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MACROCOSM

Not Crazy, Still Cheap

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Stocks have soared as the equity risk premium has mean-reverted. Where to from here?

Four weeks ago we identified a generational value opportunity in US stocks, saying stocks were "crazy cheap" (see ["Europe Fails, US Stocks Flail"]() October 4, 2011). The S&P 500 equity risk premium exceeded its level at the very bottom on March 9, 2009, and was almost back to its peak of November 20, 2008 (see the chart below). Other than that, you have to go back to October 1978, and before that to March 1955, to find comparable valuations.

Since that call, from low tick to high tick, stocks have rallied 19.8%. The extreme level of the equity risk premium proved *not* to be a value trap -- *stocks really were crazy cheap*. When we made that call a month ago, we

Update to strategic view

US STOCKS: With stocks up almost 20% from bottom tick to top so far this month, with Greece's default having been the paradoxical catalyst, stocks are no longer "crazy cheap," and our trader's…

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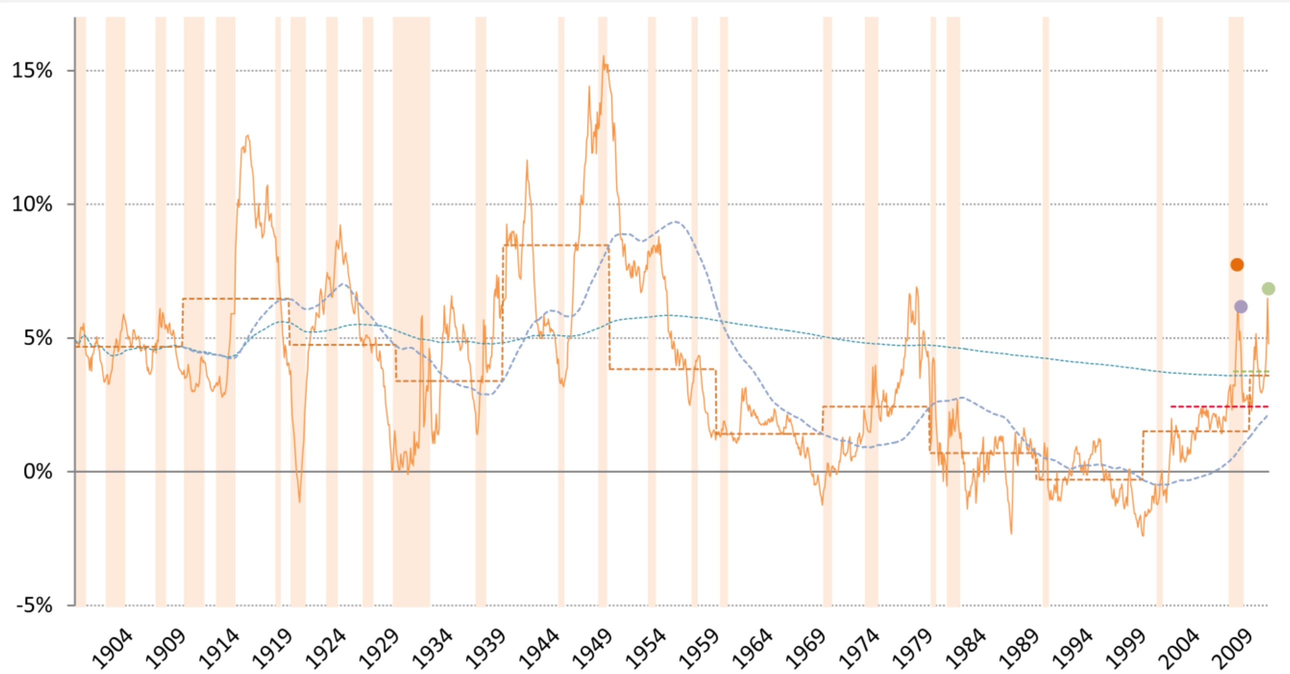
S&P 500 equity risk premium since 1900 • **11/20/08** • **3/9/09** • **10/4/11**
--- Cumulative avg --- 10-yr MA --- Decade avg --- Post Q302 avg --- Crisis-era avg Recession
Forward earnings yield minus 30-yr Treasury yield



Source: Various, TrendMacro calculations were relying on a combination of two concepts:

- *The equity risk premium is a panic indicator.* If you assume that sentiment is both irrational and cyclical -- alternating arbitrarily between excessive greed and excessive fear -- then the equity risk premium ought to be mean-reverting from extremes. That can be exploited by a contrarian asset allocation strategy. It is in that spirit that we have observed the equity risk premium on a daily basis for 24 years.
    - We judged that sentiment had swung to excessive fear in early September, when the equity risk premium for the DAX Index of German stocks blew out to heights even greater than at the worst of the 2008-2009 panic (please see the chart below).

