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MACROCOSM

Ms. Yellen, We Don't Quite Agree

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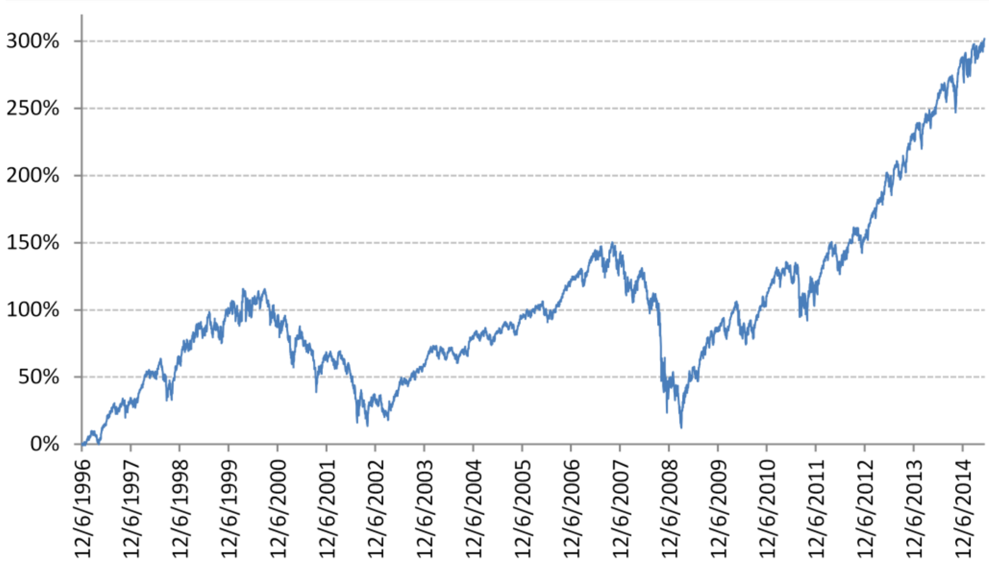
Donald Luskin

Stocks aren't cheap, but they aren't scary rich. Rising earnings can offset a yield back-up.

As we expected, stocks have recovered to new all-time highs after the holiday weekend mini-panic following a disappointing March jobs report (see "From March Badness to a Monday Miracle" April 7, 2015). Year-to-date, stocks are on track for a slightly better-than-average year, despite an amazing multi-year bull run, while long-term Treasuries are barely eking out a positive total return. As a joint consequence, the Equity Risk Premium is moving lower, toward its pre-crisis mean. So far so good. It's all as we predicted at last year-end (see "2015: Oil Change for the Global Economy, US Edition" December 31, 2014). *But looking ahead, stocks have to deal with the reality that they are definitely not cheap. Indeed, a strong narrative has emerged over the last couple weeks that they are dangerously expensive.*

- The matter of over-valuation of equities was aggravated by an aggravating speech by Fed Chair Janet Yellen, before the Institute for New Economic Thinking (yes, it's come to that -- a Fed chair actually addresses such organizations). In a Q&A session afterward with IMF Managing Director Christine Lagarde, Yellen

S&P 500
Cumulative total return from "irrational exuberance" speech 12/5/95



Source: Bloomberg, TrendMacro calculations

Update to strategic view

US STOCKS, US BONDS, US FED: When Yellen says equity valuations are "quite high," we half-agree -- they are high, but not "quite." The S&P 500 forward PE at 17.2 is only 0.9 standard deviations above its long-term mean. Yellen is right to focus on a sharp back-up in yields as the biggest risk to stocks. But she wishes to delay liftoff as long as possible, and when it comes, it will be gradual and will have a low terminal rate. It will only come against a backdrop of improving growth, in which case higher forward earnings -- which have already begun to materialized over the last three months -- will likely more than offset modestly higher yields.

[Strategy Dashboard home]

said, "I guess I would highlight that equity market valuations at this point generally are quite high."

