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David Gitlitz, Chief Economist

MARKET CALLS

Tech Hits the Wall

Wednesday, April 3, 2002
Donald Luskin

Recovery may be in the headlines. Recovery may be what the teevee talking heads are talking about. Recovery may even be reflected in the official economic statistics.

But there's precious little recovery in the forward earnings estimates for technology companies. Yesterday's NASDAQ sell-off, triggered by a warning from **PeopleSoft** and a **Goldman Sachs** mass grave of estimate cuts for **Microsoft**, **IBM**, **Sun Microsystems**, **Siebel Systems** and **EMC** should have made that abundantly clear to even the most hopeful investors.

Consensus forward earning estimates for the S&P Information Technology sector bottomed at $37.5 billion last October, down from a peak of $95.6 billion in September, 2000. By the end of February 2002 they had recovered to $45.3 billion -- but now they've stalled out, falling back to $45.1 billion at the end of March.

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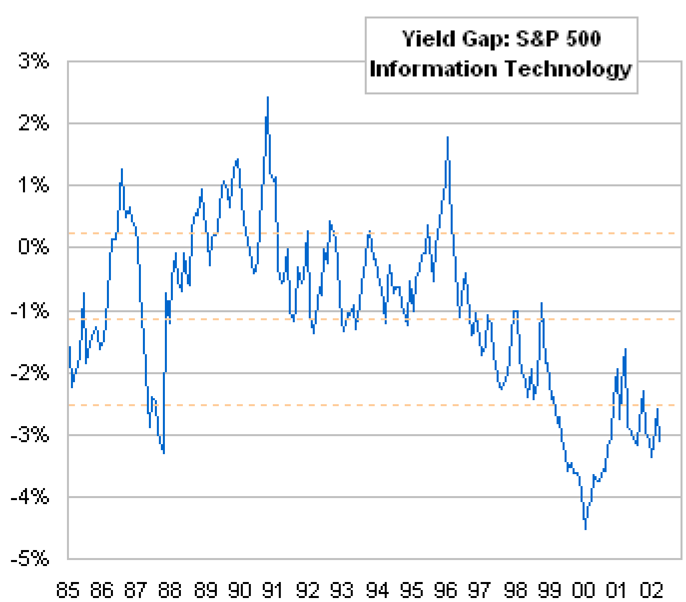
This can be seen as the ground-level manifestation of the still-depressed expected returns to capital that continues to devastate the technology sector. **Trend Macrolytics Chief Economist David Gitlitz** will have a full analysis of these constraining forces forthcoming shortly. But whatever the reasons, this stall-out is one that techstocks can ill afford -- because they are very richly priced after their recovery from the September lows. Prices are anticipating nothing less than a super-V earnings rebound.



As we have been reporting since last December, the rich valuation of technology stocks is reflected in the fact that their earnings yield is far below the coupon yield of long-term bonds. Over history this "yield gap" has averaged negative 1.1%, with a standard deviation of 1.4%. Today it is negative 3.0% -- a level exceeded only two times previously -- just

