TrendMacrolytics

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Muddling Through

Tuesday, August 6, 2002

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It wasn't as good as everyone hoped in the first quarter. So it's not as bad as everyone fears now.

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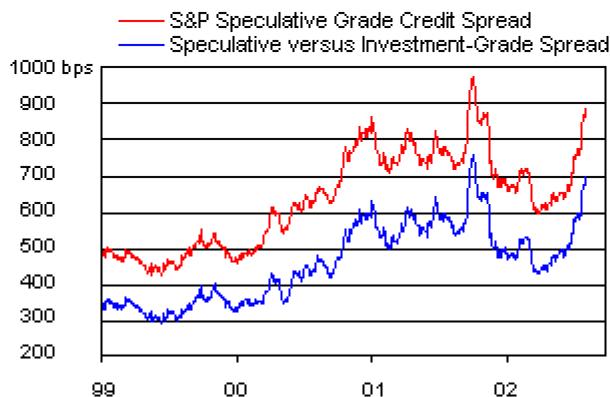
While we were highly skeptical of the euphoric "V-shaped recovery" fever that gripped the economic consensus earlier this year, the current bout of "double-dip" anxiety seems nearly as overwrought. Our analysis since early this year has held that while the major recessionary forces of massive inventory liquidation and plunging capital spending had likely come close to running their course, continued risk aversion was likely to thwart a rapid return to vibrant economic health (see "Where's the Risk?" April 23, 2002). Our view that outright economic contraction was probably over -- but that the recovery, at least in its early stages, was likely to be quite unimpressive -- has for the most part been borne out in the data available thus far.

Last week's advance estimate of a 1.1% second quarter GDP growth rate, and the restatement of first and second quarters of 2001 to show negative growth, were nearly universally viewed as highly discouraging, coming on the heels of the first quarter's 5% pace (revised down from 6%). But our perspective is somewhat more sanguine. We have said all along that the recession began earlier and was more serious than was being captured by official statistics. And we pointed out that the reported "blistering growth" in first quarter was dominated by a statistical mirage -- the sharply reduced pace of inventory liquidation and a surge in government spending (see "That Was the Quarter That Was(n't)" May 28, 2002). Without that mirage, the 1.1% second quarter GDP growth rate actually reflected expansion of real private economic activity on a par with, or even stronger than the first. At the very worst, adjusting for the accounting artifacts that artificially lifted first quarter growth, the deceleration of the second quarter appears far less dramatic. All this suggests that much of today's double-dip speculation may be rooted in nothing more than disappointment over the sorry fate of the V-shaped recovery scenario, which garnered more credibility than was ever warranted by the first quarter data.



None of that is meant to suggest that we are in now an environment of negligible macro-economic risk. The market's risk propensity shows little sign of recovery. Access to the debt markets is for all practical purposes closed to all but the "safest" borrowers, with the S&P speculative-grade credit spread now at its widest point since the immediate aftermath of 911. The extent to which access to capital is biased against higher-risk immature enterprises with the highest

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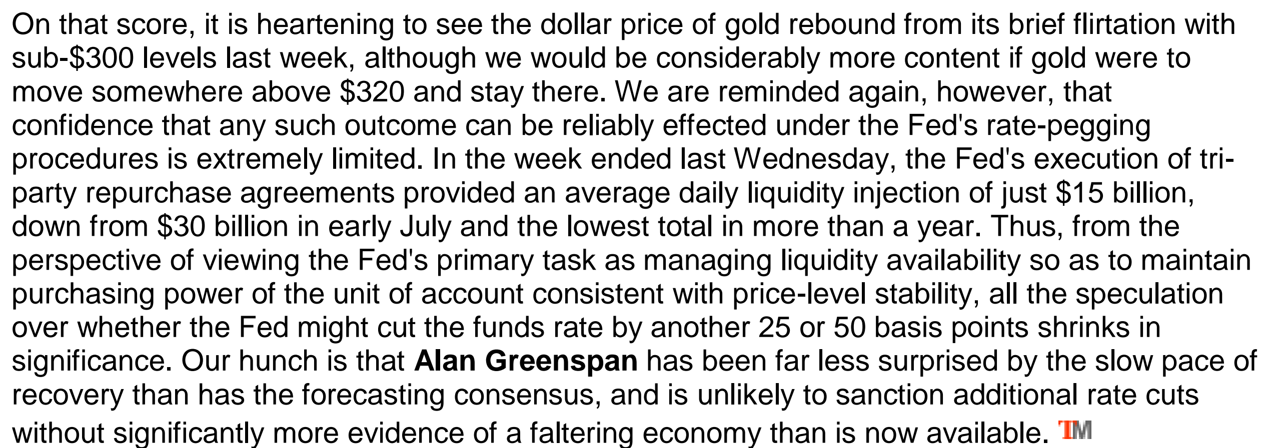
growth potential can be seen in the rising yield differential between speculative and investment-grade credits, also now at its highest point since the 911 aftermath. Venture capital financing is at four-year lows, and the market for initial public offerings has all but shut down. Clearly, the "animal spirits" so crucial to powering the economy's entrepreneurial growth engines are in hiding. At the same time, the volatility endured by the public equity markets can be seen as raising the risk premium in the cost of capital even for established high-cap companies, placing additional pressure on expansion or hiring plans.

By and large, though, this has been the economic backdrop all year. While it certainly is not conducive to a resumption of growth on the order of the late 1990s, it does not necessarily spell a return to the contraction of last year. The asset price deflation imposed by **the Fed's** earlier massive monetary errors can be seen as having induced a capital supply shock from which we are just starting to see the first inklings of recovery. Equipment and software investment in the March-June period, for example, had its first up quarter since summer 2000, growing at a rate of 2.9%. The supply shock, in other words, has probably been absorbed, and additions to the capital stock will likely continue a gradual recovery barring additional policy error.



On that score, it is heartening to see the dollar price of gold rebound from its brief flirtation with sub-$300 levels last week, although we would be considerably more content if gold were to move somewhere above $320 and stay there. We are reminded again, however, that confidence that any such outcome can be reliably effected under the Fed's rate-pegging procedures is extremely limited. In the week ended last Wednesday, the Fed's execution of tri-party repurchase agreements provided an average daily liquidity injection of just $15 billion, down from $30 billion in early July and the lowest total in more than a year. Thus, from the perspective of viewing the Fed's primary task as managing liquidity availability so as to maintain purchasing power of the unit of account consistent with price-level stability, all the speculation over whether the Fed might cut the funds rate by another 25 or 50 basis points shrinks in significance. Our hunch is that **Alan Greenspan** has been far less surprised by the slow pace of recovery than has the forecasting consensus, and is unlikely to sanction additional rate cuts without significantly more evidence of a faltering economy than is now available. TM