

ECOMENTARY™

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A Paradox on Both Your Houses

Have fun with this one. It has not been a pleasant day for most Longs.

- 1. ECB at the Siegfried Line**
- 2. The Costs of Zero-Cost of Capital**
- 3. How badly will Eurotech get squeezed? In the blackest of the night, we are only using the lanterns offered by US Multinationals who use US Tech Service Companies. Note page 3 attached.**
- 4. GDP growth counts --even for Tech. Central Banks, front and center! March!**

The ECB was a bit cowardly this morning, but Deutsche Bank is predicting 50 basis point cut April 9. What they know we don't know. We don't understand their reasoning. Schroeder is visiting Bush today. Maybe they will talk about a trade: Aggressive Monetary Policy if Bush does the Kyoto Treaty?

With the tech world falling in around our heads, it is often hard to hear one's inner voices. The inner voice says Central Banks should inflate. We're moving, but look around. The Germans and the Japanese have some traits in common...they can be incredibly stubborn. We will have to hope that some insight of what a restrictive monetary policy can do will turn on some of the lights at the next ECB meeting. Dimly lit castles are not always good for creative thinking. The sunshine is more prevalent in Tokyo than in Frankfurt, but judging by the Civil War over Money in Japan, maybe light is not the answer either. Having made my bet that Europe will not be as bad as the US, (forecasting 2-2.3 GDP growth for 2001), we will have to live with it. Not comforting to hear the lack of understanding over what drives currencies in a global capital market!

That's GDP growth--not TECH. No one is quite sure where tech demand is. It has pulled a Harvey and disappeared completely! But, why a collapse in Europe? Apparently, from the attached study, follow the leader is outranking overtaking as Europe's dominant IT strategy. That doesn't make strategic sense, because allegedly Euroland wants to catch up and overtake. For Europe to lift its growth rate, it would need a productivity boost. That means invest in tech. There may be something to Behavioral Finance after all. Foot & Mouth may destroy some Herds, but not Herd Behavior.

Herd thinking says, 'The U.S. is cutting back on Tech. We should do the same!' New found labor market flexibility would argue for more IT. Maybe instinct dominates analysis. That would be both regrettable and impoverishing for equity holders. The key to TECH for the US is how much erosion in US Investment occurs. Greenspan and the Fed were right. It is just an inventory correction. We are selling off the inventory of high multiple stocks. Inventory liquidation. That's what it is.
American Zaitech

We reached nearly 20% Investment to GDP at the peak of the boom. Why? Zero cost of capital! That is when the capital market canonized Tech at the height of the bubble. If you know how to recognize a bubble (when it is over), you, too, can be the next Chairman of the Federal Reserve. Are

you wondering when Dr. Greenspan makes his declaration? Can't be much longer.

When the IPO market ran heaviest, the cost of capital in Techland went to zero. As Steve Galbraith told us at a Morgan Stanley conference, when we were in high corn in Techland, only 1 out of 10 IPO's had earnings. Well, ideas cost money. The better story was that in one out of three IPO's, the investment banking fees were greater than the sales of the companies going public. What surprised me, however, were the Texas Hedge sales programs of Cisco and other major tech producer-goods manufacturers. You should know what a Texas Hedge is. That's when a cattle feeder goes long cattle futures. So, maybe Cisco had a Texas Tech Hedge--financing its own customers? First you get long by owning the production facilities, and the inventory. Then you get a bit longer by owning your customer as the Lender of Last Retort? No wonder we can't figure the optimal capital stock. We are using a zero cost of capital! I know I have heard that before, but it was in Japanese!

I don't know if a macro economist can give much guidance on how long it will take to run off the excess capital stock here. Fortunately, this is not Japan or Shanghai or Houston real estate (as in the aftermath of the post oil boom of the early 1980's). Duration counts. What we have working for us is the rate of technical progress that obsolesces the tech capital stock. It is not like vacant buildings that hang over the real estate market for years at a time, preventing any new construction. It is true that bankrupted Dotcoms have equipment that makes its way into the re-sale market. That makes for poor visibility, to which we can now add **FD**. No visibility--higher risk premia and Tech's drop in value probably has a way to go...I don't know how far either! Zero cost of capital costs something after all. It's like free booze. Everyone drinks too much and suffers in the morning. Some worse than others.

In Japan during the late 1980's (it was called Zaitech), a world of wonder and merriment. The Japanese financial technique *du jour* was to float warrant bonds with very low interest rates and they were gobbled up. Result? Japan experienced huge over-investment in manufacturing. Not surprisingly, rates of return to heavy investment in manufacturing began to fall. Off to the real estate brokers, in Japan and here and don't forget art dealers. (Pebble Beach was acquired for an outlandish price to be later re-sold at a large markdown. Impressionist Art was marked up and down with the the Art Auction Houses riding the elevator both ways for rigged fees. Back to Japan (and hoping this is not 'Back to the Future'), the bottom dropped out. And in its place, a punish-the-excess mentality prevailed in policy circles. Monetary Policy was truly awful...the worst by any major Central Bank since 1931. Add to that a preoccupation with the very long run—Japan raised taxes worrying about pensions not its current economy. The justification was that excess spending had to be trimmed in order that Japanese could provide for their old age!

What about here? Eerie parallel. Not quite, but some lessons anyway. Two major macro adjustments must be made over the next few years. First, we will probably need to bring the ratio of investment to GDP to a more realistic number. Why? The cost of capital is not zero---no matter what the Tech IPO's sold for. How much does the Investment/GDP ratio have to go down? We can argue about that. Right now, we know it must be lower because of the fire sales in Wall Street.

Second, it would be a great help to the US if while investment is dropping as a ratio to GDP that net exports, as a ratio to GDP would rise. That would take some strain off GDP generation. Conventionally, that means that growth outside the US needs to go up faster than our growth. In addition, the trade weighted dollar needs to fall or at least stop rising. Paradoxically, that means that both the Euro and the Yen have to Appreciate against the Dollar! How can that happen? Euro maybe! Yen? Never. It is a trash currency, correct? You have to be kidding! Read on!

Well, the first thing is to get the rid of the Siegfried Line mentality at the ECB. If they were to lower rates, the odds are that the EURO would appreciate. (Maybe they know that and want to push their exports and reduce ours? That is too Machiavellian even for me). An appreciating currency is the way to fight imported inflation. Ask Alan! More importantly, were the Bank of Japan to begin an aggressive program of stopping deflation--in short, inflating by aggressive monetary measures, it might also strengthen the Yen. Investors can move on a dime particularly if they start from an underweight position. While the BoJ made some important moves last week, they are still engaged in a Civil War over the political restructuring of Japan (including Bank Debt write-offs and asset sales from NPL's

already on the books of their RTC-equivalent agency). That lessens the immediate chance for the BoJ to play a helpful role in righting the world economy's imbalances. The instructions given to the Postal System to buy equities and the 'encouragement' to large financials in Japan that buying Equities was a good thing is a bad thing to see. It means diktat still prevails over market directions in Japan. But, an aggressive easing policy by the BoJ could have an interesting result. Extra liquidity that is consistently applied will finally spill to equities. That could mean that world portfolios that have been underweighted in Japan might come to the party. That in turn could moderate or even reverse the effects of BoJ easing on the Yen.

A paradox on both your houses!