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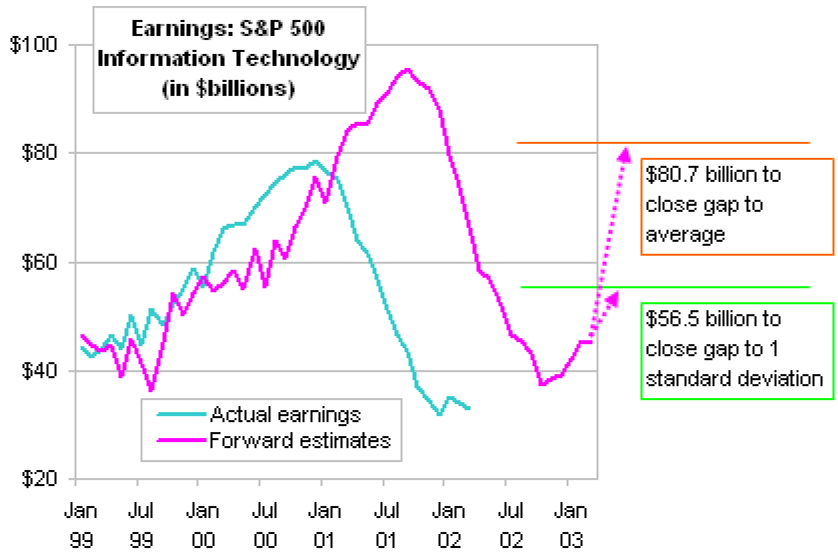
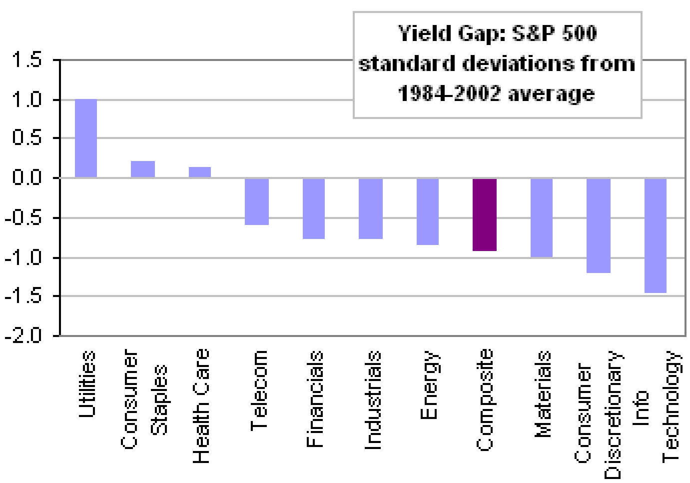
before the crash of 1987, and at the top of the so-called bubble in early 2000. Last December 10, when the yield gap reached 3.6%, we recognized a major disequilibrium and declared the markets to be "Vay Out of Vack, Even for a 'V'".

At that time we established a model position to profit from this disequilibrium, a tactical asset allocation trade shorting the NASDAQ 100 and buying long-term Treasuries. For fully-invested equity managers who cannot short technology stocks nor buy bonds, we have suggested underweighting technology stocks and replacing them with non-cyclicals. With the NASDAQ 100 off 14.3% (and bonds delivering a total return of 0.8%, and the S&P 500 only off 0.3%), this strategy has already yielded significant profits at the same time as it has reduced portfolio risk.



But it is not too late -- while the yield gap has narrowed from negative 3.6% to negative 3.0%, it is still very negative by historic standards. And the stall-out in upward earnings revisions stands in stark contrast to the kind of surge it would take to justify today's rich valuations. To bring the yield-gap back to its long-term average of negative 1.1%, forward earning estimates would have to be revised up from today's $45.1 billion to $80.7 billion -- that would top the $74.0 billion all-time high in realized earnings attained for the twelve months ending December, 2000. Just to bring the yield-gap back to within a single standard deviation from its long-term average would take a revision up to $56.5 billion.

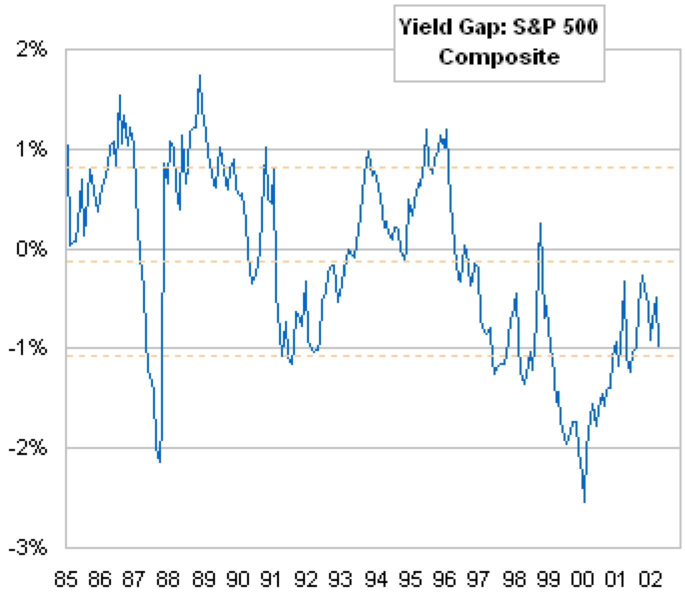
If such dramatic upward revisions were to occur, that would not mean that techstocks would necessarily be priced any higher than they are today. Quite the contrary -- these absurdly large revisions are what is required *to justify the prices at which techstocks are already trading today!*

