

TOPICAL STUDY #2
THE TEN PILLARS OF FAITH

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Economics

INTRODUCTION

In recent weeks, we've talked with several money managers all around the country. Those who manage equity portfolios demonstrated a remarkable complacency about the outlook for the stock market. Most were more concerned about missing the next leg up rather than about getting hurt some more if the market moves lower.

The bulls' optimism seems to be based on several assumptions. We've been able to identify ten that we've heard so often that we call them the ten pillars of faith. These pillars seem to be holding up the market in the face of rising interest rates and disappointing earnings. Our valuation model suggests that with interest rates at current levels the stock market is somewhere between overvalued and grossly overvalued. Our work suggests that government bond yields should peak somewhere close to 14% early next year.

We currently expect that the earnings per share of Standard & Poor's universe of 500 stocks will equal \$16.50 in 1984 and \$18.15 in 1985. Given our interest rate outlook, we would be hard pressed to justify a market multiple of more than eight times earnings. In this case, the S&P 500 index should be around 134 right now and no higher than 145. At the time of this writing the market was selling around 160. That's why we expect another 10% to 15% decline in stock prices from current levels. If interest rates rise to our worst-case level, then a bigger decline is possible.

It's possible that the ten pillars of faith will keep the market from falling as hard as we've calculated using our valuation model. However, if the ten pillars turn out to be as weak as we believe, then a hard fall is still possible if and when money managers start to agree with our view of the world.

THE TEN PILLARS

We've kept you in suspense long enough. Let's unveil the pillars of faith. We believe that over the next few months most if not all of them will crumble. You may believe that they are all structurally sound. We hope that the following discussion will help you to organize your investment thoughts whether you agree with us or not.

1) Slower economic growth is bullish for bonds and stocks.

One of the key assumptions made by those economists and strategists who are bullish on stocks and bonds is that the economy is about to slow down but will continue to grow. Some slowing in the economic recovery would allow credit easing by the Federal Reserve, according to this scenario.

We've heard this view expressed so often in recent visits with clients that we have to conclude that if the economy does slow down then both bonds and stocks will rally. But we believe the rallies would be short-lived and not worth playing. A slower economy will not necessarily deliver lower interest rates. Indeed, a comparison of the government bond yield to the yearly percent change in industrial production shows that slower growth is usually associated with rising interest rates!

Economic growth during the second and third years of expansion is usually less than during the first year. But credit demands swell as an expansion matures. That's partly because business cash flows often slow along with the economy.

2) The economy is about to slow down but will continue to grow, unimpeded by the current level of interest rates.

The bulls anticipate that real GNP might increase by only 2% during the second quarter following the first quarter's 7.2% flash estimate. According to one widely accepted story, much of the strength in real GNP during the first quarter was caused by a sharp 17.1% increase in auto production, from a seasonally adjusted annual rate of 7.6 million units during the fourth quarter of last year to 9.1 million units during the first quarter of 1984.

At the end of March, the domestic auto industry planned to produce at a seasonally adjusted annual rate of 7.3 million units during the second quarter. This is 18% below the first quarter's pace. It's possible that the seasonal adjustment factors are overstating output during the first period and are understating output during the second one. However, early model changeover shutdowns at several key plants are the major reason that the industry will be hard pressed to assemble significantly more cars in the second vs. the first quarter.

According to the slow-growth bulls, the sharp drop in auto output will constrain real GNP growth to roughly 2% during the second quarter. If auto production had stayed at the fourth-quarter rate, real GNP would have increased 5.5% instead of 7.2% during the first quarter of 1983. Auto production will pull real GNP down by two percentage points during the second quarter. So if all other sectors of economic activity increase by four percentage points, then real GNP will rise by no more than 2% during the second quarter.

Our forecast anticipates that the nonauto components of GNP will add 6 1/2 percentage points to this measure of the economy during the spring quarter. So real GNP should rise by 4 1/2%.

February's surge in housing starts to 2.20 million units from 1.98 million units in January and 1.69 million units in December should boost the residential component of real GNP during the second quarter.

Capital spending indicators are all booming. In terms of 1977 dollars, new construction spending rose a lofty 6.6% during February. Office building leaped 15.1% during February, surpassing the record 1982 level of activity. Industrial plant construction increased 13.3% during the month. The capital spending boom reflected in February's construction report is also visible in new orders for nondefense capital goods, which rose 6.2% in February.

Inventory investment should be another source of economic strength during the second quarter. In both real and nominal terms, the business sector's inventory-to-sales ratio is the lowest on record. We don't believe these ratios are this low by choice. Many industries have been shipping products out the door faster than they can produce them. We believe production is now finally catching up with sales.

Inventories of manufacturers rose a strong 1.2% in February. By stage of fabrication all components increased, with finished goods showing the first increase since last August. The increase in finished goods of 1.4% resulted from increases in the durable goods sector of 1.1% and the nondurable goods sector of 1.8%.

And don't count out the consumer. The Consumer Sentiment Index jumped to a new cyclical high of 101 during March. If employment continues to expand by over 100,000 per month, consumers will have the confidence and the income to spend in the retail stores.

