Mean Markets?
Like Nothing Before. Or Is It?

➢ We think it would be foolish to argue that nominal bond and earnings yields (or P/Es) will regress to their historic average means.

➢ The current equity earnings yield gap (earnings yield less bond yield) is 145 bps below the long-term mean. But there are grounds to believe a long-term average may not be the most appropriate metric. The current equity earnings yield gap is 225 bps above the post-1982 average equity earnings yield gap.

➢ P/E ratios have tended to be highest not when inflation is nil, but when it is modest enough not to engender fears of a deflationary profit collapse — historically between 2% and 4%. But current stock market P/Es already appear to be at levels that reflect the benefit of any modest pickup in inflation.

➢ Between stocks and bonds, stocks seem the better relative choice. Bonds are unattractive, reflecting low nominal yields, low real yields, and a forecast of rising rates.

➢ Near-term fundamental and technical concerns weigh on the equity market, but any significant downside risk seems moderate.

➢ Our asset allocation remains neutral equities, underweight bonds, and overweight cash.
What Is the Mean?

Forecasting seems to often assume that it is just a matter of time until history repeats itself. On average, the future will be average. The mean is the mean. Even statistical techniques that isolate dependent variables from independent variables presume a regression to the mean. But what is the relevant sample to determine what is average, what is the mean?

Ten-year U.S. Treasury issues are yielding 4.5%, about 65 bps below what they yielded, on average, over the past 75 years, and 260 bps below the average yield post-1982 (see Figure 1). (Why 1982? It’s not a totally arbitrary starting point — that year marked the beginning of a great bull market in financial assets, for both bonds and stocks.)

The “earnings yield” of the S&P 500 (i.e., the inverse of the P/E ratio and, supposedly, a popular metric at the Federal Reserve) is 4.6%. This compares with an average earnings yield of 7.5% over the past three-quarters of a century, and 5.7% average post-1982.

Figure 1. 10-Year U.S. Treasury and S&P 500 Earnings Yield, 1925–Present

Source: U.S. Census Bureau, Historical Statistics of the United States, and U.S. Federal Reserve

It’s a Real World

Yet we believe it would be foolish to argue that these “nominal” numbers will regress to their means. Why? Because it’s a “real” world. Bonds are bought for their real yields, i.e., after taking inflation into account. The same holds true for equities. Indeed, the same is true for any and all investments.

In real terms, Treasury yields do not look compelling: The real 10-year bond yield is 2.5% today versus a long-term average of 2.0% and 3.9%, on average, post-1982 (see Figure 2). Likewise, there is no compelling case for equities either: The real earnings yield is 2.6% today versus an average of 4.3% long term and 2.5%, on average, post-1982 (see Figure 3).
In recent years, it was rare that the stock market earnings yield was above the U.S. Treasury yield. (We discuss this in more detail below.) The fact that this has not been the case recently does not mean that equities are less risky than Treasuries. Rather, the key issue is that equities offer the potential for a growing stream of income (i.e., earnings and dividends), whereas bonds offer a static — and relatively puny — stream (i.e., coupons).
A Relative Case for Stocks Versus Bonds

Comparing stocks and bonds, the current 10 bp equity earnings yield gap makes a relative case for stocks, given that the current equity earnings yield gap is 225 bps above the post-1982 average (see Figure 4). However, versus the long term (i.e., 1925 forward), the current equity earnings yield gap is still 145 bps below average. So which period is relevant? Which mean will the markets regress to?

Figure 4. Equity Earnings Yield Gap, 1925–Present

The period beginning in 1925 includes the depression and World War II, times of great uncertainty. That could well account for the materially higher equity earnings yield gap over the long term (i.e., from 1925 on) than in the post-1982 period. Indeed, it was not until 1968 that the earnings yield first fell below the government bond yield, although only for a five-year period. It really was not until the 1980s that the earnings yields remained below the bond market yield.

Why has the spread moved lower? As Citigroup economist Steven Wieting has noted, the “Great Moderation” (as Fed Governor Ben S. Bernanke has dubbed it) seems to provide a possible explanation. According to this theory, as economic volatility has declined (as evidenced by the declining standard deviation of GDP growth), the inherent risk of equities has declined and, therefore, so has the equity earnings yield gap (see Figure 5).

Also note that, until the second half of the 20th century, stock market dividend yields were actually higher than bond yields. This was not because stocks were riskier back then, but rather because a larger portion of the total return from equities came from dividends. Indeed, it was not until 1959 that the stock market dividend yield fell below bond yields. The dividend payout ratio prior to 1959 was, on average, over 62%; after 1959, the average payout was under 50%.
**The Absolute Case for Equities Requires Low Inflation**

Based on the post-1982 averages, in order to make any absolute case for equities today (rather than simply a relative case versus bonds), one has to assume that the key post-1982 variable of low inflation remains in place.

