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Connections

Tying Markets Together

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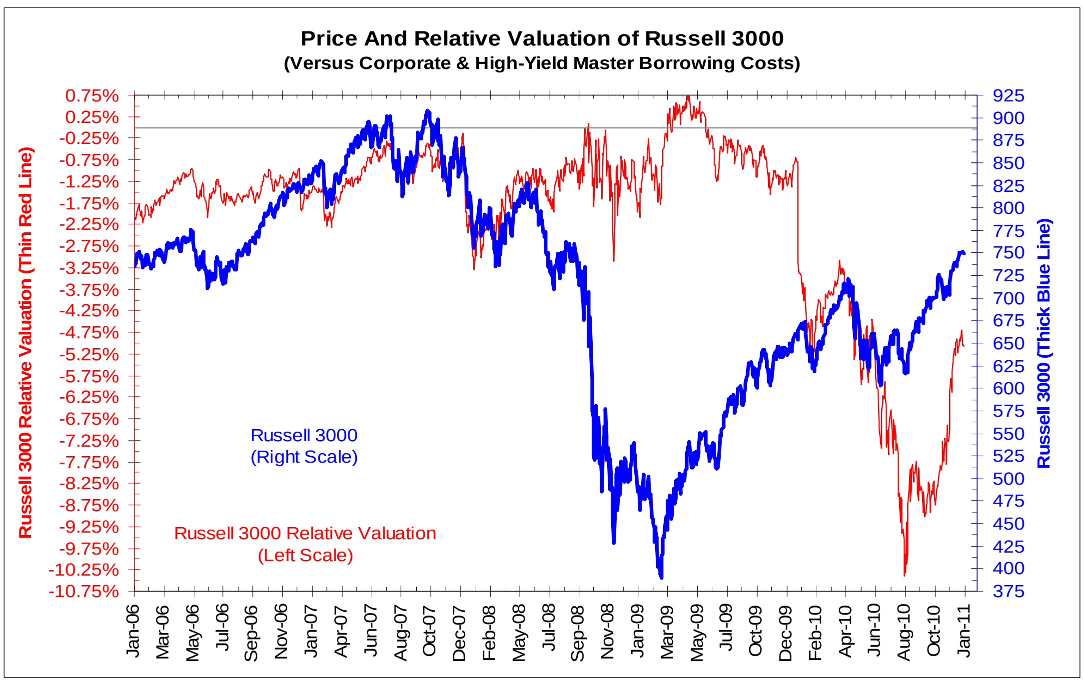
U.S. Stocks Closing Valuation Gap

We concluded in November 2010:

> *Money-printing has served to compress high-yield and emerging-market credit spreads, to fuel dollar carry trades and to convince investors the Bernanke put will be attached to the Bernanke QE2 purchases to create the Bernanke synthetic call option.*
>
> *… the convergence of equities to full valuation could proceed quite rapidly. Whether this produces the wealth effect desired by Chairman Bernanke remains to be seen, as do the political consequences of trying to solve structural unemployment by rewarding risk-seeking investors, but why let tomorrow's inevitabilities interfere with today's realities?*

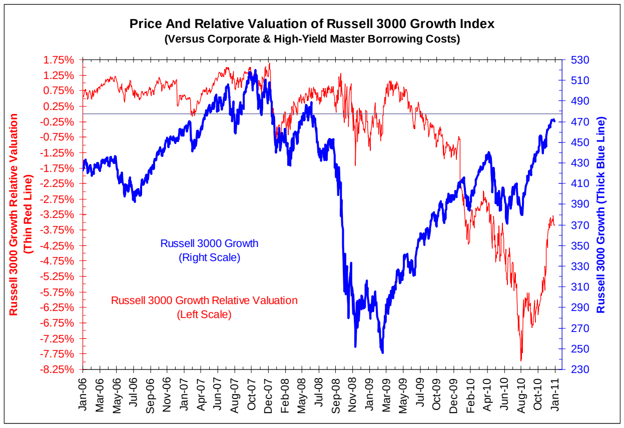
Even though the total return on the Russell 3000 (thick blue line) was only 3.55% since that time, the 49 basis point increase in yield to maturity for the Corporate & High-Yield Master index and the increase in top-down forward-looking P/Es from 15.04 to 15.88 led to a significant reduction in the relative undervaluation measure (thin red line). It rose from -8.06% to -5.07%.