3) Inflation will come back a little, and this may have positive ramifications for certain stock groups.

In the 1970s, corporate managers could maintain earnings growth by raising prices. In that inflationary decade, price increases would stick. Now price increases don't stick. To sustain earnings momentum, firms must sell more units. Since most product markets are mature in the U.S., producers have to gain market share to sell more units. That's a very competitive ball game and nothing like the inflation game played in the 1970s.

Deeply indebted less-developed countries are struggling to avoid depressions. The U.S. has experienced a sharp decline in exports to these debtor nations and a sharp increase in imports from these countries. This is another reason why U.S. firms are faced with new competitive pressures that limit price increases.

For two years now, we've argued that the main risk to disinflation is deflation, not reflation. If inflationary pressures start to build, we expect that bond investors would bail out of their investments so quickly that interest rates would rise much faster than inflation.

A soaring real interest rate would choke off the inflationary pressures by depressing economic activity. So the more we hear others saying that inflation is coming back, the more we worry about deflation.

4) The dollar has peaked and could fall further.

Those who see inflation coming back are convinced that a falling dollar will allow U.S. firms who compete with foreigners to raise prices more aggressively. They see a weaker dollar because the huge U.S. trade gap will cause an excess supply of dollars in the foreign exchange markets. Foreigners, who willingly absorbed these dollars last year, won't invest their savings in dollar denominated assets this year because of increasing fears of the huge U.S. government deficit and reinflation.

The U.S. federal and trade deficits are symptoms of an over-consumptive society. We consume more products than we produce, so we have a trade deficit. Our government's outlays exceed tax receipts, so we have a federal deficit. This tendency to consume more than is produced means that we aren't generating enough savings to satisfy all the credit demands generated by a booming economy. So we must attract foreign savings by offering high interest rates.

In our opinion, interest rates will continue to rise to attract foreign savings into the U.S. Higher interest rates should keep the dollar from falling. If rates rise as high as we think is possible before the next recession, then the dollar could actually rise to a new peak.

5) Political and international considerations suggest that the Federal Reserve has found it undesirable to tighten extensively at this time.

In his February 7 testimony before the House Banking Committee, Fed Chairman Paul Volcker said, "It is a deeply held belief on the part of a lot of people that our actions are politically motivated. I hear it all the time. It is a source of great frustration, but I don't know what you can do about it." He also said, "Markets have a mind of their own. They have never waited on the convenience of kings or Congressmen--or elections."

This is an election year, and most investors believe that the Fed will avoid any tightening until after the election. The latest evidence, however, suggests that the Fed will tighten in the face of rapid economic growth, which is generating strong credit demands. On March 20, six days before its regularly scheduled meeting, the Federal Open Market Committee held an unusual telephone conference meeting. According to the Fed's account of that meeting, "it was the consensus of the Committee that, in the short interval until the next scheduled meeting, pursuit of the degree of reserve restraint and associated reserve paths, consistent with the money and credit objectives set at the January 30-31 meeting, should not be constrained by a federal funds rate at or above the monitoring range set at that

meeting." In other words, the funds rate could trade above the 6%-10% monitoring range.

6) Slower economic growth should ease credit demands. Oil merger loans explain most of the surge in business borrowing. State and local surpluses should offset a portion of the Treasury's financing demands.

In past cycles, credit demands have typically risen to higher and higher levels as the economic expansion matured. That's even though real economic growth decelerated. Slower economic growth does not push credit demands down, only recessions do so. Perversely, slower growth tends to boost credit demands as business cash flows often slow along with the economy.

During the first twelve weeks of this year, short-term business debt rose \$22.6 billion. Some of these funds were undoubtedly used to finance oil company mergers which occurred during the first quarter. But the bulk of these funds were used to fill a growing gap between booming capital spending and internal cash flow. Since the beginning of the year, total commercial paper outstanding rose \$10.6 billion. Such borrowing is not related to oil company mergers.

There has been a lot of talk among a few Wall Street analysts of the \$60 billion state surpluses, as if this would rescue the credit markets from the deluge of Treasury debt. We would point out that half of these surpluses reside in state pension funds, which hold little Treasury paper. The other half has come along unexpectedly, but it will get returned to the public rather quickly in tax cuts or spending increases by election time.

7) A miracle solution of the deficit problem is bullish for stocks and bonds. A deficit compromise is coming.

Our Washington Research group believes that there is a 40% chance that the President's "downpayment" package will pass both the Senate and the House unchanged. They see a 20% chance of a bipartisan deadlock with nothing at all being done this year. And they assign a 40% chance to the House passing its own deficit-reduction plan that will eventually be reconciled with the Senate-passed President's plan.

The President's three-year \$150 billion deficit-reduction plan will probably pass the Senate intact just before the Easter adjournment, April 13. House Democrats hope to pass their own program, which would call for lower defense outlays and higher social spending. The President has stated that any proposal which cuts military spending below his plan will be vetoed.

Our Washington analysts conclude that a remarkable amount of energy is being spent to reach an agreement on what virtually everyone knows is little more than "a downpayment on the downpayment." If Congress does finally present the President with a plan and he signs it, little in the way of actual reductions on projected deficits will result.

