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MACROCOSM

Upside, Downside

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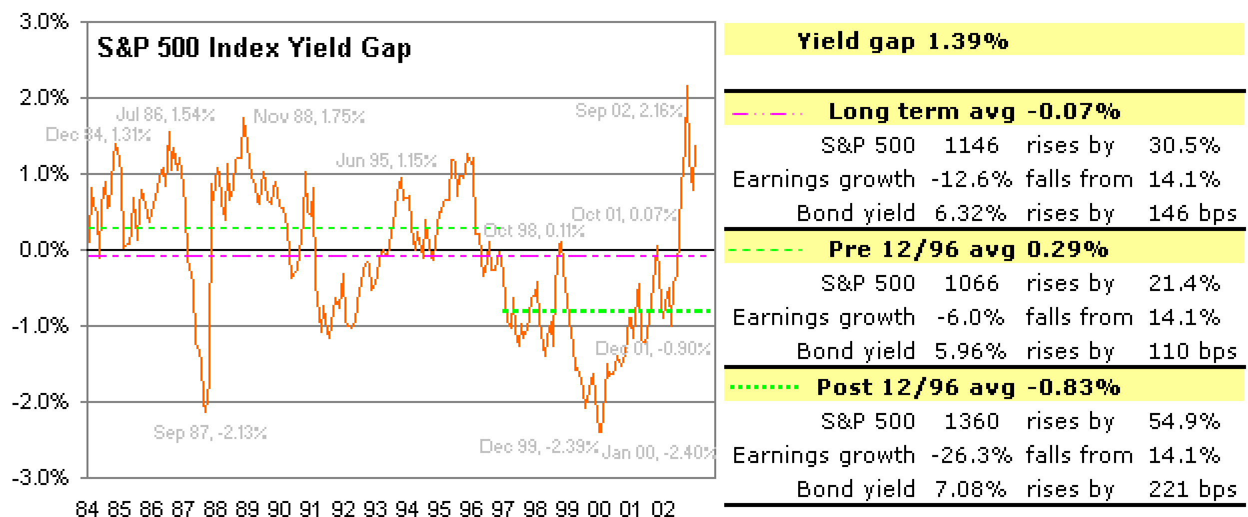
A market addicted to bad news is overlooking some fundamental positives.

The rapid evaporation of the better-than 5% gains chalked up by stocks in the year's opening sessions continues a pattern that has been evident in the market's performance over the past three months. Since the surge that pulled the S&P 500 nearly 12% higher in the four trading days following October 9, the market has essentially been treading water, with periods of tight range-bound trading interspersed by rallies that soon falter, pulling the averages back to their earlier levels. At yesterday's close, the S&P -- at 878.36 -- was slightly below the October 15 levels which marked the end of the four-day upswing, and within three points of the lows following the failed rallies of November and December.

According to our yield gap model of equity valuation, the market remains attractively priced strictly on a valuation basis, with an upside of more than 30% available in the S&P to get valuations back in line with their long-run average. But the still-gaping yield gap amounts to a risk premium, the persistence of which indicates that prevailing uncertainties continue to pose downside risks that overwhelm the potential upside. Certainly, the increasingly likely prospect of war with Iraq and the accompanying spike in crude oil prices are enough in themselves to put a damper on any emerging enthusiasm. And while the post-New Year's equity market run-up was attributable in some measure to excitement generated by the **Bush** tax package, recent news has provided a sobering reality check; passage of the plan with its most important provisions intact is by no means assured.



Yield gap 1.39%			
Long term avg -0.07%			
S&P 500	1146	rises by	30.5%
Earnings growth	-12.6%	falls from	14.1%
Bond yield	6.32%	rises by	146 bps
Pre 12/96 avg 0.29%			
S&P 500	1066	rises by	21.4%
Earnings growth	-6.0%	falls from	14.1%
Bond yield	5.96%	rises by	110 bps
Post 12/96 avg -0.83%			
S&P 500	1360	rises by	54.9%
Earnings growth	-26.3%	falls from	14.1%
Bond yield	7.08%	rises by	221 bps

For all that, though, the market's sour mood has perhaps been most closely connected to the glum perspective on forward prospects offered by many top-tier companies while releasing their fourth quarter earnings results. It appears that "once burned, twice shy" has become the mantra

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of the executive suite -- opting for the safety of keeping expectations in check with largely downbeat guidance is now seen as the prudent thing to do. Of course, it's understandable that in this post-**Enron**, post-**WorldCom**, post-**Sarbanes-Oxley** world, guarding against undue optimism is considered politically correct executive behavior. Today's swing to positive ground, it should be noted, was kicked off by a few companies bucking the trend and offering some reason for hope about the outlook.

But if the pendulum swung out too far in the direction of unrestrained corporate confidence through -- and beyond -- the crest of the late-'90s boom, it may now be swinging nearly as far back in the direction of unmerited caution. To be sure, our outlook remains for a moderate pace of expansion in the period ahead -- another boom is not yet in sight. But neither is the double dip recession that present valuations would appear to foretell. The current 30% S&P undervaluation on a yield-gap basis indicates either earnings collapsing from their current 14% growth rate to a contraction of 12.6%, or the long bond yield rising from levels around 4.9% to about 6.3%.

The dour corporate guidance has also been lent some surface support by misleading interpretations of a few recent data releases. Word last week that the trade deficit in November surged by 13.9% to a record $40.1 billion, for example, effectively quashed any hopes that next week's initial estimate of fourth quarter GDP would print with a growth rate of much more than 1%. But while the GDP accounting conventions dictate that a decline in "net exports" is recorded as growth-negative, statistical methodology should not necessarily be confused with economic reality. The jump in the trade deficit was explained primarily by imports, at $123.3 billion, rising to their highest levels since Oct. 2001. A growing appetite for imports, of course, is an indication of economic strength, not weakness.

Similarly, the report of a 0.2% decline in industrial production for December was widely seen as indicative of an economy-wide stall. The drop in output, however, was entirely explained by a fall in auto production which, as we've noted previously, is the nearly inevitable consequence of car sales having been driven higher in earlier months by special financing incentives. Within the industrial production report there were actually some very welcome signs of life. In the hard-hit high-tech sector of computers, telecommunications and semiconductors, output rose at more than a 6% annual rate last month. High-tech production is now up nearly 7% year-on-year, after bottoming with a year-over-year decline of 10.3% in December 2001 and not having poked into positive territory until last June.

Our analysis has been that the tech sector was at the eye of the monetary hurricane unleashed by **the Fed's** deflationary policy stance of the past several years. The Fed-induced deflation at one and the same time crushed the nominal revenue streams from which profits are derived, increased the real burden of debt and raised the risk premium in the cost of capital to prohibitive levels. Now, the inklings of a recovery in high-tech capital goods are coinciding with an increasingly convincing demonstration from various market price signals that the deflationary siege of the dollar is over. Further confirmation that the Fed's monetary posture is no longer posing an obstacle to economic expansion can be found in the growth-critical high-yield debt market. Even in the midst of this equity market pullback, junk yields and spreads maintained their levels which, while high by historical standards, had rallied by more than 200 basis points from their worst levels of last fall. It's our bet that the best is yet to come for such high-risk spread product, and as the market's appetite for risk gradually improves, the portents for equities are positive. TM