Declining inflation has largely been attributed to above-trend productivity gains. Indeed, nonfarm productivity rose 9.5% during the third quarter of last year and averaged 4.5% overall during 2002–03 — its best two-year performance since the survey began in 1947, and the first time it exceeded 4.0% for two years in a row. These outsized productivity gains have, in turn, suppressed resource utilization and inhibited job growth.

To be sure, fourth quarter productivity declined to 2.6%, which may have contributed to the surprisingly strong addition of 308,000 to March nonfarm payrolls, as well as to upward revisions to the prior two labor reports. Moreover, bellwether economic indicators such as the core CPI and the GDP price deflator have risen, and the personal consumption deflator — a measure of inflation tied to consumer spending favored by the Fed — rose at its fastest pace since the third quarter of 2000.

Despite renewed inflation fears fueled by these reports, Fed Chairman Alan Greenspan and other members of the FOMC have been quick to state that concerns about broad-based inflationary pressures are unwarranted given the still considerable slack in the economy. We concur, and expect new efficiencies fostered by technology and the growing integration of a global workforce to help sustain relatively high productivity gains longer than in past economic cycles.

Of course, reinflation, or fears thereof, could take a toll on *both* the stock and bond markets. Or would it? Clearly any reinflation would be a negative for bonds. But could a little inflation actually be good for stocks?

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**Figure 5. GDP Volatility and Equity Earnings Yield Gap, 1925–Present**

- GDP Volatility (RHS)
- Equity Earnings Yield Gap (LHS)

Source: U.S. Census Bureau, Historical Statistics of the United States, U.S. Federal Reserve, Standard & Poor’s, and Smith Barney
In theory, the lower the inflation rate, the lower the rate at which future growth is discounted; therefore, the lower the required earnings yield and the higher the P/E ratio. (The P/E ratio is the inverse of the earnings yield.) But, in fact, the equity market has historically had a “sweet spot —” i.e., where earnings yield is lowest and P/E is highest — when inflation has been between 2% and 4% (see Figure 6). Understandably, high inflation has been a negative, but so has low inflation/deflation. Why? Possibly because deflation, and fears of deflation when inflation fell to very low levels, threatened the future growth of profits.

Figure 6. P/E Ratio versus the CPI, 1926–2003

P/E is the inverted earnings/price ratio, where earnings/price ratio = averages of quarterly ratios, which are ratios of earnings (after taxes, for four quarters ending with particular quarter) to the S&P price index for the last day of that quarter. White bar includes below (2)% CPI.

Source: U.S. Census Bureau, Historical Statistics of the United States, U.S. Federal Reserve, Standard & Poor’s, and Smith Barney

So does that mean that reinflation from today’s low levels to the 2%–4% “sweet spot” would drive stocks higher? Not necessarily — not if stocks are already valued to reflect that higher inflation level. Indeed, current earnings yields (and therefore P/E ratios) seem to be already at levels commensurate with inflation rates that are higher than those currently prevailing.

Any Downside Risk to Equities Seems Moderate

As my colleague and chief U.S. equity strategist Tobias Levkovich points out, the best scenario for stocks (modest inflation, stable rates, strong profits) might merely justify current, or slightly higher, stock prices. The bull case is that, although bond yields may rise, stocks will “lose” a bit less in P/E than they “gain” in earnings, so that stock prices nudge higher. The risk, however, is that either too high inflation or interest rates or too low earnings growth could take a further toll on stocks. In that regard, Tobias, who is not in the bullish camp, thinks the equity market will slide another 7% by year-end, and possibly more over the next few months, with a late-year recovery.

Chief technical analyst Louise Yamada believes that it is not outside the realm of possibility that equities are in a transition from the first in a hypothetical multiyear series of cyclical bull markets to the next declining phase. In other words, equities are in a long-term structural bear market, with cyclical rallies and cyclical declines. In the April 29 tech@lert, the technical team noted that there is “evidence that a renewed equity market decline may be at hand.”
Co-head of quantitative research Keith Miller’s stock-cash asset allocation model remains bullish on equities versus cash. And with cash, by definition, always producing a positive return, this implies positive absolute returns for equities from a quantitative perspective. The key positive drivers for equities are a positively sloped yield curve and narrow credit spreads.

All things considered, it seems that any downside risk to equities seems moderate, barring, from a fundamental perspective, a profit collapse or a strong reinflation. And given the high daily price volatility (see Figure 7), probably only the most adroit trader should move asset allocations around aggressively. In a market where the average daily price change is around 1%, does downside risk of 5%–10% warrant a structural shift in asset allocation weightings?

