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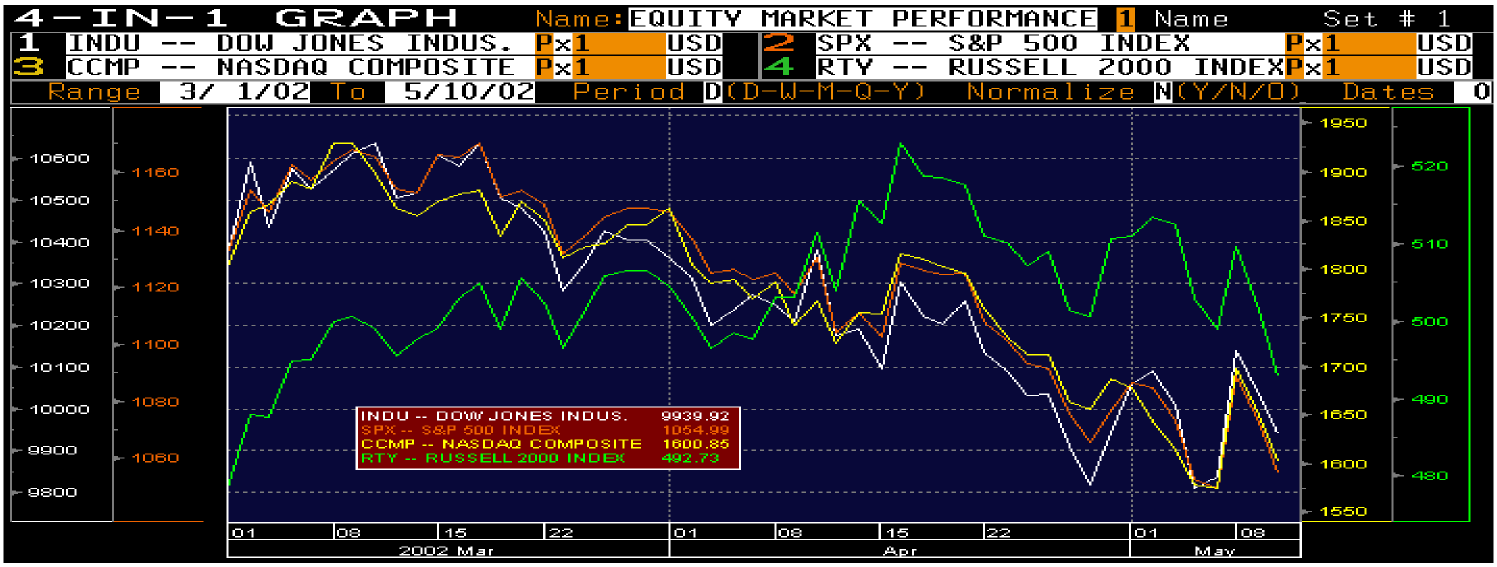
MAS 051502

Good News is Bad News



graph: Bloomberg

Judged solely on the basis of the equity market's performance over the past month, good news in economics has translated into bad news for the market. In the graph above, the Dow and S&P (lhs) and the NASDAQ and Russell 2000 (rhs) are graphed from March through the close on Friday, May 10th. The major indices have shown a significant collapse since the beginning of the second week of March, while the small caps indexed by the Russell rose until the index peaked on April 16th. The NASDAQ reached a high of 1929.27 on March 8th and has descended to a low of 1573.82 on May 7th. The rally on May 8th took the NASDAQ to 1696.27 (a 7.8% rally) from which point the index declined 5.6% on Friday. This downward pressure has coincided with generally improving economic news. A glance at the upcoming data for this week

Bloomberg Survey

Date	Time	Time Period	Indicator	BN Survey	Prior
5/14	8:30	April	Retail Sales	0.6%	0.1%
5/14	8:30	April	Retail Sales Ex Autos	0.4%	0.3%
5/15	8:30	March	Business Inventories	-0.2%	-0.1%
5/15	8:30	April	Consumer Price Index	0.4%	0.3%
5/15	8:30	April	CPI Ex-food & Energy	0.2%	0.1%
5/15	8:30	April	Real Earnings	-0.1%	-0.1%
5/15	9:15	April	Capacity Utilization	75.6%	75.4%
5/15	9:15	April	Industrial Production	0.4%	0.7%
5/16	8:30	April	Housing Starts	1.628M	1.646M
5/16	8:30	5/11	Initial Jobless Claims	405K	411K
5/16	12:00	May	Philadelphia Fed	12.0	12.3
5/17	8:30	March	Trade Balance	-32.4B	-31.5B
5/17	10:00	May Prelim	Confidence UMich	93	93

