Zacks Research System (ZRS) – Macroeconomic Analysis

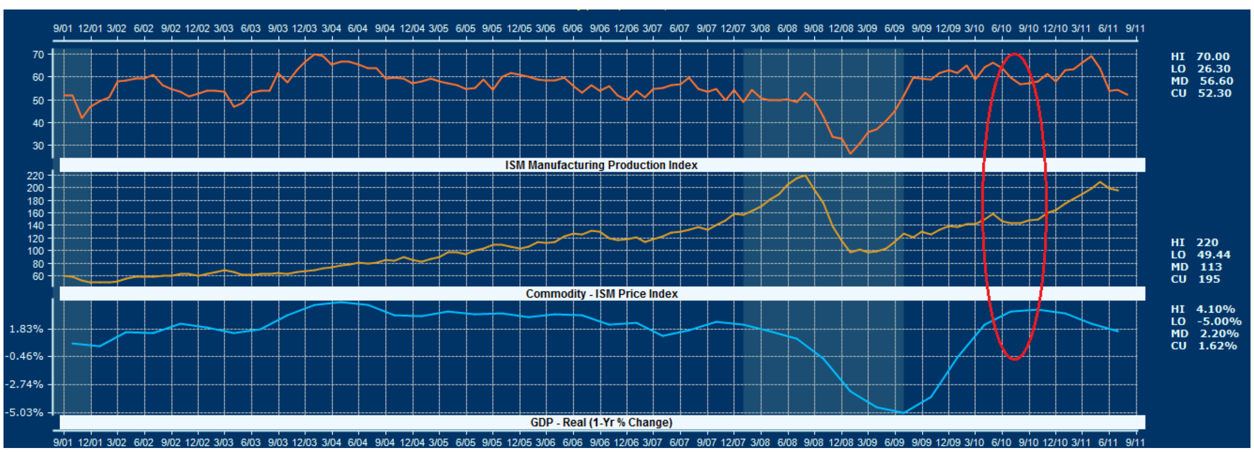
Q3 2011 Downturn Analysis

Only one short year ago the nation grappled with the threat of economic slowdown and deflation, along came the Federal Reserve and ‘Quantitative Easing 2’. Federal Reserve monetary policy of quantitative easing in support of a weak US Dollar rapidly inflated commodity prices, equities rallied and fears of deflation quickly diminished. By January 1, 2011 the problem appeared to be resolved at least in the short-term.

Rolling the clock forward to the downturn of Q3 2011, we will use the Zacks Research System (ZRS) to explore macroeconomic factors impacting equity valuations from summer 2010 to the Q3 2011 downturn.