**Figure 7. Market Daily Price Volatility, 1925–Present**

Absolute value; 200-day moving average

![Market Daily Price Volatility Chart](source: Reuters)

**Downside Risk to Bonds Exists, but Appears Somewhat Limited**

As Fed Chairman Alan Greenspan recently observed, “The federal funds rate must rise at some point to prevent pressures on price inflation from eventually emerging.” Indeed, fed fund futures currently imply that the first (25 bp) rate hike should occur by August, followed by an additional 50 bps of tightening by year-end. In addition, the market is pricing in more than a 50% chance of the first Fed move by next month.

The exceptionally steep yield curve is consistent with expectations for tighter monetary policy in the near term. In fact, the spread between the fed funds rate and 10-year Treasuries is approximately 350 bps, nearly four times greater than its 91 bp average since 1982; the 2- to 10-year spread is 225 bps, approximately 90 bps above historical norms.
Although we expect interest rates to trend higher for the balance of this year, it seems unlikely that Federal Reserve policymakers would move as aggressively as markets currently expect. Indeed, even though the reference to “patience” was absent from the May 4 FOMC statement, it did say “accommodation can be removed at a pace that is likely measured.”

However, with the fed funds rate at a 46-year low and Treasuries still hovering near their lowest levels in 40 years, a further backup in bond yields appears imminent. While the massive financing needs of the U. S. Treasury are a concern, this is not the main challenge for now because we believe the federal deficit has already peaked on a cyclical basis and will probably be below recent forecasts. A greater concern would be the potential for reduced liquidity, yield curve flattening, and the unwinding of leveraged fixed income positions as the Fed tightens.

Absolute yields in other bond sectors already seem to have troughed. On a spread basis, most taxable sectors appear fully valued, or simply rich, with valuations hovering at or near historically tight levels. Continued low external financing needs in the private sector due to strong internal cash flow are likely to further limit corporate bond issuance relative to Treasuries. Although relatively less supply from the corporate sector compared to Treasuries should support spreads, absolute yields are still likely to rise, assuming a backup in yields in the government sector.

In short, it is hard to make a case for bonds, especially given our forecast for higher yields in coming months. However, it should be noted that our economists expect only a modest rise in yields — their 12-month forecast for the 10-year Treasury yield is 5.1%. In this environment, intermediate maturities still make sense, given their more limited market volatility and the steep positive slope of the yield curve in both taxables and municipals. We believe this is the beginning of a progression toward 6% over the next 18 months. Louise Yamada points out that historical patterns suggest that interest rates may remain low, though volatile, within a transitional trading range between 3% and 5% for an extended period of time. Essentially, shifts from falling rate to rising rate cycles have historically been slow, saucer-like, multiyear affairs.

We Are Neutral Equities, Underweight Bonds

Between stocks and bonds, stocks seem the better relative choice. Clearly, cash is an alternative. But with limited downside for stocks, and, in our view, after-tax cash rates at near 0%, the high daily price volatility means that missing just a couple of days’ stock returns could eliminate a year’s return.

Our asset allocation is neutral equities, albeit recognizing that in the near term there are still fundamental and technical concerns. But over the next 12–24 months, equities seem likely to outperform bonds as well as the very low hurdle rates that money market cash rates offer.

We are underweight bonds. Bonds are unattractive, reflecting the reality of low nominal yields, low real yields, and a forecast of rising rates. While the economic recovery may periodically disappoint and produce somewhat lower interim yields,
the likelihood is that bonds will prove the less attractive alternative over the next 12–24 months.

That leaves us overweight cash, but with our fundamental strategist and technical analysts anticipating an opportunity to put that cash into equities over the next few months.

Smith Barney’s benchmark normal asset allocation for a moderate-risk individual investor has been set at 55% equities, 40% bonds, and 5% cash. Our tactical allocation currently is 55% equities (neutral), 35% bonds (5% underweight), and 10% cash (5% overweight).

**Risks**

The risk to underweight bonds is that the economy is weaker than expected, and that we are too cautious on bonds. Conversely, if there is a much stronger than expected economy, we may not be cautious enough on bonds. Alternatively, if the Fed raises rates sooner — and by much more — than currently expected, a greater underweight in bonds may be warranted. Both of these two latter scenarios would also likely mean that we are too positive on equities. And if the economy is weaker than expected, profit growth may disappoint and have a negative impact on equities, jeopardizing even a neutral equity position. On the other hand, if corporate profits are stronger than expected and rates remain low, we may not be positive enough on equities. Finally, note that a terrorist attack or other unpredictable geopolitical event are additional risks to the analysis outlined above.
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