Donald Luskin, Chief Investment Officer
David Gitlitz, Chief Economist

MARKET CALLS

Godzilla Meets Bambi

Tuesday, October 15, 2002

Donald Luskin and David Gitlitz

Capital markets priced for the worst are reacting well to a little good news.

RELATED REPORTS

1001 Bearabian Nights
October 10, 2002
Q1 2000 Upside Down?
October 1, 2002
What's Ahead for Bonds?
September 27, 2002

We were more than half kidding in a client report last Thursday when we said "...if you believe in numerological predestination in markets, then this is The Bottom" (see "1001 Bearabian Nights" October 10, 2002). Our quip was based on the fact that Thursday was the 1000th day of the bear market that began when the Dow Jones Industrial Average peaked on January 14 2000. If Thursday morning's low was indeed the trough, then we can retire the jersey with the number "1001" on it -- that was the number of days of the great bear market from 1929 to 1932. That record may remain unbroken -- by a single day.

We see no particular macro catalyst that screams "The Bottom." That said, we have been saying for some time that stocks are at historical levels of undervaluation in relation to bonds (see "Q1 2000 Upside Down?" October 1, 2002). And we have noted that bonds have fully priced in residual deflationary risks and the prospects of anemic economic recovery (see "What's Ahead for Bonds?" September 27, 2002). So the equity rally that began from last Thursday's lows, and the bond pull-back that began two days earlier reflect, more than anything else, capital markets that had been priced for Armageddon reacting to a series of mildly positive news developments.

- Last Thursday's jobless claims confirmed our anemic recovery scenario, and took away an important argument from the double-dip doomsayers.

- **General Electric** reported slightly better than expected earnings last Thursday and reaffirmed guidance, bucking a tide of negative Wall Street research reports. **Citibank** and **General Motors** reported strong quarters this morning, also thwarting worst fears. We will survive earnings season.

- The **Senate** passed a resolution granting **President Bush** powers to pursue military action in Iraq, avoiding what could easily have been a prolonged, bitter and dysfunctional political confrontation.

- Two market-friendly tax-cut bills have been introduced in the **House of Representatives**, one to end double-taxation of dividends and the other to extend the deductibility of capital losses. As long as **Paul O'Neill** is Treasury Secretary they'll never pass, but at least the **GOP** managed to introduce them, and for a market so deeply undervalued even this slender reed is a plus.

- The first IPO's in two months successfully came to market last week.

- Yesterday a management-led leveraged buy-out of the medical information management firm **Quintiles** was announced. How long has it been since we've seen *that* ultimate expression of management confidence in equity valuation?

None of this represents any kind of paradigm shift -- at least not yet. Much of it simply reaffirms exactly what we've been saying -- that the economy is in an anemic recovery, that equities are deeply undervalued, and that bonds have probably come to the end of a very nice run. If there are any surprises here it all, they are in the nascent signs of a relaxation of economy-wide risk-aversion.

We are taking this opportunity to close the residual portions of two long-standing Model Positions which have now come to full and profitable fruition. These positions both reflect an important mission of **Trend Macrolytics**, established when we founded the firm a year ago -- to use cutting-edge macroeconomic analysis to identify investment opportunities arising from the mispricing of markets based on the conventional -- and usually, wrong -- economic wisdom.

As it turned out, in short order we were presented with two exciting opportunities to put our mission into action, and the results have been extraordinary. Last December, highly skeptical of the V-shaped recovery scenario then driving tech stock valuations to absurd heights while at the same time hammering bonds on the premise that the Fed would soon be forced to begin taking back last year's rate cuts, we established a **Model Position short the NASDAQ and long long-term Treasuries**. Then in March, at the height of the rate-hiking frenzy, we put on an additional **Model Position long long-term Treasuries** to capture the gains from what we saw as the inevitable unwinding of those expectations.

For both positions, it's been a great run. But as the saying goes, "all good things must come to an end."

- As of the opening this morning we have closed out the Model Position short the NASDAQ and long long-term Treasuries. We remain skeptical of a significant recovery in the technology sector any time soon, but with our metrics showing technology stocks undervalued for the first time since 1996, we are prepared to take profits. Established on December 10 2001, this Model Position has earned a profit of 57.8% on a cash basis, and of 271.2% on a futures basis. Since inception the NASDAQ 100 has fallen 42.8%, and long-term Treasuries have appreciated 16.8%.

- As of the opening this morning we have closed out the Model Position long long-term Treasuries. Not only has the anemic recovery taken out any expectations of **Fed** tightening, by late last month the yield curve was priced for at least one 25-basis-point rate *cut* by year end. As we noted on September 27, after rallying by some 60 basis points in just four weeks' time, long maturity Treasuries were highly vulnerable to any appearance of better-than-dismal market or economic news. The sentiment shift that has amounted to a direct hit on Treasuries is most clearly quantified in the interest rate futures markets. The November fed funds contract which on October 1 was more than fully priced for a rate cut at the November 6 **FOMC** meeting is today showing just a 25% chance. Established on March 26, 2002, this Model Position has earned a profit of 9.6% on a cash basis, and 392.8% on a futures basis. Since inception long Treasuries have appreciated 16.0%.

We are making no change today to our **Model Position long the S&P 500**. At inception on June 11, the position was begun with a 10% allocation to stocks. As the equity market has fallen and values have become more compelling, the position has been built up through a series of small trades so that it is now allocated 55% to stocks. Since inception the Model Position is down 4.5%, compared to a loss of 14.0% in the S&P 500. TM