# TrendMacrolytics

Donald Luskin, Chief Investment Officer
David Gitlitz, Chief Economist
Thomas Demas, Managing Director

MACROCOSM

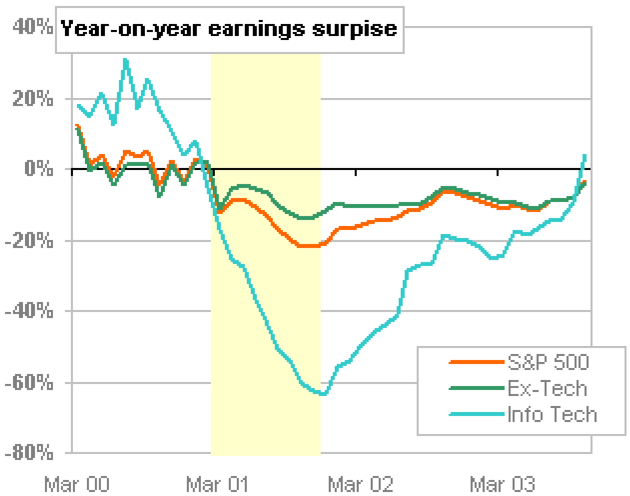
## The Road to Hope

Thursday, November 6, 2003

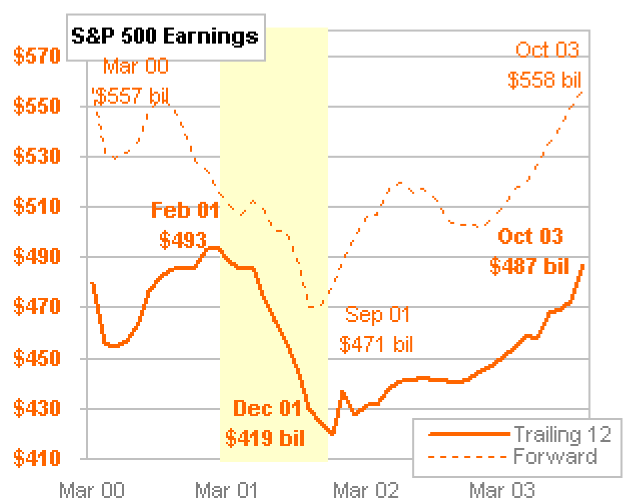
**Donald Luskin**

### Risks abound, but is it time to stop worrying and love the expansion?

As always, **Cisco CEO John Chambers** captures the *zeitgeist*. He told investors in yesterday's earnings report, "While things are starting to look better, it is still fragile." Thus the conventional wisdom evolves from the state of fear exemplified by last year's regrettable "Dow 5,000" call by **PIMCO's Bill Gross**, into grudging admission that recovery is upon us and lingering worry that it will not mature into a real expansion. Having gone now from "fear" to "worry," the groundwork is laid for the next step: "hope" (and then maybe even someday "greed").




Reality is less worrisome than the conventional wisdom seems to think. Earnings are accelerating to the point where they are delivering positive year-over-year surprises for first time in more than two and a half years (in other words, reported trailing 12-month earnings are higher than the consensus forecast made one year prior). Technology -- the most growth-sensitive sector, and the one hardest hit in the recession, is leading the way. As of month-end October, reported earnings for the S&P 500's Information Technology sector beat the year-ago consensus by 4% -- remarkable, considering that the consensus is congenitally too high, on average historically by about 10%, making this upside surprise effectively 14%. For the S&P 500 overall, earnings are now falling short of expectations by 4% -- but that's the smallest shortfall in years, and the consensus has historically been too high by about 6%. It's simple: reality is telling the consensus, "you've been too pessimistic."




The consensus is learning. At month-end October, consensus one-year forward earnings for the S&P 500 quietly nudged into all-time high ground at $558 billion, edging out the previous record of $557 billion set in March 2000. And today's record S&P 500 forecast is especially remarkable considering that the S&P 500's tech sector remains so far *below* peak earnings (the consensus for the sector is now $23 billion *lower* than it was in March 2000). This does not bespeak mere recovery -- it fairly shouts "expansion!"

Cutting against the grain of improving realities

http://www.trendmacro.com
don@trendmacro.com
dgitlitz@trendmacro.com
tdemas@trendmacro.com

Offices:
Menlo Park CA
Parsippany NJ
Stamford CT

Phone:
650 429 2112
973 335 5079
203 322 1924

and expectations of earnings expansion are the risks for markets of protectionist or inflationary policy errors. If these occurred, they would undercut the powerful pro-growth policies that have done so much to turn the economy around (see "Desperately Seeking Inflation?" October 29, 2003 and "Frustrated and Concerned" October 21, 2003). Another risk that cannot be ignored is the possibility that **President Bush** will not be re-elected. Setting overall political preferences to one side, the reality for markets is that all of the **Democratic** candidates are running on dangerously anti-growth economic platforms. In our view these are legitimate reasons for not entirely abandoning the "worry" stage and moving whole hog into "hope" -- and they may go a long way toward explaining the persistent undervaluation we see in most market sectors (except, notably, for technology).

Yet these concerns all have one thing in common: to an important extent, they are all products of recession -- and to the extent that a new expansion takes hold, they will simply drop off the risk radar. Consider the political dynamics of job creation. If the expansion begins to generate notable levels of new payroll employment, then calls for protectionism will lessen, **the Fed** will have less reason to mistakenly keep interest rates unsustainably low for a "considerable period," and President Bush will become more re-electable.

We think the expansion has already started to generate jobs, and will continue to do so. We predict that jobs growth will start surprising the too-worried consensus, just like earnings have done, and that the consensus will have to recognize *that* reality, too. But for now, the conventional wisdom is mired in urban myths that perpetuate the notion that job growth is virtually impossible. I myself fell prey to such a myth in a recent client report, writing that it is "a virtual certainty that Bush will be the first president since **Herbert Hoover** to have presided over net job losses during his administration." Is it really beyond hope that the economy over the next year could add the 2.6 million jobs necessary to beat this "virtual certainty"? No -- the reality is that the post-war US economy has generated that kind of job growth in 57% percent of all 12-month periods.

So let's say that we do start seeing employment growth and other evidence of continuing and sustainable expansion. At that point, the resultant lessening of political risk would itself feed back into markets and the real economy, which would lead to even further economic expansion (which would, in turn, lessen political risk even further, which would, in turn... and so on). It could be a case of what **George Soros** has called "reflexivity." And that's something devoutly to be hoped for. TM