TrendMacrolytics

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

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Tough Time for Tech

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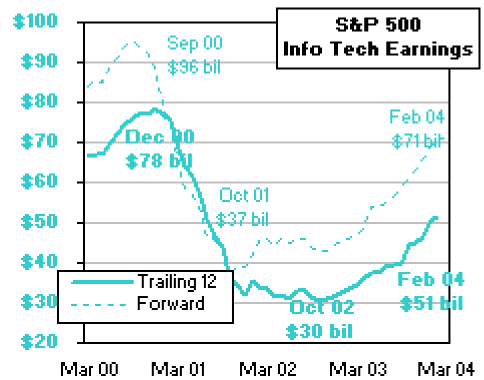
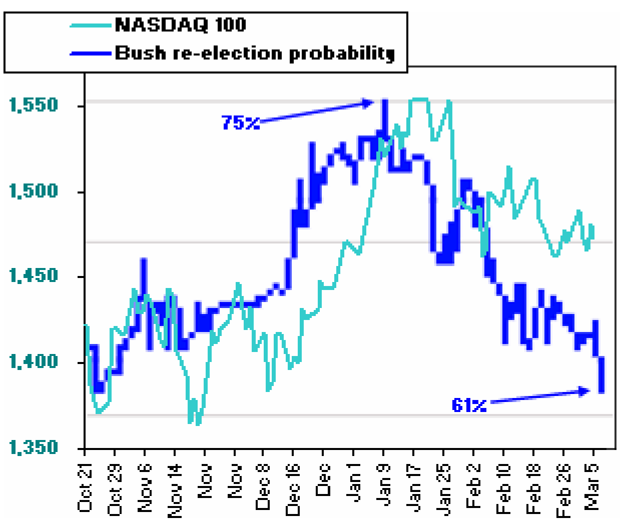
Donald Luskin

The most growth-sensitive sector is caught in the crossfire of political and monetary risks.

The **S&P 500** hovers quiescently near recovery highs and the economy charges ahead by most accounts, other than payroll jobs statistics. Yet we are concerned that the canary in the mineshaft is looking a little pale. The growth-sensitive **Information Technology Sector**, which led the recovery from the March 2003 bottom, has fallen into fourth place behind the **Materials**, **Financial**, and **Consumer Discretionary** sectors. With a 52% gain since the March 2003 bottom, ahead of the S&P 500 by only 8%, the technology sector hasn't even earned its beta. What is tech trying to tell us?

It's not a question of earnings, at least not directly. Consensus forecasted earnings for the tech sector are growing at an annualized rate of 73%. At $71 billion, today's forward consensus, if achieved, would put earnings within 10% of the all-time peak in actual earnings, booked in December of the glory year 2000. No, it's a question of sentiment -- or, more precisely, risk premium. According to our "Yield Gap" risk premium model, the tech sector is undervalued, as much so as it was last June shortly after the tax cuts were enacted. While still less undervalued than most other sectors the tech sector is cheaper today than it has been at any time since March 2001, relative to the S&P 500 Ex-Technology.





The tech sector's problems began in mid-January, following by several weeks the peak in the probability of **George Bush** being re-elected -- at 75%, according to futures contracts traded online at **Tradesports.com**. The sharp run-up in tech stocks in December similarly followed a run-up in the Bush contract, triggered by the capture of **Saddam Hussein** and the expectation that Bush would have an easy opponent in **Howard Dean**. Now, with Dean out of the race, and **John Kerry** the presumptive **Democratic** nominee, the Bush contract has dropped to a probability of 61%. If the Bush contract is to continue leading the tech sector by several weeks, then the **NASDAQ** has another drop in store shortly.

With Bush's probability of re-election *falling*, the

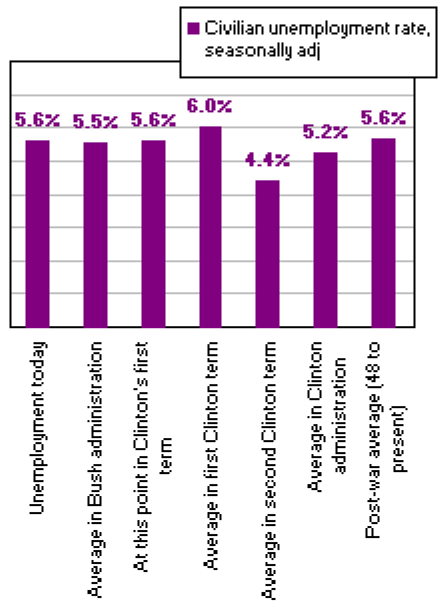
http://www.trendmacro.com
don@trendmacro.com
dgitlitz@trendmacro.com
tdemas@trendmacro.com

