TrendMacrolytics

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MARKET CALLS

A Techless Recovery?

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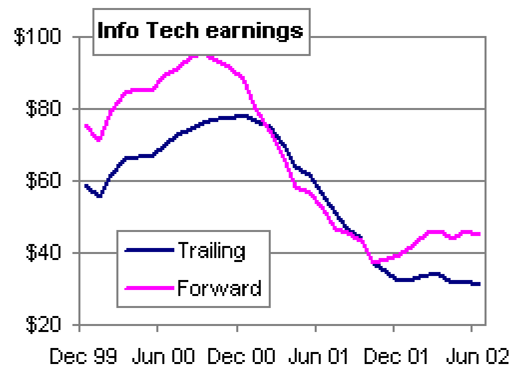
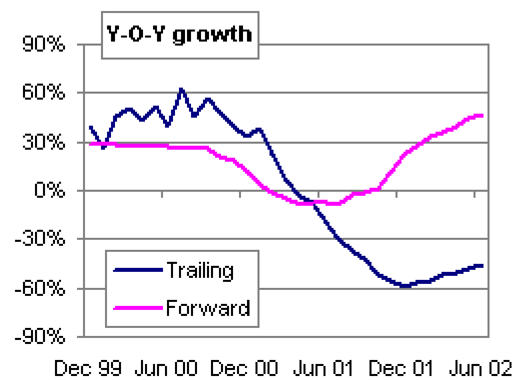
In tech, recovery is elusive and stocks are still rich. The Old Economy is now the engine of recovery -- and it's cheap.





Trailing earnings for the Information Technology sector continue to make new lows, falling 3.42% in June month-on-month to $30.9 billion -- a drop of 60.6% from the peak achieved in December 2000.

The only good news is that the *rate* of earnings deterioration has slowed -- year-on-year comparisons troughed at negative 59.1% last December, and have now improved (if you can call it that!) to negative 45.5%.

At the same time as trailing earnings have continued to drift lower, consensus forecasted earnings have remained stable at about $45 billion. That means the gap between trailing and forward earnings has been steadily expanding throughout the year -- and *that* means that forecasted growth rates have been steadily rising. At month-end June, forecasted earnings growth for the Information Technology sector measured this way stood at 46.3% -- which is even higher than it was at any time during the so-called "bubble" of 1999 and 2000.

There would seem to be little evidence to support these growth expectations. Many of the largest tech companies warned ahead of the upcoming earnings season -- and even the ones who have reaffirmed forecasts have suggested that they see no recovery in the near future.

And there's little comfort to be found in official government data -- it offers a mixed bag on whether any recovery in capital investment is taking hold sufficient to breathe life back into the high-tech economy. New orders for non-defense capital goods (excluding aircraft and parts) grew by just 1.3% over March-May, the most recent three-months for which data is available, which is actually below the 2.1% growth rate of the previous three months.

On the bright side, such as it is, **Federal Reserve** data shows industrial production in the high-tech sectors of computers, communications equipment and semiconductors in May was 3.7% higher than year-ago levels, the first measurably positive year-on-year comparison in more than

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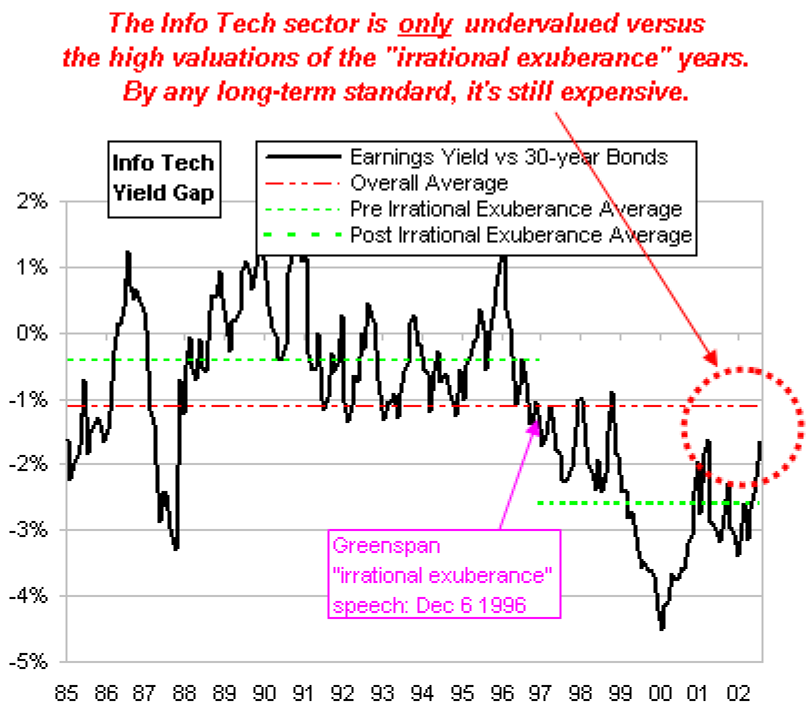
a year. That's a somewhat misleading show of strength, though, because at this time last year the collapse in high-tech output was accelerating rapidly. More than likely, year-on-year growth rates for high-tech production will continue to show significant gains over the next several months due -- if nothing else -- to the fact that it was sliding so precipitously during the same months in 2001. If tech output does nothing more than tread water for the next three months, it will post year-on-year growth of more than 10% by August.

Still, that means activity in technology industries at least has come off its worst levels. For the March-May period, production expanded at an annualized rate of about 15%. In December-February, however, annualized growth in the tech sectors had registered about 25%. To some extent, this data is being skewed by the telecommunications sector, which exists in its own parallel universe of devastation. Abstracting out the telecom component of the data, semiconductor manufacturing registered an annualized growth rate of about 20% for the three months, while computers and office equipment showed growth at about an 18% annual rate. Again, though, that is appreciably slower than the growth rate for both sectors in the previous three months, hardly the norm for the early stages of economic recovery.

