TrendMacrolytics

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MARKET CALLS

Tech Out of Whack, Once Again

Monday, November 25, 2002

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In the last month's recovery, technology stocks have become extremely overvalued relative to the rest of the market.

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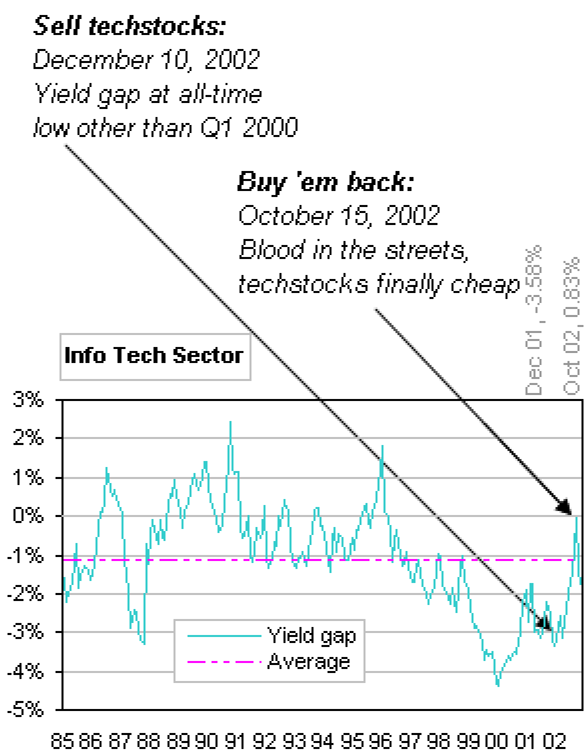
It's time to sell technology stocks again -- but not for the same reasons or in the same way that we sold them a year ago.

On December 10 of last year we initiated a Model Position short the NASDAQ 100 and long long-term Treasuries. Qualitatively, we were highly skeptical of the "super-V" recovery hopes that dominated mainstream economic forecasts then. Quantitatively, we noted the near-record negative spread between the forward earnings yield of the Information Technology sector of the S&P 500 and the income yield of bonds -- what we call the "yield gap" (see "Vay Out of Vack -- Even for a 'V'" December 10, 2001).



We closed that Model Position on October 15, when the yield gap returned to normal and a little bit beyond -- for a brief period, technology stocks were undervalued, and that's when we covered the short. From inception of the Model Position, the NASDAQ 100 fell 42.8% and bonds returned 23.4%.

Since closing that Model position just seven weeks ago, the NASDAQ 100 has rallied 24.7%. From its closing low on October 7, a week earlier, it has rallied 38.7%. Now, according to our yield gap model, *technology stocks are overvalued again*.

What is intriguing about today's overvaluation is not so much its magnitude -- it's not especially extreme. What catches our attention is the fact that the Information Technology sector is overvalued at all -- it is only one of two sectors to be overvalued (the other one, Consumer Discretionary, is only very slightly overvalued). The rest of the S&P 500 remains steeply undervalued, even after a 19.8% rally from the closing low of October 9.

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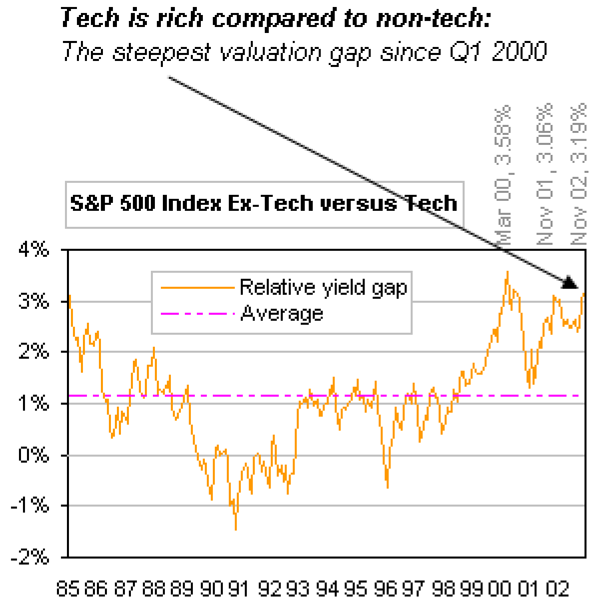
Technology stocks are not so overvalued that we would sell them outright. We continue to be cautiously optimistic on the market overall, and the technology stocks are not so overvalued as to make further gains unlikely if the overall market continues to recover. That said, technology stocks are extremely overvalued *relative to non-technology stocks* -- as overvalued as they've been at any time in the 18 years for which we have data, other than in March 2000 at the very top of the so-called bubble.



