slower growth than the economy enjoyed in the 1990s. That is due, in part, to the fact that the overall economy is dependent on technology, and technology *is* facing its own Great Depression.

Technological innovation and technology adoption is the primary driver of productivity growth in almost any company. And as **Trend Macrolytics chief economist David Gitlitz** pointed out in a client report earlier this week, the anemic pace of new orders in technology capital goods means that the productivity "miracle" of the 1990s has been aborted. David notes that without continuing investment in technology, companies won't even be able to reap the full rewards of the technology investments they've already put in place.

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Stocks overall are also reflecting an extraordinary level of risk aversion. As we've pointed out over and over recently, the equity risk premium reflected in our "yield gap" valuation model is at all-time highs. Investors are today demanding a greater premium to take equity risk in relation to bond risk than at any time in the 19 years for which data is available. The risk premium today is more extreme in the direction of equity *under*valuation than it was in the direction of equity *over*valuation in March 2000. Other reflections of extreme risk aversion include the record levels of implied options volatility reflected in the **CBOE** Volatility Index; a virtual shutdown in initial public offerings and venture capital fundings; and greatly expanded credit spreads in fixed income markets.

Expectations for slower growth and extreme levels of risk aversion are tangled together today in complicated chicken-and-egg ways. Sufficiently powerful growth expectations can inspire even terrified investors to take some risk. But risk aversion itself depresses growth expectations, because superior growth is the result of taking risk on innovative ideas.

We have long argued that today's extreme risk aversion has its origins in the **Federal Reserve's** deflationary monetary policy error of the late 1990s -- relentlessly raising interest rates in a *jihad* against what **Alan Greenspan** famously called "irrational exuberance." As a trigger event for a catastrophic stock market decline and a major economic contraction, this error of monetary policy is substantively different than the policies errors that triggered the crash of 1929 and the Great Depression.

Back then the passage of the **Smoot-Hawley Tariff Act** and a series of increases in federal income taxes slammed the brakes on an economic boom, and stocks quickly began to discount diminished growth expectations. In the case of today's bear market, stocks have had to discount the effects of botched regulation of telecommunications, antitrust persecution of technology giants, and now the criminalization of corporate management through the **Sarbanes Oxley Act**. But what's different this time is that the Fed's *jihad* against "irrational exuberance" was a calculated direct attack on stock prices themselves. The crash of stocks prices was not an accidental by-product of that policy -- it was the objective of that policy.

We are *not* arguing that the extremely high equity valuations of late 1999 and early 2000 were justified. That is entirely beside the point. We *are* arguing that investor risk aversion will be substantially heightened when the nation's central bank takes it upon itself to adjust equity valuations. It's difficult enough for business to do business when the Fed arbitrarily controls the cost of short-term capital by adjusting overnight interest rates. But when they start trying to control the cost of long-term capital by adjusting equity valuations, then the risk of undertaking important long-range projects becomes intolerably high -- and long range projects will cease.

INTELLECTUAL AMMUNITION

1001 Bearabian Nights

Thursday, October 10, 2002

Donald Luskin

By Monday we could be in the longest bear market in history -- and it was all caused by one man.

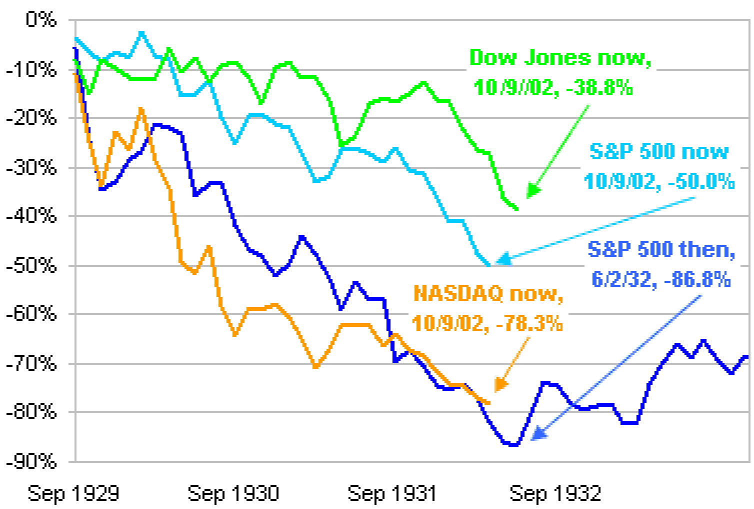
Today is the 1000th day since the Dow Jones Industrial Average touched its all-time high at 11908.50 on January 14, 2000. Tomorrow will be the 1001st day of the present bear market, exactly tying in duration the 1001-day bear market that followed the peak of September 7, 1929 -- which included the Great Crash and ushered in the Great Depression.

Friday evening will mark -- dare I say it -- 1001 bearabian nights, and Monday morning will mark what will be then the longest bear market in history.

Or, if you believe in numerological predestination in markets, then this is The Bottom.

As this 1000th day dawns today, the Dow has lost 38.8% since its peak. The S&P 500 has been precisely cut in half since its peak on March 24, 2000 -- 930 days ago. And the NASDAQ has lost 78.3% since its peak on March 10, 2000 -- 944 days ago.