- She went on to qualify that, saying "they're not so high when you compare the returns on equities to the returns on safe assets, like bonds." And she concluded that "risks to financial stability are moderate, not -- not -- elevated at this point. And I say that because we're not seeing any broad-based pickup in leverage."
- It's easy to compare Yellen's comment to former Fed Chairman Alan Greenspan's "irrational exuberance" speech of December 5, 1996. The mythology of the market's memory holds Greenspan's famous *bon mots* to be a prescient and market-moving prediction. In fact, they were not prescient, market moving, nor even a prediction. Greenspan used those words in a hypothetical question about the limits of central bankers' knowledge about markets. And any investor who bought US stocks on the day of his speech was never sorry. Other than a bit of turbulence the following few days, stocks never after that delivered a loss on a total return basis (please see the chart on the previous page).

Yellen's headline-grabbing remarks have unleashed a torrent of commentary about how overvalued stocks are. All the usual suspects are rounded up. Robert Shiller's Cycle-Adjusted Price Earnings (CAPE) metric is dutifully cited. Even James Tobin's "Q" is brought back from the dead.

- Clients ask us about CAPE all the time. We understand the logic of it, but it has never had any utility as a tool to actually make asset allocation decisions in any practical timeframe.
- As to "Q", again we understand the logic of it. But we don't see why replacement cost is any better than, say, earnings as a base metric against which to compare prices. In fact it's worse, because it is relatively unobservable, all the more so in an "information economy" in which intellectual capital in the form of patents, copyrights and cumulative management expertise explain a great deal of a firm's earning-power.

Generally (that is, with some qualifications), we agree with Yellen here -- and with Greenspan.

- Yellen says equity market valuations are "quite high." We'd take out the "quite."
- The S&P 500's forward price/earnings ratio is now 17.2. That's the highest since March 2004, coming off the bubble years. And it's higher than at the October 2007 peak of the prior bull market. But it's not "quite" high. It's about 0.9 standard deviations above the long-term mean (please see the chart on the following page).
- Yellen is right to contextualize high valuations against "the returns on safe assets, like bonds." *Computationally, the expected return on bonds is the discount rate used to value the stream of earnings from stocks -- so lower bond yields mean a higher present value of future earnings, which would express itself cross-sectionally as a higher multiple on one-year forward earnings.*

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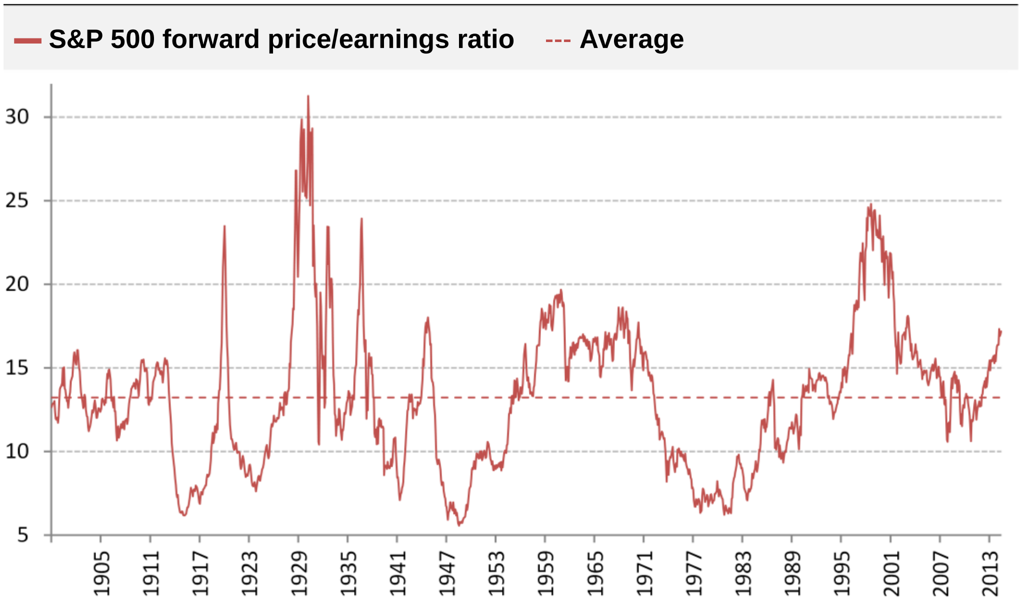


