Brian Wesbury: "The Market is Significantly Undervalued"

Robert Huebscher
January 13, 2009

Brian Wesbury is Chief Economist at First Trust Advisors L.P., a financial services firm based in Wheaton, Illinois and serves on the Board of Advisors to First Trust Capital Partners, an affiliated private-equity firm. The Wall Street Journal ranked Mr. Wesbury the nation's #1 U.S. economic forecaster in 2001 and USA Today ranked him as one of the nation's top 10 forecasters in 2004. Mr. Wesbury writes frequently for the editorial page of The Wall Street Journal and is the Economics Editor of "The American Spectator." He is also a frequent guest on Fox, Bloomberg CNBC TV and BNN Canada TV.

We interviewed Mr. Wesbury on January 12, 2009.

At the end of last year you wrote that stocks were "dirt cheap," with a fair value of the Dow at 15,000. Can you please walk through your logic behind this estimate?

> We use a capitalized profits model. This has several components: measuring corporate profits, discounting them to determine a present value, and then translating this to a market level. I will go over each of these steps.
>
> First, we do not use reported earnings as a measure of corporate profits. We use the income that corporations report to the IRS, because we believe this is the most conservative approach. No corporation is going to pay taxes on profits it has not really earned.
>
> Normally, we would use the 10-year Treasury rate (currently 2.35%) as a discount rate. But, because we believe 10-year Treasury bonds are now overvalued, we use a rate of 5%, again to be conservative. This produces a value of 1494 for the S&P 500 or approximately 15,000 for the Dow.
>
> To suggest that the market is fairly valued now, you would need to assume either profits would fall by 40% or that interest rates would quadruple to 8.5%. These are extremely significant events and, in my mind, highly unlikely.

© Copyright 2009, Advisor Perspectives, Inc. All rights reserved.

Our model is very robust and we are confident in our belief the market is significantly undervalued.

One of the components in your valuation model is the translation of the capitalized profits to a market level. Can you explain in more detail how this works?

As you say, when we capitalize profits, it gives us a value, but that value does not correspond to a level in the S&P 500 or the Dow. In order to make that translation, we need to look at historical data to determine the appropriate relationship between capitalized profits and market index values.

We have a historical database that goes back to 1953. We look at quarterly data (capitalized profits and market index levels) over this 56 year period, and we take an average value to do this translation.

In other words, our model adjusts for periods of extreme under- or over-valuation in the markets.

You said recently that "the most intense parts of the economic contraction are behind us" and that the current recession will end "sometime in early 2009." What are the catalysts that will create positive growth in the GDP early this year? What will cause a revival of consumer spending?

My belief is that the US economy was not in a recession until as late as July or August of 2008. Housing was in a depression, but not the rest of the economy. GDP, excluding housing, has not yet had a reported quarter of negative growth, although that will change once the fourth quarter of 2008 is reported. The non-housing economy grew through September, although the third quarter was virtually flat. As a result, we believe that the cause of the recession was what happened in September.

That event, of course, was the failure of Lehman, followed by the failure of the initial TARP plan, after which the President went on TV said we could lose our jobs, pensions, and houses, but "don't panic." Everyone panicked. This caused a drop in the velocity of money. It was a textbook example of how to create a recession

The last time this happened was in 1907, and that recession lasted a year.

According to Milton Friedman and classic economics, the way to get out of this kind of a recession is to print a lot of money. It is very clear we are doing that. The panic is beginning to subside. I expect a v-shaped

© Copyright 2009, Advisor Perspectives, Inc. All rights reserved.

recovery - not a u- or l-shaped recovery or a long drawn out recession. We were not in a recession until September.

Financial advisors need to remember that reported data is lagging. The employment report last week was ugly, but the data was from early December and reflects decisions made by executives as far back as October or November. It's old data. But many act as though the employment data is real time. It's not. Car sales actually improved in December over November. Holiday spending in December, according to Bloomberg, was down 2% versus last year, but that is a better report than mid-November reports, which showed down 4%.

Construction data for November was not as bad as most people thought. Corporate and public building were both robust. Real (inflation-adjusted) earnings were up about 4.5% in December over last year, mostly due to a drop in oil prices. Consumers are now saving the equivalent of $425 billion, due to the drop in gas prices since June. This actually offsets the loss in income from rising unemployment. The total pool of earnings available to workers is up 1/10 of a percent in December 2008 over December 2007.

Some of the panic is subsiding. Things are not good, and I don't want to be cast as a Pollyanna. But many pieces of data have begun to show an improvement in the economy.

What is your current forecast for the housing market? Has the housing price decline ended? What role does housing now play in your overall economic forecast?

Housing prices will decline another 10% and that will take about a year. The inventory of unsold homes is still too high, and it will probably take a year to work off inventories. I expect the recovery to begin in the fourth quarter of 2009 or the first quarter of 2010.

There are pockets and regions that are basically back to normal. These include smaller college towns, many of which are in the mid-West, which have seen population growth. They may have had excess building but no subprime lending. In those areas there are normal inventories. For many areas there will be better data sooner than the end of this year.

© Copyright 2009, Advisor Perspectives, Inc. All rights reserved.

