Capital Market Comment

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"Mind the Gap" between Fundamentals and the Equity Market

The disconnect between the U.S. economic and company fundamentals and the behavior of the equity market continues to widen. European contagion fear remains pervasive and the U.S. budget impasse has only added to investor uncertainty and apathy. Waiting has proven to be beneficial to "buyers" while "sellers" have become increasingly impatient. As a result, valuation disparities persist. The "Fed Model" relative valuation framework indicates that the S&P is selling at a 75% discount to the 10 year Treasury based on an 11.4 X multiple of First Call forward earnings. Furthermore, the S&P 500 dividend yield of 2.2% exceeds the 1.95% 10-Year Treasury yield.

It's interesting to note that despite the downgrade of U.S. debt in August of this year, U.S. bond rates are lower and the dollar is higher. Explanations for market behavior often do not appear consistent with long-held theoretical principals and/or rational observations.

If inflation is such a concern, as some Fed members suggest, then why are rates so low and the dollar so strong?

If the debt ceiling crisis were so overbearing and the downgrade so serious, then why are rates so low and the dollar so strong?

Disparities and inconsistency can persist for a long time and often appear to defy reality. In fact, the "new state of affairs" appears to be a new reality. Eventually, a readjustment occurs, a movement toward equilibrium emerges, and the valuation gap gets closed. This closure occurred swiftly in 1987 as stocks fell sharply between August and October of that year after inexplicably rising to stretched relative valuations between January and August.

The euphoria that captured the "dot com" era with stocks trading at a 60% premium to 10-Year Treasuries largely corrected in 2001 and 2002. Many companies disappeared from the investment landscape and stocks fell to a 60% discount to the 10-Year Treasury.

In 1972 to early 1973, we were in the period of the "Nifty Fifty." Investors were deluded in believing that certain large cap stocks could be bought forever despite multiples of 50 to 60 times earnings. The bear market of 1973-1974 changed investor thinking. Valuations adjusted dramatically and the asset classes moved toward relative equilibrium. Today, we face a very different investment landscape. It appears that bonds, which have been in a secular bull market since October 1981, have now moved to extreme valuations relative to stocks.

Most certainly, the uncertainties that permeate the financial environment (European contagion and the Super Committee) have engendered fear and paralysis, which appear unlikely to end soon. However, some progress has been made. The governments of Greece, Italy, and Spain have changed with a greater focus upon sustaining the Euro. The political jockeying by Germany, France and the ECB, though frustrating, are moving toward creating a "lender of last resort" through the EFSF and ultimately the European Central Bank. The IMF has even entered the equation.

The European problem is likely to persist for some time and the slow pace will be unnerving. Unfortunately, the structure of the Euro Zone lends itself to such a pace. At the same time, the process promises to bring about the necessary reforms that would foster consistency and a quicker resolution of problems.

The failure of the Super Committee to deal with the U.S. deficit reduction program should be of no surprise to anyone. The structure of the committee and the philosophical divide of its members virtually assured failure. An absent White House only added to this likely outcome. However, unlike the August debt ceiling crisis, Plan B is in place. The $1.2 trillion in automatic cuts is on track starting in 2013. Consequently, these developments are unlikely to have an impact on the credit rating of U.S. debt. Whether one approves or disapproves, another element of uncertainty has been removed.

Despite difficult domestic and international politics, the U.S. economy continues to move further away from a recession and exhibits a resiliency in the face of macro headwinds, particularly from slowing growth overseas. The 9% increase in the composite index of leading indicators for October suggests more growth ahead. Initial claims for unemployment have been hovering below 400,000 for several weeks. Retail sales and industrial production have expanded and the ISM surveys for Manufacturing and Non-Manufacturing suggest the same. Most importantly, employment continues to grow with 80,000 jobs added in October and a 102,000 upward revision in the prior two months. Although the gains are not sufficient to have a meaningful impact on the unemployment rate, they are nonetheless growing.

Against this backdrop of European drag on world economic activity, the monetary climate is undergoing dramatic change. Another round of monetary accommodation is underway. The U.S., the U.K., and nine other nations, along with the ECB have already moved toward increased monetary stimulus. Additionally, China appears ready for a change. The Federal Reserve is prepared to move to a QE3, a new round of quantitative easing. This sea change internationally should elicit a financial market response which could be swift and surprising. In the meantime, compelling valuations, attractive dividends, and essentially no competition from competing assets should reward investors while they wait.

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