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Oil, the Middle East, and IBM

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Now that **oil** prices have retreated below their levels of two weeks ago when they first jumped on eruption of the **Israeli-Palestinian** crisis, perhaps the V-shaped recovery true-believers will be deprived of yet another rationalization for the increasingly likely demise of their vision. Given the lackluster response of equity markets as petroleum prices moved lower this week, it appears that portfolio investors have more pressing issues to contend with than what may well turn out to be a fleeting price spike.

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Expectations and Realities for Earnings Season
by Donald Luskin
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Certainly, we don't minimize the potential for significant economic disruption arising from the Middle East conflict, and agree that that potential has been a factor, at the margin, in the market discounting a somewhat higher risk premium in equity assets. And, no question, rising crude oil prices are the primary vector of that risk. Somehow, though, the alarms of analysts and pundits with the most at stake in the nascent-boom story seemed somewhat disproportionate relative to the risks at hand. Cries issuing from the V-recovery camp last week as oil hits its recent peak near $28 per barrel suggested the price increases could extract as much as $40 billion from U.S. GDP this year. But such a judgment issued on the basis of one or two days (or even one or two weeks) of pricing behavior is virtually meaningless.

The economic effects of price changes in a commodity as integral as oil are cumulative, and therefore best viewed over some relevant time frame. On a 13-week moving average, NYMEX light crude has risen from less than $19.50 per barrel in early February to just above $22 currently. Were prices to be sustained around current levels above $25 or move significantly higher, the economic impact obviously would grow. Futures markets, however, are suggesting prices are more likely to fall from current levels, with the December contract now priced at less than $24.

While the macro impact of such a move would not be entirely trivial, by far the more relevant downside risk to the V-recovery scenario was highlighted by **IBM's** warning earlier this week that it would miss first quarter profit expectations by some 20%. Particularly troublesome is that IBM's expected shortfall is concentrated in its Technology Group, which supplies semiconductors, storage drives and other components to producers of high-tech capital goods. IBM said it expects the unit to post a loss of $200 million on the quarter, on a revenue decline of some 35%. IBM's announcement represents compelling ground-level corroboration that the anticipated capital-investment recovery, key to any sustainable expansion taking root, remains on hold. Indeed, Big Blue's warning may have been the most eye-catching, but it is only one of any number of indications that the tech sector remains in deep malaise. Also this week, for example, **Thomas Seibel**, CEO of enterprise software manufacturer **Seibel Systems**, suggested that the first quarter may have been the worst in the history of the industry. "The contraction is not over," he said.

It's important to recognize that concern over a resumption of high-tech investment activity is far more than a matter of waiting for more dollars to show up in the "investment spending" tables of the national income accounts so as to boost reported GDP growth. Expansion of the capital stock amounts to an expansion of the economy's ability to produce future income. To the extent that recent technological innovations have enabled more efficient deployment of the existing capital base, their widespread adoption is tantamount to growth in productive capacity. It is axiomatic, however, that producers will add productive factors -- capital and labor -- only to the extent that marginal expected returns justify the marginal cost. The fact that technology investment shows few signs yet of breaking out of the doldrums also suggests that expected returns have yet to recover sufficiently to support the commitment of investment resources. Those expectations, moreover, are in an important sense both self-fulfilling and self-reinforcing. With **General Electric** reporting this morning expected pro-forma earnings against lower-than-expected revenues, it is clear that technology end-users prefer cost-cutting to technology expenditures. The fact that anticipated growth does not yet justify increased investment is another way of saying the cost of capital remains too high to support the real investment activity essential to producing future growth. TM