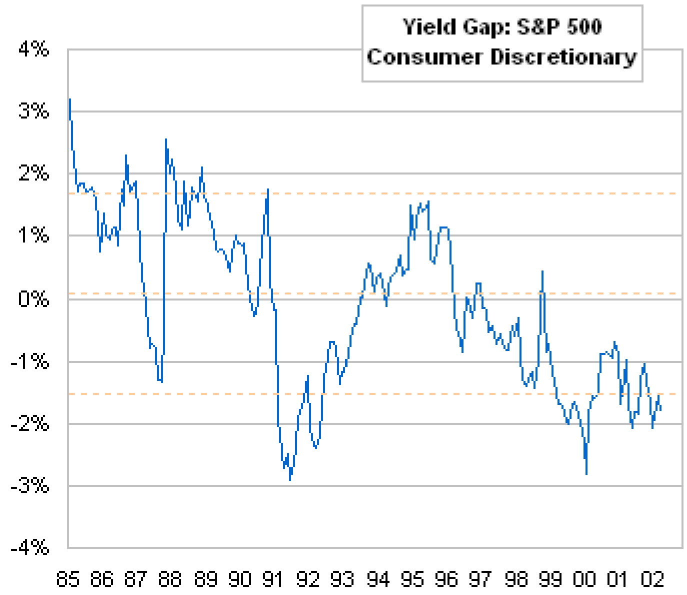


The technology sector is the most extreme example, but most sectors (and the overall market) are at least somewhat overvalued according to our yield gap analysis. The table at left shows all the S&P sectors (and the S&P 500 Composite) ranked from most undervalued to most overvalued, based on the number of standard deviations their respective yield gaps are from their respective long-term averages. Attached at the end of this report, please see complete historical yield gap charts for each sector, current through the end of the first quarter of 2002. As a general observation, the riskiest and most cyclical sectors are the most overvalued, and the least risky and most non-cyclical are most undervalued.

This strongly suggests that equity investors are willing to pay a hefty premium to bet on economic recovery. But when premiums like this are paid, the bets are rarely profitable -- even when the bettor "wins." As every casino operator knows, it makes more sense to take the other side.

But that doesn't stop techstock investors from seeking the lost glories of 1999 and 2000 -- seemingly no matter how violently they must be taught that those days are gone. When it comes to techstocks, there's a seeker born every minute. TM


Yield Gap: S&P 500
Composite
2%
1%
0%
-1%
-2%
-3%
85 86 87 88 89 90 91 92 93 94 95 96 97 98 99 00 01 02


