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MARKET CALLS

Time to Earn the Panic Premium

Tuesday, November 13, 2007
Donald Luskin

Stocks are the king of carry trades once again.

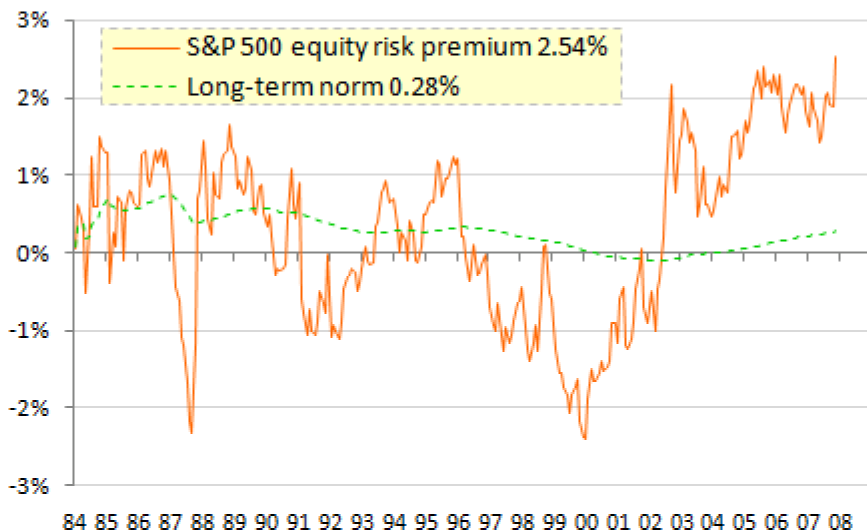
Either it's the end of the world or US equities are an outstanding bargain. We don't think it's the end of the world. We do think stocks are a bargain. The equity risk premium stands at 2.54% -- the difference between the 7.13% forward earnings yield of the S&P 500 and the 4.59% yield of 30-year Treasury bonds -- higher than on any single day since high-quality data became available in 1984. The previous record was 2.46% on October 9 2002, the very bottom of the second longest bear market in history, from which the S&P 500 rallied 15.3% over the following month (and 103.2% through today).

Update to strategic view

US STOCKS, US BONDS: The panic gripping equity markets is reaching an unsustainable extreme. The equity risk premium versus bonds is at a record high in absolute terms, and near a record relative to historic norms. From such levels, stocks can be expected to outperform bonds, probably very strongly -- and soon.

[see Investment Strategy Dashboard]

Again, we don't think it's the end of the world. But if it is, then US equities are still an outstanding bargain. The whole point of a risk premium is to compensate you for things going wrong in the future (which is precisely what so many creditors forgot, until they were abruptly reminded this summer). Even if some version of the "US-led global slowdown" story now making the rounds comes true, the record equity risk premium is a significant cushion. Based on historic norms, today's level makes the S&P 500 46.3% undervalued. And if those stories *don't* come true, then the record equity risk premium is pure upside to be captured when confidence returns to the market.



Now some caveats. First, even granting the inevitability of mean reversion in the equity risk premium, there is no law of nature that dictates

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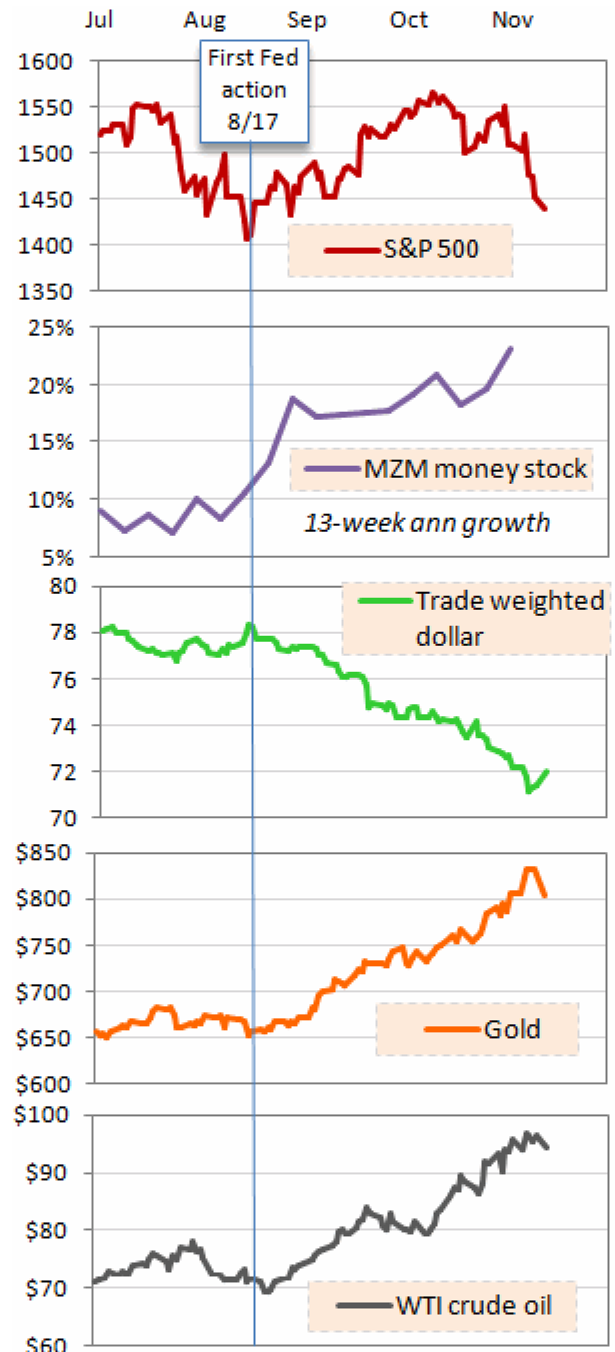
that any particular extreme -- even an all-time record -- is the limit of how extreme it can get before it corrects. Second, in our way of thinking about the equity risk premium, the absolute level of it is not the only factor; we also consider its level relative to historic norms. Because the risk premium has been unusually elevated over the last five years, the historic norm has gradually increased. Based on the lower norm of October 9 2002, the equity risk premium then implied that the S&P 500 was undervalued by 55.5%. So in that sense, with the S&P 500 only -- only! -- 46.3% undervalued, there is still room on the downside before we really have a new record.