Offices:
Menlo Park CA
Parsippany NJ
Stamford CT

Phone:
650 429 2112
973 335 5079
203 322 1924

most growth-sensitive sectors of the economy have to start discounting a *rise* in the probability that Bush's pro-growth tax cuts -- which have played a large role in the investment-led growth recovery of the last three quarters -- will be compromised. Kerry hasn't been very specific, but when he talks about repealing the Bush tax cuts "for the rich," it's an easy guess he's talking about dividend and capital gains tax rates. Will Kerry get elected? Probably not. If he did, would a **Republican congress** go along with repeal? Probably not. But those "probably nots" are less robust than they were two months ago. And at the same time: does George Bush have the political capital right now to make his tax cuts permanent, by removing their 2008 "sunsets" in this year's budget process? *Very* probably not.

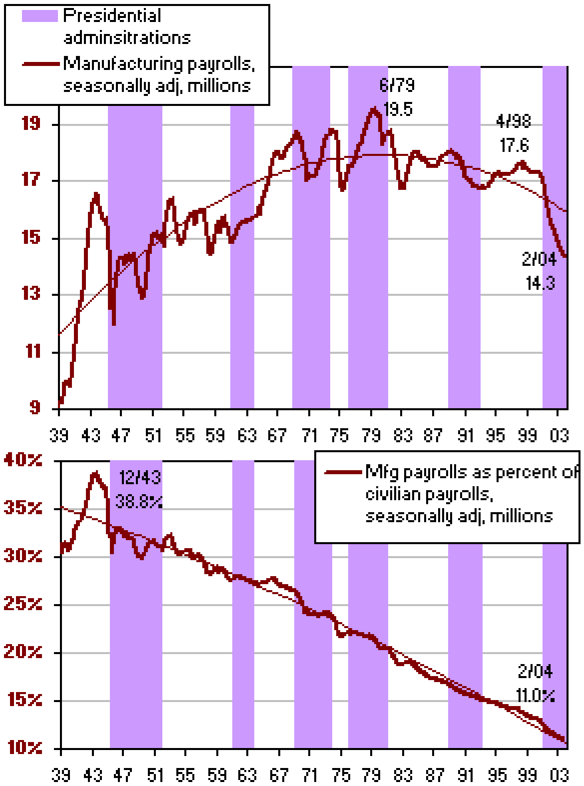
There's another factor at work, too. The Democratic primary season has been an opportunity for the public showcasing of very negative messages about the economy. However politically motivated and unrealistic these negative messages may be, they seem to be having some impact. Obviously, to the extent that they are effective, Bush's re-election probabilities fall. But that aside, a rising sense of fear -- somewhat reminiscent of the risk aversion that gripped the market across the W-bottom of October 2002 and March 2003 -- may be directly playing into a rising risk premium in the most growth-sensitive stocks, and may explain the recently reported drop in consumer confidence, both despite a rising tide of economic recovery.



The centerpiece of the negative messaging about the economy has been jobs. But of course -- that's the one element of the recovery for which some negative statistical evidence, however dubious, can be cited. Yes, payroll jobs as reported in the **Department of Labor's** establishment survey are down by 506 thousand since the official end of the recession. But at the same time, DOL's household survey reports a *gain* of 2.223 million jobs over the same period. And today's 5.6% unemployment rate is *not* unusually bad -- in fact, it is not unusually *anything*, expect perhaps unusually usual. Indeed, unemployment today is precisely what it has been on average since 1948. It is precisely what it was at the same point in the first presidential term of **Bill Clinton**. But the **Bush administration** has been unable to mount any positive messages to contradict or counteract the negative ones. On the economic front, if the Bush administration were a prize fighter, it would be **Rocky**. It's being pummeled bloody -- and one has to hope that it will get off the ropes in the last reel.

Sadly, the electorate is being coached to worry about today's jobs picture not only by self-interested politicians, but also by the economics establishment. Mainstream economists speak of it as evidence of "slack resource utilization," a sign of an economy that can't get unstuck from deflationary recession and requires extreme monetary stimulus. But before the singular experience of the late-1990's tech boom and **Alan Greenspan's** doctrine of New Economy productivity, the establishment would have regarded today's 5.6% unemployment rate as an inflation risk, well below the so-called "non-inflation accelerating rate" (NAIRU) -- and requiring aggressive **Fed** tightening lest the economy "overheat." In our economic model the unemployment rate has nothing to do with inflation or deflation, so these establishment interpretations are little more than random utterances at best, and Rorschach tests at worst: look at the ink blot and tell the doctor what you're afraid of.