Major market indices:
Percentage loss from 2000 peak
versus S&P 500 loss from 1929 peak



The Dow did even worse than that in the 1929-1932 bear market, losing 88.3% from peak to trough. The S&P 500 lost 86.8% then. The NASDAQ's huge losses in the current bear market invite comparison with the 1929-1932 debacle, and by now everyone has surely seen the oft-published chart overlaying the NASDAQ today on the market then. At least superficially, the comparison in magnitude, duration and pattern is striking.

But the NASDAQ comparison is deceiving. In the 1929-1932 bear market, those huge losses were borne by the entire US equity market. A 50% drop in the broad-based S&P 500 today is no romp in the park, but it's a far cry from the 78.3% loss in the NASDAQ that represented only one third of US equity market value at its peak.

In the 1929-1932 bear market, stocks were discounting the Great Depression. Today, stocks overall are not discounting a depression, Great or otherwise. But they are discounting much

And that's precisely where we are today, with Alan Greenspan's *jihad* against "irrational exuberance" a ringing success, with the NASDAQ having been pushed down 78.3% (at the cost of a technology sector that lays in ruins, and an overall economy now stunted because its engine of productivity growth has been destroyed). Who will now dare make a long-range investment when, at any time, the Fed could come along and decide that the investment was "irrationally exuberant" and then cause it to lose 78.3% of its value?

To be sure, Greenspan denies it. In a highly publicized speech in August he expressed regret that he hadn't dared to do anything to avert the putative stock market bubble of the late 1990s, saying it couldn't "be preempted short of the central bank inducing a substantial contraction in economic activity." The market has fallen steadily ever since that speech, and signs of economy-wide risk aversion have steadily increased, because -- bluntly -- Greenspan's statement was a bald-faced lie. He set out to burst the bubble, and he did just that -- by "inducing a substantial contraction in economic activity."

All along, in speeches and Congressional testimony, Greenspan denied that he was "targeting stock prices." But when he started relentlessly jacking up interest rates in 1999 and 2000 as the equity markets soared, this was in fact precisely what he was doing -- though he found a path of words that allowed him to justify himself in terms of traditional price stability objectives. Greenspan began talking about the "wealth effect" -- the common-sense notion that people may tend to spend more when their stock market investments show gains. Greenspan stretched that simple idea beyond its conceptual breaking point, using it to assert that with stock prices having appreciated so much in the 1990s, the wealth effect was causing an "excess of the growth of demand over supply" (see Greenspan's congressional testimony in July 1999). Presumably we were to believe that when people demand more than can be supplied, prices rise and inflation is the result.

Thus an argument that begins with high stock prices ends up being about inflation -- and inflation is something that the Fed is supposed to be doing something about. Unfortunately, at that time there was no objective evidence of inflation or inflationary expectations -- other than Greenspan's theory that high stock prices would lead to inflation. Indeed, all the evidence at that time was of raging deflation -- reflected clearly in collapsing commodities prices and a soaring US dollar.

These signs of monetary deflation began to be visible in the spring of 1997, the season following Greenspan's famous "irrational exuberance" speech of December 5, 1996. The signs of deflation across the broad front of commodities prices started to materialize near the same time that Greenspan made what I believe is his first public mention of the "wealth effect," in congressional testimony on March 20, 1997. Five days later the **FOMC** slowly began a campaign of interest rate hikes that would culminate in May, 2000. This campaign was only interrupted briefly by a series of rapid-fire rate cuts in the autumn of 1998, necessitated by global markets instabilities triggered in large part by the Fed's growing deflationary policies.

Greenspan's idea of the "wealth effect" started showing up regularly in FOMC statements in 1999. Neither the "wealth effect" nor the equity market was ever mentioned directly -- the statements typically used such language as "...the growth in demand has continued to outpace that of supply..." (see FOMC statement of October 5, 1999). The last time that language appeared was in the FOMC statement of May 16, 2000, documenting that infamous meeting in which the fed funds rate was raised for the final time, to 6-1/2%. By then the NASDAQ was already a deader, and the rest of the market was soon to follow.

The "wealth effect" and its "excess of the growth of demand over supply" was never mentioned again in an FOMC statement. But it did find its way into the introductory paragraphs of Greenspan's recent August speech. There Greenspan casually mentions that the "wealth effect" is not, in fact, operating in the economy after all. "The massive drop in equity wealth over the past two years... might reasonably have been expected to produce an immediate severe contraction in the U.S. economy. But this did not occur." There is not one word about the central role the "wealth effect" played during the rate-hiking exercise that triggered today's bear market.

This kind of intellectual dishonesty tells the market that future policy decisions will be made without principle -- that they will be arbitrary, whimsical, unpredictable. That has transformed the extreme optimism and risk tolerance that characterized the stock market and the economy in the 1990s into a symmetrically extreme pessimism and risk aversion.

The NASDAQ is now 15% lower than where it was when Alan Greenspan first spoke of "irrational exuberance" on December 5, 1996 -- even though the NASDAQ's actual earnings are now 21% higher than they were then, and both short-term and long-term interest rates are far lower. The S&P 500 is only 4% higher than it was on December 5, 1996 -- even though its actual earnings are now 37.5% higher than they were then. We were always skeptical when the media called the equity surge of the 1990's Alan Greenspan's bull market. But there's no doubt in our minds that this bear market is all his. TM