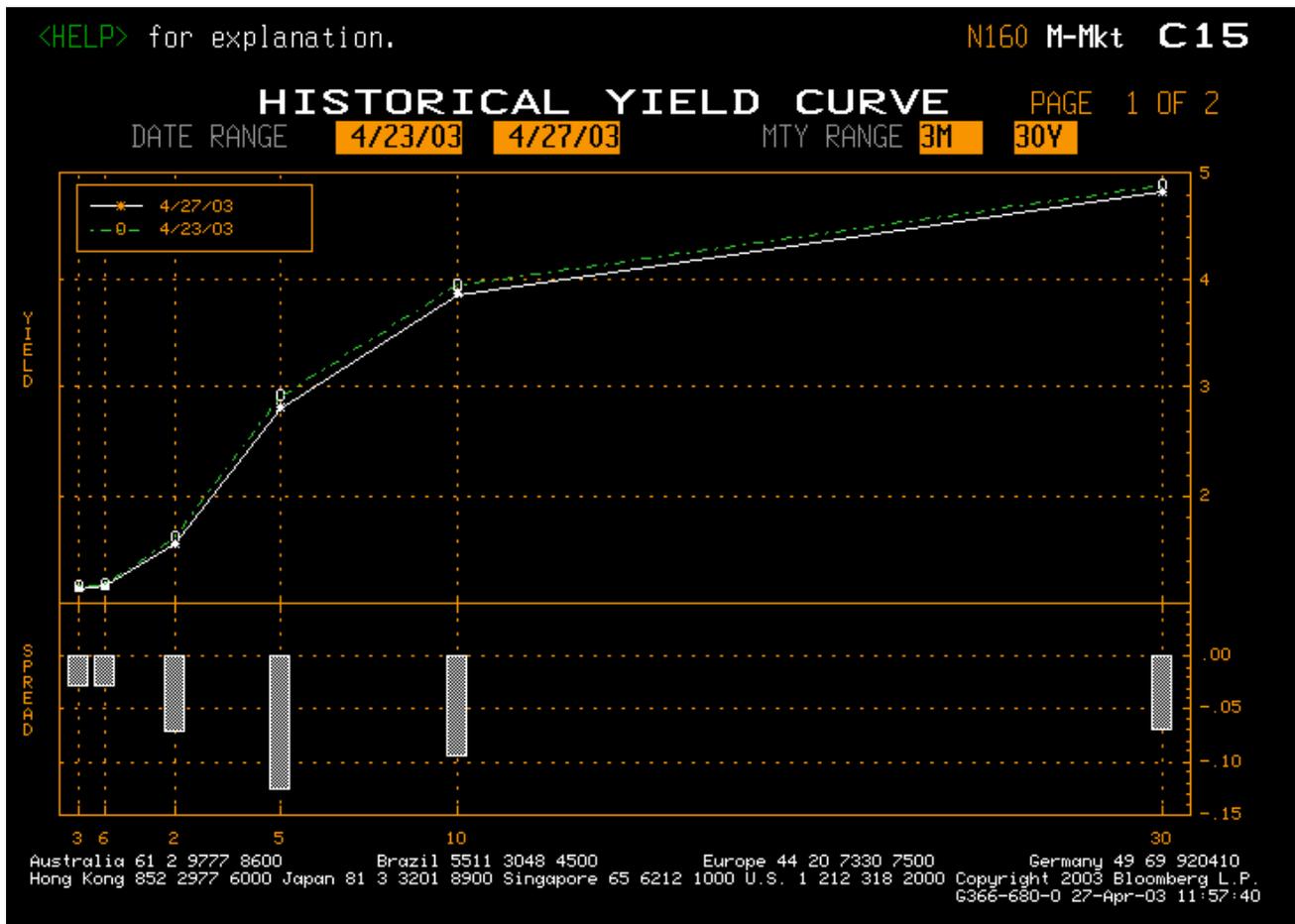




**Cycle Notes and Explanations: will pessimism lift?**

The GDP advanced report revealed a less-than-consensus growth of 1.6% in real terms over the prior quarter. Many estimates were in the 2's, and some as high as 2.6%. (The Bloomberg Consensus was 2.4%). The disappointment was palpable but apparently not overwhelmingly bearish to the broad equity indicators. The bond market lowered yields from six months out to the longest maturities on the yield curve, with the biggest



change in the 5-year bond. The GDP report contained some negative news on business investment, particularly in equipment and software that declined 4.4% in real terms in Q1 after relatively strong performance in the prior three quarters. For tech investors, there was some respite because hi-tech hardware and software gained 11% on an annualized basis. The weakness in overall investment stemmed from the transportation sector and that is a highly volatile series. Noise or new trend? We cannot be sure at this point. Inventory growth slowed (reducing GDP growth by about ½ %, while residential investment was very strong with a 12% rise). The top line growth number is suspect when we note that a narrowing trade deficit contributed 0.9% to

