TrendMacrolytics

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

MACROCOSM

# Slowdown?

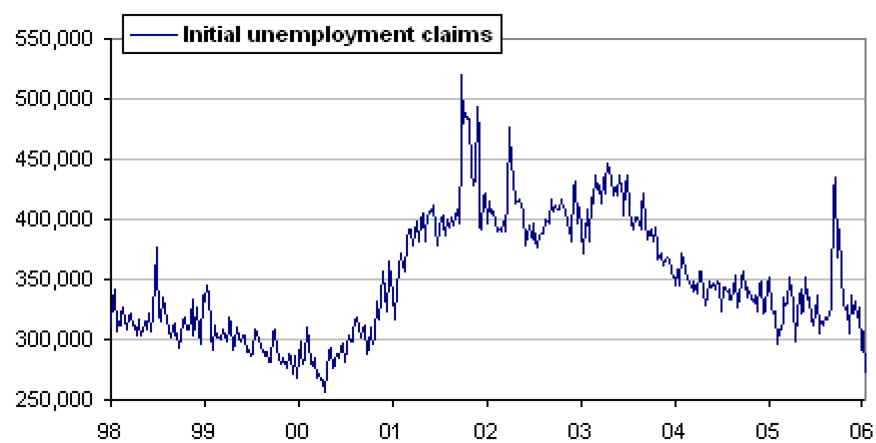
Thursday, January 19, 2006
**David Gitlitz**

**The pessimists have been wrong all along, and they're still wrong.**

Once again the economic pessimists are taking center stage, as reflected Tuesday by the ***Wall Street Journal*** opening a holiday-shortened week with a front-pager trumpeting the views of a "handful of forecasters" who see a "marked slowdown in the works." The dour case is based on the notion that a **cooling of growth** late last year reflects a trend shift that will pull the economy back to a growth rate of less than 3% this year. But we see little in this latest spate of naysaying to alter our view that the climate of **risk-taking**, **capital formation** and **wealth creation** remains robust, part and parcel of a self-sustaining dynamic of vigorous **economic expansion**.

In fact, it's debatable whether the economy slowed in any real sense in the fourth quarter last year. Much is being made of a slowing in **non-auto retail sales**, which rose at an annual rate of just 1.9% in the final three months of 2005. All else equal, plugging this reputed softness in **consumer spending** into the **GDP** tables yields a growth rate approaching 3%, down from 4.1% in the third quarter. Potentially, next Friday's fourth quarter GDP release might garner headlines as showing a sharp slowing in growth, with consequent implications for the anticipated path of **the Fed's rate-normalization campaign**.

We believe that would present a compelling opportunity to take the other side of the bet. There is scant evidence available to confirm that overall economic performance fell back significantly late last year, and more **forward-looking indicators** show that the economy remains poised for solid **expansion** going forward. It's quite possible that recent consumer spending data is reflecting nothing more than **volatility** resulting from the **hurricane-related dislocations** of late last summer. Certainly, it is not consistent with other measures capturing an economic engine hitting on all cylinders.

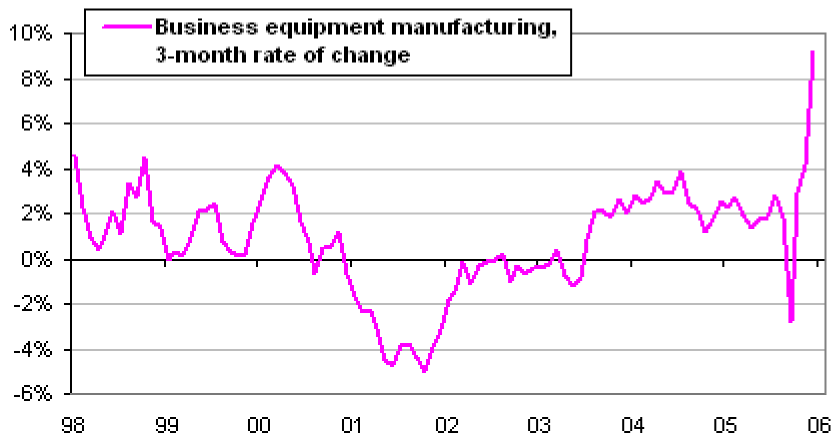



It's not likely, for one thing, that a decelerating economy would be yielding the kind of **tax revenue gains** now flowing into federal coffers. In the fourth quarter, tax receipts were up by nearly 9% from the same period a year ago, and **Treasury** recorded an $11 billion **surplus** in December. At the same time, the **labor market** is now exhibiting the kind of strength unseen since the height of the last expansion. Weekly **initial unemployment claims** have fallen below 300 thousand, a level considered a benchmark of economic nirvana in the late '90s.

