

MACROCOSM

## Better Than It Looks

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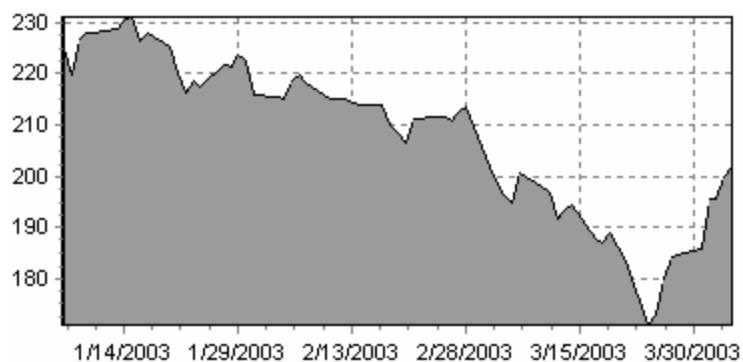
**Warning: data in the rear-view mirror is smaller than it appears.**

It was a grim week for the U.S. economy, at least according to the latest batch of macro indicators. Topped by today's employment report, the indicators -- including the ISM manufacturing and services indexes, factory orders, and initial unemployment claims -- portray an economy operating virtually at stall speed. But more to the point, they portray an economy that was operating at virtual stall speed in March, a month of stark uncertainty in the final countdown to war in **Iraq**. An ugly breakdown of diplomacy among traditional allies, crude oil prices surging to 12-year highs near \$40 per barrel, and doubts about **George W. Bush's** ability to weather the challenge with his credibility intact were among the prominent features marking this period of extraordinary geopolitical irresolution.

Even more than under "normal" circumstances, in other words, the usefulness of backward-looking data as a reliable indicator of the economy's ongoing strength should be treated with considerable skepticism. The uncertainty bred by the near-\$10 per barrel oil price spike over the first 10 weeks of the year can explain a good part of the reported weakness. With the energy efficiency gains of the past few decades, crude price movements don't have near the economic impact that they once did. But oil still represents a critical production input and is a major variable in consumer outlays. While most analyses concluded that the price jump was likely to prove short-lived, such a volatile move in so compressed a time frame can do significant short-run damage to business and investor confidence. Add to that the political risks engendered by the diplomatic/military stalemate, and the dulling impact on marginal investment and hiring decisions becomes clear.

Certainly, we don't suggest that positive resolution of these uncertainties presages a new boom in the making. Neither, though, do we subscribe to the widely propagated view that the equity market's gains this week are simply a measure of the euphoria over US military advances in **Iraq**, and have come "despite" the stream of dreary data. Rather, the easing of the extreme uncertainty that has plagued the financial-economic setting is again allowing the market to absorb the risk premium in asset values. As we have described it over the past several months, the broad equity market has been priced as *if* it expected an earnings decline which would be consistent with deep recession. Rather than discounting for a decline in expected returns, however, our analysis has been that the market has been characterized by a sharp jump in estimated *risk* to those returns.

The diminution of those risks amounts to a concomitant decline in the cost of capital, which -- provided it is sustained -- should be reflected in a recovery of capital formation and risk-bearing activity. We have noted that even in the midst of the broad equity market's risk aversion, one encouraging indicator of a rise in expected returns was the performance of high-yield debt; the S&P Speculative Grade Credit Spread has now tightened by nearly 85 basis points since early March, and at just above 700 bps has returned to levels last seen in summer 2002. An additional early sign of relief from the dearth of risk capital has also become visible in a somewhat stepped up pace of venture capital disbursements.



The Venture Wire index of VC funding shown in the chart above -- computed on a 90-day moving average -- fell to its lowest levels yet on March 24, but has since recovered by nearly 15%. Recovery of the risk-taking activity that we view as indispensable to robust, productivity-based growth is still in its early stages, but at least it's moving in the right direction. **IM**