

MACROCOSM

Flies in the Ointment

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David Gitlitz and Donald Luskin

The growth case is compelling, but the markets are pausing to consider the risks.

We have little doubt that the case for an upbeat economic outlook, and a bullish take on an equity market that is still attractively priced relative to that optimistic perspective, remains largely intact. After several years of a monetary deflation that added an exorbitant risk premium to the cost of capital and crushed the market's capacity to finance innovation-driven growth, monetary policy has turned decisively reflationary. At the same time, the tax bill signed into law less than two months ago featured several pro-growth elements that fundamentally reduced tax-based obstacles to productive economic endeavor. Taken together, these changes in the policy setting can be seen favorably altering the risk/reward calculation in the decision to put capital at risk, paving the way for a regeneration of the capital formation process.

Despite the dark tone of much of the media's ongoing coverage, we see compelling indications in the data that the economic landscape is, indeed, turning brighter. This week's industrial production release, for example, was widely considered disappointing due to a weak 0.1% growth rate in the overall index for June. That apparent softness, however, was primarily attributable to a slow month for electric utility output owing to a cooler than normal start to the summer season in much of the country. Manufacturing production rose last month by 0.4%, its best performance since January. And though it remains largely overlooked in the media, the fastest growing sector of manufacturing now is the one that was devastated most in the deflation tsunami of 2000-2002: high tech. The category of computers, telecommunications equipment and semiconductors had its fifth consecutive month of better than 1% growth, and has been expanding at an annual rate of some 14% over the past three months.

Forward-looking financial markets, of course, are far more sensitive to economic turns than are the lagging data, and for the past several months they have been absorbing the risk premium in asset values and thereby pricing for a significant growth acceleration (see ["Betting on Growth"](#) July 11, 2003). The equity risk premium revealed in our "yield gap" valuation model has pulled back from the extraordinarily high levels seen in the worst of the risk aversion spasms of the last 12 months. But investors are still pricing equities to reflect a demand for higher relative returns compared to Treasury bonds than at almost any time in the last 20 years. If our forecast for a return to robust growth proves correct, then equity investors will profit not only from upward earnings revisions, but from the continued absorption of a generous risk premium. It could be a growth win and a value win at the same time.

That said, we detected a somewhat disquieting tone in equity market movements of recent days. We don't yet have reason to call into question the sustainability of the gains achieved to date, nor doubt the still-compelling upside prospects. But neither do we think the clichéd analysis that the market may have come "too far, too fast" offers a full explanation. Rather, we see the market reflecting further evidence of what we have already characterized as intensified political risk (see ["Four Pillars of Wisdom"](#) June 20, 2003).

First is the imbroglia over the State of the Union address and what the **White House** did or did not know about the reliability of cited intelligence pertaining to **Saddam Hussein's** efforts to obtain African uranium. From the beginning, we have highlighted the importance to **President Bush's** political capital -- with all that implies about continued political momentum for pro-growth policies -- of the discovery of weapons of mass destruction as both a trophy and an after-the-fact justification for the war on Iraq (see ["WMD and the Market"](#) *Trend Macro Live!*, April 10, 2003). Not finding WMD is a missed opportunity to create political capital; if it were proven that Bush lied or manipulated intelligence about WMD, it would be a blow to political capital.

Objective analysis would seem to cast considerable doubt on the proposition that the President engaged in purposeful deception. Most important, the assertion was sourced to **British intelligence**, who -- most recently yesterday in the person of **Prime Minister Tony Blair** -- continue to stand by it. But whether or not allegations that the President made knowingly misleading statements ultimately stick may prove to be beside the point. In this evolving political season, the objective of the **Democrats** is not to prove "truth" but to sow doubts about Bush's integrity and candor in the minds of voters. Polls taken since the controversy first erupted appear to show little if any effect on Bush's standing. But if the party's candidates and officials believe they've found a vulnerability in Bush's seemingly impregnable leadership stature, they're likely to continue hammering away and an erosion of his popular support is certainly not inconceivable. Of course, an overtly politically motivated smear campaign could also boomerang against the Democrats and end up redounding to Bush's benefit.

The market significance of this episode has been magnified by it breaking at the same time that new budget estimates were released showing a "record" \$455 billion deficit for the current fiscal year. From our perspective the significance of the federal deficit is primarily political, in that it has the potential to weaken support for tax cuts and bolster the case for tax hikes to eliminate the red ink. To one extent or another, every Democrat now running for the party's presidential nomination is calling for reversal of the tax cuts enacted in President Bush's first two-and-a-half years in office and would doubtless put an end to any hope of further tax cutting for the foreseeable future. While at this point it would seem Bush remains well-positioned to capture re-election, there's no such thing as a sure thing in politics, and it's certainly not outside the realm of possibility that the Iraq uranium affair could yet be highly damaging to those prospects. In any case, whatever the realistic possibility that tax hikes rather than further tax cuts will be on the agenda come 2005, the odds are higher now than they were two weeks ago, a reality that the market cannot ignore.

A different kind of political risk is reflected in the cautious tone that is pervading earnings report conference calls this earnings season. While solid results have generally been reported, forward guidance remains highly cautious -- and even when guidance has been quantitatively raised or affirmed, it has been accompanied by subjective protestations of caution by CEOs and CFOs (see ["Intel Earnings"](#) *TrendMacro Live!*, July 16, 2003). In good part, this seems at least as much an ongoing adaptation to a new legal/regulatory framework as it is a reflection of continued economic uncertainty. The **Sarbanes/Oxley Act**, enacted just one year ago this month as the culmination of a legislative and media *jihad* against "corporate crooks," may be having the unintended consequence of virtually outlawing executive optimism -- even when such optimism would be the truest reflection of reality.

But executive actions speak louder than executive words. Even as forward expectations are kept in check for purposes of public discourse, the wave of mergers, acquisitions, takeovers, and refinancings now underway tells of a much more optimistic outlook (see ["A Whiff of Animal Spirits"](#) July 10, 2003). At root, these are commitments of capital that reflect a rising willingness to take the risks necessary to bet on future growth -- and in part by the very act of betting on it, to make it happen. **TM**