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MACROCOSM

The Incredible Shrinking Equity Risk Premium

Thursday, February 21, 2013

Donald Luskin

Stocks are vulnerable to correction because they're neither a value nor a growth proposition.

As we've been saying all year, despite our less than bullish arguments to the contrary, "it feels like stocks want to keep melting up" (see "2013 Outlook: Think Globally, Shrink Locally" January 14, 2013). US stocks have now melted up to the point at which they *are in no way a value proposition*. At Tuesday's close, before Wednesday's jolt to the downside, the S&P 500 equity risk premium was only 0.2 standard deviations from its crisis-era mean (please see the chart below). If stocks are not a value proposition, then to rally much further they must be a growth proposition. We don't think the facts support much of a growth story. So we see stocks as increasingly vulnerable to correction on even the smallest shift in sentiment.

- The equity risk premium stands right where it did in March 2012, just before a 9.3% correction, and in September 2011 just before a 14.9% correction.
- Anything can be the trigger. Why not yesterday's apparent alarm from the January FOMC minutes that "many members" are

— S&P 500 equity risk premium --- Average from July 2007 Recession
Consensus forward earnings yield minus 30-year Treasury yield

Source: Zacks, Bloomberg, NBER, TrendMacro calculations

Update to strategic view

US STOCKS, US FED: The S&P 500 equity risk premium has almost entirely mean-reverted -- but it is due almost entirely to an improvement in risk-tolerance, with almost no improvement in growth expectations. This leaves US stocks vulnerable to substantial correction, such as those that began in March 2012 and September 2011, the last two times the equity risk premium was at the present level. Any change in sentiment could be the trigger, such as yesterday's FOMC minutes that hinted at the earlier than expected termination of asset purchases that we have warned about.

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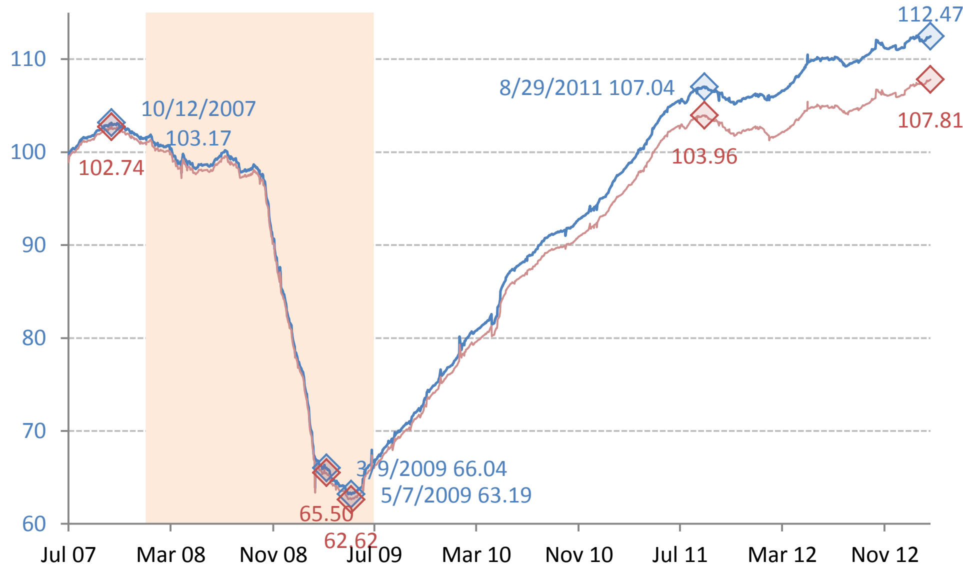
concerned with the risks of ongoing asset purchases? This would seem to be a bit of an escalation from the December minutes in which "a number of participants" were said to be concerned. But that's only consistent with what we've been telling clients since the December FOMC -- that its statement made clear that asset purchases would end "a considerable period" *before* the so-called Evans Rule would trigger rate hikes as soon as mid-to-late 2014 (see "On the December FOMC" December 12, 2012, and "2013 Outlook: Doves Ruled Out at the Fed" January 25, 2013).

