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MACROCOSM

Do Equities Have a Valuation Problem?

Tuesday, June 9, 2020

Donald Luskin

The risk premium is near post-GFC lows – but estimate upgrades haven't even begun.

It's official – we're in recession, with the prior business cycle peak set at February (as we predicted it would: see "On the March Jobs Report, and Being in Recession (Whatever that Means)" April 3, 2020). Our best guess is that eventually the gurus at the National Bureau of Economic research will set the trough at June. In other words, *this is it*.

- *The S&P 500 could match its all-time high of February – the business cycle peak – by rallying only about another 5%, even though we are, we believe, at the recession trough. This would not be especially unusual. Equities were already at new highs at the troughs of five of the ten postwar recessions* (please see the charts on the following page).
- *But for the short-term, risk-adjusted valuation will get in the way of much further upside.* Our equity risk premium model called the bottom on March 23 when, at 6.21%, it registered within a couple basis points of its panic valuation on the day of the Global Financial Crisis climax on March 9, 2009 (see "On the Fed's Massive Intervention" March 23, 2020). *Now this mean-reverting indicator of the relative value of risky equities and default-free bonds has more than cut in half, narrowing by 3.48%, more than entirely reverting to its post-GFC mean. Just 33 more basis points and it will match the post-GFC low of 2.40%* (please see the chart below).

Update to strategic view

US STOCKS, US MACRO: We're officially in recession, with the prior peak dated at February. We think this month is the trough. Equities are almost back to the highs, as has happened at the trough of five of the ten post-war recessions. Risk-adjusted valuations are getting stretched, with the equity risk premium having reverted from 2009-type highs to the post-GFC mean and below, approaching the post-GFC record. At economic turning points, equities often get ahead of earnings. There have …

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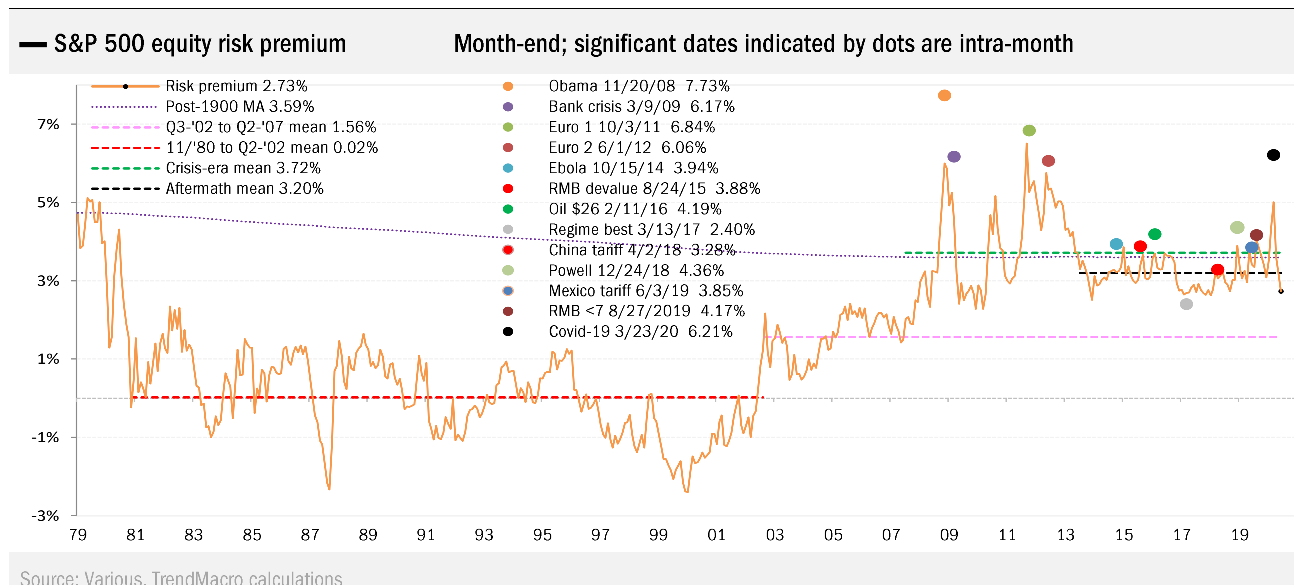