DAX equity risk premium

Forward earnings yield minus 30-yr bund yield

Source: Bloomberg, TrendMacro calculations

    - That was when we noted that rumors and misinterpretations of events were so rampant in Europe's banking sector that prices had probably already discounted anything and everything. So why not take at least a speculative trading position (see "CHooF!" September 6, 2011)?
- *But the equity risk premium also captures the entirely rational appraisal of the amount of risk in the environment* -- separate from whatever emotions investors may *feel* about it.
    - If the amount of risk is great enough, and if we believe that the risk will eventuate, then panic-driven price discounts aren't enough. So to take something more than a speculative trading position, we'd have to believe that the risk *won't* eventuate -- that is, that the worst-case scenario won't happen -- that the markets risk appraisal is rational, but wrong.
    - Our judgment since early summer has been that the much-feared global banking contagion that could arise from a default in Greek sovereign debt was a risk that would *not* eventuate (see "Greece: Suicide, Not Murder" June 7,

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…gut tells us it's time for at least a rest, and probably a correction. It will take a little time, and perhaps the difficult test of enduring a speculative attack, to establish that Europe has really built a robust safety net. But after that plays out, with the equity risk premium still at elevated levels similar to those at the 2010 double-bottom, we expect further significant gains for stocks this year.

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2011). In fact, we've argued that a Greek default would trigger the release of fear and tension with the conversion of "unknown unknowns" into "known knowns." So it would be a catalyst for mean-reversion of the equity risk premium, and a rally in stocks (see ["Infectious Fear"] September 22, 2011).

Over the last several weeks we've had many interesting discussions and debates with clients about the equity risk premium. In that context, it's worth being clear about a third concept we were *not* relying on when we said stocks were "crazy cheap" in early October.

- *We did not expect that forward earnings would not fall, nor that long-term interest rates would not rise.* We granted that these things *would* happen, and that *they* would tend to cause the equity risk premium to mean-revert no matter what happened to stock prices.
    - Forward earnings *have* fallen over the last month, and long-term yields *have* risen. But stock prices have rallied very substantially at the same time.
    - Large mean-reverting episodes in the equity risk premium are frequently trifectas, implicating all three of the model's inputs at the same time -- rising stock prices, falling forward earnings and rising long-term yields.

So where do we go from here, after what is likely to be the best single calendar month for stocks in 37 years?

- The equity risk premium remains *very* elevated, despite considerable mean-reversion over the last month (please see the chart below).
- It's about where it was at mid-year 2010, before QE2 had been officially announced, and when the consensus took it as a

S&P 500 equity risk premium in the crisis era **Recession**
Forward earnings yield minus 30-yr Treasury yield

Source: Bloomberg, TrendMacro calculations

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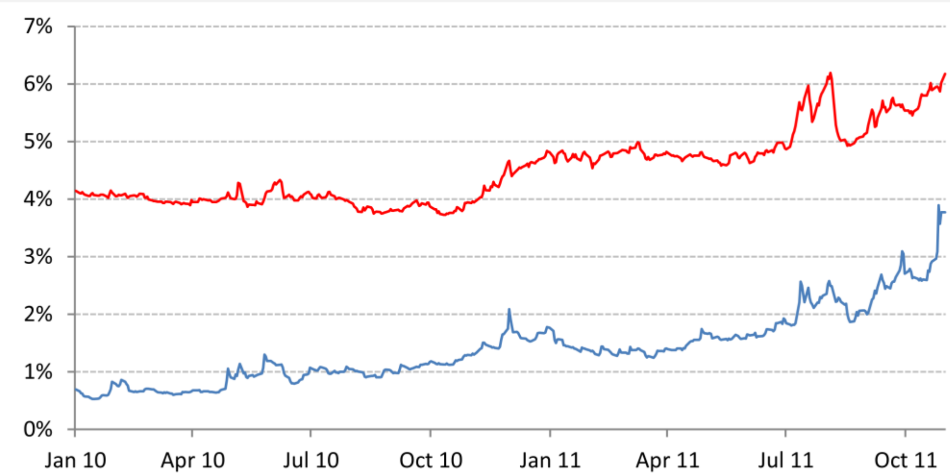
foregone conclusion that there would be a double-dip recession. It was also when we called the double-bottom in stocks, ahead of what would prove to be a major eight-month rally (see "Betting Against a 'Double Dip'" June 30, 2010, and "On Bernanke at Jackson Hole" August 27, 2010).

