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MACROCOSM

Regime Change for the Equity Risk Premium?

Monday, April 19, 2021

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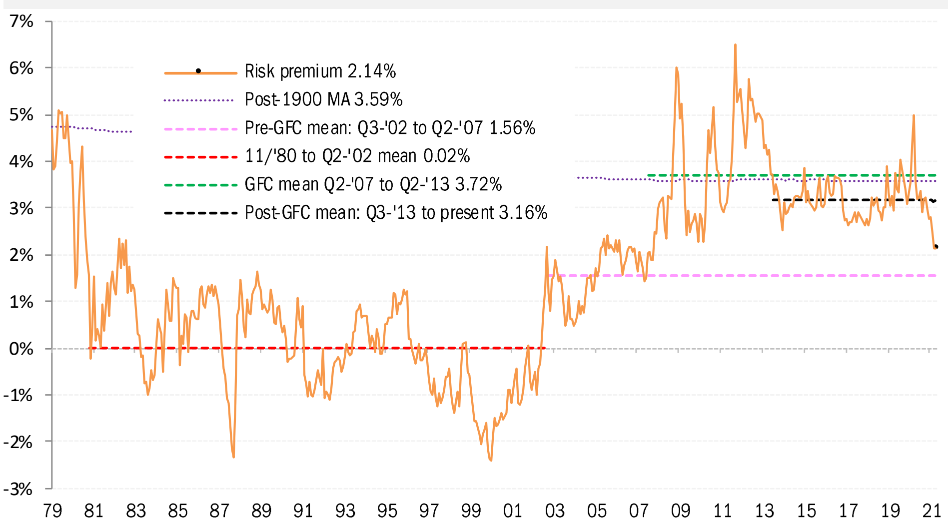
Post-Covid productivity and the Fed drops the Phillips Curve. More growth, fewer recessions.

We're struggling with how to understand the current S&P 500 equity risk premium – the difference between the 1-year forward earnings yield of the S&P 500 and the yield-to-maturity of the 30-year Treasury.

At a new post-Global Financial Crisis narrow (please see the chart below), _it might be telling us that equities have gotten too bubblicious, and that the back-up in Treasury yields has run its course for a while_. We've seen it that way most of this year-to-date, and have called for corrections more than once (for example, see "On the Coming Corporate Tax Hikes" March 31, 2021). There have been three S&P 500 corrections in 2021, 4.6% in late January, 5.8% in early March, and 3.3% in late March. But they were barely tradeable, and when each ended, stocks were at new highs and the ERP was narrower than before.

Now the ERP is closer to the pre-Global Financial Crisis mean that obtained from Q3-2002 to Q2-2007 than to the post-Crisis mean that has obtained from Q2-2013 (again, please see the chart below). _We know that the ERP is mean-reverting, and is therefore a valuable tactical asset allocation tool – especially when calling bottoms that can be associated with visible events about which one can form a principled opinion. But we also know after almost 35 years of working with the ERP every day that it_

S&P 500 equity risk premium — Month-end data-points except most recent day



Source: Various, TrendMacro calculations

Update to strategic view

US STOCKS, US BONDS, US FED, US MACRO: The US equity risk premium is narrower than at any time since the Global Financial Crisis ended, and closer to the pre-crisis mean than the post-crisis mean. The ERP is a mean-reverting indicator, so this suggests that stocks are due for a more serious correction than the three small ones so far this year. But the ERP mean is non-stationary, and we have to ask whether we are on the cusp of a new regime. Two credible candidate explanations emerge. First, there are large and durable future productivity gains to be derived from the reorganization of work after the pandemic. Second, the Fed has abandoned the fallacious Phillips Curve as a policy tool. This means the Fed will no longer mistakenly cause recessions out of the false belief that low unemployment causes inflation. At the same time, average inflation targeting will make the Fed more patient about inflation itself. Fewer recessions mean less risk, and less risk means a durably narrower equity risk premium.

[Strategy dashboard]

is harder to use it to call tops, because they are often not associated with visible events.

Most important for this report, we also know that the mean to which the ERP reverts is non-stationary. It can suddenly shift from one "regime" that lasted for years, to another one that will also last for years. Could we be experiencing a "regime change" that will lead to years of a lower mean ERP?