Source: Various. TrendMacro calculations

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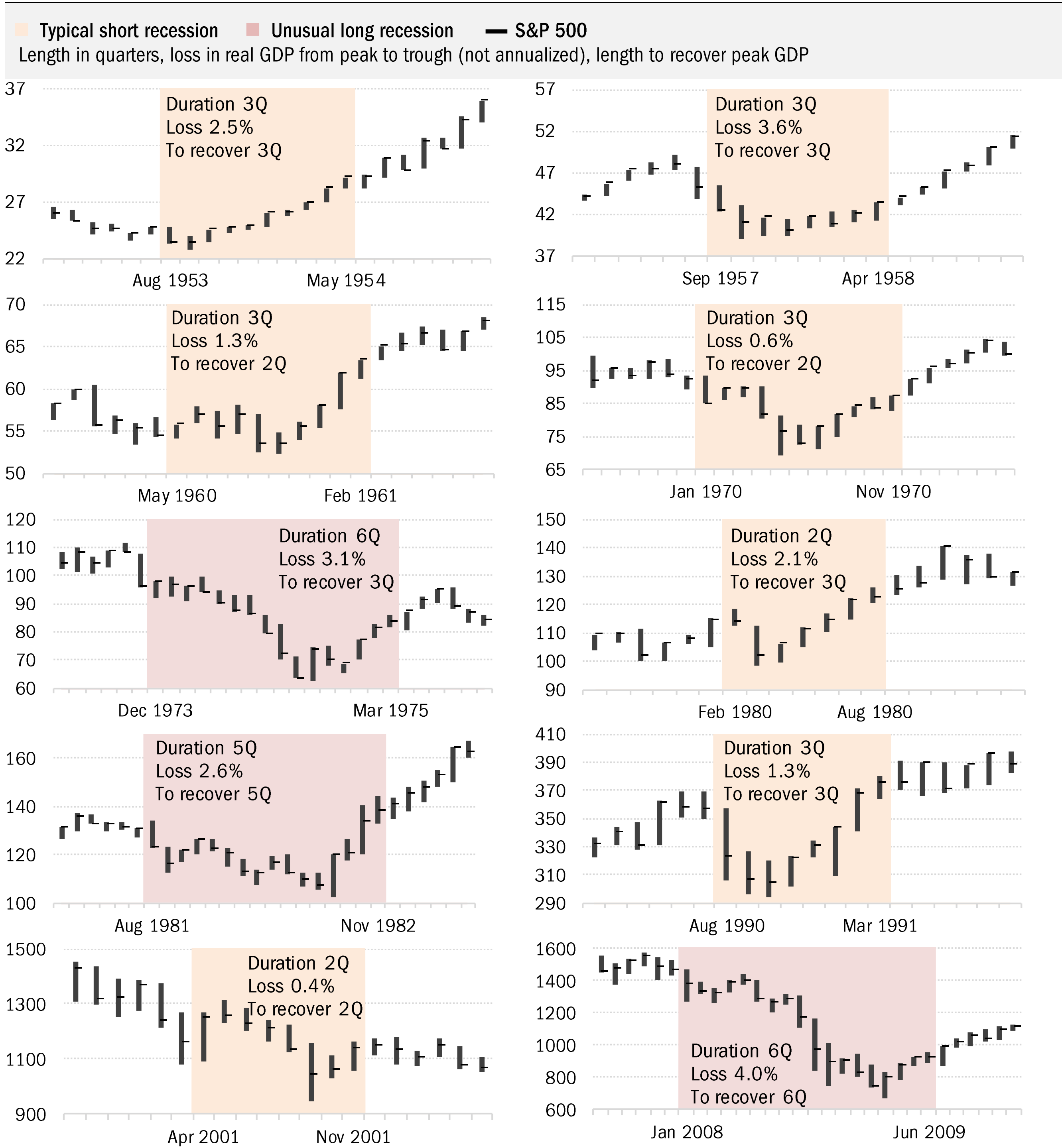
- *But it's not unusual for equity prices to get ahead of valuations based on earnings at recession troughs.* Forward-looking equities rally strongly off panic bottoms before economic recovery is assured and reflected in earnings data or estimates. It happened in Q3-2009, following the mid-year trough of the Great Recession. *The structure of quarter-by-quarter forward consensus earnings points to the same thing happening now, which points to further*