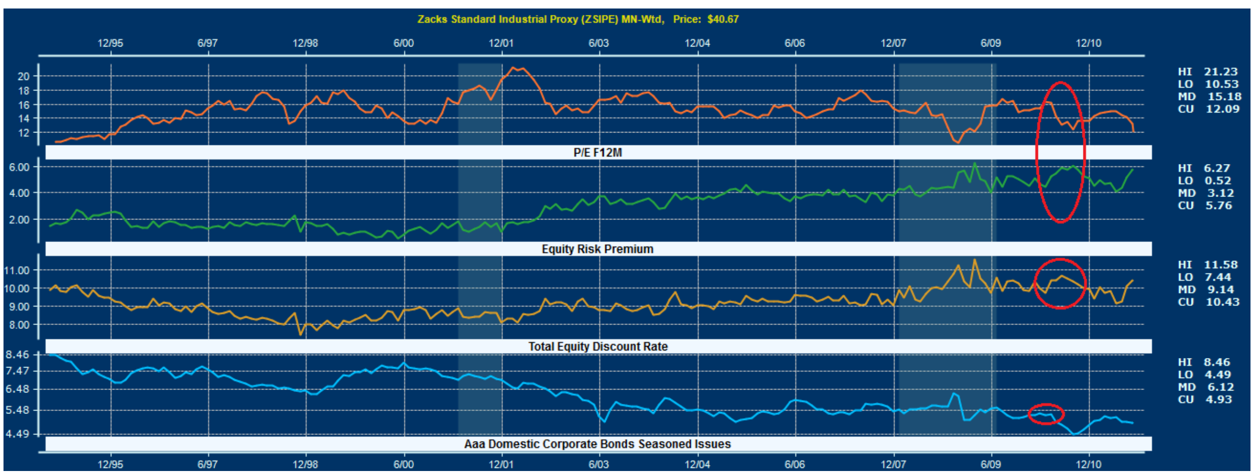
Summer 2010

During the summer of 2010, the Federal Reserve had its eye on the growth rate tapering of Real GDP, the growth rate decline in the manufacturing sector and the slump in commodity prices. One of the most highly regarded indicators of economic expansion and contraction, the ISM Manufacturing Index, peaked at 66.40 in the spring of 2010, the index hit a low point during the post-recessionary cycle in July 2010 and continued floundering between 56.90 and 58.10 through the September 2010 reading. During this time period the related ISM Commodity Price index began a mid-cycle slump and the 1 year % change in Real GDP growth began to flatten.



As manufacturing and overall econommic growth in the US began slowing, the investment community responded to the uncertainty by shifting funds out of equities into risk free assets. As funds flow out of equities into risk free assets, yields drop and valuations rise on the risk free asset class; the counter party equity class of securities suffers a P/E multiple contraction as investors exit the equity market. ***Zacks Investment Research is one of the only providers that can effectively quantify this shift in asset class and its impact on equity valuations. See the Zacks Equity Valuation Model.***

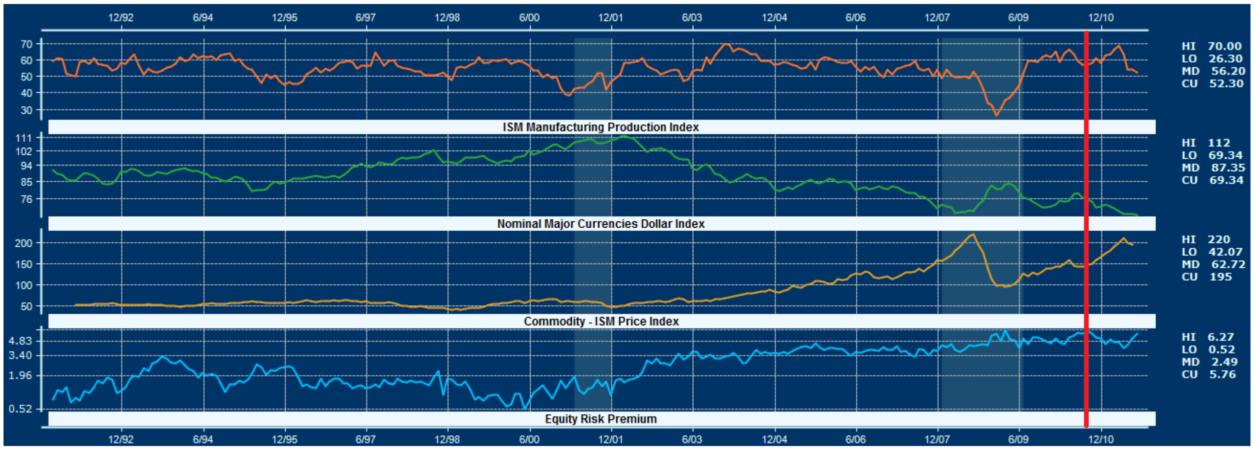
To effectively illustrate the Equity Risk Premium phenomenon and its impact on overall equity valuations we must look at a ‘pure’ macro level, industrial proxy. Zacks maintains a small group of ‘pure’ industrial composite proxies based on current membership of the S&P 500 index. The Zacks pure industrial proxies are a hand selected group of securities whose combined membership represents the ‘average’ industrial company thereby eliminating ‘tilt’ sector bias and other accounting irregularities present in reported benchmarks. ***See the Tim Nyland paper “Value of ZRS Composites” for additional information on Zacks composite proxies.***



The chart above offers a ‘top down’, macroeconomic perspective of changes in Equity Risk Premium (ERP) and resulting impacts on the forward 12 month earnings multiple of the market. In this case the Zacks Standard Industrial Proxy, ZRS ticker symbol (ZSIPE), represents an equal weighted basket of pure industrial companies, aka ‘the market’. Note the dramatic contraction in the P/E F12M multiple as the Equity Risk Premium rises. Also, note the corresponding increase in the Total Equity Discount Rate. The rise in Total Equity Discount Rate illustrates that ERP rose in excess of the decline in the proxy for the risk free rate, Aaa 30 Year Corporate Bond.

