

Stocks Are Cheap, Bonds Are Not

Stocks are still cheap and the bull market is still young. Bonds are expensive and bond yields are headed higher. Quantitative easing is under attack and better fiscal policy is on the way. Put it all together and the bearish (or “risk aversion”) trade of recent years is losing ground.

We use a capitalized profits approach to valuing stocks. It’s relatively simple – divide (discount) the government estimate of corporate profits by the 10-year Treasury yield, compare the result to each quarter for the past 60 years and use it to find an average fair value for stocks.

Using current 10-year yields (which are being held artificially low by the Fed) gives us a fair value for the Dow of 27,000. Wait! Before you write us off as crazy, we do not believe that this result is correct. The reason the model kicks out such a high number is because Treasury yields are so low.

But, bonds are overvalued. With nominal GDP running above 4% growth in the past year, we think a 2.8% yield on the 10-year is too low – so we use a 5% yield in the model. This provides a “fair value” estimate of 15,000 on the Dow, which will rise as corporate profits grow.

As a stress test, we estimate what yield would make the Dow fairly-valued right now. That number is a 10-year yield of 6.75%. And, remember, even with interest rates at this level, any gains in profits would send the valuation level higher. And profits look set to continue their strong performance.

While some argue that the economy is still vulnerable, retail sales rose 1.2% in October and are up 7.3% in the past 12 months. If this is a “new normal,” let’s have more of it. This

kind of growth means that top-line revenue growth will continue to accelerate. Moreover, with productivity booming, margins and profits will continue to expand. In other words, equity investors should look out above.

To top it off, government policy is being pressured to move in the right direction. Around the world, politicians are finding the small government religion. Students are rioting in Great Britain, but the government is staying the course toward austerity. Republicans picked up a modern-day record number of seats in the House and are promising spending restraint. President Obama’s Deficit Commission has released its first draft ([link](#)) and we see some good news.

The proposal on Social Security looks pretty good: lifting the retirement age along with changes in the benefit formula – making it less generous for higher earners – would reduce the Social Security deficit over the next 75 years by 80%. A series of small changes would reduce spending on Medicare. Proposals on income taxes would reduce the top income tax rate on both workers and companies to 28%, maybe less.

We certainly don’t like everything proposed. In particular, we think the Commission is over-hyping its proposed cuts in discretionary (non-entitlement) spending and relying too much on higher tax burdens to reduce the deficit.

Nonetheless, here and abroad the political winds are shifting in favor of fiscal retrenchment. In addition, the loose Fed is coming under attack. These are welcome developments, which will put more upward pressure on economic growth and equity prices – while bond yields rise, too.

| Date/Time (CST) | U.S. Economic Data | Consensus | First Trust | Actual | Previous |
|-----------------|------------------------------|-----------|------------------|--------------|-----------|
| 11-15 / 7:30 am | Retail Sales - Oct | +0.7% | +1.0% | +1.2% | +0.6% |
| 7:30 am | Retail Sales Ex-Autos - Oct | +0.4% | +0.7% | +0.4% | +0.4% |
| 7:30 am | Empire State Mfg Index - Nov | 14.0 | 18.0 | -11.1 | 15.7 |
| 7:30 am | Business Inventories - Sep | +0.8% | +0.9% | +0.9% | +0.6% |
| 11-16 / 7:30 am | PPI - Oct | +0.8% | +0.8% | | +0.4% |
| 7:30 am | "Core" PPI - Oct | +0.1% | +0.1% | | +0.1% |
| 8:15 am | Industrial Production - Oct | +0.3% | +0.3% | | -0.2% |
| 8:15 am | Capacity Utilization - Oct | 74.9% | 75.0% | | 74.7% |
| 11-17 / 7:30 am | CPI - Oct | +0.3% | +0.4% | | +0.1% |
| 7:30 am | "Core" CPI - Oct | +0.1% | +0.1% | | +0.0% |
| 7:30 am | Housing Starts - Oct | 0.598 Mil | 0.580 Mil | | 0.610 Mil |
| 11-18 / 7:30 am | Initial Claims - Nov 13 | 442K | 431K | | 435K |
| 9:00 am | Philly Fed Survey - Nov | 5.0 | +7.4 | | +1.0 |
| 9:00 am | Leading Indicators - Oct | +0.5% | +0.6% | | +0.3% |