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

Offices:
Menlo Park CA
Parsippany NJ
Charlotte NC

Phone:
650 429 2112
973 335 5079
704 544 6900




The **industrial** side of the economy, meanwhile, has also been restored to vibrant health, and particularly is gaining from a full-bore recovery in **capital investment** activity. Overall, **industrial production** grew by 3.8% in the fourth quarter, up from 1.5% in the third. Most impressive, however, was a gain of more than 9% in **business equipment manufacturing**, as production in this critical area ramped up to meet the **capital goods** needs of **American** enterprise in expansion mode. **High-tech production** grew by some 26% last year, as businesses continue to retool to capture the efficiency gains made possible by the ongoing technological revolution.

This data, while an encouraging snapshot of recent activity to enhance and expand the **capital stock**, tells us nothing in itself about the outlook for continued growth in the economy's **income-producing capacity**. More sensitive market-based gauges, however, suggest that the contemporaneous data reflects an investment setting where strong **expected returns** are fostering an environment of **risk tolerance** crucial to the growth-sustaining capital formation process. If the pessimists had a leg to stand on, a significant curbing of **growth expectations** would surely be showing up in some of the more risk-sensitive market segments such as **high-yield debt**. The **Merrill-Lynch high-yield spread**, however, has remained in a range around 350 bps since last fall, after briefly spiking above 450 bps last spring. As a warning sign of economic trouble ahead, we'd note that in the last economic downturn, the high-yield spread began a sustained rise from its previous ranges in late 1999, nearly three months prior to the first rumblings of a bear market in equities.

As a rough and ready proxy for the market's **risk preference** and growth expectations, we also monitor the ratio of the **NASDAQ Composite Index** to the **Dow Jones Industrial Average**, which has reliably foreshadowed shifts in the economic climate over the years. Presently, the NASDAQ/DJIA ratio is at its highest post-bear market level, up some 10% since **"soft patch"** anxieties early last year precipitated a stretch of underperformance for higher-risk stocks. It's worth noting that the current wave of economic misgiving is apparently regarded as even less credible in the markets than that earlier episode.

Economic expansions don't die of old age or peter out of their own volition. Almost invariably, downturns result from **policy errors** of one sort or another, whether **monetary**, **fiscal** or **trade**. While we dismiss the current negativity as being unfounded, that's not to say we don't see **risks** in the current environment. Most pressing is **the Fed's** unfinished business in restoring **monetary equilibrium** after an extended period of extraordinary **accommodation**. Should recent speculation that the central bank is preparing to soon call an end to this cycle be proven correct, we believe it will end up being a relatively short-lived pause. As the lagged effects of the Fed's long-standing **hyper-easy posture** begin to show up in the **core inflation** data, policymakers will have no choice but to re-start the **rate-hiking process**, quite possibly overshooting the economy's tolerance for higher rates in the process. There is, as well, the open question of whether **Congress** is prepared to extend the **dividend and capital gains tax cuts** which have been so vital to launching and sustaining the accelerated pace of expansion over the past two and a half years. On both counts, we remain hopeful that policy will end up getting it right. There is, however, a significant margin of uncertainty that attaches to both issues, and we intend to keep a close watch as developments unfold.

**Bottom line:** Economic pessimism is again the flavor of the week, but our analysis finds that any suggestion that this economy is in the process of rolling over is grossly premature. Nonetheless, next week's GDP release could print "soft," due to what's likely to amount to a short-run aberration in consumer spending data. That could, in turn, give rise to another round of speculation that the Fed will terminate the rate-hiking process *post-haste*. If that transpires, this speculative episode is no more likely to be proven correct than any of the others that have failed to pan out during this policy normalization process. TM