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MACROCOSM

Leap Forward… or Leap of Faith?

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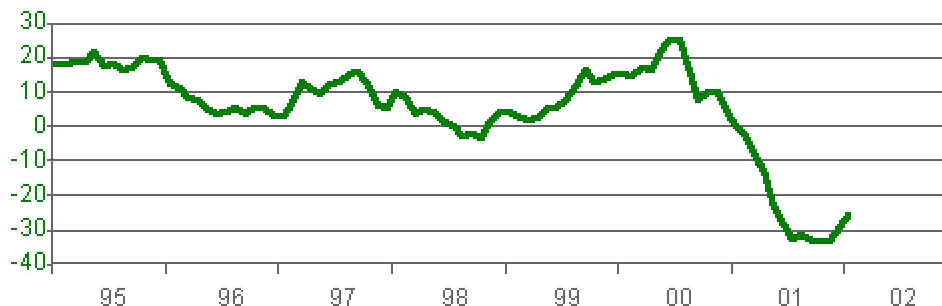
Happy days are here again? One would think so, judging by the press, pundit and market response to a smattering of positive data releases the past several days. The near-breathlessness of it all perhaps was captured best by **Reuters**, which within a matter of hours Friday afternoon moved two separate reports that were exemplars of barely restrained ebullience. “It's all but official: 'R' is for recovery, not recession,” said the lead of the first piece. “Is it a V? Is it a U? Whatever its shape, economists are getting ready to spell it R-E-C-O-V-E-R-Y,” said the second. Such sentiments, however, appear at this point to represent a leap of faith rather than a realistic appraisal of currently observable conditions. Indeed, overly optimistic extrapolations from preliminary readings of the available data could turn out to be a headlong leap into the shallow end of the pool.

At the same time, we do not overlook the potentially positive ramifications of the evident easing in deflationary pressures exhibited recently in the rising dollar price of gold and other commodities. We would caution, though, that the economic benefits of the softening in real dollar purchasing power seen thus far are likely to proven uneven across various sectors of the economy, and among companies within those sectors. To date, the jury remains out on whether the dollar easing seen thus far will have enough of an economy-wide impact to reduce risk premiums to levels that would be consistent with revitalization of a capital-rich environment essential to restoring robust risk-taking and innovation-led expansion.

New orders: computers and electronics

3-month moving average of 12-month percentage change



Friday’s **ISM** manufacturers’ survey capped last week’s flurry of positive data, with the overall purchasing managers’ index registering 54.7, the first reading in 18 months above the expansion/contraction 50 line. The production and new orders components of the ISM survey, meanwhile, spiked to levels above 60, unseen since the salad days of the late-‘90s boom. The ISM survey came on the heels of the January durable goods report, which showed new orders jumping a stronger-than-expected 2.6%. In the past three months, growth of new orders in the high-tech area of computers and electronics has surged at an annual rate of nearly 30%. All in all, a pretty impressive-looking start on a sustainable rebound in the economy’s hardest-hit sectors, right? Well, no… at least, not necessarily.

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The fact is that nothing in this data as yet confirms anything more than the potentially ephemeral uptick that would be expected following the unprecedented inventory liquidation of recent quarters. As excess inventories are drawn down to more normal levels, maintaining even subdued levels of business activity necessarily results in some increment of increased production and new-order activity. It should be noted, moreover, that these are bounces off extremely depressed levels. As recently as last November, new orders for computers and electronics were running more than 30% below prior-year levels, and are still down 25% year-on-year (see the chart on the previous page).

Fed Chairman Alan Greenspan underscored the transient effect of this bottoming in the inventory cycle in his congressional testimony last week, telling the **House Financial Services Committee**: "Stocks in many industries have been drawn down to levels at which firms will soon need to taper off their rate of liquidation, if they have not already done so. Any slowing in the rate of inventory liquidation will induce a rise in industrial production if demand for those products is stable or is falling only moderately." But he was quick to add that this "impetus to growth… will be short-lived" unless sustained increases in activity are seen before the effects of the inventory swing play out.

It's now a foregone conclusion that this turn in the inventory cycle will print large in first quarter GDP, which could show annualized "growth" of 3% or more. As a bookkeeping matter, that will close the books on last year's recession as one of the shortest and shallowest on record. We've pointed out here previously, however, that a *technical* end to recession should not be confused with sustainable expansion (see "A Green Eyeshade Recovery" January 9, 2002). And were a vibrant growth phase actually taking flight, we'd expect to see some confirmation of it in signs that risk capital was becoming more readily available. A rising capacity to absorb risk would indicate that the market expected the risk to be compensated by higher returns, *i.e.* faster growth. An environment characterized by a healthy risk preference is also essential if immature enterprises at the grassroots of entrepreneurial and innovative activity -- with the highest payoffs in terms of future growth potential -- are to have ready access to affordable capital.

In January, we concluded that then-current indications of a scarcity of risk capital presented significant obstacles to resumption of vibrant expansion (see "The Risk Aversion Hurdle" January 15, 2002). In the weeks since, despite increasingly widespread conviction that the economy has entered a recovery phase, those indicators have shown little if any improvement. January and February saw pricing of just 10 initial public offerings, the lowest total for the first two months of any year since 1979. The high-yield debt market remains moribund, with spreads actually widening from already elevated levels in the wake of the **Enron** scandal. There are some scattered signs of life in the venture capital space, with a smattering of start-ups receiving funding in the past couple months. The big story here, though, as discussed in Sunday's ***New York Times***, is that VCs are currently sitting on $75 billion in uninvested capital. For the most part, they are unwilling to part with the cash due to the highly uncertain prospects for future returns in an essentially inert new-issues market. The institutions which provide the funding as limited partners, meanwhile, are growing increasingly impatient over declining returns and fading prospects, and there is movement afoot to force the general partners to return some portion of their contributions.

Despite these evident hazards in the sustainable recovery-is-assured story line, this is not an environment likely to prove conducive to gains at the long end of the Treasury yield curve. Since the middle of last week, expectations for Fed action this year reflected in December Eurodollar futures have jumped from less than 125 basis points to more than 150 bps, pushing the long bond yield from 5.37% to 5.53%. While we think these expectations are significantly overdone, this probably isn't the time to fight the tape. Still, we see opportunity here in that given the

complete absence of inflation risk, the vulnerability of long-term issues is significantly less than that of the short maturities which respond most directly to Fed expectations. A curve-flattening trade structured to capture the asymmetry in downside risk -- more intense at the short end, less so at the long end -- appears to present a good bet. Today we will establish such as trade as one of the Model Positions that clients can track every day on our web site. TM