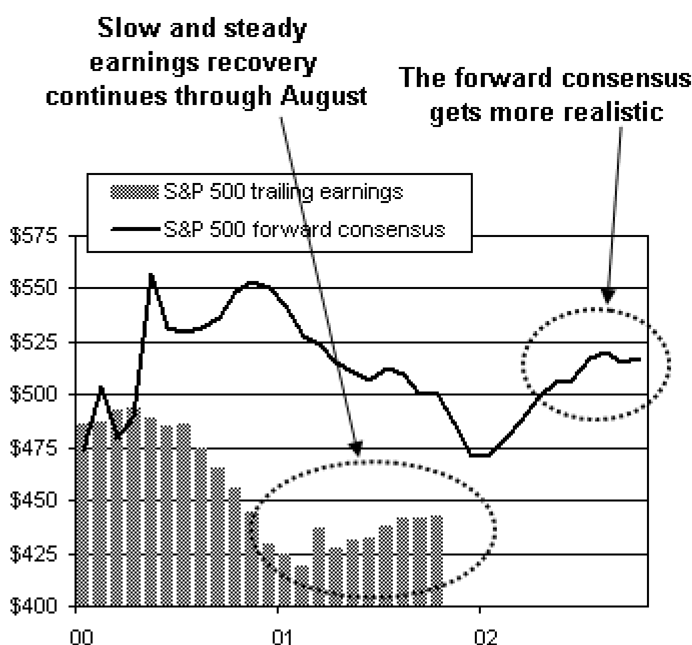
Then why so little bullishness? For one thing, many investors told us that they had simply given up on quant valuation models altogether. We heard several times the mantra "value models don't work."

It's surely that case that most valuation models would have kept you underinvested during the mo-mo years from 1997 to 2000. But it's just as certain that investors who gave up on valuation then have lived to regret their revisionism. So perhaps **Keynes** was right when he said "Markets can remain irrational longer than you can remain solvent." But that's not to say that value models don't work -- it's simply to say that value strategies face the risk of "gambler's ruin."

Let's grant that value models, taken in isolation from other judgment factors, are imperfect market timing tools. But the value of value models over the long term is compelling -- especially when you use them, as we do, to indicate times when the markets are *in extremis*. For our yield gap model, the average 12-month return to the S&P 500 subsequent to an extreme <u>under</u>valued reading of greater than 1% has been 20.5% -- while the average return subsequent to an extreme <u>over</u>valued reading of less than negative 1% was only 0.05%.

Some investors told us that their present skepticism about value models was based on their belief that the economy remains in a deflationary cycle, and that "value models don't work in a deflation." There is merit to this argument, but there are problems with it, too.

Value models that are based on forward earnings estimates (as our yield gap model is) are vulnerable to the possible failure of the Wall Street consensus to properly take deflation into account when forecasting future earnings. Even if they are right about everything else, a deflationary headwind could lead to an earnings miss. Right now, with value models signaling such extreme undervaluation, it's hard to believe that this would make much of a difference. That said, it's simple enough to stress-test any value model for this effect. In our yield gap model, the earnings consensus for 16.8% growth could end up, in reality, being a 9.4% *decline* -- a miss of 26.2%! -- and the S&P 500 would *still* be no worse than fairly valued at today's prices. Is the magnitude of deflation risk greater than 26.2%? Surely not.



On the earnings front, by the way, so far so good. With August's month-end results in, we can see in the chart above that the S&P's slow and steady earnings recovery continues. At the same time, forward earnings estimates are flattening out and becoming more realistic as "V"-shaped recovery fantasies dwindle away. If there's a big earnings miss coming up here, it has at the very least been deferred by another month.

Another problem with the deflation critique of value models is that deflationary periods should be expected to be associated with low bond yields -- and low bond yields are good for equity valuations. When bond yields are lower equities are rendered relatively attractive, all else equal, and earnings multiples are free to rise.

Over history our yield gap model has actually done *better* in deflationary periods. When the Consumer Price Index was running at an annual rate of less than 1.0%, average 12-month S&P 500 returns following extreme undervalued readings from the yield gap were 25.6%, compared to 18.7% when the CPI was greater than 1.0%.

The most important problem with the deflation critique is that, in our view, monetary deflation is now merely a *risk* rather than a *reality*. Having been blindsided by the ravaging of forward earnings from late 2000 through last year as a result of the cumulation of **Fed** deflation error, it's understandable that market participants would remain on heightened deflation-watch now -- once burned, twice shy. It seems, though, that just as investors were caught unaware of the damage done by the excessive strength in real dollar purchasing power until it was too late, evidence of the currency's recent softening also has been slow to register. Since early this year, the dollar's decline of better-than 10% against the trade-weighted G-6 index has been matched almost equally by the rise in the price of gold and a bounce off 25-year lows in the CRB Spot (non-petroleum) index. This consistency across the major market-price indicators tends to confirm that rather than a "flight from the dollar," the currency's highly visible drop against foreign exchange earlier this year signaled relief from a deflationary liquidity squeeze.

That's not to suggest that the deflation relief seen thus far in and of itself paves the way for a return to robust earnings growth rates. The dollar appreciated by 30% in real terms from late 1996 through 2001, putting severe downward pressure on prices, revenues and profits. The profit recovery now will likely continue to be slow and gradual.

It does suggest, though, that the risk of further deflation damage is fairly limited, provided the trends in the dollar indicators are not reversed. On that score, we have been heartened to see the dollar price of gold establish what appears to be a fairly stable range above $310 in recent trading. As well, the narrowing of high-yield bond spreads from near-record levels suggests credit risks have probably peaked. In a more price-stable environment less punishing to debtors, the premiums now available to less risk-averse investors could prove highly rewarding.

So why are we not raging bulls? It's because the best investment opportunities are the double-barreled variety in which you have *both* a crystal clear vision of the future *and* market valuations in your favor. That's what we had last December when we called unreservedly for shorting the NASDAQ -- we had a crystal clear vision that the much-vaunted "V"-shaped recovery wasn't going to happen, *and* a market that was severely overpriced according to our value model (see "Vay Out of Vack, Even for a 'V'" December 10, 2001).

Today we certainly have an undervalued market. But we don't have a crystal clear vision. We've been right about a slow and steady economy so far, and we see deflationary pressures largely sidelined. But there are important policy risks that have yet to resolve themselves one way or the other. That's why we're only cautiously optimistic, and why our Model Positions reflect only a 45% long commitment in the S&P 500, and retain a 25% short commitment in the NASDAQ. TM