

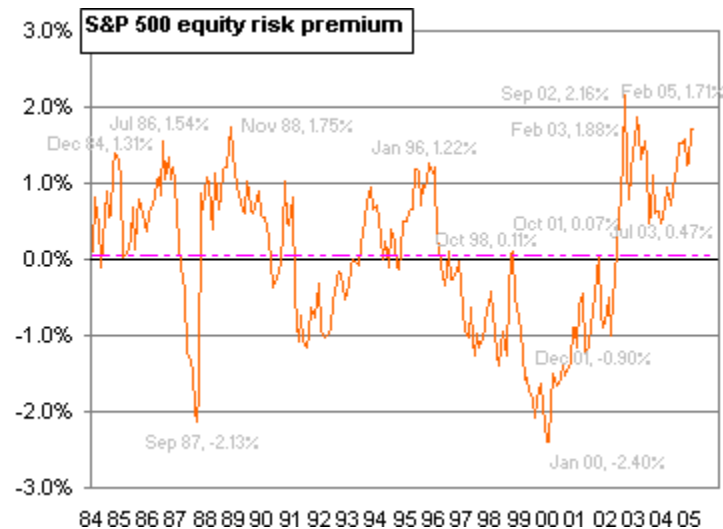
## MARKET CALLS

### A Question of Value

Monday, February 14, 2005  
Donald Luskin

#### Cheap stocks in a robust economic environment are an outstanding risk/return play.

Last week we ended a report by noting that the S&P 500 was almost 40% below fair value, according to our model (see ["The 3% Finesse"](#) February 8, 2005). One new client reacted by asking if that was a rather "extreme" statement. No, it's the undervaluation of equities here that is extreme, not our statement -- and that undervaluation makes stocks very attractive in our view. Nevertheless, for clients old and new, let's look at the factors that have come together to create this extreme condition -- and talk about what it means and doesn't mean for equity market performance. In particular, we'll take a close look at how higher interest rates and questions of earnings quality impact valuations.



Our valuation model is very simple. That means it probably ignores some relevant subtleties. But we like it -- not just because it works (and you'll see shortly how very well it works), but because its simplicity makes it highly transparent. We take the forward consensus earnings yield of the S&P 500 (the **First Call** forward consensus for dollar operating earnings), divided by market capitalization -- and subtract the yield-to-maturity of long term Treasury bonds. And that's *it*. The result is a rough estimate of the equity risk premium: the difference in expected returns between stocks and

bonds. As of the close on Friday, with the S&P 500 forward earnings yield at 6.20% and the long-term Treasury yield at 4.49%, the equity risk premium -- or "yield gap" -- was at 1.71% (which implies that stocks are 36.8% undervalued). There have only been three month-ends in the last 20 years at which the equity risk premium was greater than where it stands today (November 1988, September 2002, and February 2003). From such extreme levels, our simple model has never missed. The table below shows the total return to the S&P 500 following each of those three month-ends.

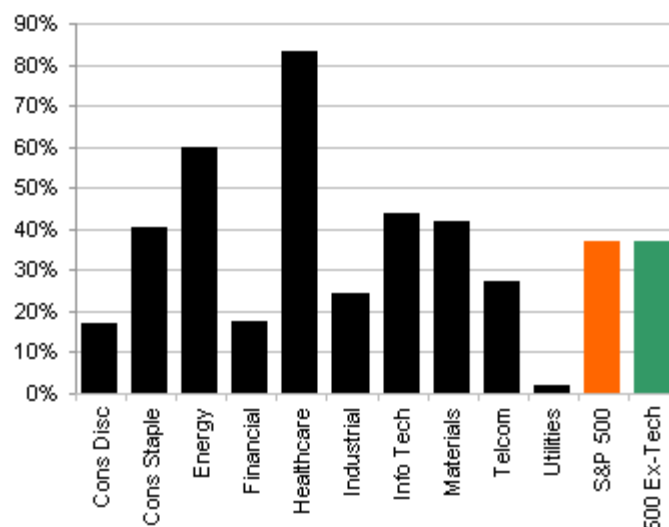
	1 mo	3 mo	6 mo	9 mo	12 mo
<b>Average return</b>	3.9%	10.0%	15.0%	26.8%	31.2%
<b>Best return</b>	8.8%	15.0%	20.9%	31.7%	38.5%
<b>Worst return</b>	1.0%	6.5%	5.0%	21.2%	24.4%

The model is most effective when it is at extreme levels (in fact, we don't pay much attention to it when it's not). That said, over the last 20 years, on average, simply sorting month-ends into

overvalued and undervalued -- based on whether the equity risk premium was below or above average -- has very successfully discriminated between high-potential and low-potential periods for equities.

