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MACROCOSM

Escape from Taperphobia

Monday, July 8, 2013

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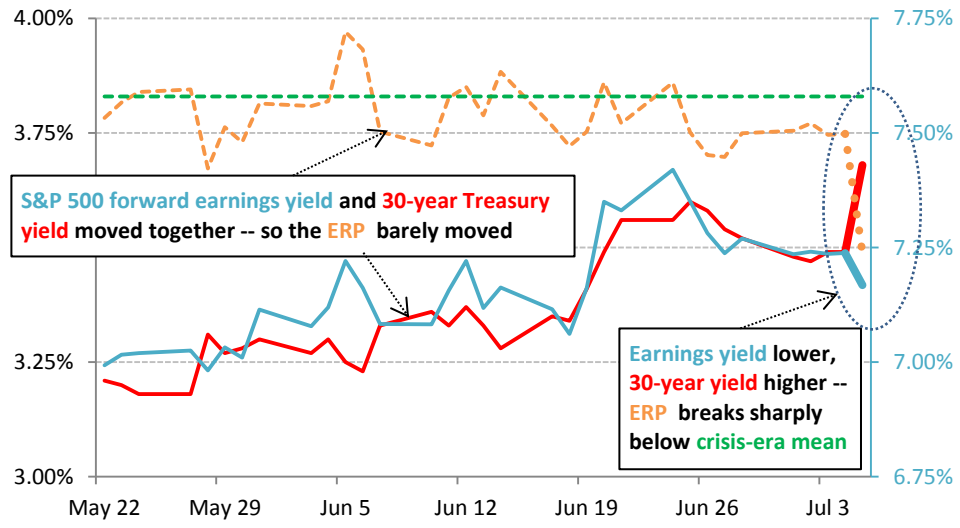
Stocks no longer in lockstep with bonds -- but it's about lower risk, not higher growth.

US stocks seem to have broken out of their 8-week correction, in which they lost as much as 7.5% following Fed Chair Ben Bernanke unmistakable hint in late May that Large-Scale Asset Purchases (LSAPs) would be tapered and then terminated (see "QE Steps Down Before Bernanke Does?" May 23, 2013). During that correction stocks had been in the grips of taperphobia -- tick for tick, when long-term bond yields went up, stocks went down, and *vice versa*. That pattern reversed dramatically on Friday when Treasury yields moved to new highs following a very taper-friendly jobs report (see "On the June Jobs Report" July 5, 2013) -- yet stocks moved sharply higher at the same time.

- This would seem to break the fever of taperphobia. But it doesn't change our neutral outlook for stocks for the rest of the year.
- As stock prices rise, their forward earnings yield falls -- while long-term bond yields are rising. That moves the S&P 500 equity risk premium (ERP) below the mean to a level of relative overvaluation of stocks not seen since May 2011 (please see the chart below).

Equity risk premium dynamics since Bernanke's May 22 taper hint
Left axis: **10-yr Treasury yield** **ERP** **Crisis era mean**
Right axis: **S&P 500 forward earnings yield**



Source: Bloomberg, TrendMacro calculations

Update to strategic view

US STOCKS, US BONDS: Stocks seem to have broken free from taperphobia, surging on Friday despite a very taper-friendly jobs report. But we continue to think that the Fed isn't that much of a factor here. The simultaneous rise in both stock prices and long-term yields over the last year has a common cause -- the restoration of risk appetite as global systemic risk has receded. But unless that turns into an acceleration in upgrades of forward earnings, stocks don't stand to gain much from further improvement in sentiment -- which would raise bond yields more than it would stock prices.

