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Green Overshoots

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How much more recovery can the economy take?

Update to strategic view
US STOCKS: Rising Treasury yields have eroded the value proposition in stocks, as the "tradable rally" has degenerated into a narrow trading range. Stocks are still cheap by the lofty standards of the boom years of the 1980s and 1990s -- but they're about average for the 1960s and 1970s, the decades that we think are more similar to the current strategic environment.
[see Investment Strategy Dashboard]

The "tradable rally" in stocks (see "Quantum of No Solace" March 10, 2009) has been stuck in a narrow trading range for more than a month. Our trader's gut is still telling us that stocks don't feel like they want to go down. But at the same time the upside is limited by serious threats to the emergent economic recovery, the latest being the alarming back-up in Treasury yields. Ultimately we think that threat will become very real as yields move higher still --*much* higher -- in response to both massive supply and higher inflation, the price that will have to be paid for solving the global banking crisis with extraordinary levels of government spending and monetary easing (see "No, Mr. Bond, I Expect You to Die" May 22, 2009). But for the moment, yields are to a large extent just returning to normal now that global credit markets have stabilized and safe haven demand for Treasuries has subsided. The question the stock market should be asking itself is whether the economy is *ready* for normal yet.

For us, there's little doubt that some kind of recovery is at hand, evidenced in a wide variety of coincident and leading indicators (see the charts on the following page). New jobless claims continue to look as though early April was the peak, a development closely associated with every official recession trough since 1975. The headlong plunge in S&P 500 consensus forward earnings has nearly halted, with analyst revisions now falling at a 14.6% monthly annual rate (and only a 2.4% rate ex-financials) -- up from worse than 60% two months ago. And growth in new orders for non-defense capital goods excluding aircraft have turned higher on a three-month basis -- a genuinely positive "first derivative" result, not just another case of things getting worse more slowly, and especially welcome considering that a collapse in fixed investment more than fully explained the first quarter's decline in Gross Domestic Product (see "It's an Old New Era" May 1, 2009).

But with Treasury yields and other examples of emergent recovery, it may be a case of too much too fast. Granting that the recession has troughed, how robust a recovery can we expect if mortgage interest rates rise when housing prices have yet to even stabilize -- with sales of

