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Downunder Daily

I Don't Like EYBY

If you believe the message of the equity earning yield/bond yield model (aka the Fed model) it seems that equities are braced for recession. In fact, as discussed yesterday, they look cheap (Exhibit 1). I don't buy it. I don't like the earnings yield/bond yield (EYBY) model. Here's why:

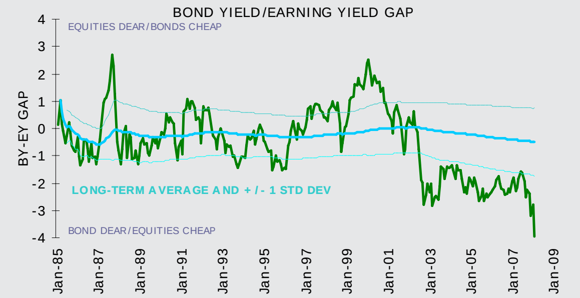
First, this is a relative value model: stocks relative to bonds. This may be useful for asset allocation purposes (where the important call is relative value), but doesn't provide a good guide on the absolute equity value. Yesterday's DuD focused on that issue.

Second, the EYBY model can send persistently misleading signals if there's a change in long-term earning expectations. In fact, the key problem with the 'model' is that it takes no account of earning forecasts beyond one year (which are embedded in the forecast equity earning yield). If long-term expectations fall, then the model can suck investors into a value trap.

That, in my view, is exactly what happened in Japan through the 1990s. Exhibit 2 shows the EYBY model for Japan. Throughout the 1990s it signaled that equities were hitting new historical levels of relative cheapness. But equities kept getting 'cheaper'.

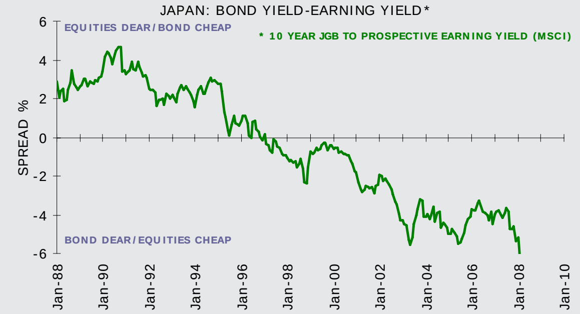
Long-term earning expectations are an unobservable variable. However, it is possible to calculate a crude estimate from market pricing, assuming a given equity risk premium. (The ERP may also vary over time, so this implied earning expectation is a rough estimate.) Exhibit 3 shows an estimate of the implied US long-term earning expectations (smoothed over 2 years). It suggests – plausibly in my view – that long-term earning expectations increased in the second half of the 1990s, but have now fallen to around the levels seen in the late 1980s/mid-1990s. (Our US strategy team calculates the proportion of current share value attributed to future earnings growth that shows a similar change.)

Exhibit 1
US Equities Look Relatively Cheap



Source: Bloomberg, IBES; Morgan Stanley Research

Exhibit 2
Japanese Equities Have Looked Cheap Also



Source: Bloomberg, IBES; Morgan Stanley Research

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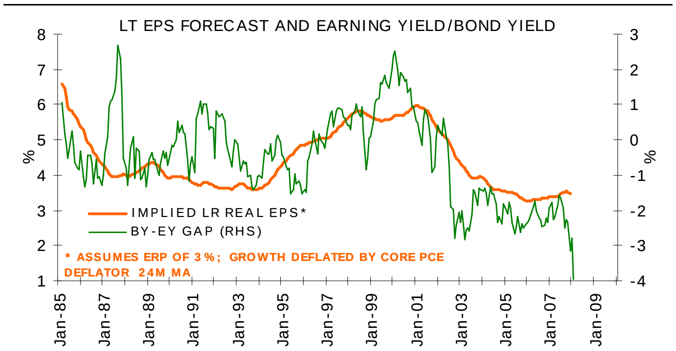
Long-term earning expectations are important because they set the range for the EYBY relationship. In other words, rather than EYBY mean-reverting to a constant level (often taken to be zero), the centre of gravity changes. That's why the EYBY sent persistently misleading signals that equities were too expensive in the late 1990s, and has persistently signaled that they were extremely cheap over the past few years.