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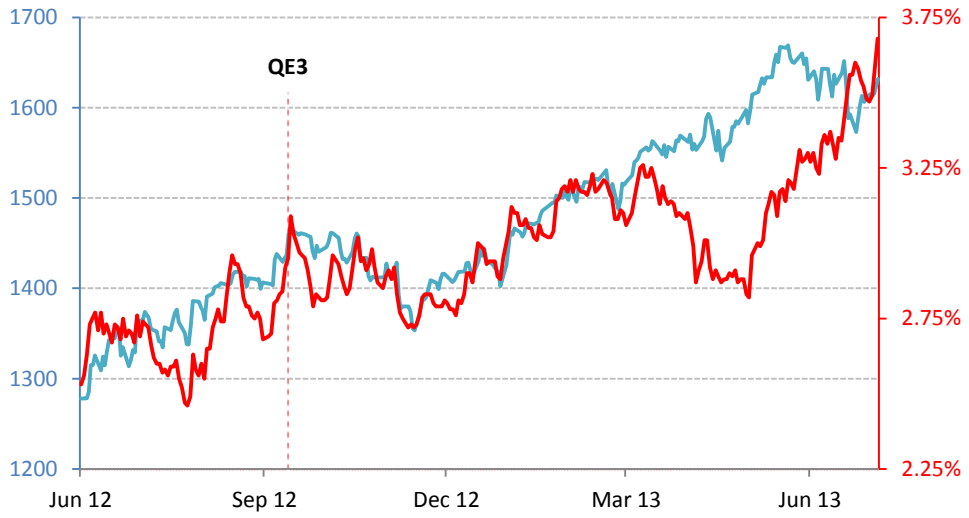
- On the face of it this observation sounds like a conventional taperphobia argument -- that higher bond yields are bad for stocks because (1) they provide better competition for stocks, and/or (2) they will slow the economy and thus slow earnings growth.
- But there's more to it than that.
- We've been arguing that long-term yields are rising for reasons having little to do with what the Fed does or doesn't do (see "US Fixed Income Strategy: The Fed Irrelevancy Hypothesis" July 2, 2013). Indeed yields have been rising before, during, and now facing the end of QE3.
- Stock prices have been rising, too, over the last year (please see the chart below). If rising yields are bad for stocks, you'd never know it from this historical evidence.

S&P 500 **30-year Treasury yield**



Source: Bloomberg, TrendMacro calculations

- To be sure, perhaps there is a Fed-based explanation for why stocks have been rising. Bernanke has rationalized LSAPs as driving a "portfolio rebalance channel" that pushes investors into stocks when the Fed sops up long-term bonds, first with Operation Twist and then with QE3 (see "Is the Fed Moving the Stock Market?" March 11, 2013). But it remains unclear why, at the same time, long-term bond yields should have been rising.
- The single explanation that accounts for all the known facts (and trumps the known contradictions) is that both stocks and bonds have been responding to a lessening of global systemic risk over the last year (see, among many, "Risk Reappraisal" January 20, 2012).
- In fact, as we have already pointed out, the low for bond yields almost one year ago -- an all-time historic low for the 10-year Treasury -- occurred the day before the single greatest and most persistent post-recession systemic risk factor was brought under control. The next day European Central Bank Governor Mario Draghi gave his "whatever it takes" speech in London, committing

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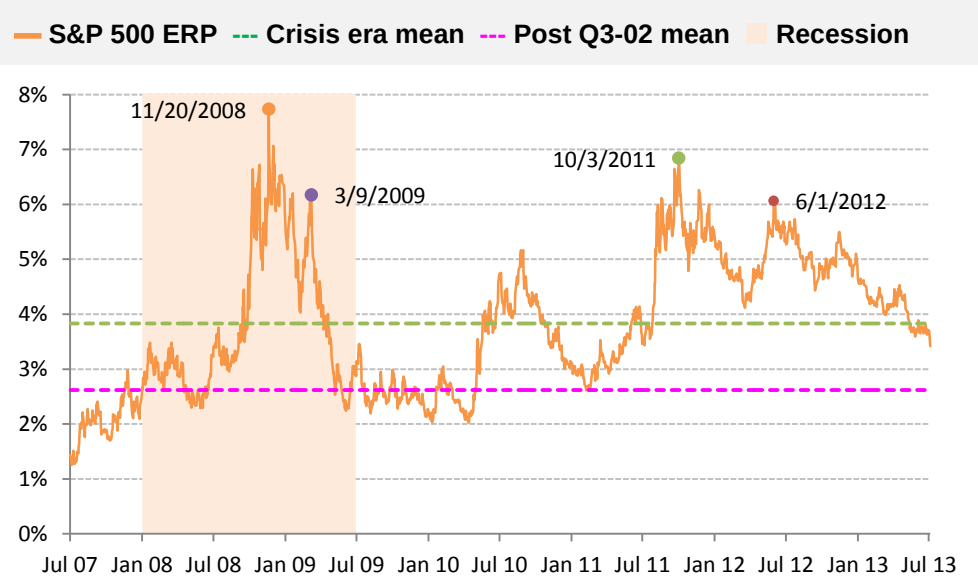
the ECB to any necessary bail-outs to prevent European banking and sovereign defaults, or the break-up of the euro currency (see "On Draghi in London" July 26, 2012).

