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The Disconnect: Business Sector Perceptions and Economic Forecasts

Over the past two months, a widening disconnect has occurred between the profit expectations of business leaders and GDP growth forecasts of economic forecasters for the balance of the calendar year.

Most economic forecasts now target GDP growth for 2002 at somewhat above 3%. Some forecasters are even more optimistic. This means that “consensus” growth rates on Q/Q basis may be well above 4% for particular quarters in 2002. While there is some downward “hedging” for QII2002 by forecasters (QI seen by some forecasters to be stronger than QII), for 3-4% growth performance, one might well expect business profits to be much higher than what is now being heard anecdotally in business circles. Business expectations, particularly for profit growth, seem much more conservative. Will business spending catch up? This is a disconnect worrisome to policy makers, particularly the Fed and to equity analysts. It may be central to the observed lack of clear direction in equity prices in recent weeks.

What could go wrong with the growth forecasts?

Frequently voiced concern of business leaders suggest that while some inventory replacement must take place, businessmen are quite cautious on capital expenditures for new plant and equipment. The lack of pricing power and the changed nature of GDP composition seems to be acting as a “drag” on their capital investment plans. Many firms have undertaken strong measures to slash capacity by closing lines or shipping excess capacity to overseas locations that can be run much cheaper. These capacity reductions entail retrenchment of employment. With profits significantly off their highs experienced during the Boom, capital and employment retrenchment is seen as the quickest way to restore some profitability. That is not consistent with strong growth in private sector spending.

While recessions always end, capital stock conservatism could operate to ‘delay’ significant growth in investment spending. This means that the timing of a fully sustainable rebound could be pushed backward. This may account for the growing sentiment in Fed Watching circles that the Fed will wait longer to finally begin its “reel in.” That in turn raises two significant questions: (1) how high will Fed Funds go during the current calendar year? (150-200-250 basis points?). (2) How fast will Fed Funds rise? If the ‘reel in’ cycle starts in say June and the end of the year target is 250 basis points higher (4%), the Fed could get there with 25-point moves. **If the Fed waits until August, then a 50 basis point move will occur. Investors need to be wary that the market has not properly priced the ultimate path of Fed tightening.**

What is “recovery” going to look like?

The rapid rebound in Q42001 that has continued to accelerate in Q12002 has been driven by consumer spending, and in particular housing, on the private side, a massive slowdown in inventory slashing and by a sharp acceleration in Government spending. All this, while gross private domestic investment is still anemic. GDP growth will be pushed up by the cessation of sharp cuts in business inventories—but that is not a quality recovery. Furthermore, driving GDP with Government spending has questionable productivity consequences. In a March 13th speech, Greenspan worried about this recovery’s over-dependence on the consumer and the need for business investment and inventory spending to go back to healthy levels. This is the “balance” issue.



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The New Geopolitics of Oil? A threat to a full recovery?

One unforeseen outcome of the escalating Mid East difficulties is the impact on the price of crude oil as well as the prices of refined products. Crude touched \$28/barrel and some forecasters are thinking that the crude price could still be \$27 during much of the spring/summer season. This would be in spite of the enlargement of 'spare capacity' in the Middle East. This rise comes despite larger Russian exports that are a principal driver of non-OPEC production growth. Except for Iraq, the major OPEC producers are not threatening the use of the 'oil weapon,' but futures markets have embedded a large geopolitical risk premium. The danger to the economy is that a sharp and sustained rise in oil prices could vitiate much of the positive drive coming from the tax cuts and rebates. This would make the resumption of business investment spending even more critical.

"Winter Kills"

Prior to the beginning of February, the East Coast was 'plagued' with an unduly warm winter. This accelerated housing construction giving more lift to Q12002 GDP. It also reduced spending on fuel for heating purposes. In March and April, a return of cold weather in the East pushed up the demand for 'heating' materials just as the political situation in the Mid East deteriorated. The price of Natural Gas on the NYMEX for May 2002 Natural Gas was \$2.57 on 12/31/02 and the price fell throughout January, February and early March. This gave consumers more spendable income. Since March 8th, however, Natural Gas has steadily risen, hitting \$3.65 per mcf today. That has revived the Oil Patch, but it is pinching consumers. The conditions for a small double dip could be emerging.

The Capital Exit Story Continues

The real key to a steady business sector that expands its demand for investment goods is the reduction of excess capacity in many key industries and the return of some moderate amount of pricing power. This is a process of capital exiting industries with excess capacity. In particular, the Telcom sector seems to be going through a significant process of Capital Exit. This means much pain to investors now, but a chance to create a profitable Telcom sector later on. It strikes us that there is an interesting comparison between the American telcom 'excess' and the Japanese Banking sector.

In the later case, while everyone admits that Japan is heavily overbanked--- the 'survivors' have little possibility of becoming profitable until some of the 'excess' is finally closed out. The Japanese have been unwilling to suffer the sharp setbacks to employment that a rigorous purge would insure...and perhaps it is not so surprising after all that Japan's 'recovery' has been so abortive. Rapid recovery does require painful adjustments to capital stock in many key industries. U.S. business behavior represents a strong preference for rapid change, while Japanese policy makers make the absence of change a virtue...to the detriment of the Japanese recovery.

The comparison between the U.S. Telcom and Japan Banking does suggest some early warning indicators: when sufficient amounts of 'Telcom' capacity and supplier capacity has been taken down, another driver for U.S. growth will emerge. In this example, it seems evident that both Japan and Europe will 'play at recovery measures' a very long time without a strong impetus to new banking capabilities. In some ways, we should be cheering the demise of Global Crossing and the falling stock prices of other members of the telcom set (e.g. Worldcom). When enough financial capital has been destroyed, and enough competitors close up shop, consolidation will cause profitability in the Telcom sector to rise...unless of course the Congress begins to behave like their Japanese counterparts and tries to slowdown the capital exit process. The about-face on U.S. import policy regarding steel makes us wince. Hopefully, this is a one-off policy retreat. The U.S. has a lot to learn from Japan. The important insight is how a political process can really make recovery difficult.