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MACROCOSM

At Least They're Cheap

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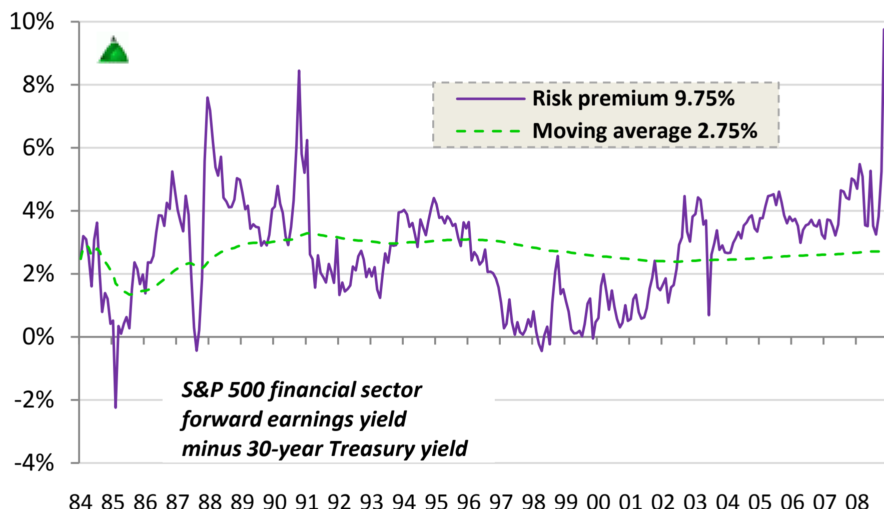
Even financials are now deeply undervalued, for the first time in this bear market.

Stocks have broken to new lows, led on the downside by the financial sector. Our cautious optimism that deeply undervalued stocks could find their footing somewhere above the level of the October 10 panic lows has not been rewarded. But we have been correct to remain negative on financials throughout (see, for example "Subprime Lending Was Their Best Idea" June 4, 2008). We've argued that in the short-term, despite being the focal point of ongoing panic, financials have never achieved the kind of extreme undervaluation seen in most other sectors. And for the long-term, we think the sector's earnings growth model is fundamentally crippled by the shrinkage of the securitization business and of the use of leverage.

Now, whatever other problems financials might have, at least they're cheap. With this week's sharp decline, the financial sector has for the first time in this bear market become substantively undervalued. The equity risk premium for the sector now stands



Update to strategic view

US FINANCIAL STOCKS: At last, the equity risk premium in the financial sector has risen to all-time highs above the previous peak set during the savings and loan crisis. The sector's long-term earnings growth model is still very unattractive. But with systemic meltdown risk now all but ruled out, and at today's record low valuations, for the first time in this bear market one can bottom-fish in this sector with a straight face.

US STOCKS: Stocks overall are off-the-charts cheap. The runaway train to systemic meltdown has been replaced by the train-wreck of recession -- and the sudden shock of it has unleashed panic liquidation. But volatility cuts both ways, and any positive surprise such as a last-minute political resolution of the automakers bail-out would catalyze a strong reversal.

[see Investment Strategy Dashboard]

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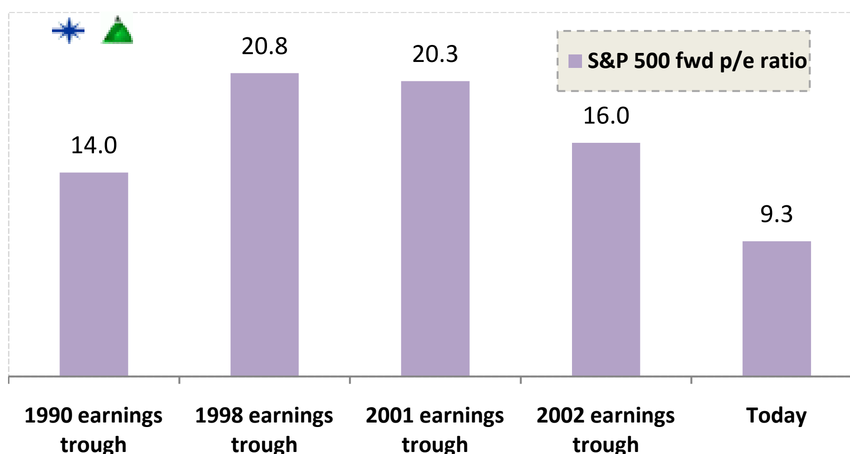
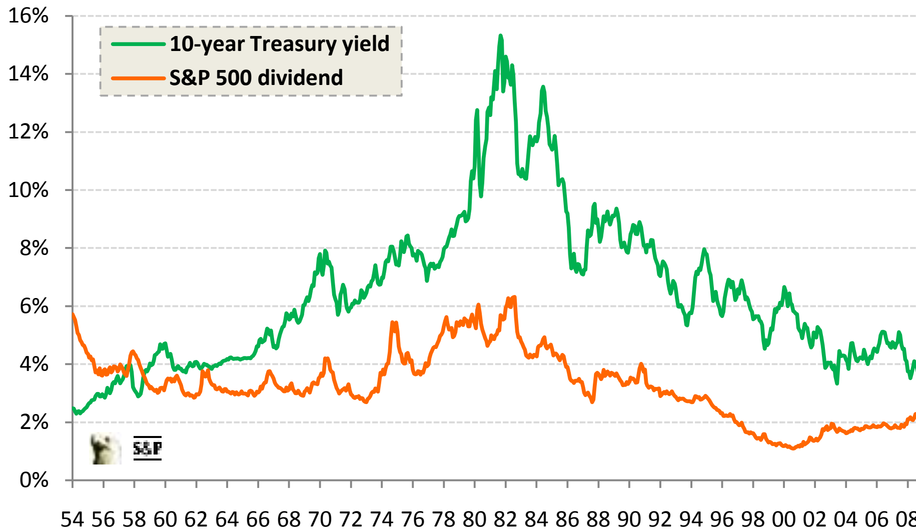
higher than the previous high set in October 1990, at the worst of the savings and loan crisis.