Yield Gap: S&P 500
Consumer Discretionary
4%
3%
2%
1%
0%
-1%
-2%
-3%
-4%
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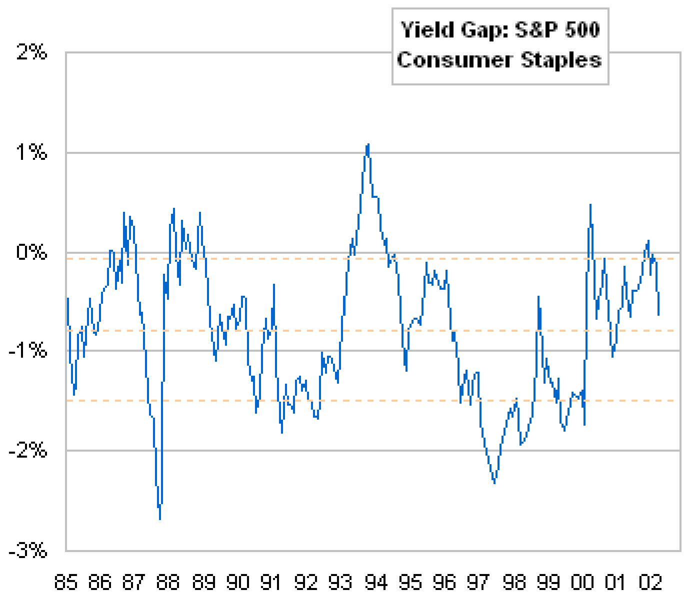
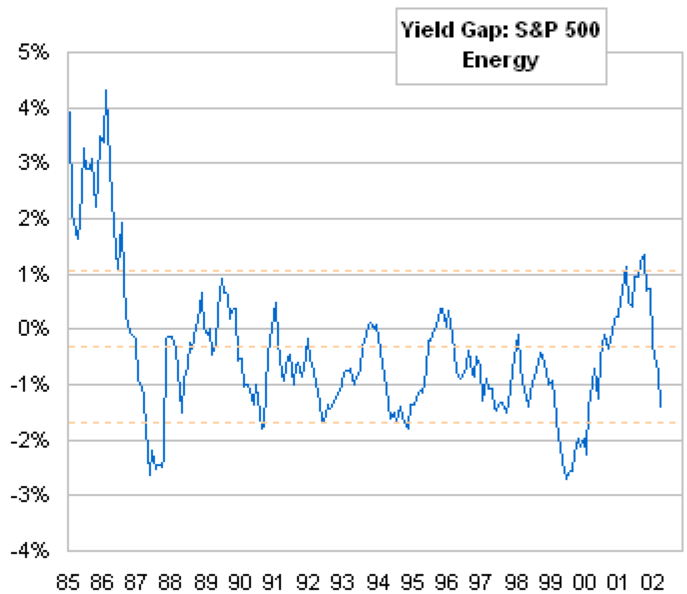
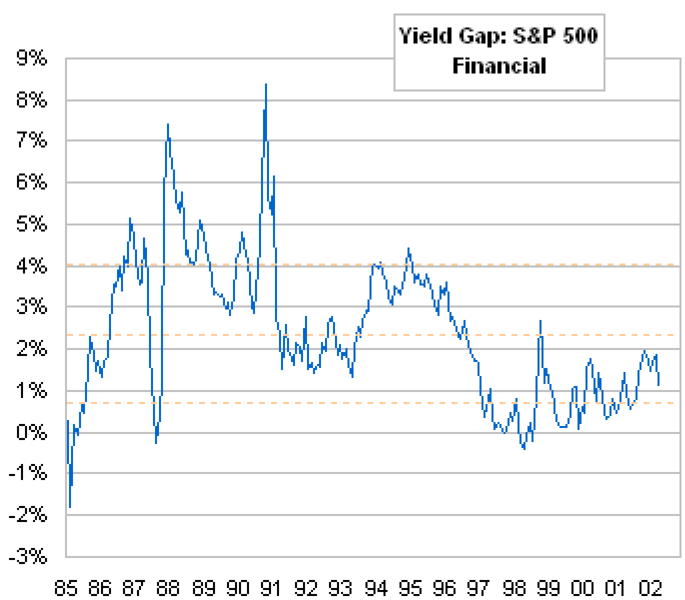
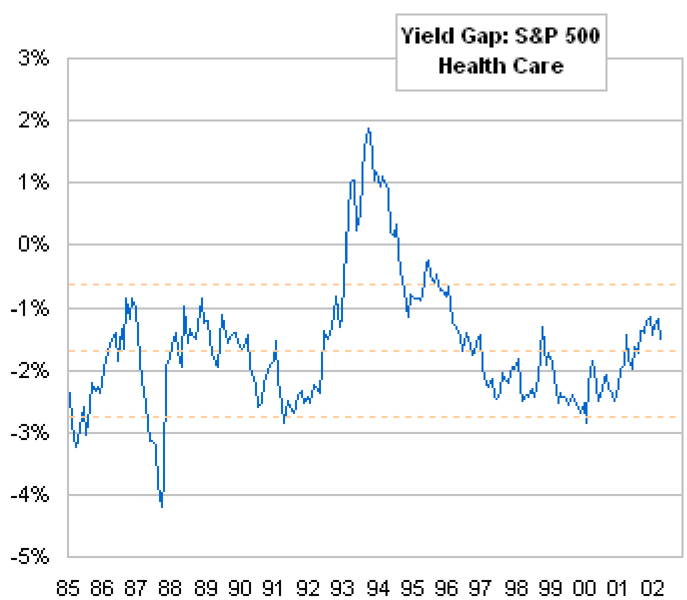

