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First Trust

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Monday Morning Outlook

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Unfunded Liabilities and Cheap Stocks

Despite cries of "uncertainty" that reverberate through the financial markets, US equities remain grossly undervalued. Risk premiums are exceedingly high. Too high!

In total, S&P 500 companies reported after-tax annualized earnings of $716 billion in the second quarter and had a market capitalization of $9.3 trillion. In other words, for every $100 in market value, the companies in the S&P 500 were generating $7.70 in after-tax profits – an "earnings yield" of 7.7%.

Comparing that earnings yield to the 10-year Treasury yield (currently 2.8%) reveals a gap of nearly five percentage points, the largest such gap since the late 1970s. And with profits expected to continue their upward climb, this gap is highly likely to increase even more in the next few quarters.

Relative to bonds, stocks are undervalued by a considerable margin. So, what's holding investors back? Why are bond flows continuing to outpace equity flows?

One reason is fear of government spending. Current deficits and future deficits related to Social Security and Medicare are one reason. Every dollar the government spends must eventually be paid for by taxpayers. If these higher future taxes confiscate enough corporate profits, then the market will reflect that fact today with lower prices. So, is the market discounting these costs accurately? Let's crunch the numbers.

The Trustees report for Social Security and Medicare estimates the present value of all unfunded entitlement benefits are roughly $50 trillion. On the same present value basis, this is equal to 3.8% of future GDP. In other words, rather than taxing 19% of GDP (as the CBO predicts for 2012/13), total tax revenue would need to climb to 22.8% of GDP – an increase in tax revenues of 20% from everyone and everything that the federal government already taxes. In other words, a 10% tax rate will need to rise to 12%.

Of course, everyone realizes that a 20% tax hike would never generate 20% more revenue. A dynamic model would forecast slower economic growth and more unemployment if the government hiked taxes by this much. This is why some are advocating benefit cuts. But, for our purpose here (analyzing the impact of paying for unfunded liabilities) we assume tax hikes are the only method used.

A 20% increase in corporate taxes as well as taxes on capital gains and dividends, would reduce total returns to shareholders by roughly 11%. This would reduce the earnings yield (currently 7.7%) to about 6.9%. – more than 4 percentage points above current 10-year Treasury yields.

Don't take this the wrong way. We are certainly not advocating a massive tax hike to fix Social Security and Medicare. Raising tax rates will hurt the economy. Moving to private accounts would be our preferred solution. But, the current level of fear about the costs of fixing these entitlement problems is out of proportion to reality. Things are far from perfect, but the stock market is grossly undervalued.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
9-13 / 1:00 pm	Treasury Budget - Aug	-$95.0 Bil	**-$95.0 Bil**		-$165.0 Bil
9-14 / 7:30 am	Retail Sales - Aug	+0.3%	**+0.4%**		+0.4%
7:30 am	Retail Sales Ex-Autos - Aug	+0.3%	**+0.5%**		+0.2%
7:30 am	Business Inventories - Jul	+0.7%	**+1.0%**		+0.3%
9-15 / 7:30 am	Empire State Mfg Index - Sep	8.0	**9.0**		7.1
7:30 am	Import Prices - Aug	+0.2%	**+0.4%**		-0.2%
7:30 am	Export Prices - Aug	+0.2%	**+0.2%**		+0.2%
8:15 am	Industrial Production - Aug	+0.2%	**+0.1%**		+1.0%
8:15 am	Capacity Utilization - Aug	75.0%	**74.9%**		74.8%
9-16 / 7:30 am	PPI - Aug	+0.3%	**+0.3%**		+0.2%
7:30 am	"Core" PPI - Aug	+0.1%	**+0.1%**		+0.3%
7:30 am	Initial Claims - Sep 11	459K	**476K**		451K
9:00 am	Philly Fed Survey - Sep	0.0	**-1.0**		-7.7
9-17 / 7:30 am	CPI - Sep	+0.3%	**+0.3%**		+0.3%
7:30 am	"Core" CPI - Sep	+0.1%	**+0.1%**		+0.1%
8:55 am	U. Mich. Consumer Sentiment	70.0	**70.0**		68.9