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Sobering Up

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When the stock market soared in the first two weeks of this new year, it seemed to validate a growing confidence that the economy was destined to overcome the tech-wreck and the recession, just as America had moved beyond the terrorist attacks of September 11. Tentative talk of a "V" recovery took on the celebratory tone of a foregone conclusion, and some even spoke of a "super-V" recovery. But now the market has given back all the early January gains and then some -- all the major averages now show losses year-to-date. Suddenly the party's over, and it's time to sober up.

What happened? Actually *nothing* happened outside of what we have been predicting all along. The deflationary chickens have come home to roost. And there's nothing that sobers you up after a New Year's party as quickly as having a chicken roost in your champagne. The feathers and other things tend to ruin the flavor.

Alan Greenspan's speech of January 11 set the tone for the new sobriety. According to a story by the *Washington Post's* ace **Fed**-leaker **John Berry**, "Fed sources" were surprised by the market's negative reaction to Greenspan's speech. "Part of the confusion over the speech was due to the subtlety of Greenspan's intended message that the recession was likely to end soon, but that a quick, strong rebound was not assured."

While we often have much to criticize about Greenspan's conduct of monetary policy, this forecast for the economy is really very much like our own (see "The Green Eyeshade Recovery" by David Gitlitz, January 9, 2002). Things *have* stopped getting worse. They *aren't* getting better. What's so subtle about *that?* I suppose it's too subtle if you've talked yourself into a "super-V," in which case this is simply not a message you want to hear, subtle or otherwise.

What seems to be too subtle for Alan Greenspan, though, is *why* this is happening (see "Greenspan's Message, and Why It Clocked Stocks" January 14, 2002). His speech spun an elaborate fairy tale about rapid inventory cycles in the age of instantaneous access to business information, but it included scarcely a word about the monetary deflation -- of his own creation -- that has throttled the growth potential of the New Economy he himself has celebrated so often. It's really not so subtle -- all he has to do is admit it: "Honey, I shrunk the economy."

There's really no denying it anymore -- after all, last week the deflationary chickens roosted right in the headlines of the nation's newspapers as the Consumer Price Index registered a *negative* 0.2% reading.

The companies that are trying to operate in the deflated New Economy know that it's true. Tech giants like **Intel** and **Microsoft** may have beaten their quarters, but they still got beaten up by investors -- that's because spokesmen for both companies made explicit statements to the effect that they see no signs of global economic recovery -- not a "V," and certainly not a "super-V" -- and their guidance for the coming quarters reflected it: flat to lower. When technology stocks are priced near all-time historic multiples, forecasts like that are death.

Many Old Economy companies are finding even more feathers in their champagne from those deflationary chickens. For example, **General Motors** reported last Tuesday that its pension obligations had swung from being overfunded by $1.7 billion a year ago, to being *under*funded by $9.1 billion now. That's a $10.8 billion dollar negative swing in a single year -- and it's going to take $1.1 billion out of earnings in 2002, or $1.37 per share.

This happens to companies like GM because Inflexible unionized labor costs don't ratchet down with deflation -- and those costs flow directly into an ever-increasing pension obligation as workers accrue more and more claims on the pension plan through continuing service. At the same time, rates of return on pension assets fall in a deflation, as stock prices stagnate or fall and bond yields move lower. The GM plan showed an overall loss of 5.7% last year, versus actuarial assumptions that must be somewhere between positive 8% and positive 10%. Lowering these assumptions to more realistic deflationary levels -- a step that is probably inevitable at some point -- will make the value of pension liabilities on the balance sheet soar. It will *hurt.* And GM isn't the only one. I'll be writing more on this subject later in the week.

All these issues add up to a lot of chickens for just one week -- and a lot of unpleasant reality. There's a big fantasy structure still to come undone. It's based on the mistaken belief that, just because America rapidly recovered from the blow of September 11th, the economic consequences of years of monetary deflation will be just as quickly overcome. They won't be. And the market is starting to realize that.