Yield Gap: S&P 500
Consumer Staples
2%
1%
0%
-1%
-2%
-3%
85 86 87 88 89 90 91 92 93 94 95 96 97 98 99 00 01 02


Yield Gap: S&P 500
Energy
5%
4%
3%
2%
1%
0%
-1%
-2%
-3%
-4%
85 86 87 88 89 90 91 92 93 94 95 96 97 98 99 00 01 02


Yield Gap: S&P 500
Financial
9%
8%
7%
6%
5%
4%
3%
2%
1%
0%
-1%
-2%
-3%
85 86 87 88 89 90 91 92 93 94 95 96 97 98 99 00 01 02


Yield Gap: S&P 500
Health Care
3%
2%
1%
0%
-1%
-2%
-3%
-4%
-5%
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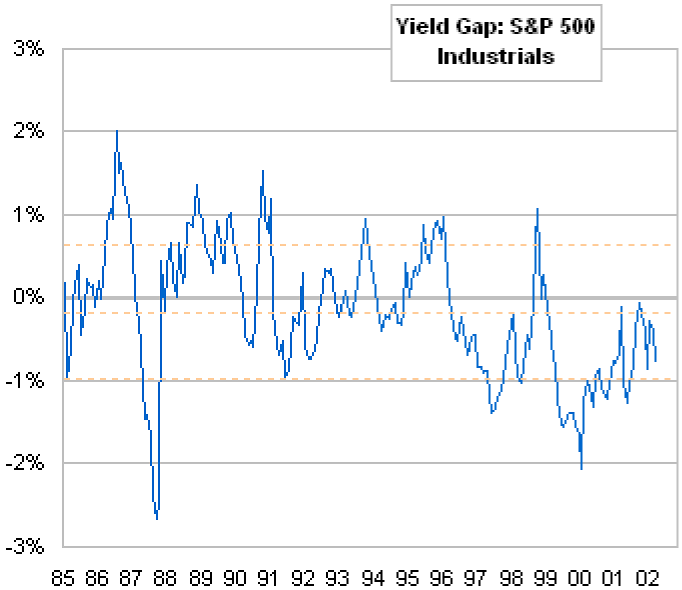
Yield Gap: S&P 500
Industrials
3%
2%
1%
0%
-1%
-2%
-3%
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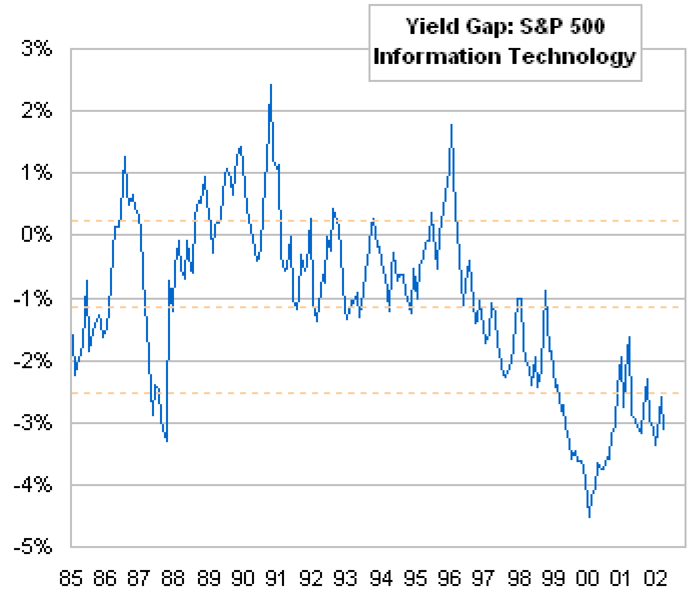
Yield Gap: S&P 500
