TrendMacrolytics

Donald Luskin, Chief Investment Officer
David Gitlitz, Chief Economist

MACROCOSM

Resistance

Monday, October 21, 2002

David Gitlitz

The stock market may be "cheap," but deflationary risk and systemic risk-aversion are making it tough to capture the value.

RELATED REPORTS

The Tech Depression: Will It Never End?
October 8, 2002
Monetary Hall of Mirrors
October 11, 2002

As encouraging as the equity market's powerful rally off the October 10 lows has been, uncertainties that continue to beset the economic outlook appear to augur against a sustained straight-line shot to substantially higher ground. No question, broad equity market valuations still appear to provide an appealing risk premium under most circumstances short of a virulent economic downdraft, which we view as unlikely. Even so, and much as market sentiment has taken a decidedly less dismal turn, resistance to capturing the bulk of the risk premium that remains available could still be considerable. The easiest part of this rally may be nearing its end.

Caution in this regard is underscored by the thus-far timid response by higher-risk financial assets to the stock market's rebound. Were this rally a convincing signal of brighter economic vistas, we'd expect to see it reflected in some greater relaxation of the market's overall risk aversion. To date the equity market recovery has corresponded with only tentative hints of a reawakening of the market's risk appetite. After a nearly two-month hiatus for new stock offerings, overlapping the new-issue market's worst quarter in more than two decades, four IPOs have priced since October 9. In fact, the market's October 10 bottom coincided with trading commencing on the first two of these issues, which could well have contributed to a sense in the broader market that the worst was over. It's also noteworthy, though, that these deals came to market only after their already low offering prices were heavily discounted in the final pre-launch preparations. To attract sufficient buying interest, in other words, the issuers were forced to concede an even heftier risk premium in their initial offering prices. By our count, moreover, more new issues have been withdrawn or postponed than have priced during this period -- and there are surely countless others who aren't even bothering to enter the deal pipeline in this environment.

In the critical high-yield debt arena, where spreads blew out to levels surpassing those of the early-1990s' regulatory *jihad*, there is yet little visible sign of greater risk tolerance. The S&P Speculative Grade Credit Spread has recently tightened by more than 60 basis points. But that narrowing has been almost entirely accounted for by soaring Treasury yields, not falling junk yields. At about 950 basis points, which is up on net some 300 bps since early June, the junk spread still stands as a stark symbol of the hurdles to financing the entrepreneurial and innovative activity that powers productivity-based economic expansion. So while the most extreme levels of risk aversion may have been quelled, at least for now, it would be premature to suggest that a revival of the market's "animal spirits" is in view.

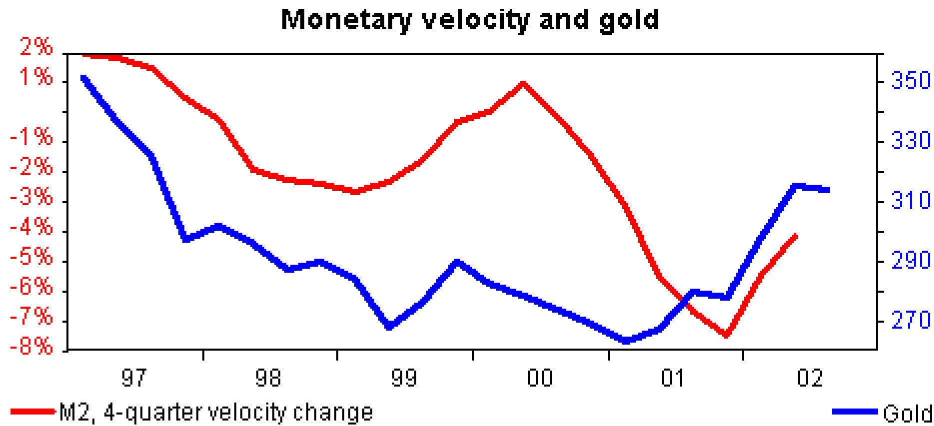
We have suggested in recent reports that monetary uncertainty continues to bear much of the blame for the market's continued risk aversion (see, most recently, "The Tech Depression: Will