Fall 2010

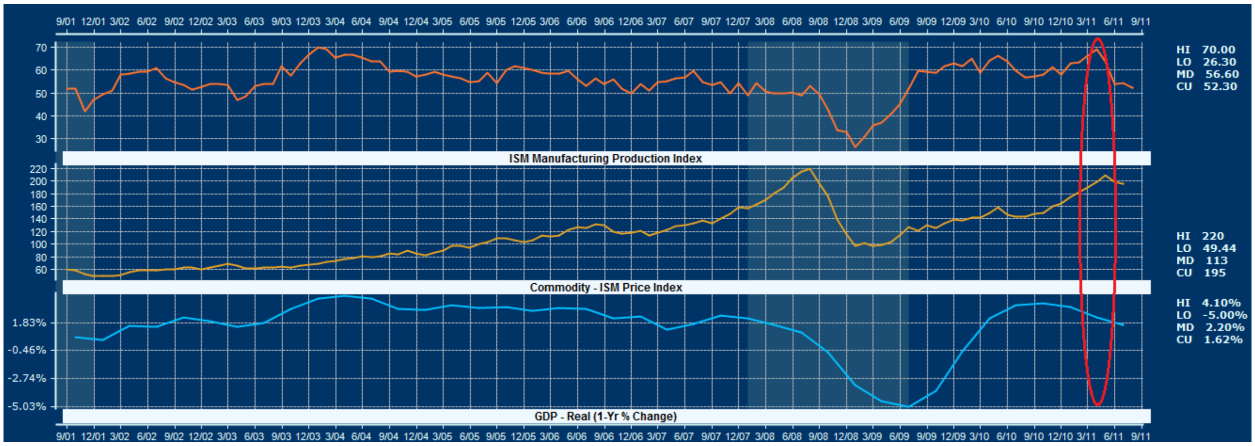
On November 3rd, 2010 the Federal Reserve announced it will pump billions into the economy. Dubbed QE2, "the central bank will buy $600 billion in long-term Treasuries over the next eight months". The Fed also announced it will reinvest an additional $250 billion to $300 billion in Treasuries with the proceeds of its earlier investments.



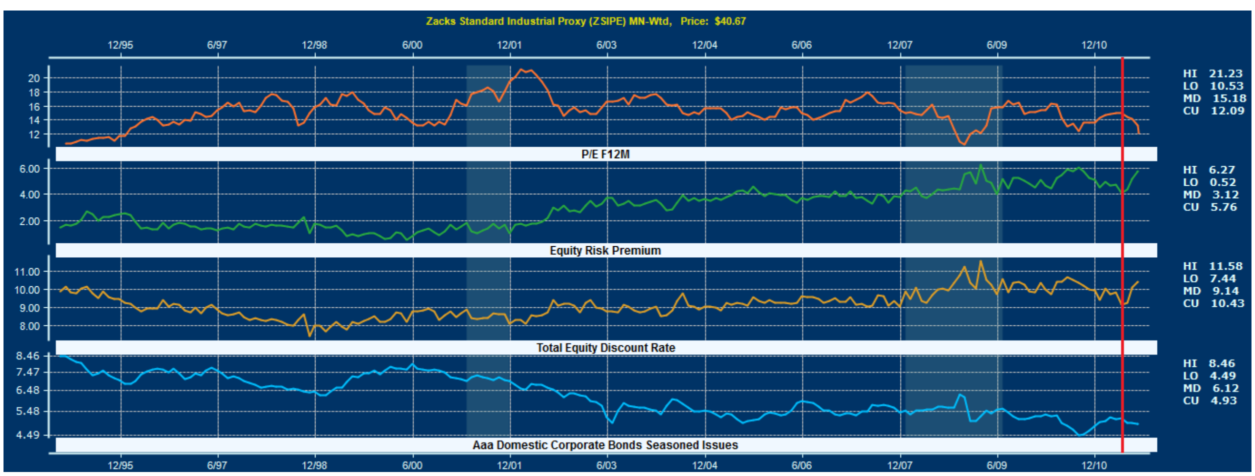
As illustrated by the ZRS view above, the effects of quantitative easing speculation that began in August 2010 were astounding. ISM Manufacturing skyrocketed to heights not seen since 2003, the dollar slid relative to other major currencies, commodity prices skyrocketed and the Equity Risk Premium began its decline as investors bid up the price of equities relative to earnings.

