TrendMacrolytics

Donald Luskin, Chief Investment Officer
David Gitlitz, Chief Economist

MARKET CALLS

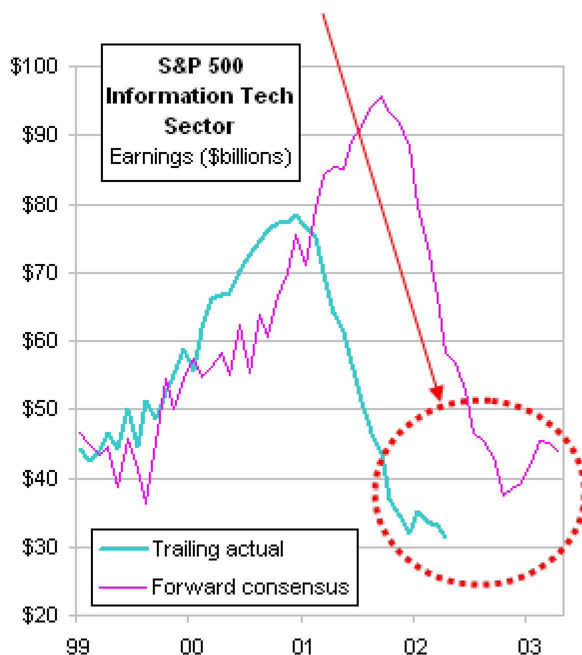
Into the Valley of Death Rides Cisco

Wednesday, May 8, 2002
Donald Luskin

After several days of panic selling in key technology stocks such as **IBM** and **Oracle**, it wouldn't be surprising to see at least some kind of short-term relief rally triggered by **Cisco's** third quarter FY02 earnings last night. The relief rally could be substantial considering how far technology stocks have fallen, but in the end it is likely to prove to be just as ephemeral as it was when similar reports from **Intel** and **Microsoft** were released several weeks ago.

The pattern is getting embarrassingly familiar. Beat or meet... a little light on revenues... better than expected margins... lackluster guidance... gaining market share... the economy is still uncertain... we don't see any turnaround.

The newspapers and the Wall Street research reports are full of good things to say about Cisco this morning. My favorite spin -- because I admire its sheer looniness -- is that Cisco is well positioned to recover because its business mix is skewed 65% to the enterprise market, and only 35% to the down-and-out telecom carrier and Internet service provider markets. The truth is that this mix was not a strategic choice for Cisco, but rather the consequence of these markets imploding all on their own. Enterprise didn't get bigger for Cisco so much as the carrier and ISP markets got smaller. Carries and ISPs are the markets that made Cisco's peak earnings and peak growth-rates possible. It's going to be tough -- no, *out of the question* -- to make it back without them.



Now with Cisco out of the way and the bulk or earnings season behind us, we can see that the earnings devastation in the technology sector deepening, amidst continuing talk of stabilization and recovery. As of month-end April, trailing 12-month earnings for the S&P Information Technology sector moved to new post-bubble lows. This means that year-on-year comparisons are still continuing to worsen -- and that the stabilizing effects of drawn-down inventories have not yet, on balance, taken effect.

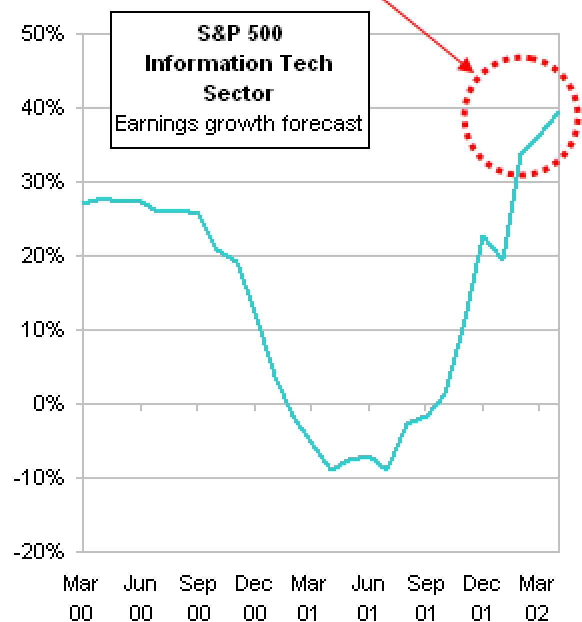
At the same time, we've now had two months in a row of downticks in the consensus for forward earnings, following a strong surge from the lows in October, 2000. Analysts on average are now seeing lower total earnings one year out for the technology sector than they saw two months ago.

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

325M Sharon Park Drive #325
Menlo Park CA 94025
Phone 650 429 2112
Fax 650 429 2112

42 Forest Drive
Parsippany NJ 07054
Phone 973 335 5079
Fax 973 335 8016

While trailing actual earnings make new lows, and forecasts for forward earnings turn lower, the consensus forecast earnings *growth-rate* -- the year-on-year forecasted percentage change in earnings, as opposed to the forecasted total dollar value of earnings -- for the S&P Information Technology sector has moved to new post-bubble highs. This means that forecast earnings aren't coming down as fast as actual reported earnings, and suggests -- if you rule out that Wall Street analysts have true forecasting abilities -- that the investor community is still finding it difficult to accept the full measure of technology's loss of earnings power.



I saw a version of this same difficulty as we visited with clients in Boston and New York last week. I was struck by the near-universality of the view that "everyone else has given up on tech," and that, therefore, the smart contrarian thing to do is to buy tech here. But what are we to make of it when everyone says that "everyone else" has given up? Has anyone *really* given up -- or is everyone hanging on to his own private hopes, each believing himself to be the only one doing so?

The best evidence that hope continues to spring eternal is in the simplest measure of value in the technology sector. In the panic bottom at the end or March, 2001 the forward price/earnings ratio for the S&P Information Technology sector fell to 26.9 -- a low it hadn't seen since September, 1998. And it hasn't seen such a low since, either. At yesterday's close, even after all last week's tech devastation and with the NASDAQ making lower lows than it made in March, 2001, the forward p/e for Information Technology is still 31.1.

That forward p/e was above 50 early last December when we first suggested selling technology stocks and tactically shifting into long-term Treasuries (see our Sell NASDAQ/Buy Bonds Model Position). As the forward p/e has come more into line, we've suggested closing half the position and taking significant profits on both sides. In some sense this has been the ultimate contrarian trade, because "everyone else" says that you can't trade tech based on value. You *can* -- and while the easy money is now out of that trade, there's no reason today based on value (or anything else, in our view) to think that the technology sector can now sustain anything more than a short-lived relief rally. TM