A particular element of jobs fear -- ignited by Democratic politicians and fanned by a dutiful media and economics establishment -- is the recent drop in manufacturing payroll jobs. In the top panel of the historical chart of manufacturing jobs (on the following page), that drop does

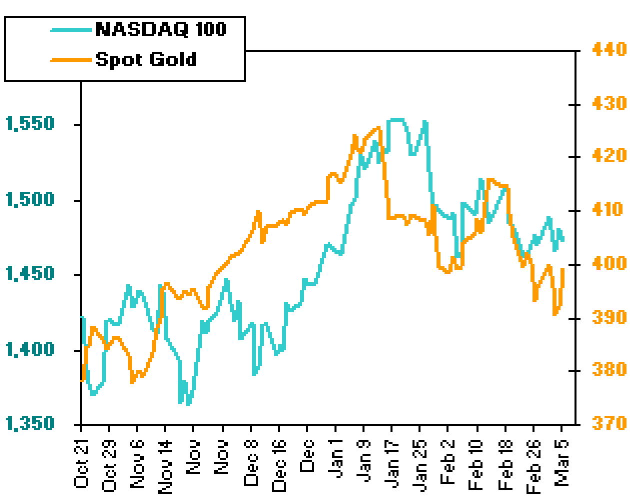


stand out. But more striking is that the drop occurs in the context of a long-standing secular decline that began almost 25 years ago. And the recent drop began not with the last recession, but right in the middle of the late-1990s boom.

Measured in relative terms -- as a percentage of overall jobs, in the lower panel of the chart -- we see that manufacturing jobs have been in steady decline for over half a century. Ironically, today the percentage of manufacturing jobs is actually *above* trend, as it has been since 1996. As the last half century has been an era of unprecedented **US** economic growth and global dominance, there would seem to be no foundation whatsoever for fears that manufacturing jobs are an indispensable success factor, or that their decline ought to be especially risky for the US economy. If anything, these fears are the analogues of those heard in the first half of the 20th century, when agriculture was beginning the process of shrinking from the most important employer in the economy to its position today as one of the smallest.

On the one hand, there is some cause for optimism that the negative messaging about jobs won't stick for long, because it is generally at variance with the real-world experience of the electorate reflected in the charts above. But on the other hand, these messages are cleverly designed to stick. "Outsourcing" is an effective economic bogeyman to strike fear into the hearts of even the employed and the prosperous -- the message is: what happened to manufacturing can happen to services, too.

And remember, in the post-9/11 world, fear is always just beneath the surface -- especially fears that have to do with the capability of seemingly powerless foreigners to disrupt the American way of life. If nothing else, fears of terrorism and war evoke isolationist longings for self-sufficiency at any price. We want to believe that we can be safe by shutting out the rest of the world and by being self-sufficient. Even so-called **neocons** have their fears, imagining that, with the loss of US manufacturing jobs, **Rosie the Riveter** won't be there if we ever need her again (although in their imaginations it is always some Rosie who is supposed to be patiently riveting in the meantime while we wait for war, never themselves).



I've saved for last another factor that has no doubt been weighing on the tech sector -- not because it is less important, but because we have discussed it so often before. By maintaining monetary policy that has been too easy for too long, the Fed has set in motion new inflationary dynamics that cannot help but be reflected in the sector that is the most growth-sensitive and the most speculative. In the long run, a resurgence of inflation would be bad for all stocks -- especially the highest-multiple sectors that have the most to lose from a sudden hike in discount rates. But as the chart at left suggests -- showing the relationship of the NASDAQ to the highly inflation-sensitive spot price of gold -- in the short run, inflation can be a good thing. Rising when gold rises and falling when gold falls, it's hard to not draw the conclusion that the tech sector likes inflation.

No, what the tech sector likes is easy money. A sector that always needs capital -- to finance its own rapid growth directly, and that likes it customers to be able to finance ambitious capital spending plans -- thrives on liquidity. Remember, this sector has just been through the business cycle from hell, in which for several years liquidity was infinite and free, and then suddenly became unobtainable at any price. Now, after being lost in a financial desert for three years and having just found water, it may be a while till the tech sector worries much about drowning. The more immediate concern is that the water will dry up. Drowning is for another day.

We have long argued that the Fed should be ending its cycle of extreme easiness -- indeed, it should have ended it six months ago. When that end comes, it will be disappointing at first for the market, the tech sector most of all, and perhaps that's just what we've been seeing. As we've said all along, that makes a "buyable dip," because long term earnings growth is best served not by easy money but by stable money. But with Friday's disappointing payroll jobs report, the monetary policy deck has been shuffled once again.

Until these risk factors begin to resolve, it's hard to believe that the Technology Sector will reclaim its place at the head of the bull market. But in relative risk premium terms, the sector is priced quite attractively: again, compared to the S&P 500 Ex-Technology, the tech sector is cheaper today than it has been at any time since March 2001. Correctly identifying any catalyst of risk resolution will be well rewarded. If such a catalyst doesn't come, then the problem will be a lot more than tech.