- As we write these words, we are very self-aware *that the justification of high equity valuations by positing a "new regime," a "new era" and so on is itself a sign of a top*.
- But the mean ERP nevertheless really does move through different regimes, and we can't not consider that this is what's happening now.
- Looking back on it, what might have caused the regime change from the high ERPs of the 1970s to the almost zero-mean regime that obtained throughout the 1980s and the 1990s (again, please see the chart on the previous page)? We would suggest that this was an era of disinflation, after an era of inflation. And the introduction of inflation-indexing, even in an era of declining inflation, ended relentless "bracket creep" that had automatically hiked personal income taxes for two decades. The regime might have been extended by the end in 1989 of the US-Soviet Cold War, opening the door to civilian adoption of previously military-only high technology such as the Internet.
- What might have caused the ERP to suddenly shift to a higher regime in mid-2002, and stay there till the Global Financial Crisis? We would suggest that the September 11, 2001 terrorist attacks ended the post-Cold War peace dividend; that the July 2002 passage of the Sarbanes-Oxley Act signaled the end of an era of deregulation; and that Ben Bernanke's November 2002 speech warning of deflation, by name, signaled the end of the era of salutary disinflation.

What might justify a move now to a new narrower regime for the S&P 500 ERP?

- We are not inclined to think that the end of the pandemic crisis is enough on its own. Simply the arrival and then the passage of an emergency doesn't, in and of itself, change anything. On the face of it the best case is that you manage to put Humpty Dumpty together again, and lose a year doing so.
- That said, there's more to it than that. *We think the Covid-19 crisis put a yoke of necessity on all of us. Necessity being the mother of invention, we have had to invent a great deal over the past year – and now we will harvest growth dividends from those inventions for years to come.*
- For example, 21% of the employed labor force is presently teleworking due to coronavirus, according to the Bureau of Labor Statistics (see "Data Insights: Jobs" April 2, 2021). That we are

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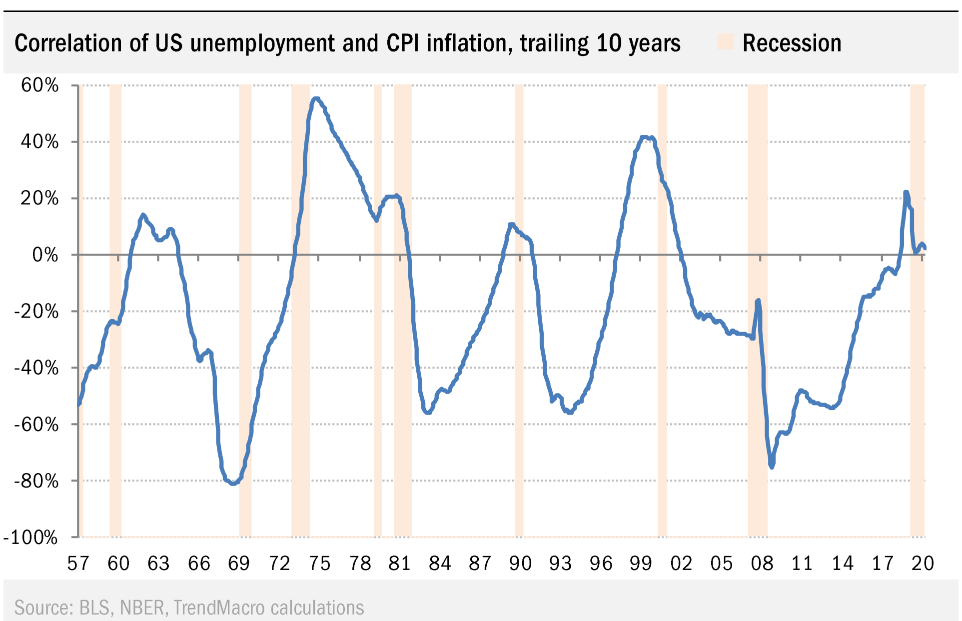
basically back to prior-peak GDP with one out of five employed persons working in a modality at a scale they didn't even know was possible a year ago is a miracle of resiliency and technology adoption. We think it will usher in *an era of the re-organization of office labor, which over time, and after much experimentation, will settle at the point of highest potential productivity – a point unthinkable until an emergency forced us to think*.