The President's \$150 billion, three-year deficit-reduction program that is being debated in the Senate includes \$75 billion of the proposed cuts already in the Administration's January budget proposal. So most of the so-called compromise isn't for real. The "new" \$75 billion in cuts includes only a modest \$11 billion in fiscal 1985 reductions.

Given our analysis of the budget proposals now being considered by Congress, we conclude that investors might actually sell bonds if a budget compromise occurs. Isn't it possible, though, that a compromise along with a better-than-expected economic expansion will narrow the deficit enough so that interest rates can fall. Maybe. However even if the deficit is narrowed, soaring private credit demands and rising inflationary expectations will put upward pressure on rates. If the deficit problem is eliminated, then interest rates might stop moving higher, but they are not likely to move lower either.

8) Corporate profits should rise 25% this year.

During the 1970s, as inflation accelerated, research analysts tended to underestimate the growth of corporate earnings because they underestimated the ability of companies to raise prices. Since 1980, industry analysts have tended to overestimate earnings growth because they haven't fully incorporated the process of structural disinflation into their models.

We are forecasting a 19% increase in after-tax corporate profits this year. That's quite good for the second year of an economic expansion. The consensus of money managers we've sampled expects a 25% rise in profits this year.

One reason our forecast is lower than the consensus is that we are more optimistic on inflation than others. In addition, we believe that industrial deregulation and a strong dollar will make both domestic and foreign competition quite fierce. The costs of competing will go up and the prices of products will be held down.

9) Operating profits are rising much faster than book profits and stock values will rise to reflect the better quality of earnings.

We've been among the few bears who argued that the stock market discounts book, not operating profits. Starting in July of last year, our investment strategy group argued that the market had limited upside potential. Since November of 1983, we've warned that stock prices could decline by at least 10% as investors were disappointed by the growth of book profits.

Last year, the bulls argued that book profits would increase by at least 25% in 1983. A few economists projected a gain of over 30%. These super-bullish estimates rested on the notion that many industries were much "leaner and meaner" as a result of the discipline imposed by the severe recession of 1982.

We forecast an increase of no more than 15% in after-tax book profits during 1983. Our conservative estimate assumed that increased

domestic competition resulting from a strong dollar exchange rate would limit price increases during the recovery. In other words, disinflation would restrain profits growth.

By last summer, it was fairly clear that our low forecast for book profits was on the mark. But the bulls didn't throw in the towel. Rather, they shifted their attention to operating profits. They still believed that the stock market would be driven higher by better-than-expected earnings, if not on a book basis, then on an operating basis.

Since January, the market has resolved the book vs. cash flow debate in favor of the bears. Given the dramatic improvement in the quality of earnings, why aren't investors willing to look beyond book profits?

Corporate managers are spending their firms' cash flow faster than it is coming in. More specifically, capital spending has been remarkably robust over the past year. Many companies that have lost their ability to raise prices because of increased domestic and foreign competition are trying to maintain their earnings growth by selling more units. To do this successfully, costs must be kept low relative to the competition. Massive capital outlays on cost-saving and productivity-enhancing equipment seem to be a consequence of these competitive pressures.

Do you want to pay up for the shares of a company that is spending all of its cash flow on capital equipment so that it can maintain the same earnings momentum that in the past it achieved simply by increasing prices? We don't. Anyone who buys or sells stocks based on a dividend discount valuation model would agree with us. If increased cash flow growth is not likely to lead to faster growth in dividends, why would you pay more for equities?

10) The stock market overall is becoming attractively valued—even growth stocks are selling off to more attractive valuations.

Since July 1983, investors have asked us what would it take for us to turn more bullish. Our answer has been lower prices. The interest rate and earnings assumptions we plug into our valuation model still suggest that the market has little upside potential and more downside risk.

CONCLUSIONS

If we are right about structural disinflation, then managing money in the 1980s will be much harder than in the 1970s. During the last decade the major investment theme was inflation-hedging. If you understood that concept, then picking the right stocks wasn't too difficult. The oils and metals were an obvious way to play inflation. It didn't matter much which stock you picked in a group as long as the group was an inflation-hedge play.

In the disinflationary world of the 1980s, stock selection is much

trickier. A disinflation investment strategy is to buy the equities of companies that have better-than-average and visible unit volume growth. Typically, these firms will be the low-cost producers in their industry. So during a period of inflation almost any stock in the right group will do. But during disinflation, only the low-cost producer will assure unit volume growth. And even if you pick the right company, how do you know it will continue to be the low-cost producer?

In a disinflationary world, nominal interest rates are likely to stay well above inflation. We still find many investors who ask us: "Why are interest rates so high, when inflation is so low?" Our answer is that inflation is so low because interest rates are so high! That's the way disinflation works.

High nominal interest rates will continue to be a tough hurdle for equity managers to jump over. So don't fight high rates; enjoy them. Returns on cash are hard to beat in the equity market. Larger-than-normal cash positions and high-yielding equities make a lot of sense to us.