Forward earnings per share — S&P 500 — Snapple ▇ Recession



Source: Zacks, Bloomberg, NBER, TrendMacro calculations

- If not that, then it will be something else. If it didn't start yesterday, it will start soon.
- Stocks are vulnerable here because the mean-reversion in the equity risk premium from its two prior peaks in October 2011 and June 2012 has been due, we believe, entirely to an improvement in risk-tolerance, not growth expectations.
- We say that because from those two equity risk premium peaks we've had stock price gains of 39.3% and 19.9%, respectively. But at the same time forward earnings advanced only 5.6% and 2.6% respectively. Yes, forward earnings are indeed making new highs every day -- with or without Apple -- but what matters is the growth rate, and it has slowed to an unhealthy crawl (please see the chart above).
- Since the two equity risk premium peaks in October 2011 and June 2012, the 30-year Treasury yield has risen 68 bp and 45 bp, respectively. Arithmetically, this explains about one third of the mean-reversion in the equity risk premium. It should not be a surprise to see Treasury yields rise as risk-tolerance improves -- straightforwardly, safe-haven demand for Treasuries is diminished.
- That risk-tolerance has vastly improved is corroborated by the fact that S&P 500 volatility has fallen to a seven-year low, as reflected

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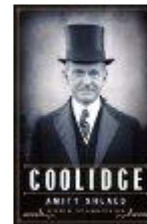
Recommended Reading

The Coolidge Lesson on Taxes and Spending
Amity Shlaes
Wall Street Journal
February 19, 2013

Based on the new book:



Coolidge
Amity Shlaes
Harper 2013

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in the VIX Volatility Index.

- We don't disagree that the quantum of risk to be borne by investors has objectively diminished over the last 16 months since the October 2011 bottom (see "Oh What a Relief It Is" January 23, 2013). But if the tremendous upside move in stocks since then has been primarily driven by that -- if it is just a massive "relief rally" -- then it must run out of fuel when risk cannot be diminished any further.
- This is not unrelated to the present Fed scare. Remember, we think the Fed initiated QE3 in unspecified size and duration last September when it was seized by fears of a European depression, a China hard landing and a headlong plunge off the year-end fiscal cliff (see "On the October FOMC" October 24, 2012). None of those risks has eventuated. As the FOMC experiences its own "relief rally" as it lays aside these panicky scenarios, it makes sense that the size and duration of asset purchases would have to be scaled back.
- As the market contemplates this change in the Fed's stance, it will have to weigh the good news that so many risks have dematerialized against the bad news that the Fed's money spigot will leave asset markets less well financed than they have been. Such considerations are the stuff of stock market corrections.
- To be sure, from here the equity risk premium *can* go below the mean (after all, the mean wouldn't be the mean if there weren't datapoints above it *and* below it). But such moves are fueled by large upgrades in growth expectations. For example, in October 2010, from the same level as today, the equity risk premium fell below the mean and ushered in a 17.0% rally in stocks over six months. But over the same period forward earnings grew by 12.3%, more than twice the growth in less than half the time compared to the experience from the October 2011 bottom to the present.
- We resolutely don't think a growth expectations upgrade like that is in the cards now (see "Tax Hikes Have Consequences" January 2, 2013). Neither, apparently, does growth in consensus forward earnings.
- We continue to see interesting growth stories in several economies around the world, of which the US economy and US stocks will be collateral beneficiaries (again, see "2013 Outlook: Think Globally, Shrink Locally"). But we continue to expect growth in the US to be as tepid as it has been throughout the "Not So Great Expansion" following the Great Recession.

Bottom line

The S&P 500 equity risk premium has almost entirely mean-reverted -- but it is due almost entirely to an improvement in risk-tolerance, with almost no improvement in growth expectations. This leaves US stocks vulnerable to substantial correction, such as those that began in March 2012 and September 2011, the last two times the equity risk premium was at the present level. Any change in sentiment could be the trigger, such as yesterday's FOMC minutes that hinted at the earlier than expected termination of asset purchases that we have warned about.