Information Technology
3%
2%
1%
0%
-1%
-2%
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-4%
-5%
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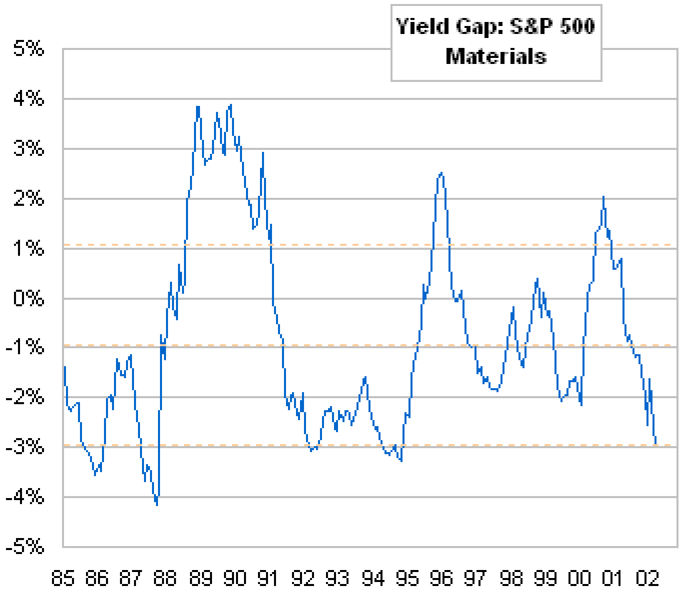
Yield Gap: S&P 500
Materials
5%
4%
3%
2%
1%
0%
-1%
-2%
-3%
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-5%
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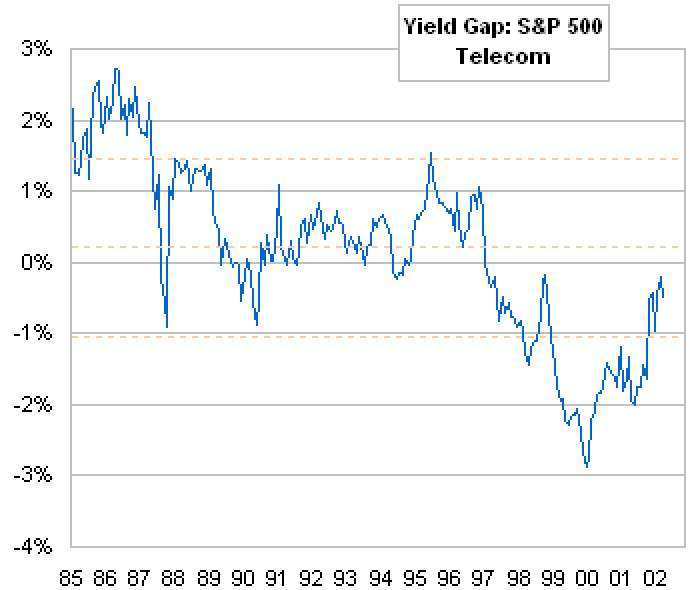
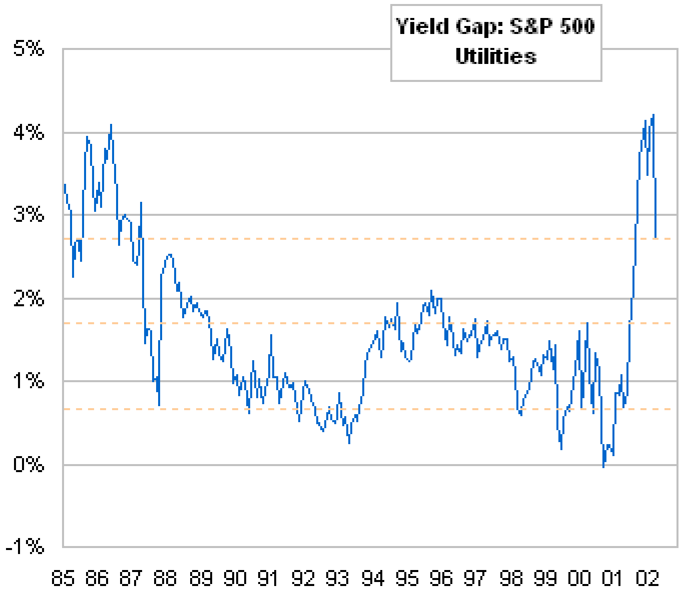

Yield Gap: S&P 500
Telecom
3%
2%
1%
0%
-1%
-2%
-3%
-4%
85 86 87 88 89 90 91 92 93 94 95 96 97 98 99 00 01 02


Yield Gap: S&P 500
Utilities
5%
4%
3%
2%
1%
0%
-1%
85 86 87 88 89 90 91 92 93 94 95 96 97 98 99 00 01 02