Spring 2011

By the spring of 2011, the US economy was hung over from QE2 with no resulting uptick in GDP growth. ISM Manufacturing and Commodity Price Index values both peaked as a prescription for a mid-cycle economic slowdown yet to come. The S&P 500, having been range bound between 1200 and 1350 for the prior 4-6 months, was pricing in the fact that this was nothing out of the ordinary; economies do not grow in a straight line and the resulting valuations were absolutely indicative of the cyclical nature of economic growth.



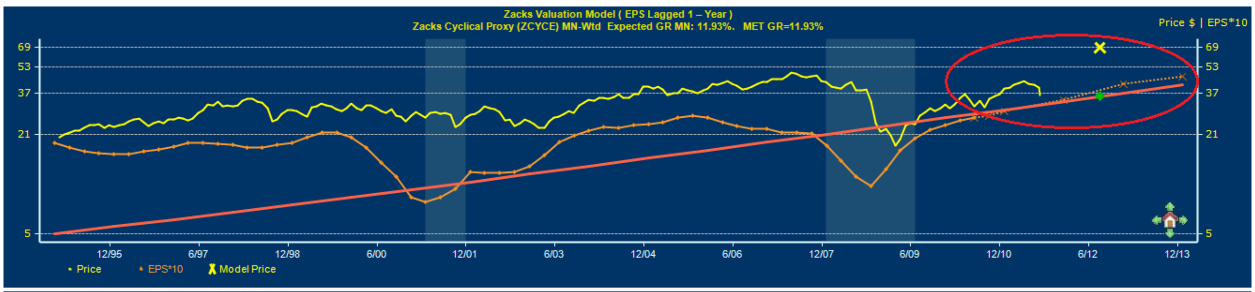
Shifting our attention back to the Zacks Standard Industrial Proxy (ZSIPE), as illustrated below, by April 30th, 2011 we had bottomed out the Equity Risk Premium at 4.07 and resulting P/E F12M multiple had expanded relative to pre QE2 levels as investors bid up the price of equities. At the expense of the move into equities, yields on the proxy for the risk free rate rose as investors fled the risk free alternative in search of greater return. Total Equity Discount Rates also hit bottom during this same period further reflecting asset flows into the equity basket.



Q3 2011 Downturn

As I am writing this article on August 8th 2011 the DOW is down another 500+ points despite the fact that the outlook for corporate profits remains positive. Although GDP estimates have been reduced, the rate of growth remains positive. How do we quantify the market selloff?

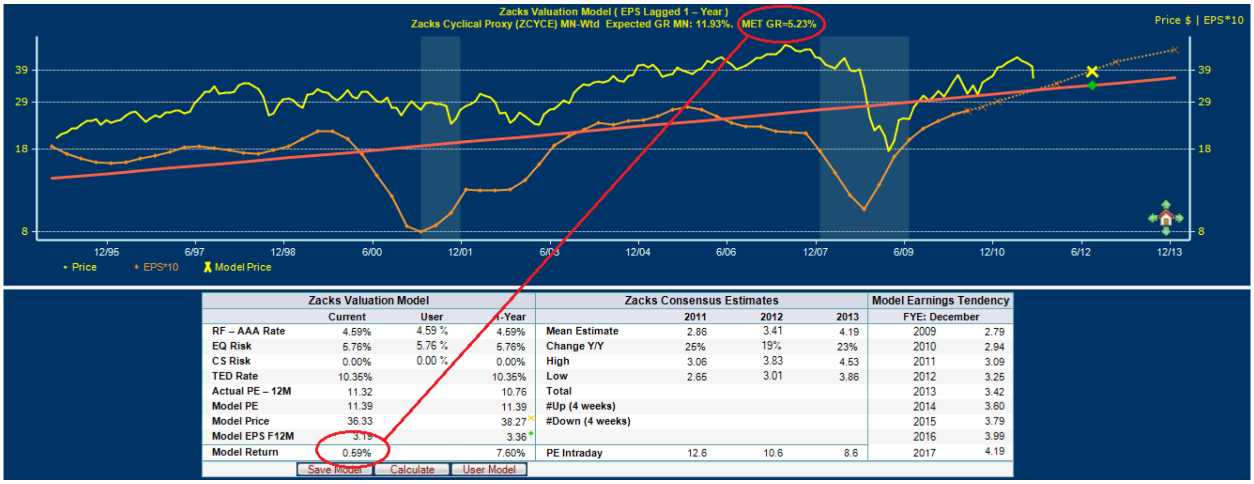
Shifting our focus to the Zacks Cyclical Proxy as an indicator for the likelihood of another economic downturn, sell side consensus estimates for forward growth remains positive on an equal weighted basis. The 3-5 year consensus earnings growth remains high at nearly 12% and the percentage change between the bottom up FY1, FY2 and FY3 annual consensus EPS estimates remains in excess of 19% for each year.



