TrendMacrolytics

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Twists and Turns on the Road to Reflation

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Reflationary impulses are taking hold, reducing risk aversion and brightening prospects for continued recovery. But is the news good enough for US equities?

For an equity market hungry for reassurance that last week's welcome bounce wasn't just the latest in a long series of bear-market head-fakes, immediate prospects appear less than propitious. Although last week's nearly 9% NASDAQ rally was aided considerably by better-than-expected retail sales results, for example, there's not much doubt that prospects for the beleaguered tech benchmark hinge on resolution of still-critical economic uncertainties. On that score, the best consensus opinion has to offer at this point is the hope that the early traces of economic recovery seen in various consumption indicators will be confirmed by a hearty upturn in capital investment sometime before the end of this year. Few of those making that case, however, offer a rationale that goes much beyond the notion that capital spending always picks up once recovery is in place and profits are growing. That line of reasoning is less analysis than truism, and says nothing about the factors that actually will determine whether early traces of recovery mature into sustained expansion characterized by the reawakening of a robust environment for capital formation and risk taking.

We have maintained that the uncertain economic outlook is primarily a hangover of **the Fed's** deflation errors of the past several years, which destroyed trillions of dollars worth of capitalized wealth and crippled the market's capacity to absorb risk. The glacial pace of recovery in capital spending can be seen as one consequence of a lingering deflation risk premium in the cost of capital. But that premium, a reflection of the higher risk attached to future returns due to the Fed's calamitous monetary stringency, is not only restraining corporate purchases of state-of-the-art IT gear. Perhaps even more important is the effect it has had restricting availability of the capital crucial to breathing life into the entrepreneurship and innovation from which growth-enhancing technological advances spring forth.

While those obstacles certainly have not been conclusively cleared from the financial scene, the deflation relief implied by the 12% rise in the dollar price of gold since the beginning of the year is starting to show signs of taking hold in a variety of ways. A purer read on the deflationary impact of the Fed's dollar shortage, and the extent to which it has eased in the past few months, can be gleaned from indicators in certain key overseas markets. Hong Kong, by virtue of maintaining a fixed exchange rate with the dollar, is essentially at the mercy of US monetary policy. With a shorter maturity of debt and a less "sticky" pricing structure due to its more *laissez-faire* regulatory environment, Hong Kong price gauges are considerably more responsive to changes in the dollar's relative strength or weakness than are those in the US. Between mid-1998 and the end of last year, the Hong Kong CPI fell by more than 12%, and was declining at a year-on-year rate of 3.5% as of January. Since then, Hong Kong's deflation appears to have broken, with the CPI turning up marginally in February and March (the April figures will be released this week).

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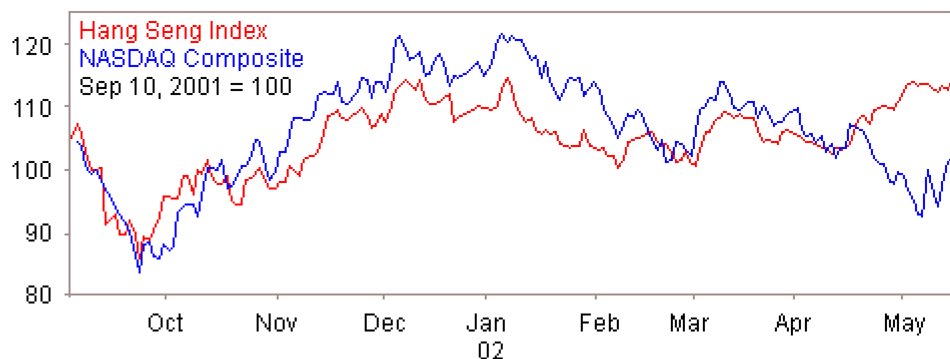

It appears that the dollar's reflation is now having a positive influence on Hong Kong stocks. The accompanying chart plots the NASDAQ against Hong Kong's Hang Seng equity market benchmark, indexed to September 10, 2001. While the two moved nearly in tandem over the first seven months of that period, in mid-April the Hang Seng started to break away. Since then it is now up by about 6% while the NASDAQ, even after last week's rally, is down more than 6%.

On the domestic front, over the past several months we have detailed the degree to which a stubborn risk aversion continued to cast doubt on notions that a robust, V-shaped expansion was in the offing. While it would be premature to proclaim that a corner has been turned in that regard, there are some early hints that the market's risk propensity is in the process of being restored. The market for initial public offerings, having suffered through one of its worst quarters in the past 20 years, is showing tentative signs of life. After just 17 deals worth $9.3 billion were priced in the first three months of this year, the past few weeks have witnessed a noticeable pick-up in the pace of both filings and new offerings. Clearly, no one is confusing current conditions in the IPO market with the heady days of the late 1990s. The most that can be said is that the window for new offerings is slowly reopening for selected enterprises that have won the confidence of a shell-shocked IPO investment community. Still, that represents progress and, provided it continues, indicates that relief from deflation pressures and the onset of reflationary impulses is allowing the market to begin absorbing a degree of risk that should be consistent with a moderate expansion taking root.

Whether that translates into significant upside opportunity in US equities, however, is another question. As the analysis conducted by **Trend Macrolytics chief investment officer Donald Luskin** since late last year has shown, equity prices -- particularly in the tech sector -- were priced for an earnings recovery defying the outer limits of historical experience. For sure, the market's erosion over the past four and-a-half months has taken out a good portion of the earlier extremes of overvaluation. Even when combined with the positive influences arising from the subsiding of deflation risk and the beginnings of a reflationary thrust, however, it's not at all apparent that equities have much headroom at these levels. It seems more the case that earnings will enter a long, gradual process of catch-up with valuations which, while limiting downside risk, is unlikely to provide much of a foundation for maintaining a rally footing for any extended period.

There also is little question that in significant segments of the financial system, the pain of the deflation aftermath continues as a growth-limiting factor. For below investment-grade borrowers, credit remains scarce, and spreads -- while down substantially from their worst levels -- still present an imposing hurdle. And for businesses without the wherewithal to access the securities markets, it appears that nothing less than a credit crunch is now unfolding. Commercial and industrial lending, after briefly spurting higher in the early weeks of this year, has fallen by some $25 billion since February and is now declining year-on-year at a rate of 7.8%, the fastest rate of contraction since the Fed began keeping the series in the early 1970s. The Fed's most recent survey of senior loan officers released earlier this month found that the percentage of banks

reporting tighter lending standards fell in April from levels in January (to 25% from 45%), but remained at levels suggesting borrowing conditions remain stringent. "In the current survey, three quarters of domestic and foreign respondents cited reduced tolerance for risk as a reason for tightening their lending policies," the Fed reported. "About 70 percent of domestic banks also indicated that a less favorable or more uncertain economic outlook was reason for changing their standards and terms over the past three months." TM