

MACROCOSM

Time For a Reality Check

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David Gitlitz

For nearly every encouraging piece of news or data suggesting the economy is on track for a recovery worthy of the name, another one, it seems, raises fresh doubts. Probably the biggest news in today's employment report, for example, was the revision to last month's data that wiped out what initially had been regarded as a surprisingly strong gain in payrolls.

At the same time, the February factory orders report published Tuesday was widely expected to advance the manufacturing-recovery scenario implied by last week's durable goods release and Monday's **ISM** purchasing managers survey. Instead, an unexpectedly sharp 2.4% decline in nondurables orders pulled down overall factory orders, which remained not only below their pre-9/11 levels last August, but were down \$9 billion (2.7%) relative to the post-attack bounce-back levels of October. Of course, as we noted last week, beyond the headline gain of 1.8%, even durables orders were far from stellar. Stripping out the transportation sector, which can show extreme month-to-month swings, new orders for durable goods fell 1.3%, with high-tech capital goods particularly hard hit. Semiconductor orders fell nearly 9% on the month and remain down 24.5% year-on-year. New computer orders fell 4.5% and lag year-earlier levels by some 30%. For the high-tech computer and electronics sector as a whole, new orders at \$33.3 billion were just \$1.4 billion above their October levels, and are still down 21% year-to-year.

For the most part, we tend to view such backward-looking official data as offering only slightly more useful information than one would glean reading yesterday's newspapers sometime next month. In the current context, though, the data can serve a useful function as a reality check on the emergent view that the investment-boom of the late 1990s only took a brief hiatus, and is now roaring back to life. That sort of wishful thinking appears based on a belief that the technological advances of last decade laid the foundation for long-lasting economic gains, which are now being reasserted as if by force of nature. In truth, we share much of the enthusiasm for the transforming potential of technological innovation, and agree that the bulk of the IT revolution's economic payoffs still lie ahead. But the sanguine view of the present environment overlooks several inconvenient facts about the conditions which gave rise to the dynamic late-'90s expansion -- and which remain absent today.

Most critically, the surge of technology investment was part and parcel of a capital-rich environment that both spawned an accelerated pace of entrepreneurial innovation and sped the capital stock's adaptation to the productivity-boosting technological improvements. The declining cost and increased availability of capital, in turn, were the product of a fiscal and monetary policy environment that reduced risks to capital and raised real expected after-tax returns. That extraordinarily positive setting for risk taking, wealth creation and capital formation, however, came to be viewed with alarm by monetary policy makers convinced that the rising expected returns to capital were feeding a labor shortage sure to spur a bout of "wage inflation." **The Fed's** 1999-2000 tightening campaign was the result, deepening a deflationary shortage of dollar liquidity and imposing a steep risk premium in the cost of capital that wiped out trillions in new wealth. Despite 475 basis points in rate cuts last year and indications of some relief from a

deflationary dollar scarcity, real signs of a return to health in the market's capacity to absorb risk remain scant.

NASDAQ/Dow Ratio



The NASDAQ/DJIA ratio over the years has proved a useful gauge of the market's risk tolerance and a proxy for expected returns. That is, the weighting of the aggregate portfolio will shift toward riskier NASDAQ issues relative to the lower-risk DJIA stocks when the increased risk is expected to be compensated by higher returns -- i.e., faster growth. As can be seen in the nearby chart, after falling to nine-year lows in the 9/11 aftermath, the NASDAQ/Dow ratio rallied by more than 20%, but has now returned to levels witnessed in the post-attack rout. Even at that, as **Trend Macrolytics chief investment officer Donald Luskin** points out, there is good reason to believe that valuations in the techstock universe, which the NASDAQ benchmarks, remain significantly stretched. Perhaps the ambiguity of today's recovery prospects is reflected in the fact that while less risky assets remain the dominant part of the market portfolio, more risky assets are valued at unrealistic levels. What should be clear in any case is that present market conditions bear little resemblance to the climate of risk preference and rising expected returns that drove the powerful investment-based expansion of the second half of last decade.

Nor do we see signs in grassroots capital formation activity suggesting more robust conditions are yet taking shape. Venture capital investment in the first three months of this year declined for the seventh consecutive quarter, with 445 companies receiving a total of \$5 billion in venture funding, according to **VentureWire**. That compares with the fourth quarter last year, when 628 firms raised \$6.7 billion. At the other end of the venture pipeline, perhaps the best that can be said is that it's always darkest before the dawn. A total of just four venture-backed IPOs came to market in the first quarter, raising \$376 million, according to **Thomson Financial/Venture Economics** and the **National Venture Capital Association**. That pales not only against the heady experience of the late '90s, but also looks weak relative to already depressed levels a year ago, when 9 venture-financed firms priced \$650 million in IPOs. "The sluggish IPO market continues to be troublesome to the venture capital community as it is one of two vehicles -- the other being the M&A market -- that enables venture capitalists to realize liquidity," **Mark Heesen**, NCVA president, said in a statement yesterday. "Overall performance of venture funds will not improve significantly until entrepreneurial technology companies can once again raise capital in the public markets." It is no surprise, then, that some of the large institutional investors who supply the preponderance of capital to VC funds are now demanding the return of their money that has not yet been invested -- further reducing the stock of available risk capital at the input end of the pipeline of industrial growth.

There is, though, one moderately encouraging bit of news in the midst of this otherwise disheartening environment. Increasingly, Fed policymakers are drawing a clear distinction between an inventory-driven "recovery" that is likely to show up as a strong quarter for reported GDP growth, versus conditions required to lay the foundations for sustainable expansion, of which few are now visible. As a result, market expectations of the Fed beginning a rapid reversal of the bulk of last year's rate cuts are steadily being whittled away -- just as we have repeatedly predicted they would. Eurodollar futures which early last week were pricing for 200 basis points in rate increases by year-end, are now forecasting between 150-175 bps in hikes. Odds are that those expectations will continue to dissipate. While unlikely in itself to restore the market's capacity to capitalize future income streams, there will at least be one less obstacle. **IM**