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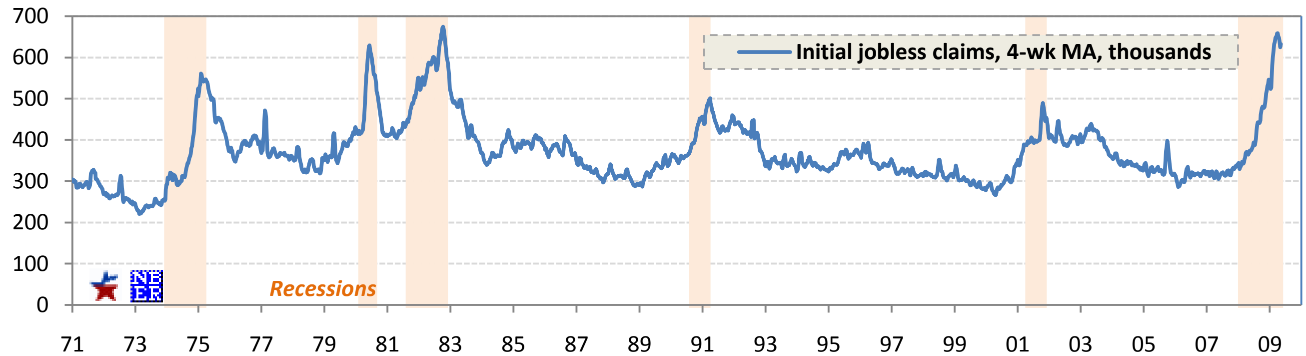
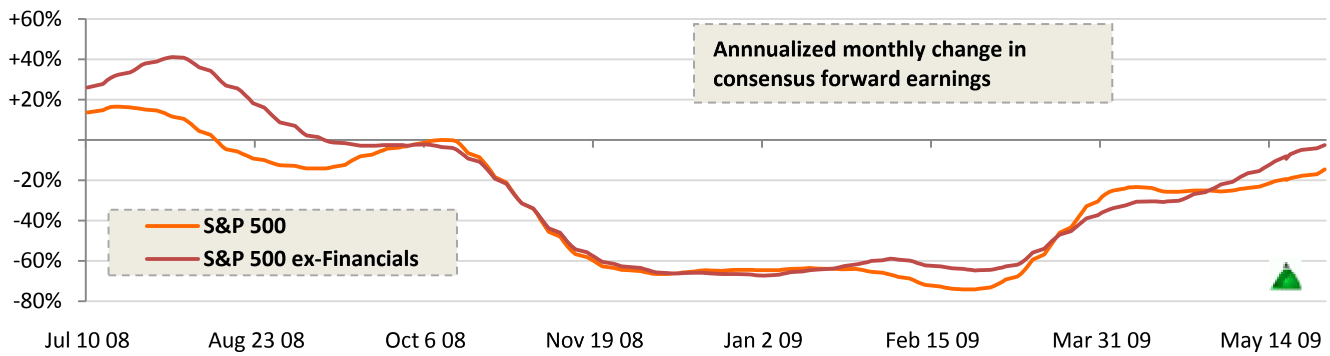
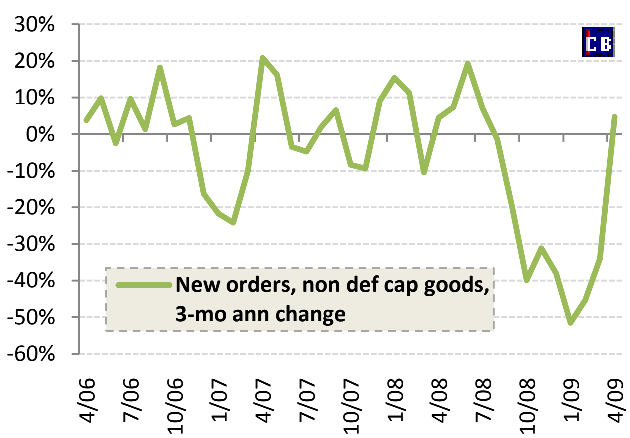
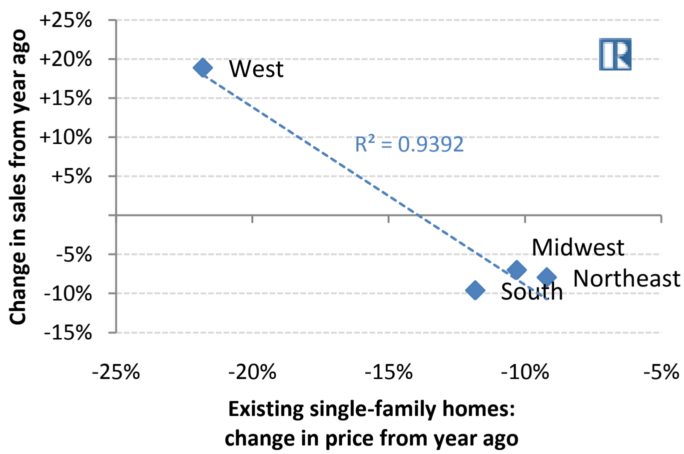
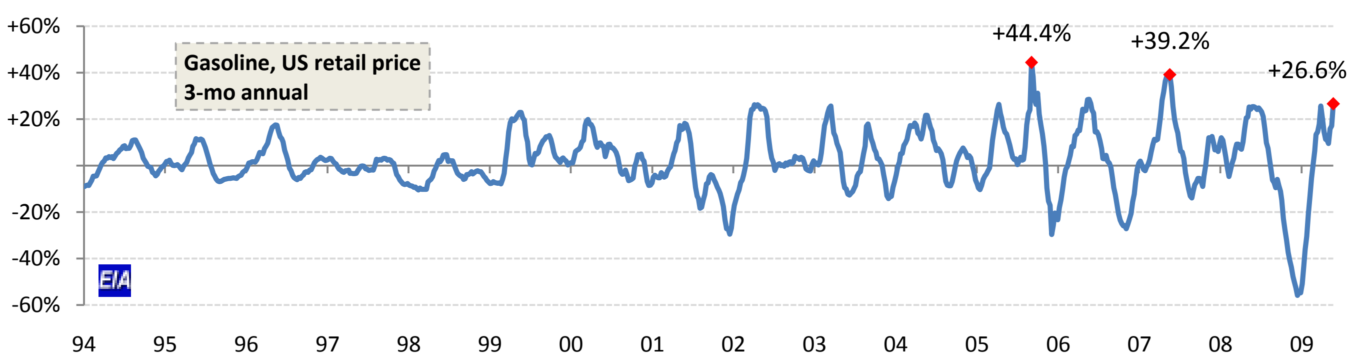
existing home moving only in the west, where prices have fallen the hardest? How robust a recovery can we expect if the recent resurgence in consumption and consumer confidence was a function of low gasoline prices that no longer obtain, with the average US price up more than 26% on a three-month basis, the third largest jump in the history of the data?