Source: Bloomberg, NBER, TrendMacro calculations

upside for equities even if we have to bear some kind of small short-term correction.

- *So far, forward earnings have priced in almost no economic recovery from the Covid-2019 lockdown. We expect a V-shape recovery unless there is an anti-growth shock arising from the run-up to the November presidential election* (see, among others, "After the Crisis, the Work Begins" May 4, 2020) – *and we expect earnings will come to reflect that recovery, and support today's seemingly high valuations.*
- *The slight upturn in S&P 500 forward earnings has been driven by nothing but the passage of time – the roll-off, day by day, of the miserable estimates for Q2-2020, and the roll-in, day by day, of the estimates for Q2-2021, which are about 65% higher* (please see the charts below).
- But about the best thing we can say about those Q2-2021 estimates is that they've stopped going down. The reason why it's 65% higher than the present quarter is just that it went down less during the lockdown (again, please see the chart below).
- If Q2-2021 estimates only maintain their present very shallow pace of recovery, year-ahead S&P 500 forward earnings will automagically be about 5% higher by the end of this month due to nothing but the passage of time.
- *But as Q2-2021 gets upgraded, when evidence of a V-shaped recovery starts to materialize and get reflected in corporate guidance – for that matter, as the three quarters between here and there do as well – we're going to see some astonishing implied forward growth numbers, especially once the present miserable quarter entirely rolls off and its reported actuals become the comparable.*
- *This dynamic is reflected in the sector distribution of lockdown losses and subsequent recovery, in terms of both prices and*

Update to strategic view

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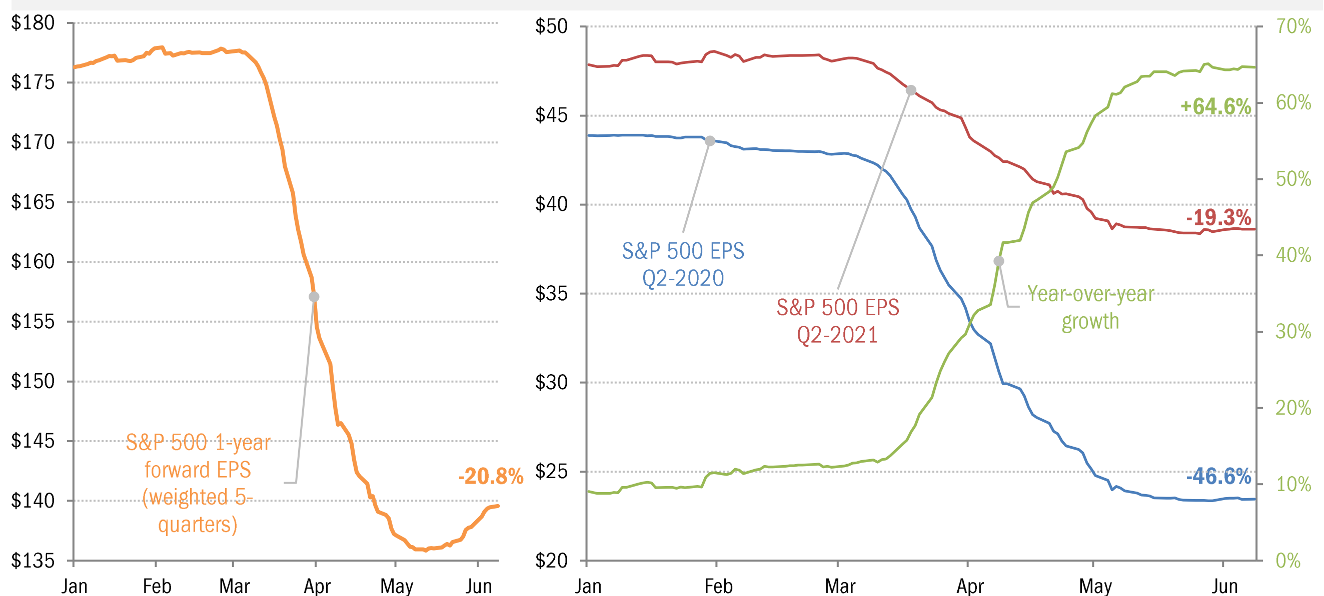
… been almost no earnings estimate upgrades yet. Forward earnings appear to be rising slightly because the present terrible quarter is rolling off. When the present quarter is done, it will become the comparable supporting astonishingly high growth estimates. The presidential election remains a risk for markets. But upgrades are coming as a V-shaped recovery takes hold. This will support the sectors that are furthest from recouping their losses.