In our internal discussions about this, TrendMacro Managing Director Tom Demas has nominated a possible regime-changer that we think is potentially more significant. *The Federal Reserve has just undergone a once-in-two-generations shift in policy orientation – dispensing at long last with the fallacious Phillips Curve, the mistaken doctrine that there is a cause-and-effect relationship between unemployment and inflation*.

- Chair Jerome Powell's speech last August at Jackson Hole was the turning point (see "Powell at Jackson Hole, and the Inflation Makeup Strategy" August 27, 2020). The shift to "average inflation targeting" (AIT) got most of the attention, but at the same time, and more significantly, Powell recharacterized the Fed's statutory mandate for maximum employment as an "inclusive goal." That word "inclusive" is a woke dog-whistle, and every time Powell uses it we hear it as a bid to get reappointed by a new Democratic president. But politics aside, as Powell said in his speech, it realistically describes a fact about the Fed's understanding of the way the economy works: it "reflects our appreciation for the benefits of a strong labor market, particularly for many in low- and moderate-income communities." In other words, it is a confession that *over many business cycles the Phillips Curve has driven the Fed to deliberately slow the economy in response to a low unemployment rate, necessarily sacrificing the livelihoods of minority and less-educated workers who are always the last to get hired and the first to get fired – all in the name of a cause-and-effect relationship with inflation that doesn't exist*.
- In case you think our political antennae are so over-tuned that we are reading too much into this, *let us quote Powell himself in a February 10, 2021, speech. Explaining the "inclusive goal" he said, "This means that we will not tighten monetary policy solely in response to a strong labor market."*
- We cannot emphasize enough how important this is: *the Phillips Curve causes unnecessary recessions, and its abandonment as a policy framework means there will be fewer recessions.*
- As recently as 2018, the Fed was pursuing a tightening regime driven by the mistaken belief that record-low unemployment would lead to inflation, culminating in an infamous nearly recession-triggering rate hike at the December 2018 FOMC, at the press conference after which Chair Jerome Powell uttered the great gaffe that balance sheet policy was on "automatic pilot" (see "It's Not 'Quantitative Tightening' – It's Powell" December 20, 2018). A Fed-caused recession was avoided when Treasury Secretary Steven Mnuchin intervened and persuaded Powell to be more dovish (see "Did Powell Just Cut a Deal?" December 23, 2018), but there have

been many unnecessary recessions caused by the Fed in the name of the fallacious Phillips Curve.

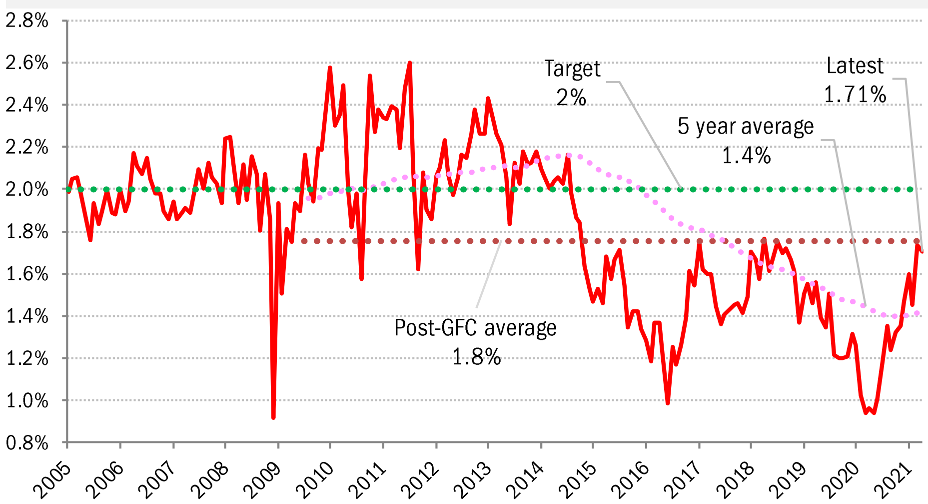
- *Why do we say there is no cause-and-effect relationship between inflation and unemployment? Because there isn't one.*
- William Phillips, the New Zealand-born economist who started the whole thing with a 1958 paper in *Econometrica*, didn't intend to say that there was. He simply showed the strong relationship between UK unemployment and UK labor wages over history – *wages*, not consumer prices. Indeed, he saw consumer inflation as a possible confounding variable that could pollute his simple and elegant findings, and argued in his paper that it had no role. It was for influential US economics technocrat Paul Samuelson – Paul Krugman's mentor at MIT, by the way -- to argue for the inflation connection that Phillips didn't make in his paper, and which does not in fact exist. It has infected central bank policy world-wide ever since, deeply embedding itself in policy-maker discourse and in the logic of their quantitative forecasting models.
- We're not sure why this idea took hold, but our experience is that it has for policy-makers something of the aspect of a religion. We remember 15 years ago when former Fed chair Janet Yellen abruptly ended a meeting with us when we pointed out the simple truth that the Phillips Curve was non-existent in the data (well, admittedly, we were a little sarcastic about it).
- The deep belief in something for which there is no evidence is really quite remarkable. Indeed, the evidence points in the opposite direction generally. In the US, inflation and unemployment go through periods of both positive and negative correlation – with the negative periods stronger and far more numerous (please see the chart below). Over the post-war record taken as a whole, the correlation is negative – lower unemployment has been associated with lower inflation.