It's ironic that the move to extreme undervaluation of the financial sector has occurred *after* the implementation in mid-October of the Troubled Asset Relief Program (TARP), and the FDIC's guarantee of deposits and bank debt. According to Henry Paulson's statement to Congress earlier this week, those "actions…helped us to…immediately stabilize the financial system." Yet in just the five weeks since then, as of yesterday's close, while the S&P 500 has lost 19.4%, the financial sector has lost almost twice that, 35.4%. Among several leading banks that received TARP capital investments, Wells Fargo has lost 19.7%, JPMorgan 32.2%, Bank of America 42.7%, Morgan Stanley 43.4%, Goldman Sachs 50.3%, and Citigroup 59.4%. We don't take these losses to mean necessarily that the October rescues were ineffective (and there is more TARP money in reserve). They did succeed at halting a runaway train that was careening toward systemic meltdown. But the shock of that near-miss left a train-wreck in its wake -- a sudden recession. So gone now is the starkly simple binary risk of total collapse, and gone now are any hopes of business as usual once the crisis has passed. Crisis risk has now been replaced with the messy task of slogging through the recession that the crisis triggered. At the worst, a recession long enough and deep enough can itself bring systemic risk back to the forefront. But absent that, now we must make sadder but wiser assessments of the earnings growth prospects of seriously damaged companies. We don't think the prospects are good. But, again, at least they're cheap.



That said, stocks overall are even cheaper relative to historic norms than the financial sector is to its norms. The S&P 500 equity risk premium is literally off-the-chart, far higher now than the levels seen in the tumultuous years of the Carter presidency. At these levels, the risk premium is robust to even a very large drop in consensus forward earnings (see "How Bad An Earnings Hit?" October 23, 2008). Consider this: the forward price/earnings ratio of the S&P 500, at 9.3, is lower today than at any earnings trough over the last 20 years. And the price/earnings ratio wasn't even especially high at the earnings

peak this cycle, in October 2007. At 15.1, it was lower than that at any of the prior earnings *troughs*! Forward earnings do have further to fall here, but the panic liquidation we're experiencing is out of all proportion to any reasonable scenario, with the apparent reaction to macroeconomic news such as this morning's unemployment claims report as though no one has ever seen a recession before. As of this writing, with stocks lower again, we're now in the most severe bear market since the two separate ones that occurred during the Great Depression.



Stocks are so cheap now that even the crudest form of the equity risk premium shows it. For the first time in 50 years, the dividend yield of the S&P 500 exceeds the yield of the 10-year Treasury bond.

BOTTOM LINE: At last, the equity risk premium in the financial sector has risen to all-time highs above the previous peak set during the savings and loan crisis. The sector's long-term earnings growth model is still very unattractive. But with systemic meltdown risk now all but ruled out, and at today's record low valuations, for the first time in this bear market one can bottom-fish in this sector with a straight face. Stocks overall are off-the-charts cheap. The runaway train to systemic meltdown has been replaced by the train-wreck of recession -- and the sudden shock of it has unleashed panic liquidation. But volatility cuts both ways, and any positive surprise such as a last-minute political resolution of the automakers bail-out would catalyze a strong reversal.