We believe this presents a significant opportunity for gains in an asset allocation trade that sells technology stocks and buys non-technology stocks on a risk-equivalent market-neutral basis. Over the last 18 years, the average return of such a trade initiated when the relative yield gap was over 3.00% has been 6.1% for one month, 16.5% for three months, 29.6% for six months, and 46.1% for 12 months (these calculations assume a ratio of $1 sold to $1.35 bought). We are embodying this trade in a new Model Position that will short the NASDAQ 100 and buy the S&P 500. This Model Position will be posted on our web site later today.

As we pointed out earlier this month, earnings for the Information Technology sector have stabilized, but show no sign of recovery (see "Return to Normalcy" November 4, 2002). The entire earnings for the sector are more than explained by just seven companies, and as a sector, year-over-year comparables are still strongly negative. For the most part, technology companies that are able to report any earnings improvements or positive surprises are doing so based on cost-cutting or market-share gains (see "Let's Play Survivor" September 24, 2002). In virtually every earnings conference call and press interview, tech company CEOs and CFOs continue to say that they see no improvement in IT spending.

To quote the poet **Maya Angelou**, "When people show you who they are, believe them." Yet when it comes to the Information Technology sector, the market apparently does not. The consensus 12-month forward earnings growth estimate for the sector is an heroic 39.9%. Based on the sector's overvaluation, the earnings growth forecast implicit in prices today is even higher: a whopping 69.7%. That's simply not going to happen.

By contrast, earnings for the S&P 500 Ex-Information Technology continue to recover from last year's recessionary lows -- trailing 12-month earnings are now only 3.3% below the all-time peak, and year-on-year comparables are turning positive. The consensus 12-month forward earnings growth estimate for the S&P 500 Ex-Tech is an ambitious but not absurd 12.7%. Based on the non-tech sectors' undervaluation, the earnings growth forecast implicit in prices today is *negative* 10.5%. That's not going to happen, either.

Under our macroeconomic forecast the Information Technology sector is not going to turn in 69.7% earnings growth over the next 12 months -- and neither are the non-tech sectors going to turn in an earnings decline of 10.5%. We continue to see evidence that the monetary deflation that triggered the recession that began in 2000 has subsided (see "A Deflation Dichotomy" November 18, 2002), and that **the Fed** is becoming increasingly committed to not seeing it resume (see a forthcoming report by **David Gitlitz**). And we're beginning to see evidence that economy-wide risk aversion is beginning to ease somewhat. There's even some encouraging talk about pro-growth tax and regulatory policies that might stand a chance when the **Republican-dominated Congress** comes back into session. It's good (if not great) news for stocks, but once again, the Information Technology sector has gotten way ahead of itself. If a reasonably growth-friendly policy scenario unfolds, tech may well advance from here, and even out-perform non-tech on a dollar-for dollar basis by virtue of sheer beta -- we're not saying it won't. But on a risk-equivalent basis, non-technology stocks are the better bet. TM

As we establish this new Model Position in equities, let us take brief note of the progress of our other Model Position in equities. This Model Position was established on June 11, 2002, with a 25% allocation to the S&P 500, based on the modest undervaluation of equities we observed at that time. Our plan was to add to the position if and when markets fell and became more undervalued -- which, of course, they did in spades -- so after three further buys, today the position is allocated 54% to equities.

Both our initial caution and our willingness to add to the position at lower prices have paid off. As of last week's close, the position showed a cumulative loss of 1.43%, compared to a cumulative loss in the S&P 500 of 8.19%. This strong out-performance of the benchmark was achieved at substantially lower-than-benchmark risk -- the time-weighted average exposure to equities since inception has been only 42%.