[Strategy Dashboard home]

S&P 500 consensus forward EPS in 2020



Source: Bloomberg. TrendMacro calculations

earnings.

- The technology-driven companies that had been the leadership of the prior bull market had somewhat less-than-market losses in the lockdown bear market of February and March because, luckily, most found themselves in businesses that were helped, not hurt, by the lockdown. This was very frustrating for active managers who had been counting on the usual historical pattern in which the bull market leaders take it the hardest in the bear market. Making matters worse, those same stocks have recovered the most since the March bottom, with the five FAANG stocks, in a cap-weighted portfolio, up about 16% year-to-date.
- But that leaves other sectors with a great deal of recovery still to be achieved. For example, we've highlighted the beleaguered S&P 500 energy sector as a uniquely compelling recovery candidate (see "How Low Can Oil Go?" March 30, 2020). Indeed. It has rallied 95% from its lows in March, yet it would take another 32% to get back to the year's pre-crisis highs – twice that of the next-worst sector, financials.
- At the worst in March, the energy sectors forward earnings had been more than entirely downgraded away. They remain 93% off the January highs. *If we are right about a V-shaped recovery, oil demand and oil prices are going to continue to firm, those forward earnings will come back, and share prices will continue to trudge higher.*
- *Different versions of the same story can be told about other hard-hit sectors – financials, industrials, real estate, small-cap. We've been talking to clients about this since early April, and it's been starting to get borne out in market action already – but there is more to come, because the V-shaped recovery is just getting started, and these sectors are the ones who depend on it actually happening.*
- *For the tech-driven stocks that have already more than recovered, we're not saying there's no upside – only that in relative terms, over the intermediate-term scope of a V-shaped economic recovery, they have had their day.*
- *If equities go through a correction here, all this will run in reverse for a while. We would treat that as an opportunity.*

Bottom line

We're officially in recession, with the prior peak dated at February. We think this month is the trough. Equities are almost back to the highs, as has happened at the trough of five of the ten post-war recessions. Risk-adjusted valuations are getting stretched, with the equity risk premium having reverted from 2009-type highs to the post-GFC mean and below, approaching the post-GFC record. At economic turning points, equities often get ahead of earnings. There have been almost no earnings estimate upgrades yet. Forward earnings appear to be rising slightly because the present terrible quarter is rolling off. The presidential election remains a risk for markets. But upgrades are coming as a V-shaped recovery takes hold. When the present quarter is done, it will become the comparable supporting astonishingly high growth estimates. This will support the sectors that are furthest from recouping their losses.

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