	1 mo	3 mo	6 mo	9 mo	12 mo
<b>Undervalued periods</b>	1.9%	5.7%	10.7%	15.5%	20.3%
<b>Overvalued periods</b>	0.4%	1.2%	3.1%	5.5%	8.0%
<b>All periods</b>	1.1%	3.4%	6.8%	10.3%	14.0%

We express the percentage by which the S&P 500 is misvalued by calculating the change in market capitalization required to restore the equity risk premium to its historical average, holding earnings and bond yields constant. In other words, for today, if the S&P 500 rose by 36.8% instantaneously, the equity premium would be at its long-term average, and we'd say the market was perfectly fairly valued. Today all sectors of the S&P 500 are undervalued -- some of them extremely so. Healthcare, the most extreme of all, has only been as undervalued as it is now twice in 20 years -- in September 1993 (then, over the following 12 months the sector's total return was about 20%), and last October (total return since then about 7%). Information Technology is the third most undervalued sector, even more so today than it was on the very day of the panic bottom on October 9, 2002 (since then, the sector has returned about 83%).



Even if we had perfect faith in the predictive value of our model, strictly speaking that would only consist of a belief that eventually the equity risk premium will revert to the mean (by the way, the mean has changed only modestly over the last 20 years, and the model's results are quite robust to that change). But we can never forget that changes in market capitalization -- that is, stock price changes -- are not the only factor that can bring the equity risk premium back to the mean. Changes in other two inputs to the model -- forward earnings and Treasury yields -- could also do it. So just as a 38.6% increase in market capitalization could return the S&P 500 to fair value today, so too could a 167 basis point rise in long-term interest rates from 4.49% to 6.16%. And so too could a drop in forward earnings, from today's \$692.7 billion (or 74.7 S&P 500 points) to \$505.9 billion (or 54.8 S&P 500 points) -- which would represent a 19% drop from trailing 12-month actual earnings.

We strongly believe that Treasury yields are headed higher, so it would not surprise us one bit to see a meaningful fraction of the equity risk premium absorbed this way (see, most recently, ["Bonds: Is This the Turn?"](#) February 11, 2004). But a move higher in yields will not be instantaneous -- while yields are rising, so too will forward earnings, and this will offset to some extent the effect of rising yields on the equity risk premium. Some would argue that rising bond yields will hold back forward earnings growth, but we are confident that this will not be the case this time. If the rise in yields is no more than the reflection of an orderly restoration of policy normality by **the Fed**, then we believe that higher yields will *encourage* higher earnings. It works the other way, too: the Fed has made it clear that rate hikes will be a function of continued economic growth. So improving earnings will likely engender higher yields, just as we believe higher yields will engender higher earnings. To put it another way, if today's anomalously low Treasury yields are signaling coming economic weakness, then if that weakness materializes

and is reflected in lower forward earnings, it is unlikely that bond yields would rise significantly. We don't see economic weakness ahead -- but be that as it may, lower forward earnings would hurt valuations but continued low yields would support them.

A particularly powerful way to think about the possible impact of rising yields on equity valuations is to remember that, at its heart, our model estimates the *relative* value between stocks and bonds. In that sense, today's extreme misvaluation could be expressed either as stocks being undervalued relative to bonds or, just as easily, bonds being overvalued relative to stocks. While there has to be uncertainty as to exactly how today's *relative* misvaluation will unwind -- whether it will be stocks, bonds, or both that effect the majority of the adjustment -- we take it as very nearly a certainty that a *relative* adjustment will indeed take place. Therefore a position long stocks and short bonds could be seen as very nearly an arbitrage. Think of it as a "carry trade," in which the short bond position costing 4.49% finances the long stock position yielding 6.20% in earnings. An investor holding such a position should expect a net capital gain on the trade, very possibly arising from both sides of it -- and he implicitly earns 1.71% per annum while waiting for those gains.

Some have argued that any undervaluation in stocks is illusory because of the composition of earnings. We've seen it claimed that most of last year's phenomenal earnings growth was due to explosive gains in the Energy sector -- or to borrow a phrase from politics, "it's all about oil." But as in politics, the reality here is quite different than the press coverage. Over the last 12 months, growth in energy earnings accounted for only 20.9% of S&P 500 earnings growth. That's surely an outsized contribution compared to the sector's size (its market capitalization is only 7.6% of the S&P 500). But Information Technology and Basic Materials made outsized contributions, too. And 20.9% is hardly the claimed majority of earnings growth -- in fact, if it had been zero, the last 12 months would still have been splendid ones for the S&P 500 overall. Looking forward, the consensus is forecasting that the Energy will earn less in the coming 12 months than it did in the last 12 months, thus taking away 2.5% from expected S&P 500 earnings growth. Given the embedment of inflation in the pipeline, we think that Energy will do better than that. But even if the consensus is right, it's useful to note that even if last year's earnings story is interpreted as being all about oil, valuations based on forward earnings are assuredly not.

**Bottom Line:** When we say stocks are 36.8% undervalued, that's not the same as saying stocks will rise 36.8% over the short term -- although based on history, such a claim would hardly be outrageous. What it means for sure is that stocks are robust to a great deal of potential bad news, including rising interest rates and declining earnings expectations. We do expect rising interest rates, which will temper the extremity of equity undervaluation, but we expect continued economic strength, too -- and thus continued earnings growth -- and *that* will temper the effects of higher rates. Stocks therefore represent an excellent asymmetrical risk/reward play: outstanding upside potential, with limited downside. **TM**