TrendMacrolytics

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The Whiff of Animal Spirits

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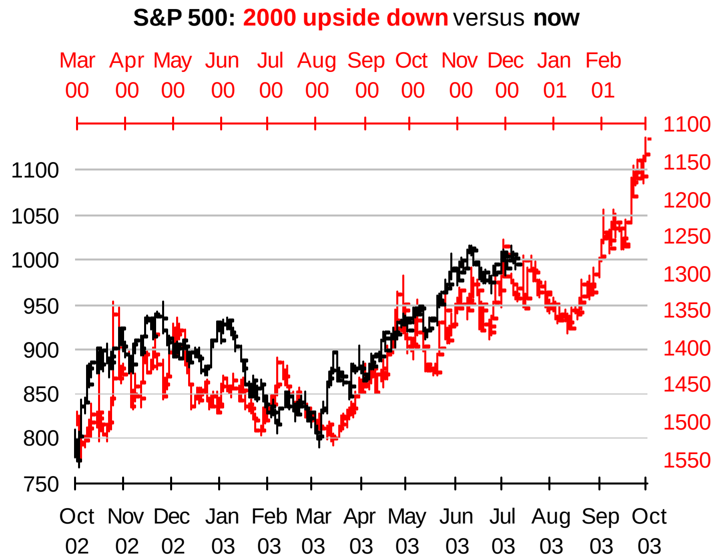
The resurgence of restructuring activity is the precursor of economic expansion.

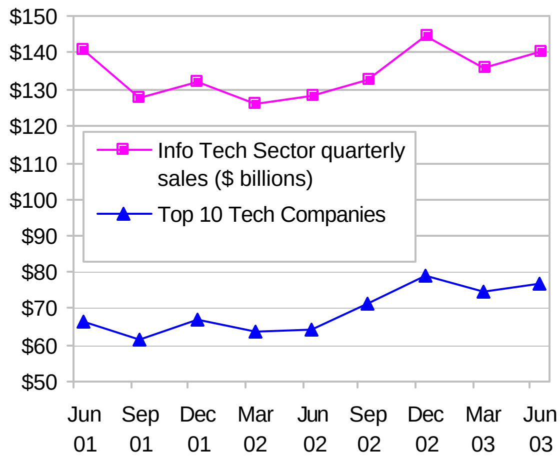
Yahoo! doesn't raise guidance as much as some hoped it might, and a bad initial claims number hits the tape -- and now talk of "too far, too fast" and "no second-half recovery" fills the air. Well, them's the facts -- but they don't tell the whole story. Market-based forward-looking indicators continue to convince us that the economy is responding to very positive changes in fundamental causal factors. And the stock market continues to confirm this by playing out a long bottoming process that startlingly resembles the long topping process of 2000, but upside-down (see "Q1 2000 Upside Down?" October 1, 2002).



Most encouraging to us is the mounting level of corporate activity that could be broadly classed as "restructuring" -- record levels of high-yield and convertible bond issuance, a wave-let of acquisitions (even a hostile takeover attempt -- remember *those?*), and **Microsoft's** new equity-based compensation plan and earnings restatement (see "Microsoft's Options Reboot" July 9, 2003). Restructuring activity is not directly *indicative* of economic expansion itself, but it represents a key causal precursor of it -- the willingness of economic actors to shake off their short-term bunker mentality, make long-term plans, and take long-term risks.

Restructuring activity cannot occur in an economy like the one we've had for the last two years, with too little financial liquidity, high forecasted levels of risk, and high aversion to taking that risk. Refinancing and M&A activity tells us that the **Federal Reserve** has successfully reversed its recession-triggering deflationary error (while gold, commodity and forex markets suggest that, so far, the Fed has avoided triggering a new cycle of inflation in the process). Microsoft's move -- which we expect will be imitated in various forms by other companies -- tells us that corporations are beginning to be able to trust the long-term stability of the tax and regulatory environment.

Restructuring makes expansion possible -- but it can be confusing and painful. Acquisition activity, in particular, can be especially dislocative in the short term, but it is necessary to eliminate inefficient firms and extinguish excess capacity. It is no coincidence that there is so much acquisition activity going on in the Information Technology sector, where so much excess



capacity was created by the deflation-induced recession. The resurgence of financial liquidity in the economy is giving worthy smaller technology firms a new lease on life -- but undifferentiated second- and third-tier firms are about to be gobbled up by first-tier firms (see "Let's Play Survivor" September 24, 2002). To see how inevitable this is, consider that in the S&P 500 Information Technology sector, there has been virtually no aggregate sales growth for two years -- but that's because the largest ten companies have grown their aggregate top line by $10 billion per quarter, *entirely* at the expense of the other 73 companies in the sector.

While this restructuring process goes on, it may be a while before employment statistics show marked recovery. And while the animal spirits of entrepreneurship may be resurgent in the breasts of the CEOs who have to carry out this restructuring, it may be a while before they are willing to say anything the least bit irrationally exuberant in an earnings conference call. The stock market may not see all the initial claims numbers and earnings guidance it would like -- yet -- but it's smart enough to see the necessary conditions for expansion falling into place.