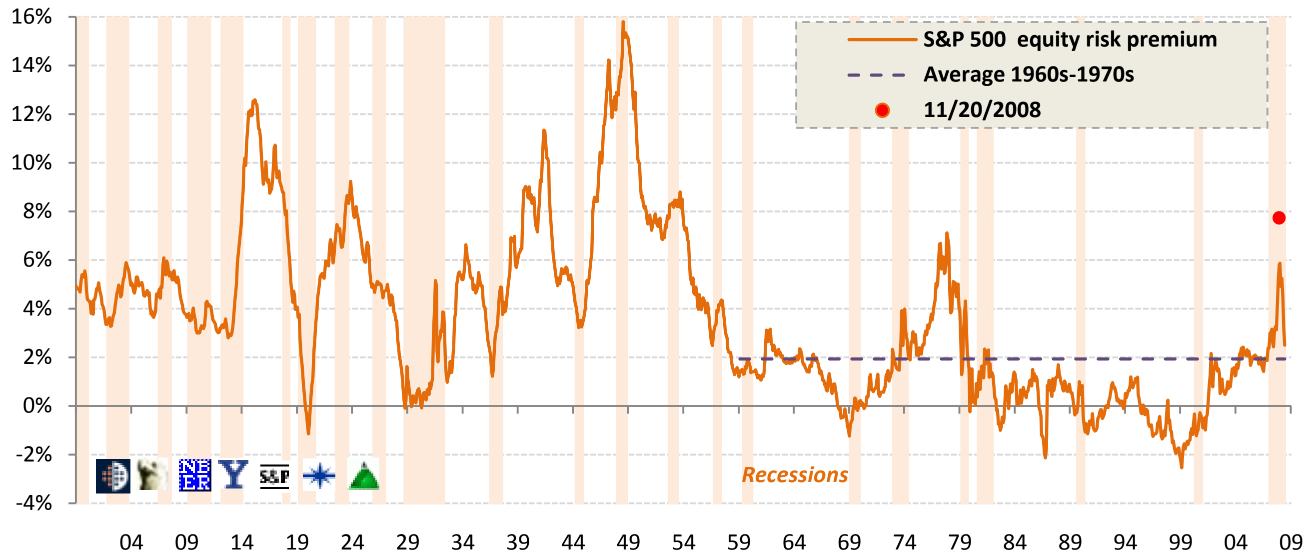






Similarly, rising Treasury yields have rendered the stock market no longer an especially compelling value proposition, even though stocks have rallied only 34% from their March bottom (even in the Great Depression we had a 50% rally). The equity risk premium -- the difference between the forward earnings yield of the S&P 500 and long-term Treasury yields -- is now back to a level last seen in June 2008, before the worst of the global financial crisis hit. That means stocks are cheap, based on forward earnings in relation to competing long-term riskless returns, but only by the standards of the 1980s and the 1990s -- decades of disinflation, deregulation, low taxes and high productivity. By the standards of the 1960s and the 1970s -- decades more like the one we are facing now, of inflation, regulation, higher taxes and low productivity (see ["Wolf in the Fold"](#) May 18, 2009) -- stocks are only a little better than fairly valued.

Recommended reading
Getting Off Track John Taylor Hoover Institution Press 2009
[Recommended Reading home]



BOTTOM LINE: Rising Treasury yields have eroded the value proposition in stocks, as the "tradable rally" has degenerated into a narrow trading range. Stocks are still cheap by the lofty standards of the boom years of the 1980s and 1990s -- but they're about average for the 1960s and 1970s, the decades that we think are more similar to the current strategic environment.