http://www.trendmacro.com
don@trendmacro.com
dgitlitz@trendmacro.com

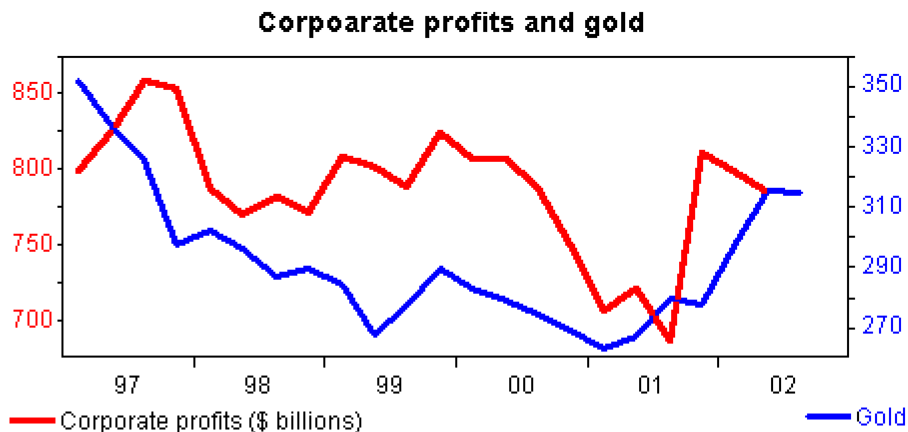
325M Sharon Park Drive #325
Menlo Park CA 94025
Phone 650 429 2112
Fax 650 429 2112

42 Forest Drive
Parsippany NJ 07054
Phone 973 335 5079
Fax 973 402 5074

It Never End?" October 8, 2002). The dollar's moderate softening from its deflationary peaks since early this year, as seen in market price indicators such as foreign exchange, gold and broader commodity indexes, has indeed been heartening. But evidence of relief from the worst of the deflationary pressures does not necessarily imply confidence that it can be sustained. For one, the meanderings of the gold price, which in the past seven weeks has gone from trading below $307 per ounce to above $325, and is now back within hailing distance of $310, gives good reason for pause.



In the final analysis, of course, equity prices are a bet on expected future returns -- i.e. profits -- which in the aggregate are derived from the revenue streams represented by nominal GDP. As the accompanying charts help illustrate, the past few years have proved an object lesson in the vulnerability of this relationship to deflationary monetary error. The deflationary dollar scarcity has been reflected in a declining turnover ratio of money in the nominal economy (velocity), manifesting a demand for money in excess of the goods and services for which it exchanges. The relentless strengthening of real dollar purchasing power seen in the falling gold price pulled velocity down with it, as nominal GDP growth collapsed from a four-quarter rate of 7% in the second quarter of 2000, to 2% by the final quarter of last year. Profits (shown here as the official national income account series, with inventory valuation and capital consumption adjustments) inevitably followed.



While these charts suggest that the worst is over, they also point to some of the remaining risks. Going forward, for example, profit growth would likely be constrained without some additional sustained reflation of the unit of account reflected in the price of gold. And that would require a continued redress of the scarcity of dollars relative to demand, as captured here in the velocity of M2. Recent growth of M2, which was up at an annual rate of about 10% in the third quarter,

should be seen from that perspective. The advance estimate of third quarter GDP is due for release next week, and is likely to show nominal growth on the order of 5% to 5-1/2% annualized. But that would also imply another negative quarter for velocity, suggesting that strong growth of the so-called "money supply" is more accurately seen as a reflection of continued excess money demand. That is both a reflection and cause of the risk-averse environment. Even at the current 40-year lows for short-term rates, essentially riskless cash balances can be seen providing a competitive real return, while the highly risk averse environment is itself rooted in **the Fed's** failure to fully satisfy the system's money demands to begin with. And as we have pointed out (see "Monetary Hall of Mirrors" October 11, 2002), the Fed is wholly incapable of responding to such pressures in timely fashion through its Byzantine rate-targeting procedures, a defect which is unlikely to be fixed even by another rate cut. TM

.