- So let's say the equity risk premium has more room to mean-revert. Where, exactly is the mean to which it is to revert? *This is always the great question in using the equity risk premium as an asset allocation tool* -- because the mean is not stationary through time. Instead, the mean appears to go through regimes, reflecting different levels of risk in the world, and different phases of investor attitudes toward risk (please see again the chart on the first page of this report).
    - The 1980s and the 1990s were decades of both low risk and high risk-tolerance, so the mean equity risk premium was quite low.
    - It appears that this regime ended in mid-2002, as the mean equity risk premium rose substantially and persistently. This corresponds with three fundamental changes in the macro environment -- the passage of the Sarbanes Oxley Act after a generation of deregulation, the advent of the risk of monetary deflation after a generation of salutary disinflation, and the passage of the Iraq Joint War Powers Resolution after a generation of peace and generally stable oil prices.
    - The mean equity risk premium has been even higher since the first foreshocks in mid-2007 of what would turn into the Great Recession. It so happens that this current mean is about the same as the cumulative average of the equity risk premium from 1900. While the crisis era mean seems high in relation to the low equity risk premium that has obtained throughout the careers of most of today's investors, it is actually "normal" in the context of over a century of market experience.
    - From today's level of the equity risk premium, there is still a great deal of room for further reversion to the crisis era mean (please see again the chart on the previous page).
    - Holding forward earnings and long-term yields constant, complete reversion to the crisis era mean would move stock prices 21% higher, to approximately the level of all-time highs.
    - Forward earnings will probably continue to fall at least to some extent, and long-term yields are very likely to rise if confidence in the global banking system continues to be restored. A trifecta mean reversion -- like we've seen so far -- would imply something less than a 21% rally in stocks.
    - But there is nothing that says the equity risk premium has to *only* revert to the mean. It could go below it, as it did after the March 2009 bottom and the July 2010 bottom. If that happens -- which we see as entirely likely -- then stocks could well be at new all-time highs in 2012.

All that said, with the equity risk premium no longer at extraordinary levels, we cannot rely on panic pricing as a cushion against event-shocks. So all the pressure now is on the assumption that there won't be any more event shocks in the present tactical timeframe.

- The risk to the world economy from a disorderly default in Greece, which could trigger the dissolution of the euro currency, which in turn would result in cascading sovereign and bank defaults, has always been extremely salient. *That's not to say it's been probable, or is probable now* -- only that if it were to happen, it would be an extraordinary global catastrophe.
- It's remarkable that global stock markets have rallied over the last month as a Greek default -- once utterly unthinkable in our post-Lehman world in which it has been believed that all bondholders must always be kept whole -- has in fact occurred, with private sector bondholders now expected to take a 50% haircut.
- If that were going to cause a speculative attack or a non-linear collapse in confidence -- or some other manifestation of contagion -- with respect to Europe's debt, or Europe's banks, you'd think we'd have seen it by now.
- Not necessarily. Remember, the systemic consequences of Lehman Brothers' failure in 2008 were not immediately apparent. It wasn't until two market days later that contagion through money market funds came to light -- and then all hell broke loose.
- We can't know what could yet go wrong in Europe in the wake of the Greek haircut. Many of its details -- indeed, the details of just about everything announced after last week's marathon summit -- remain to be worked out (see "On the Europe Summit" October 27, 2011). It may be that the devil is in those yet-unknown details.
- A threat has already emerged. Italian long-term interest rates have risen back above 6%. More alarming, short-term rates have risen to new highs near 4% -- with neither getting any relief in the aftermath of the summit (please see the chart below). If there is going to be a

Italy government bond yields **6-month** **10-year**



Source: Bloomberg

speculative attack, this appears to be the most likely battleground.

- If it happens, then this will be Europe's true test -- either the Greek default will be Europe's Lehman moment, or it won't. We fully expect the test will be passed. The anti-contagion tools at Europe's disposal are powerful and capacious, even though still not battle-tested. They provide the *way* -- now all it takes is the *will*.
- But if a test has to be taken in Europe, then markets will have to consolidate the gains of the last month with some form of correction. We'll watch it carefully as it plays out, but our expectation now is that it will be a buying opportunity.

Bottom line

With stocks up almost 20% from bottom tick to top so far this month, with Greece's default having been the paradoxical catalyst, stocks are no longer "crazy cheap," and our trader's gut tells us it's time for at least a rest, and probably a correction. It will take a little time, and perhaps the difficult test of enduring a speculative attack, to establish that Europe has really built a robust safety net. But after that plays out, with the equity risk premium still at elevated levels similar to those at the 2010 double-bottom, we expect further significant gains for stocks this year.