Donald Luskin, Chief Investment Officer
David Gitlitz, Chief Economist

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Beyond Iraq

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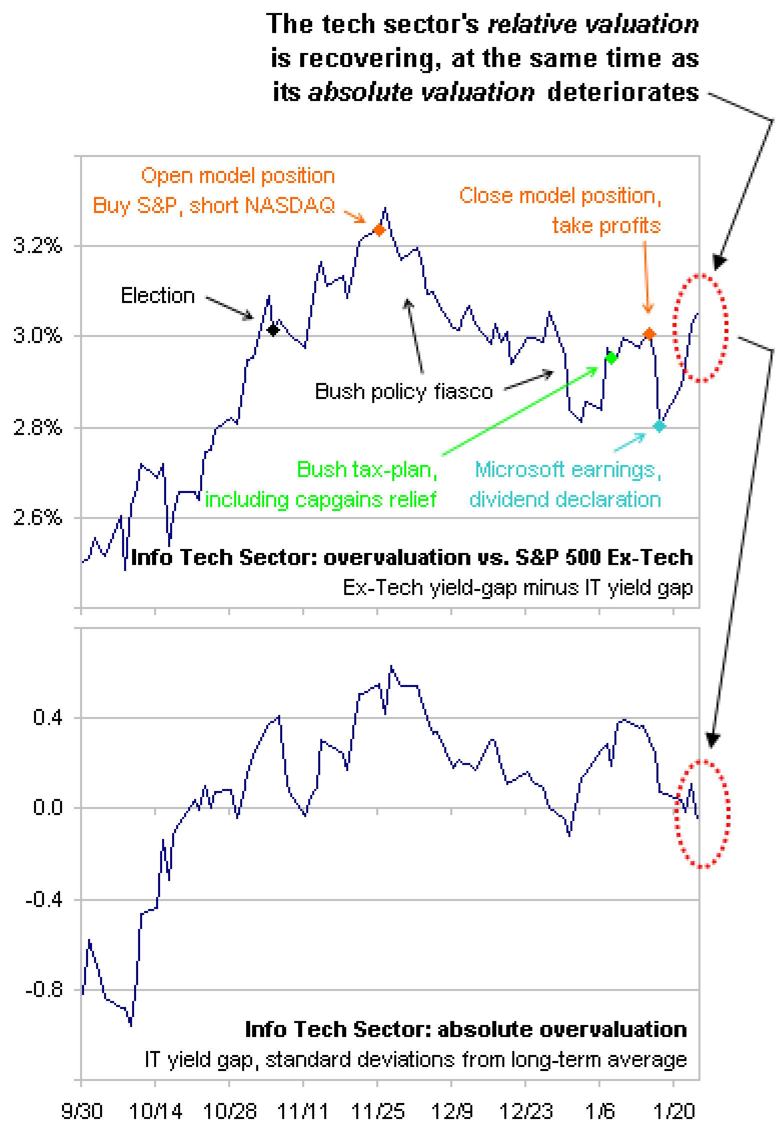
Donald Luskin

Shifts in valuations are hinting that there's growth out there beyond the risk of war.

We may be facing an unusual moment in the history of market valuations in which both risk *and* expected returns are on the rise at the same time -- and unfortunately, at the moment risk is winning. Clearly, fears of the domestic consequences of possible war with Iraq -- both realistic and unrealistic -- are building back into overall stock prices the extreme risk premiums we saw in the summer and fall of last year. Yet, at the same time, there is evidence that markets are seeing that, beyond the valley of war worries, the preconditions for a return to robust growth are falling into place. For example, last week my **Trend Macrolytics** colleague **David Gitlitz** pointed out that high-yield bonds have held up surprisingly well during a time of heightened risk aversion (see ["Upside, Downside"]() January 23, 2002). A look into the relative valuation of equity sectors leads to a similar conclusion: that today's whiff of panic is in the realm of global *risk*, and not a reflection on potential long-term economic *rewards*.



The two charts at left are different portraits of the evolution of the risk premium in stock prices since the October 2002 lows. The top panel shows the *relative valuation* of the S&P 500 Information Technology sector versus the rest of the S&P 500, and the bottom panel shows the Technology sector's own *absolute valuation*. Note that the two measures of valuation have moved pretty much in lock-step -- till last week.

Both relative and absolute Tech sector valuations rose first in anticipation, and then in celebration, of the November **Republican** electoral sweep -- in hopes that a sweep would usher

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 973 402 5074

in pro-growth policy initiatives that would disproportionately benefit the growth-sensitive Tech sector. In late November, the Tech sector was one of only two equity sectors to be *absolutely* overvalued, and its *relative* valuation attained the highest levels since the very top of the techstock bull market in March, 2000. Then through December, the **Bush administration** foundered with weak appointments for key policy positions and the floating of uninspiring "stimulus" proposals -- and valuations backed off considerably. When the administration surprised the markets with a bold tax-cut plan that included both top-bracket and cap-gains relief, valuations began to recover.

Then a week ago Friday, markets dropped on disappointment in **Microsoft's** earnings and guidance -- and the Tech sector fell disproportionately. We argued at the time that there was nothing in Microsoft's report that was a surprise, and that the market was failing to discount the growth prospects embedded in the current policy mix (see "Microsoft's 'Starter Dividend'" January 17, 2002).

This brings us up to the present -- and *now* there *is* evidence that perhaps new growth prospects *are* beginning to be embedded. Last week, and especially in Friday's big drop, absolute valuations across the market tumbled, including in the Tech sector. But as stocks fell last week, riskier technology stocks should have fallen more -- but they didn't. As a result, the Tech sector's *relative valuation surged higher*, and is now above where it was when Microsoft's results were announced.

What does it mean when the riskiest, most beleaguered, and most growth-sensitive sector of the economy surges in *relative* valuation even when valuations overall are falling? It means that global risk is on the rise, suppressing *all* valuations. But at the same time, expected returns are rising, too -- reflected disproportionately in the *relative* valuation of the most growth-sensitive sector. The market loathes the wild-card risks of a politically divisive war that may invite terrorist retaliation. But at the same time, the market is beginning to see that stabilized monetary policy and the potential for significant pro-growth tax policies have opened up a new world of upside potential.

There really is something good now on the other side of the valley. The only question is getting there -- and the markets are clear that this is a non-trivial question. While it's being answered, the implication for stock investors is that in this time of great risk, the sector that is normally the riskiest may be among the most resilient. TM