- It is noteworthy that the breakout from taperphobia by US stocks on Friday actually occurred on Thursday -- in the futures markets, when physical US markets were closed for Independence Day -- when the ECB doubled-down on Draghi's "whatever it takes" stance by issuing forward guidance assuring continued easy policy (see "On the July ECB and BOE Policy Decisions" July 4, 2013). To be sure, on Friday US stocks shrugged off the taper-friendly jobs report -- but the gains had already come the day before.
- In the presence of less risk, investors value risky assets like stocks more highly (and assign higher multiples), and they value safe-haven assets like Treasuries less highly (demanding higher yields).
- *Do not underestimate the enormous performance consequences of this effect -- all by itself.*
- Since the major bottom for stocks in October 2011, the S&P 500 has gained 48.5% (without dividends). Yet forward earnings have grown only 9.8%. Almost all the gains came from a dramatic change in sentiment -- a reappraisal of risk. At the bottom in 2011 the equity risk premium was extraordinarily high -- higher even than at the panic bottom in March 2009 (please see the chart below). We said stocks were "crazy cheap" -- and indeed they were (see "Europe Fails, US Stocks Flail" October 4, 2011).



Source: Zacks, Bloomberg, NBER, TrendMacro calculations

The problem now is that stocks aren't "crazy cheap" anymore. The ERP -- no longer at an extreme, but instead slightly below the mean -- would suggest that investor risk-aversion is no longer extreme. The move toward a more normal risk appetite is probably about complete.

- Just because risk aversion is not extreme, that doesn't necessarily imply that it can't still improve. Indeed, the mean equity risk

premium to which it has already improved is itself somewhat extreme, and could improve. For our valuation work the last several years we have calculated the mean as beginning in July 2007, at the onset of the global banking crisis -- we have called it the "crisis era mean." But if that crisis is over, we would expect the mean to be lower -- which suggests that stock prices could rise further as risk appetite is further restored (see "What the ERP Isn't Telling Us" May 15, 2013).

- Consider, instead of the crisis era mean from mid-2007, a somewhat longer-term mean from Q3-2002 -- when a series of shocks beginning with the WorldCom scandal shifted the mean abruptly upward from the unusually low levels seen in the giddy 1980s and 1990s (again, please see the chart on the previous page).
- All else equal, a move by the ERP to that lower mean would put stocks about 15% higher.
- But it's highly unlikely that all else will be equal. A further restoration of risk appetite that would drive the ERP to that lower mean would surely move long-term Treasury yields higher.
- We have estimated that the present level of global systemic risk is consistent with a 10-year yield of about 3.25% and a 30-year yield of about 4.5% -- no matter what the Fed does or doesn't do with LSAPs (see "To Taper or Not to Taper?" June 7, 2013). *A 4.5% 30-year yield more than completely moves the ERP to the lower mean -- but with no further gain whatsoever in stock prices.*

We're not bearish on stocks -- we're neutral. We think that if we do see a further resurgence of risk appetite, that stocks will gain -- but not much, and not as much as bonds will lose.

- We remain struck by a rather astonishing fact. We'd have thought that the gradual restoration of risk appetite over the last year and a half would have brought with it faster economic growth and faster forward earnings growth. But so far, no. Output and jobs growth are unchanged. And the upgrade rate of forward earnings is no faster now than it has been over the last two sluggish years.
- Without an acceleration in forward earnings upgrades -- considering that sentiment is no longer at levels of extreme risk aversion -- *we really can't count on further improvement in risk appetite to drive stocks much higher.*
- *We think the greater share of any further improvement in risk appetite will be reflected in higher long-term yields, not higher stock prices*.
- As we've said many times in client meetings, we don't doubt that 2013 will be another good year for stocks. But that's mostly because it already has been.

Bottom line

Stocks seem to have broken free from taperphobia, surging on Friday despite a very taper-friendly jobs report. But we continue to think that the

Fed isn't that much of a factor here. The simultaneous rise in both stock prices and long-term yields over the last year has a common cause -- the restoration of risk appetite as global systemic risk has receded. But unless that turns into an acceleration in upgrades of forward earnings, stocks don't stand to gain much from further improvement in sentiment -- which would raise bond yields more than it would stock prices.