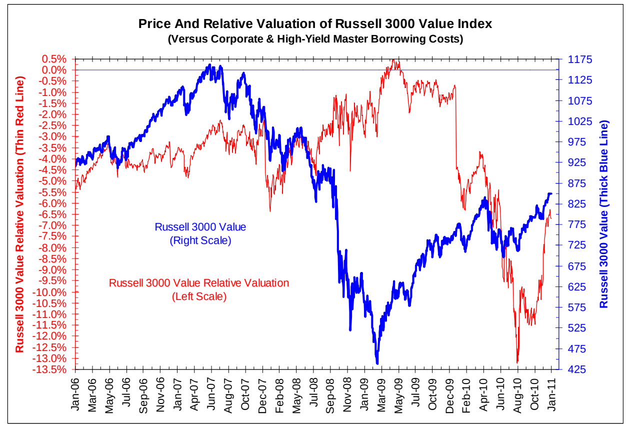
What we could refer to as an "extremely undervalued" U.S. stock market in August 2010 has closed to simply an undervalued market.



Growth & Value

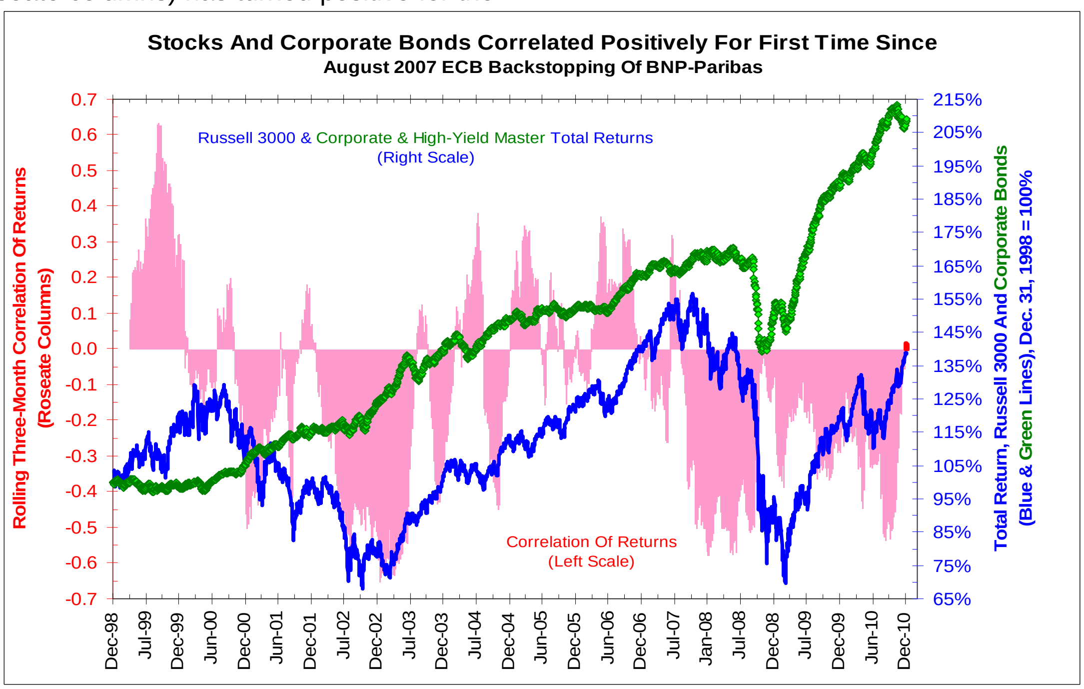
If we repeat the relative valuation calculations for the Russell 3000 growth index and value indices (thick blue line, left- and right-hand charts, respectively, following page), we find the growth index (thin red line, left-hand chart) is now undervalued by 3.61%; the Russell 3000 value index is undervalued by 6.69%.





Stock-Bond Relationship

If we map the total return series for both the Russell 3000 (thick blue line) and the Corporate & High-Yield Master series (hatched green line) re-indexed to December 31, 1998, we see how stock returns continue to accelerate upward to corporate bond returns. The three-month rolling correlation of returns (roseate columns) has turned positive for the first time since the August 2007 backstopping of BNP-Paribas by the European Central Bank, the first of a long series of extraordinary actions on both sides of the Atlantic. These positive correlation of return points, the last five days of trading in 2010, are highlighted in red.



Conclusion

The closure of the valuation gaps for U.S. equities and the convergence of returns to a state last seen when then-St. Louis Federal Reserve President William Poole was trying to convince the markets he was 100% confident the time to remain vigilant against inflation was August 2007 has reduced the Graham-Dodd margin of error. The rapid closure of valuation gaps since QE2 was not the result of a stock rally so much as a corporate bond downturn.

Even if earnings estimates and projected dividend growth rates remain at their present levels, stocks will become increasingly vulnerable to higher corporate bond yields. However, if credit spreads narrow sufficiently to offset a Treasury rate increase, the bull market in equities will remain intact.