

MACROCOSM

## Another Virtuous Cycle

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**It's not just one great quarter. The economy's growth engine has been turned back on.**

In the wake of last week's stunning report of a 7.2% third quarter GDP growth rate, many economic seers -- who up until recently were dubious that the economy could avoid sliding back into recession -- had to quickly come up with a new rationalization for their enduring gloominess. The strong quarter, you see, was pretty much a one-time *consumption* event spurred by the rebate checks sent to taxpayers last spring and a highly stimulative monetary policy, with **the Fed** maintaining a funds rate target of just 1%. With the extra cash from **Uncle Sam** now spent and the Fed unlikely to stay this easy much longer, the props of rapid expansion have already been kicked out from under the economy.

This conventional demand-based conception presents a narrow one-dimensional view of what is in reality the unfolding of a highly dynamic, self-reinforcing process of wealth creation and capital formation that points to a sustainable run of robust growth. Three years after the late-1990s boom came to a sudden and shattering halt in mid-2000, it appears that many of the ingredients of that era of elevated expansion are reemerging. A climate of rising expected returns and falling risk premiums is reinvigorating investment in productivity-boosting technological advances. Equally important, recovery of the market's appetite for risk is restoring the availability of capital to finance the entrepreneurial and innovative enterprise indispensable to sustaining a vigorous growth path.

We're not nostalgists for the late '90s by any means. The excesses and errors that occurred in the frenzy to capture seemingly limitless riches caused real economic damage in the inevitable blowback. But it would be a mistake to throw the baby out with the bath water by failing to distinguish the mistakes of those dizzying days of business-plan capitalism from the fundamental economic gains made possible by the accompanying technological revolution. For that matter, the decisive role of the Fed's super-tight monetary policy in subverting those gains should not be overlooked either. The Fed's monetary deflation crushed expected returns and caused risk premiums to soar, which turned what otherwise would likely have been a relatively modest market correction into an historic bear market and profits collapse.

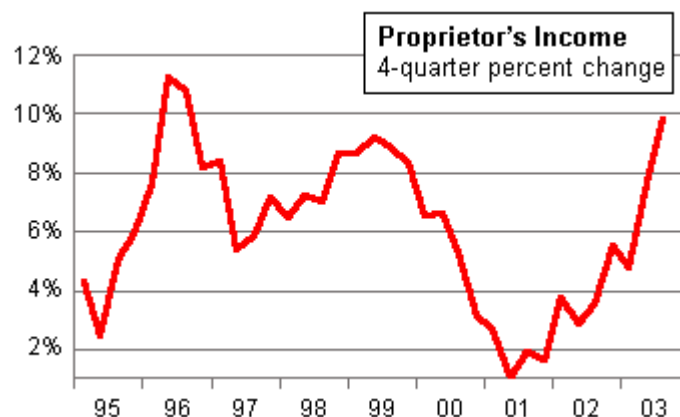
Indeed, one key catalyst for the nascent capital-formation turnaround is the Fed's reflationary policy thrust over the past year. We continue to have intense concerns about the central bank overcorrecting for its previous deflationary error and sowing the seeds of an inflation breakout. But there's no question that up to this point the Fed's reversal of the earlier excess dollar scarcity has had highly salutary effects, relieving the risks attached to expectations of future returns and thereby encouraging the resumption of fixed investment activity. The other major catalyst for the makings of a solid investment-led expansion is the improved after-tax incentives to put capital at risk resulting from the tax cuts enacted last spring. Although it escapes the myopic vision propagated by the **Keynesian** consensus -- which has "the consumer" as the

focus of all economic activity -- these increased after-tax rewards to productive economic endeavor will prove to have lasting pay-offs in terms of the staying power of this expansion.

In short, what we are now witnessing is the emergence of a new, self-sustaining virtuous cycle. As a result of reduced obstacles and increased incentives to growth, risk premiums are falling and expected returns to capital are rising. The improved growth outlook is leading to higher equity valuations, which is lowering the cost of capital. That is encouraging a more rapid expansion of the capital stock and a rising tolerance for risk. And *that*, in turn, will further increase the economy's capacity for growth -- resulting in the market discounting for the higher expected returns and renewing the cycle.

Early results of the process are becoming difficult to miss. Business fixed investment is accelerating at rates typical of the second half of the last decade, with equipment and software spending up at an annual rate of 15.4% in the third quarter, more than 6% on a four-quarter basis. Within that broad category of capital expenditures, the info tech sector is booming again.

Information processing and software investment rose at an 18.3% annual rate last quarter, posting four-quarter growth of 12.5%. For our purposes, the significance of this data goes well beyond their contribution to a single quarter's reported GDP growth. Rather, they represent a manifestation of the process by which rising expected returns to capital are captured by growth of the capital stock, thereby increasing the economy's income-producing capacity.



This rising real investment activity coincides with indications from some of the market's most risk-sensitive sectors, suggesting that a broad-based regeneration of capital formation is underway. The rally in high-yield debt, which since early in the year we have pointed to as a harbinger of the economy's improved growth prospects, continues. Having been more than halved since this time a year ago, the S&P Speculative Grade credit spread -- at less than 500 basis points -- is now

back to levels last seen in early 2000 prior to the onset of the risk-aversion that began crushing the market that spring. Continued recovery of initial public offerings is another indication that growing confidence in the sustainability of the expansion is showing through in a higher tolerance for risk. Last week saw five new offerings raising a total of more than \$850 million, the best week for IPOs in more than a year. And in a sign of health at the grassroots of the entrepreneurial economy, third quarter proprietors' income rose at an annual rate of more than 15% and is up nearly 10% in the past four quarters. This reflects the activity of partnerships and other unincorporated businesses, and is at least as encouraging as any of the other indicators of recovery in the market's animal spirits. **TM**