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MACROCOSM

# Gameplan for the New Year

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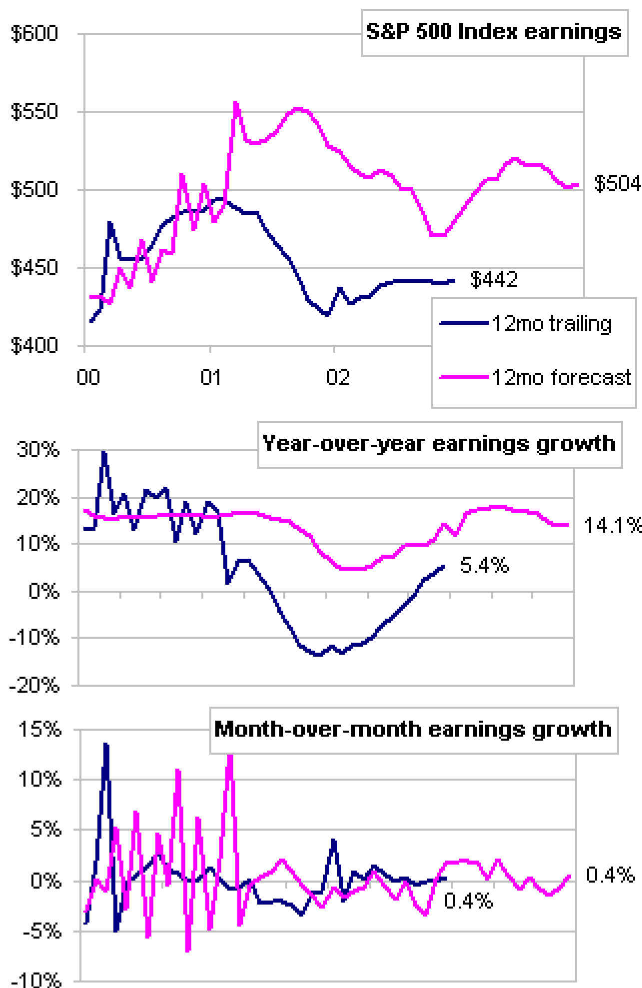
**A macro view of the major US asset classes, and a new Model Position in bonds.**

## *EQUITIES*

**US stocks are broadly undervalued.** According to our valuation model (which is based on forward consensus earnings and long-term interest rates), the S&P 500 is about as undervalued relative to Treasury bonds as it has been at any time over the last 19 years. Since we see Treasuries as approximately fairly valued here, most of the misvaluation pressure is on the stock market.




To parameterize the degree of undervaluation, our model suggests that stocks would have to rise about 24% to return to historical valuation norms (holding consensus earnings and interest rates equal). Holding stock prices equal, forecast earnings growth would have to fall from today's consensus of 14.1% growth to 7.9% *decline*; or long-term Treasury rates would have to rise from 4.99% to 6.12%.

**Earnings recovery continues.** The recovery in S&P 500 actual and forecast earnings is continuing, albeit at a modest pace, after a period of flatlining that coincided with widespread fears of a "double-dip" recession. December marked the first uptick in consensus earnings since last August. Half of the uptick is attributable to a single sector -- Information Technology. This marks the second month in a row of improving forecasts for tech.

**Monetary policy risk subsides.** We believe that the risk of monetary deflation has been sidelined, thanks to the concern of policymakers reflected in several recent pronouncements from **the Fed**, and confirmed by the recent rally in the dollar price of gold to levels around

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$350. The Fed has also shown some inclination to establish a focus on maintaining price stability, which could signal a move away from the macroeconomic fine-tuning that has historically resulted in nothing but mischief. In such transition periods for policy, the risk of the Fed overreaching to correct its earlier policy error -- *i.e.* engendering inflation risks in the name of combating deflation -- cannot be ignored. At present, there is little indication that such risk is a factor.

**Fiscal policy still suboptimal.** We are encouraged by reports that **President Bush** will press for accelerated reductions in the top marginal personal income tax rate. But we see the elimination of income taxes on dividends as a waste of political capital. Yes, it may result in a one-time upward revaluation of dividend-paying stocks; and yes, it will remove a significant market inefficiency. But at the margin, dividend tax relief just creates a subsidy for capital no longer at risk, redounding to the advantage of a small number of mature companies. Today's highly risk-averse post-boom-and-bust economy needs just the opposite incentives -- for investors to put capital at risk in immature, rapidly growing companies.