Source: Various, TrendMacro calculations

- Note that Yellen speaks of the "returns on" safe assets, not the "valuation of" safe assets. She is, we believe quite intentionally, not saying she thinks bonds are overvalued. Indeed, bonds with low "returns" are correctly valued in light of her avowed policy to keep policy rates below normal even when the economy fully returns to normal -- the doctrine we have come to call "The Yellen Rule" (see "The Yellen Rule is Taylor Minus Two" May 19, 2014).
- In 1996 Greenspan put a related qualification on his speculation about "irrational exuberance." *Instead of citing low expected bond yields as perturbing the discount rate for earnings, Greenspan cited low and stable expected inflation as reducing the risk premium attached to those earnings.*
- *Today we have both factors working together in a mutually reinforcing way, all in favor of sustainably higher-than-usual valuations for equities. We can rationally expect lower-than-usual bond yields thanks to "The Yellen Rule," and at the same time we can expect lower and stable inflation thanks to the durable supply-side revolution in oil* (see, among others, "Unyielding" May 13, 2015).

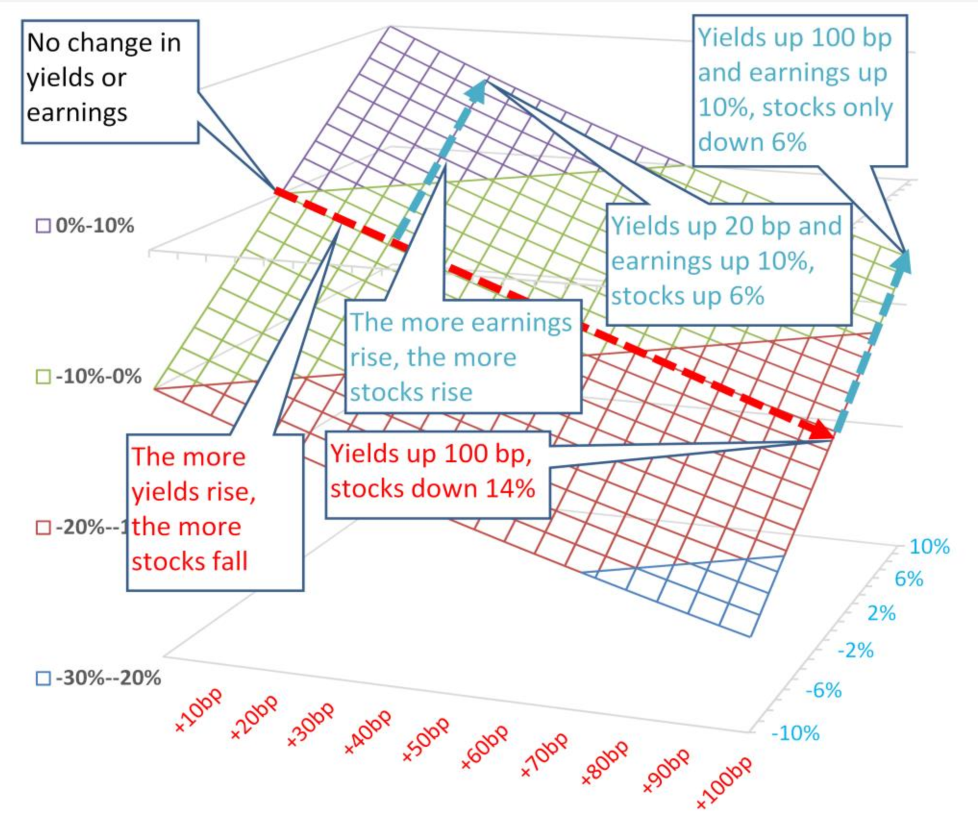
Since the view that valuations are merely high -- not "quite" high -- hinges on the expectation that long-term yields will be fairly quiescent, let's do some stress-testing on that variable.

