

MACROCOSM

Will Spring Return in the Growth?

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Value can only take the stock market so far. Stocks are all about growth.

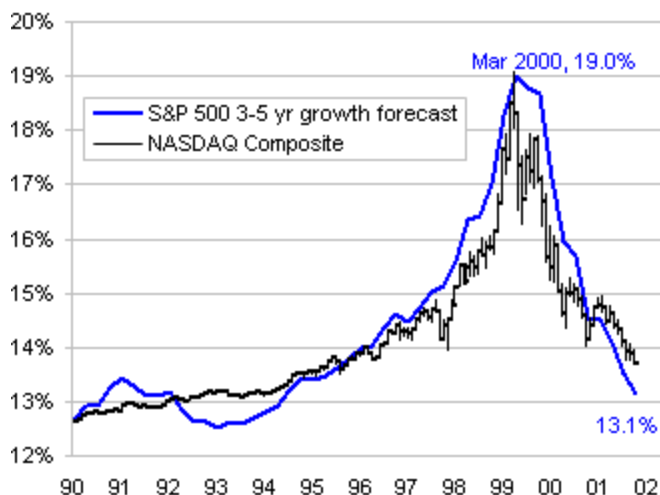
The best time to buy stocks is when you have *both* growth *and* value on your side -- when you have an out-of-consensus macro forecast that will drive accelerating earnings growth, *and* stocks are underpriced relative even to the consensus growth forecast. We do *not* have the former -- and we even have the latter only in a limited way.

We called the bottom in this move to the day based on value (see "[1000 Bearabian Nights](#)" October 10, 2002). But we also called what has so far been the top, and also to the day, based on our concern that pervasive risk aversion is putting a lid on growth (see "[Resistance](#)" October 21, 2002).

We believe that stocks continue to be significantly undervalued relative to bonds, especially in non-cyclical sectors. But there is a limit to how far value alone can carry the stock market. And we note that our equity valuation model is based on a consensus earnings growth forecast that we think is overoptimistic. So our [Model Position long the S&P 500](#) is allocated 55% to stocks, and 45% remains uncommitted. It is nothing but a value play.

Which is cause, and which is effect?

The 3-5 year earnings growth consensus for the S&P 500 tracks the health of the NASDAQ



Whatever **Warren Buffett** may say, value alone is not a very interesting basis for equity investing. *Equities are fundamentally growth-sensitive instruments.* Unfortunately, while we do see continued economic recovery ahead, our forecast is that it will be anemic at best. For a significant equity revival to get underway the preconditions for superior growth must be satisfied -- and right now they are most definitely *not* satisfied. The issue for equities, therefore, is not so much whether (as **Chauncey Gardner** said) "Growth will return in the spring." The issue is whether spring will return in the growth. Unfortunately, right now growth doesn't have much spring in it.

In our model of the world, growth is the result of "trickle-up economics." Its most important precondition is *risk-taking*. When people take the risks to invest their time and money in new businesses and technologies, the eventual result is increasing productivity. Higher levels of

productivity trickle up through the economy and give rise to increases in production, consumption and wealth -- *that's* growth.

We have pointed out repeatedly the profusion of evidence that the economy is locked in a spasm of risk aversion that is choking off growth prospects. We have noted wide credit spreads, the implosion of venture capital investing, and the shuttering of the IPO window. When an economy will not take the risk to invest in itself, growth expectations are consequently lowered.

This reality is reflected in the declining long-term earnings growth consensus expectation for the S&P 500 -- a good proxy for overall growth expectations in the economy. Over the last dozen years these expectations have closely tracked the NASDAQ Composite Index -- a key symbol of the willingness of the economy to take risks to invest in growth. Long-term S&P 500 growth expectations topped out in the very same month that the NASDAQ did -- March, 2000.

Conventionally the level of the stock market is explained as a function of earnings expectations, and indeed it is just that -- but the message of the chart on the previous page is that the growth prospects of the *overall* economy are tied inexorably to the health of that sector of the economy that is the engine of productivity gains. That engine is fueled by risk-taking -- and it is running on fumes. Indeed, the majority of publicly traded technology companies are running out of money and will soon face a widespread crisis of sheer survival (see ["Let's Play Survivor"](#) September 24, 2002).

We've noted that the economy's present spasm of risk aversion is due to a series of policy errors that have imposed heavy penalties on investments in growth -- including **the Fed's** deflationary monetary policies, activism in antitrust enforcement against technology companies, and most recently the criminalization of corporate leadership through the **Sarbanes-Oxley Act**. In light of some polling evidence that **President Bush's** approval ratings are beginning to slip a bit, and the chances of the **Republican party** re-capturing control of **the Senate** worsening every day, we can cling to the hope that pro-growth economic policies may become politically necessary. At the moment that is nothing but a hope, and so the best thing we can say about the stock market continues to be that it is cheap. **TM**