Zacks Valuation Model				Zacks Consensus Estimates				Model Earnings Tendency	
	Current	User	1-Year		2011	2012	2013	FYE: December	
RF – AAA Rate	4.59%	4.59 %	4.59%	Mean Estimate	2.86	3.41	4.19	2009	2.36
EQ Risk	5.76%	5.76 %	5.76%	Change Y/Y	25%	19%	23%	2010	2.64
CS Risk	0.00%	0.00 %	0.00%	High	3.06	3.83	4.53	2011	2.96
TED Rate	10.35%		10.35%	Low	2.65	3.01	3.86	2012	3.31
Actual PE – 12M	11.32		10.11	Total				2013	3.71
Model PE	19.37		19.37	#Up (4 weeks)				2014	4.15
Model Price	61.78		69.15	#Down (4 weeks)				2015	4.65
Model EPS F12M	3.19		3.57					2016	5.20
Model Return	71.07%		93.12%	PE Intraday	12.6	10.6	8.6	2017	5.82

Save Model Calculate User Model

Looking at the default Zacks Valuation Model output in the lower left corner of the ZRS view, make note that the "Current Model Return" is 71.07% meaning that based on the 3-5 year EPS Consensus Growth Rate Estimate mean of 11.93% and a Total Equity Discount Rate of 10.35% we have a 71% arbitrage profit. No the model is not broken, to the contrary it is actually alerting ZRS users to the fact that investors are discounting the market heavily and we must solve for the Market Implied Growth rate to determine market implied rate of growth warranted by current valuations.



Zacks Valuation Model			
	Current	User	1-Year
RF – AAA Rate	4.59%	4.59 %	4.59%
EQ Risk	5.76%	5.76 %	5.76%
CS Risk	0.00%	0.00 %	0.00%
TED Rate	10.35%		10.35%
Actual PE – 12M	11.32		10.76
Model PE	11.39		11.39
Model Price	36.33		38.27
Model EPS F12M	3.19		3.36
Model Return	0.59%		7.60%

Zacks Consensus Estimates			
	2011	2012	2013
Mean Estimate	2.86	3.41	4.19
Change Y/Y	25%	19%	23%
High	3.06	3.83	4.53
Low	2.65	3.01	3.86
Total			
#Up (4 weeks)			
#Down (4 weeks)			
PE Intraday	12.6	10.6	8.6

Model Earnings Tendency	
FYE: December	
2009	2.79
2010	2.94
2011	3.09
2012	3.25
2013	3.42
2014	3.60
2015	3.79
2016	3.99
2017	4.19

As seen in the ZRS view above, one can 'model' growth rate expectations on earnings to the point at which Current Model Return is at or near 0%. The result is a Market Implied Growth Rate for the Zacks Cyclical Proxy of 5.23%.

Although at this point we cannot rule out another recession, ***we do know for a fact that the current Market Implied Growth Rate of 5.23% is the ACTUAL rate of annual earnings growth that investors are paying for the equal weighted 'pure' industrial, cyclical basket of stocks.*** While the consensus estimate for the 3-5 year earnings growth remains high at 12% and almost double that for each of the FY1 (25%), FY2 (19%) and FY3 (23%) periods we know that either brokers need to bring their earnings estimates back in line with current growth expectations or that the market is extremely oversold and equity pricing needs to rise to more reasonable levels.

Without knowing with certainty where the US economy is heading, one can only reasonably conclude that if the economy ***does not*** slip into a recession within the next 12 months the third quarter 2011 selloff exhibited some of the finest irrational investor behavior witnessed in years. Conversely, if the US economy ***does*** slip into a recession within the next 12 months we can conclude that the market implied valuations and investors were correct and that corporate guidance and the sell side collectively missed forecast earnings and growth rate estimates.

Tim Nyland, CFA

Managing Director

Zacks Investment Research

8/8/2011

More Information

For more information about Zacks Composites, Zacks Valuation Model, Zacks Research System (ZRS) or any other Zacks Investment Research services, please contact Zacks Sales or your help desk representative at (312) 265-9199 or ZRSSales@Zacks.com