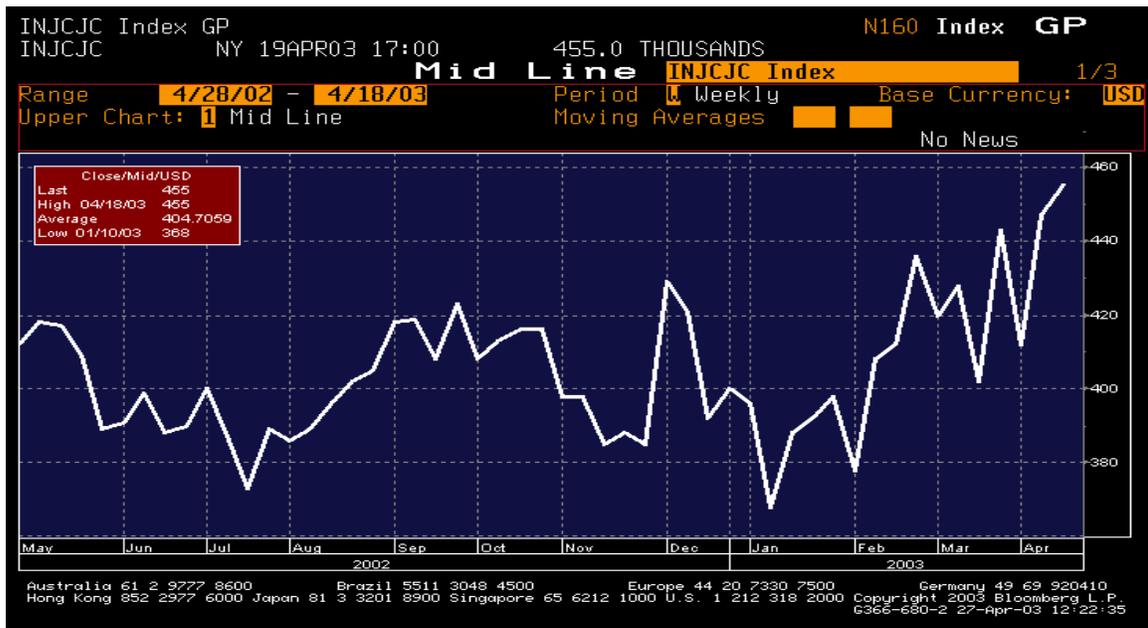


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the growth rate. In the middle, holding up the economy was a modestly positive consumption growth number of 1.4%. The consumer hasn't run for the woods, but she is not being cavalier about spending either. Earlier this month, the savings data showed that the savings rate has been rising. This has worried some economists who fear that the consumer will ultimately retreat and the Double Dip will be upon us (once again?).

The end of the war clearly generated some positive consumer sentiment with the University of Michigan Survey posting a gain from 83.2 to 86 in the top line number stimulated largely by an expectations gain from 75.70 to 79.30. Will this translate to actual spending? No one really knows.

Fed Chairman Greenspan will speak to the Congress on April 30<sup>th</sup> amidst the tepid Q1 performance and the quite bearish consensus estimates for QII growth. Initial claims have risen markedly in the past month, the durable goods numbers for March slid markedly and the Beige Book showed no zest by households or business in their spending plans. The Chairman's mantra since the last rate cut (50 basis points) on November 6<sup>th</sup> last year has been twofold: the **soft patch** and the **geopolitical fog**. The Fed has held its powder since November while continuing unemployment claims have essentially been stable. The initial



claims number has risen from 398,000 to 455,000 suggesting that the job market has witnessed withdrawal by discouraged workers. The whole world will be watching for hints of not only Fed policy, but also the thinking behind the policy and the Chairman's views as to when a real recovery will begin? Judged by the FedChat of the past week, it has been hard to make a new case for Fed activism with several FOMC'ers stating a continuing believe in better growth for 2003 SH and 2004. That case ultimately rests on a belief that business expectations will improve and consumers will not flee.

A more explicit detailing of the Fed's analysis was given in a speech by Governor Bernanke on April 24<sup>th</sup>. The Governor was clearly concerned, however. He titled his speech, **Will Business Investment Bounce Back?**<sup>1</sup>

<sup>1</sup> Remarks by Governor Ben S. Bernanke before the Forecasters Club, New York on April 24, 2003



The speech is a thoroughly readable accounting of the Fed Staff's methodology for forecasting investment. After reviewing all of the elements that make up such a forecast, the Governor gave markets no **terra firma** on which to sustain the current rally. Analyst expectations of earnings and short-term forecasts, he said, were "brightening," and if the trends continued, that would be consistent with an "upturn in investment beginning in the second half of the year." That's what the model tells him. The hinge between the cost of capital, economic spending forecasts and investment demand is **expectations**. Here there is a **disconnect**.

The disconnect is when the Fed talks to the "managers themselves—or talk to the people who talk to the managers—we sometimes get a different story." The theme from those talks is **pessimism**, but its derivation is hardly precise. Geopolitical uncertainty? Accounting Scandals and their fallout? The profitability of new technology and products? A lack of "animal spirits?"

If business managers are sufficiently pessimistic, they can create a self-fulfilling prophecy. Poor investment slows aggregate demand growth or turns it negative leading to even poorer investment demand. Here, the Governor leaves us hanging. He doesn't know whether the pessimism will lift...nor in fact does anyone else...perhaps with the exception of the monetary oracle of Washington!

Greenspan has received an endorsement from the President for an extended term and he has accepted the offer, notwithstanding his torpedoes that badly damaged the President's tax proposals. The tax bill is now mired with a clear lack of direction on priorities. The Treasury Secretary avowed he would accept some compromises and then that statement was withdrawn. Greenspan has a chance to set the rhythm of a compromise that might lift the current fog over tax policy. Like a great conductor, he loves the opportunity to orchestrate far more than the choir at the Fed. Markets will be listening.





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