- Yellen herself worries about this. In the same remarks, she said "We need to be attentive, and are, to the possibility that when the Fed decides it's time to begin raising rates, these term premiums could move up and we could see a sharp jump in long-term rates."
- This plays into a narrative of fear which we believe is being promoted by the banking lobby, specifically to delay the day of

"liftoff" from the zero bound (see "On the April Jobs Report" May 8, 2015).

- The latest round in this offensive lobbying offensive is a statement this week from a group of elite financial executives, released under the aegis of the World Economic Forum in Davos, calling for the imposition on their industry of more regulation in the form of "prudential supervision" from central banks.
- *We don't doubt that there have been all manner of adaptations to years of the fed funds rate being stuck at the zero bound, and that at liftoff, there may be some degree of disruption. But surely the Fed has done enough to warn the markets that liftoff is coming at some point, even if the exact timing is highly uncertain. Our strong expectation is that Yellen, in her understandable timidity in the face of making a potentially momentous decision, will defer liftoff as long as she can* (again, see "On the April Jobs Report"). *But when liftoff comes -- or, more precisely, when it is clear that it is about to come -- there will be an intense but very brief back-up in yields. But soon enough it will become accepted that liftoff neither implies an aggressive hiking cycle, nor an especially high terminal rate for the cycle, and yields will settle back into their lower-than-normal pattern.*
- Our framework for stress-testing the equity markets for these

Change in S&P 500 market cap within Equity Risk Premium model
— With increase in 30-year Treasury yield
— With increase/decrease in forward earnings Holding ERP constant



Source: Various, TrendMacro calculations possibilities is to think about them as a set of trade-offs between stock prices, earnings, and yields within the idea of the Equity Risk Premium. That's a simple formula -- the forward earnings yield of the S&P minus the 30-year Treasury yield -- that captures all three relevant variables.

- Within the ERP framework, all else equal, a rise in long-term yields is a deadweight loss to stock prices. For example, holding today's ERP constant, a 100 bp rise in the 30-year Treasury yield would call for a 14% drop in stock prices (please see the chart at the bottom of the previous page).
- But within the Fed's operating assumptions, such a rise in the 30-year yield could not happen outside the backdrop of a much more rapidly growing economy, in which forward earnings were considerably higher. A 10% increase in forward earnings would offset much of the impact of a 100 bp back-up in the 30-year yield, limiting the loss in stocks to 6% (again, please see the chart at the bottom of the previous page).
- We think a back-up of that magnitude in the 30-year yield is extremely unlikely. It's certainly many multiples of what the forward curve presently expects.
- Even a 20 bp back-up is more than the forward curve expects. If that occurs, and at the same time forward earnings grow by 10%, then stocks would be 6% higher (again, please see the chart at the bottom of the previous page).
- How likely is it, really, that forward earnings could be 10% higher in, say, six months or one year? We think it is highly likely. Responding to the shock to the global economy of massively and suddenly lower oil prices and, in consequence, a far stronger US dollar, S&P 500 forward earnings peaked on October 2, 2014 (see "Houston, You're the Problem" March 9, 2015). They troughed on February 27, and have since been growing at an 8.3% annual rate (at a 10.4% rate excluding the energy sector) -- and that's with the restoration of confidence after the shock only just beginning.

Bottom line

When Yellen says equity valuations are "quite high," we half-agree -- they are high, but not "quite." The S&P 500 forward PE at 17.2 is only 0.9 standard deviations above its long-term mean. Yellen is right to focus on a sharp back-up in yields as the biggest risk to stocks. But she wishes to delay liftoff as long as possible, and when it comes, it will be gradual and will have a low terminal rate. It will only come against a backdrop of improving growth, in which case higher forward earnings -- which have already begun to materialized over the last three months -- will likely more than offset modestly higher yields.