**War risk is already in prices.** We believe that the core costs and risks of military action in Iraq have already been fully discounted by the market, though it is easy to imagine extreme scenarios in which the level of discounting will prove to be insufficient. Within normal bounds, then, the actual undertaking of military action will probably be good for stocks, as it will resolve uncertainty.

**Technology stocks are somewhat overvalued.** Ironically, despite the policy environment that favors mature companies, Information Technology is the only overvalued stock sector. Its overvaluation is trivial compared to the historic extremes seen in March 2000 and December 2001. But its *relative* overvaluation -- considering how deeply undervalued the rest of the market is -- is near historic extremes. We acknowledge that there is -- finally -- some evidence in earnings of a moderate tech recovery. But nothing short of an historic tech boom would justify today's levels of relative valuation.

**Equity investment policy.** The overall undervaluation of US equities and the cessation of monetary policy risk lead us to expect that US stocks will experience their first up year in four this year. Our **Model Position long the S&P 500** is set at a conservatively optimistic equity allocation of 65%. Absence of a compelling policy driver for rapid long-term economic growth keeps us from being more optimistic and aggressive.

The same absence of a growth policy driver -- coupled with the extreme relative overvaluation of the Information Technology sector -- motivates our **Model Position long the S&P 500 and short the NASDAQ 100**. From today's posture of only modest *absolute* overvaluation (or, more accurately, *relative to bonds*), we are not arguing that technology stocks have no upside. Quite the contrary -- if the *overall* market rallies, as we expect, then technology stocks will rally too, and may well out-perform in dollar-for-dollar terms. Our Model Position is based on the idea that *relative* valuation (that is, *relative to non-technology stocks*) will cause a position in technology stocks to under-perform a *risk-equivalent* position in non-technology stocks.

## *FIXED INCOME*

**Receding deflation risk ends the bull market in Treasuries.** The better-than three-point blowout in long-dated Treasuries since last Thursday's stronger-than-expected **ISM** manufacturing number and subsequent equity rally could mark an important turning point. While we remain dubious that an accelerated pace of economic expansion is in the offing, government

bonds trading at yields near recent multi-generational lows were vulnerable to anything but continued dismal economic news.

As the pall of deflation risk steadily lifts from the economic horizon, with it go the props that have sustained the bull run in long-term Treasuries. Within that long-term view, it remains the case that any stoking of the various geopolitical and military risks could well yet prompt short-run upside episodes for instruments backed by the government's full-faith-and-credit guarantee.

**No inflation risk in sight.** The end of the bull market in Treasuries doesn't imply a bear market is yet in the offing. That would require a significant uptick in inflation expectations or risk, of which there is yet little if any indication. Indeed, that this bond market sell-off has been a *growth* rather than *inflation* play is confirmed across a host of market indicators. For one thing, the 10-year spread between nominal Treasuries and inflation-indexed TIPS has thus far been maintained almost to the basis point, at just below 170 bps. In other words, the move approximately 25 basis points higher has been a change in the real yield, not the inflation premium. The same magnitude is reflected as well in out-month interest rate futures, with the market now expecting the Fed to respond to somewhat faster growth with at least one -- and perhaps two -- 25 bp rate hikes by late this year.

**Investment policy for fixed income.** The bull market in Treasuries may be over, but absent prospects for accelerating growth or inflation -- neither of which we now expect -- the downside risk in long-maturity Treasuries appears fairly limited, probably bounded at about 5.25% on the long bond and 4.4% on the 10-year.

The shifting climate appears to present the most compelling fixed-income opportunities to portfolios willing to extend their risk exposure to asset classes so badly battered during the perfect storm of Fed monetary mismanagement, including higher-risk non-Treasury debt. High-yield bonds, for example, saw spreads blow out to record levels in the deflation-induced climate of risk abhorrence.

While real credit quality problems remain in certain sectors of the market, the worst has been absorbed and discounted. The S&P speculative grade credit spread is now just above 800 bps, down about 200 basis points from its highest levels in early October, a level which previously had been exceeded only in the immediate aftermath of 9/11. A capturing of that risk premium to bring spreads back toward norms closer to 600 bps now appears within reach.

**A new model position.** Having now closed several profitable Model Positions in Treasuries from last year, we are initiating a new **Model Position in high-yield bonds**. Starting tomorrow, this new Model Position can be tracked daily on our website.

You can review a quick one-page overview of all our Model Positions, past and present, on our website. TM