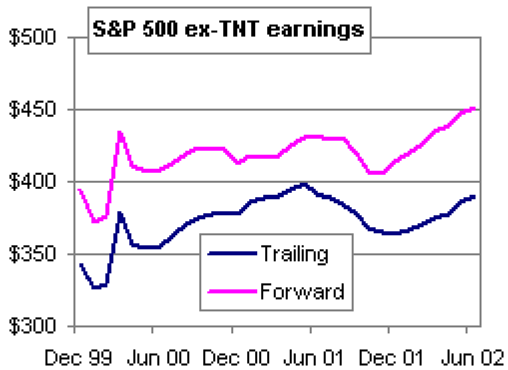


And, it would seem, hardly the stuff of which 46.3% earnings growth is made. And yet even if we take such an unlikely growth rate as given, technology stocks remain richly valued. Our metric for valuation is the "yield gap" -- the amount by which the forecasted earnings yield of stocks exceeds the yield of long-term Treasury bonds. Earnings yields are normally less than bond yields -- but when the "yield gap" is more negative than usual, this suggests that stocks are overvalued.

By this metric, the Information Technology sector is valued today about as it was in April 2001, and a little cheaper than it was in September 2001 -- both launching points for sharp but ultimately unsustainable bear-market rallies. This puts tech sector valuation at the bottom of the abnormally high valuation range that has characterized the "irrational exuberance" epoch. But at the same time, today's tech sector valuation is still somewhat rich by longer-term historical norms, and *very* rich by the standards of the pre-"irrational exuberance" epoch.

And remember: this valuation tool takes forward earnings -- which now assume a 46.3% earnings growth rate -- as given. If that growth rate is unrealistically high, then the tech sector is, in fact, *even more* overpriced.

This leaves us with a tale of two economies. For the Information Technology sector (and the Telecom sector, too) it is still very much the worst of times. But for the rest of the economy, it's very nearly the best of times. The Old Economy -- the S&P 500 *without* the Information Technology and Telecom sectors -- has already virtually recovered from its earnings recession.

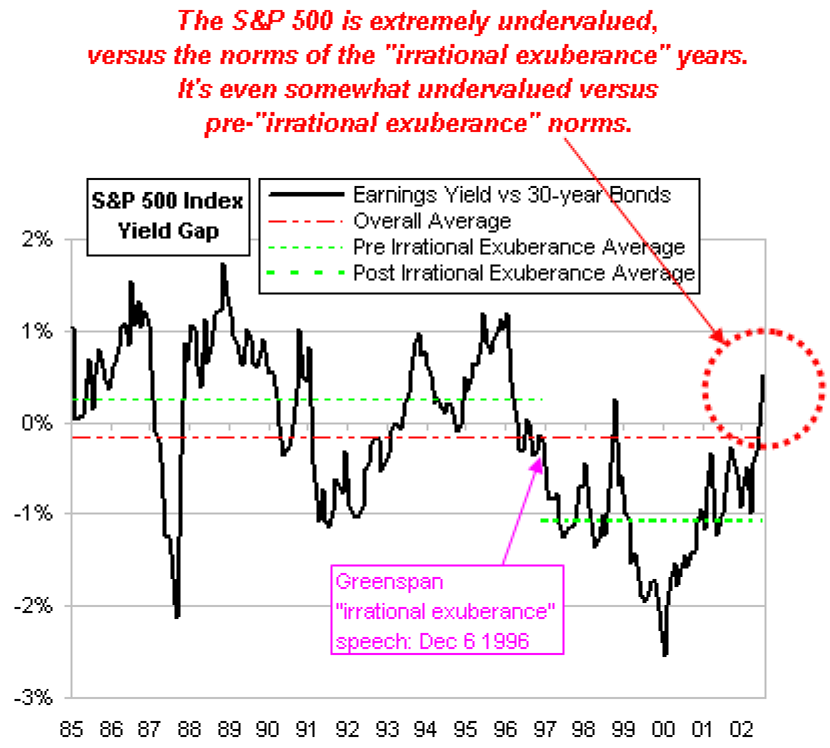


Trailing 12-month earnings grew 1.0% in June month-on-month, clocking in at $390 billion.

That's just 2% below the all-time peak of $398 billion achieved in May 2001. Forecasted earnings grew 0.9%, making a new all-time high at $452 billion, and implying an expected earnings growth rate of 15.9% for the coming year.

Clearly the much-vaunted New Economy is not leading the overall economy out of recession. If anything, it is the Old Economy that may have to pull the New Economy up out of its own separate depression. But can an economic recovery that is *not* led by technology generate 15.9% growth for the Old Economy?

If it can, then the market overall looks *very* attractively valued. According to our "yield gap" metric, the market is cheaper than it was after 911, and cheaper than it was in the panic of October 1998. It's cheaper than it's been at any time since February 1996 -- before the dawn of the "irrational exuberance" era.



We remain quite encouraged by signs that the deflationary pressures that ushered in the present recession are finally abating. And we are emboldened by temptingly cheap valuations outside the tech sector. At the same time we remain concerned that valuations are underpinned by growth expectations that may not be realistic in a recovery that seems to be leaving the technology sector behind. Therefore we remain comfortable with our relatively unaggressive Model Positions in equities -- a small long position in the S&P 500, and a small short position in the NASDAQ 100 (against a long position in long-term Treasuries). As earnings season unfolds and valuation dynamics continue to evolve over the next couple of weeks, we expect we will find opportunistic points to adjust both positions. TM