Finally, strictly speaking, the equity risk premium is a measure of three-way relative value between stocks, forward earnings, and bonds -- not just stocks alone. It's not impossible that the equity risk premium could fall back toward normal levels not because stocks went up, but because bonds or earnings went down. That said, every time since 1984 when the equity risk premium has moved from unusually high levels back to normal levels, stocks have rallied. Sometimes earnings have risen, other times earnings have fallen. Sometimes bonds have risen, other times bonds have fallen. In all instances, stocks rallied. What about this time? S&P 500 forward earnings have flattened out over the last month, thanks entirely to downward revisions in the financial sector. But they are only one-quarter of one percent off the all-time highs made about a month ago -- and excluding the financial sector, they are at all-time highs right now and growing at an annualized rate of about 10%. Bonds could certainly fall from here -- i.e., yields will rise -- and in fact we expect they will. But that's why, during this five-year period of elevated equity risk premiums, we have often called stocks "the king of carry trades" -- the best way to exploit the equity risk premium is to sell short Treasury bonds and reinvest the proceeds in stocks (see "The King of Carry Trades" June 14, 2005). It's hard to believe in this recent period when bonds have rallied and stocks have fallen, but for most periods over the last five years this has been very much a winning trade -- and from levels like today's it is nearly an arbitrage.



Especially when the world really isn't about to end, and the Fed is apparently willing to do whatever it takes to make sure of it. We still don't see why a couple hundred billion dollars in bad mortgages in the context of a global financial system thousands of times that size can have the power to trigger a global slowdown of any importance (see "Where's the There There? Part II" October 5, 2007). Be that as it may, even though the lax credit practices that gave rise to the subprime crisis in the first place were caused by excessively easy monetary policy, now in response to the crisis, policy has gotten even easier (see "Easier and Easier" October 12, 2007). A global market awash in liquidity has demanded even more, and gotten it -- as seen in the very rapid growth rate of the MZM money stock

since the Fed started easing in August. We've never met a financial crisis that couldn't be fixed with enough liquidity.

Considering how much fear remains in the markets, even more liquidity is apparently needed to support a sustainable resurgence of risk appetite. Despite attempts by the Fed to downplay the prospects of further rate cuts (see "Hawk on the Outside, Dove on the Inside" November 1, 2007), we are confident that even more liquidity is being supplied and will continue to be supplied (see "Fed Liquidity Runneth Over" November 7, 2007). We do not interpret yesterday's violent declines in gold and oil, nor the rally in the dollar, as reasons to expect less easy policy from the Fed. These moves are small speculative corrections in a larger trend, reflecting the inflationary spillover of the Fed's fire hose of liquidity being trained on the turbulence in credit markets. After a week in which a mood of panic has returned to markets, there's nothing unusual about seeing some liquidation of the trades that have been the biggest winners. Indeed, such liquidation is the way that markets communicate their needs to central banks -- we've variously called it throwing a tantrum, bullying, or just plain lobbying (see "From Line in the Sand, to Sand in the Face" October 30, 2007). It worked overnight with the Bank of Japan, which decided once again to stay on pause (back into the yen carry trade, everybody!). We have no doubt that it will work with the Fed, too.

BOTTOM LINE: The panic gripping equity markets is reaching an unsustainable extreme. The equity risk premium versus bonds is at a record high in absolute terms, and near a record relative to historic norms. From such levels, stocks can be expected to outperform bonds, probably very strongly -- and soon.