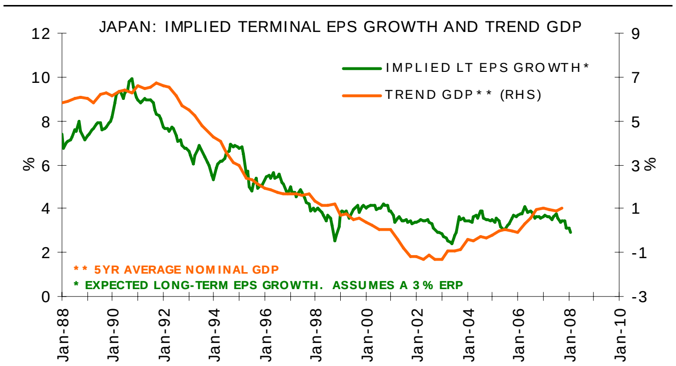
Exhibit 3
Long Term Earning Expectations Set The Range



Source: Bloomberg, IBES; Morgan Stanley

What drives long-term earning expectations? One factor should be long-term GDP expectations. Exhibit 4 shows how long-term earning expectations in Japan tracked trend GDP lower through the 1990s. That change, in my view, is why the EYBY was a Siren singing investors to shipwreck in Japan.

Exhibit 4
Japan's GDP and Long Term Earning Expectations

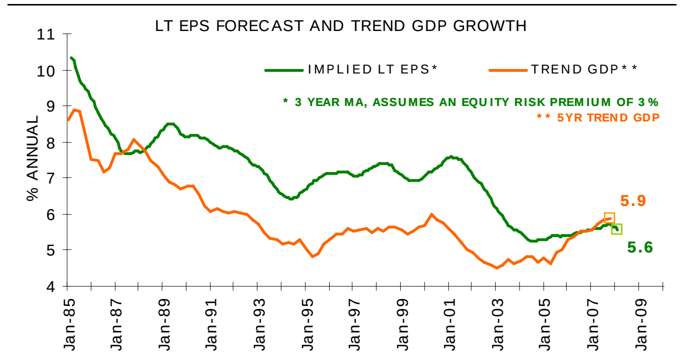


Source: Bloomberg, IBES, Cabinet Office; Morgan Stanley Research

Exhibit 5 shows the implied long-term earning expectations in the US along with trend GDP. They are now broadly consistent. Looking ahead, however, there may be a further fall in long-term earning expectations coming.

Long-term expectations were persistently above GDP growth through the 1980s and 1990s. This was sustainable because earnings were growing faster than GDP through that period (the profit share of GDP went from an extremely low level in the early 1980s to a historically high level last year). The risk now is of the reverse occurring: earnings growth falling persistently short of GDP growth as profit share mean-reverts.

Exhibit 5
Long Term Earning Expectations and Trend GDP



Source: Bloomberg, IBES, BEA; Morgan Stanley Research

The final point to note about the EYBY model is that most analysts focus on the past 20 years. That is partly because the IBES earning forecasts are available over that period. But the past 20 years was also an exceptional investment period, with long-end yields trending down, and profit share up. Over a longer time horizon (and using trailing earning yield), the past 20 years does appear exceptional (Exhibit 6). Over a longer horizon it has been normal for equities to yield significantly more than Treasuries and it may be that we are now seeing the EYBY gap returning to 'normal' levels.

Exhibit 6
Mean-reverting Where Over The Long-term?

Source: Standard & Poor's, Federal Reserve, Morgan Stanley Research

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Equal-weight/Hold	**986**	**41%**	**308**	**42%**	**31%**
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