- The results in other economies, such as Japan, the UK and the Euro zone, are similar. Now that the Fed has gone first, we think there's a good chance that the other central banks of the world will eventually also let go of the unfounded belief that full employment causes inflation.

- *This is the stuff of ERP regime change because the single biggest reason why there is a risk premium in the first place is the possibility of recessions in the future. Now, to repeat, without the Phillips Curve there will be fewer of them. Less risk, less risk premium.*
- *And without recessions, growth will be higher on average. That implies more potential return per unit of risk, also arguing for a lower ERP.*
- The other better-known part of the Fed's new policy framework – average inflation targeting – doubles down on all this. Not only will the Fed no longer tighten solely in response to low unemployment. Neither will it now tighten solely in response to inflation readings above the 2% target. Instead, it won't tighten until measured inflation runs above the target long enough to move *the average inflation rate over time* above the target. *Again, fewer recessions caused by the Fed. Less risk. Less risk premium.*
- To be sure, it may turn out in the fullness of time that the abandonment of the Phillips Curve and the adoption of AIT will turn out to have been nothing more than complacency born of a decade-plus of low inflation. Perhaps inflation will come roaring back with no one to do anything about it until it is too deeply embedded in expectations to deal with it easily.
- But in the meantime, we do know that inflation has in fact been low for over a decade. We know that so far, six months after this was all announced at Jackson Hole, inflation expectations markets are not worried one bit about it (please see the chart below).

5-year TIPS inflation breakeven, five years forward (adjusted to PCE basis)



Source: Bloomberg, TrendMacro calculations

- One more time – we've been around the block enough times to know that when people talk about a "new regime" that can be the sign of a top. Fine. Our correction calls all year haven't paid off much, so let it be now. But it is a reality, and an important reality,

> that regimes *do* change. With a period of pandemic-driven productivity gains ahead of us, and free from the risk that the fallacious Phillips Curve will cause any more avoidable recessions, there are serious and credible reasons to think this could be a regime change moment.

Bottom line

The US equity risk premium is narrower than at any time since the Global Financial Crisis ended, and closer to the pre-crisis mean than the post-crisis mean. The ERP is a mean-reverting indicator, so this suggests that stocks are due for a more serious correction than the three small ones so far this year. But the ERP mean is non-stationary, and we have to ask whether we are on the cusp of a new regime. Two credible candidate explanations emerge. First, there are large and durable future productivity gains to be derived from the reorganization of work after the pandemic. Second, the Fed has abandoned the fallacious Phillips Curve as a policy tool. This means the Fed will no longer mistakenly cause recessions out of the false belief that low unemployment causes inflation. At the same time, average inflation targeting will make the Fed more patient about inflation itself. Fewer recessions mean less risk, and less risk means a durably narrower equity risk premium.