You have forecast that the current deflation is temporary and that we should expect "a period of extremely rapid re-acceleration of inflation" in 2009. Can you walk us through your rationale?

For the next six to nine months all you will hear about is deflation. The CPI will be negative, mostly as a function of oil. All of those people who weren't worried about inflation dismissed the role of oil. Now that deflation is taking center stage, they suddenly care about oil. The press has been very negative. I expect there will be a deflation watch on CNBC.

Advisors should be wary. Inflation, above all else, is a monetary phenomenon. It will occur because the Fed is expanding its balance sheet and printing new money. This always leads to inflation. The Fed is doing everything it can to avoid another Great Depression, where the money supply shrank by a third.

From an investment view, in our due diligence meetings, throughout 2008, we said commodities were overvalued, especially oil. Now that the commodities markets have collapsed, we believe they are undervalued. If advisors typically hold a 5-10% exposure in commodities, and now, because of the decline in commodities prices, exposure has declined, it is time to boost that allocation back to normal.

Given your forecasts for equity values and inflation, what asset allocation do you recommend for a 40 year old risk-averse individual for their retirement portfolio?

I follow a guideline that 110 minus your age should equal your equity allocation. In your example, this would give a 70 percent allocation in equities.

Today, the market is undervalued by more than we have seen since the beginning of our data series (1953). It is as cheap as in the Great Depression or during mid 1970s. I would boost that exposure to 80%. About 10% of that equity exposure should be in commodity-related industries (shipping, agriculture, energy).

For the bond market, Treasuries are overvalued. We should have an increase in Treasury yields in the years ahead. This will make it difficult for a rally in bonds. We recommend staying in the two-to-five year range.

Within equities, we like small caps, which tend to outperform in inflationary and volatile periods. We also tilt toward to growth stocks and have a 15% exposure to international stocks. Today, our screens see value in cyclical

© Copyright 2009, Advisor Perspectives, Inc. All rights reserved.

growth areas (technology, health care, consumer discretionary) and not in utilities or consumer staples.

You have spoken out forcefully against mark-to-market practices. In an op-ed piece in the NYT by Michael Lewis and Douglas Einhorn, they argued the other side of the position:

> "This [suspending mark-to-market accounting] will have the double effect of reducing transparency and increasing self-delusion (gorge yourself for months, but refuse to step on a scale, and maybe no one will realize you gained weight). And it will fool no one. When you shout at people "be confident," you shouldn't expect them to be anything but terrified."

How do you respond to their assertions? Is this issue fully understood within the financial community and by the public at large? What do you believe is the proper solution?

The FASB and the SEC have bent but not broken on this issue. They have given a little more credence to cash flow and net-present-value analysis, by mentioning it in the same breath as market price analysis. But this does not give auditors a lot of comfort.

This issue is driven by a need to provide protection for auditors, and to avoid the need to use subjective judgment. Nobody wants to be the Arthur Anderson of the Enron era. The FASB and SEC have tipped their hat, and have heard the arguments, but are unwilling to change.

Mark-to-market has created an enormous burden, in terms of cost of capital, volatility, and uncertainty. If anybody says there is transparency today, in a world with mark-to-market, I don't know what they are looking at. Einhorn and Lewis admit that nobody knows what Citibank owns. Mark-to-market causes less transparency. A cash flow analysis would require footnoting in a 10Q statement or in corporate financials. Banks would need to report data such as loan performance rates, whereas today they are using a somewhat arbitrary market value.

The idea that, because an accountant writes a number it is true, is flabbergasting. We have computers that are three years old and have been depreciated to zero value. But we use them today, so this is an accounting fallacy.

We would increase transparency by having full disclosure of all methods of valuing assets, because banks would have to report their underlying assumptions.

© Copyright 2009, Advisor Perspectives, Inc. All rights reserved.

In the 1980s and 1990s, approximately 3,000 banks went out of business. There was no mark-to-market accounting. Mark-to-market can't hide losses forever. It keeps the damage in illiquid markets from taking down financial institutions. Every major money center bank would be bankrupt if mark-to-market accounting was required on their Latin American debt in the 1980s. when it was trading at 10 cents on the dollar. We did not force them to do that, and they recovered most of their money. Life went on, and the markets boomed in the 1980s.

The absence of mark-to-market accounting slowed down the process of absorbing these losses. Mark-to-market accounting today takes 20 years of losses and jams it into 18 months. It is really good for the short sellers, but not for the economy. This is why we see a lot of support for mark-to-market from short sellers.

The last time mark-to-market accounting was actively used was in the Great Depression. Then, in 1938, FDR commissioned a panel to study it, and suspended it. But it took eight years for that to happen.

We could lose thousands of banks with mark-to-market, and have a Great Depression. Or, we could lose thousands of banks without mark-to-market, as we did in the 1980s and 1990s, and still experience growth. I challenge anyone to prove that somehow mark-to-market accounting makes things better when the historical evidence clearly shows that it makes things worse.

www.advisorperspectives.com

For a free subscription to the Advisor Perspectives newsletter, visit:
http://www.advisorperspectives.com/subscribers/subscribe.php

© Copyright 2009, Advisor Perspectives, Inc. All rights reserved.