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suggests that the economic environment is getting better, albeit at a somewhat slower rate than at the growth rate of the inventory-led rebound in QI2002. During the past 10 weeks, the economic climate, as depicted by many traditional measures, is getting better and economic activity will expand during the balance of the year. Yet, the equity market clearly has a different view of the future. Either there is bad news ahead for corporate profits or as some observers have put it, the 'equity culture' is dead. If the latter, then even if corporate profits increase sharply over the balance of this year, equity markets will not award high multiples to economic growth.

Real GDP Change During Recessions

(Annualized % change from preceding period)

Recession	Starting Date	1st Qtr	2nd Qtr	3rd Qtr	4th Qtr	5th Qtr	6th Qtr	7th Qtr
1957–58	2Q57	–0.9	**4.0**	–4.1	–10.3			
1960	2Q60	–2.0	**0.7**	–5.0				
1969–70	4Q69	–1.9	–0.6	**0.8**	**3.6**	–4.2		
1973–75	3Q73	–1.6	**3.4**	–3.0	**1.1**	–4.4	–2.2	–5.0
1981–82	2Q81	–2.8	**4.9**	–4.6	–6.5	**1.7**	–1.9	
1990–91	3Q90	–0.7	–3.2	–2.0				
2001–?	3Q01	–1.3						

Note: Figures in bold denote false-starts to subsequent economic recovery
Source: U.S. Department of Commerce, Bureau of Economic Analysis

US Investment Perspectives - January 9, 2002

The "smart money" has hung out the For Sale sign, a feature particularly evident after last week's mammoth rally led to a subsequent collapse. Does the Market think the oft-mentioned "Double Dip" is going to make its appearance?

One proponent of the Double Dip, Steve Roach, Chief Economist at Morgan Stanley, put together the table above that shows the post-recession history since the recession of 1957-58. At the time the chart was published, (January 9, 2002), the data for the recession of 2001 were not available. Remember that 4Q01 and IQ02 turned in 1.7% and 5.8% annualized growth. **In the table, note that no other U.S. recession since 1957-58 had back-to-back quarters of positive growth as we experienced in 4Q01-IQ02.** Furthermore, it seems virtually impossible that 2Q02 would not be positive, resulting in a three-quarter sequence of growth.

Conclusion: the Market is not forecasting a Double Dip at least as far as GDP growth is concerned. It must be that the Market is highly skeptical of a strong rebound in corporate profits.

In fact, measured by traditional statistics of recovery, such as industrial production, capacity utilization and, most importantly, productivity, the U.S. economy is responding quite well to the combination of strong monetary stimulus and strong fiscal stimulus. Ok, what's the worry then? Why is the Smart Money on the sell side, selling the rallies with the same fervor as they 'bought the dips' during the boom?

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Economic Balance, Corporate Profits and Economic Growth

Greenspan has said it in speeches and the FOMC said in its statement last week when it worried about the conditions for 'balanced growth.' This is code for gross private domestic investment beginning to pick up the pace and 'balance' strong, early year, consumption spending, housing and government purchases. **"Nonetheless, the degree of the strengthening in final demand [excluding inventory changes] over coming quarters, an essential element in sustained economic expansion, is still uncertain."** (FOMC May 7th Statement). The Fed recognizes that the current stance of monetary policy is still "accommodative," but it feels it can take the risk of standing still until better symptoms of balanced recovery occurs because the inflation numbers are largely benign and productivity has surged enormously. To get to 'balance,' investment has to expand. This underscores the current weakness in earnings and the market's fear that the current weakness in profits could continue.

The rapid rise of unemployment last week, although typical of this stage in a business cycle, underscores the lack of new hiring. Rapid rebuilding of cash flow in the private sector is being assisted by economizing on labor and staying away from heavy corporate investment. All of this will help earnings in the short run, but is not a long run strategy for achieving rapid earnings growth over the long run. The market knows this and is discomfited by corporate sector 'slash and burn,' policies. This is particularly the case in the IT segment of the economy. Firms are finding it possible to defer much of their equipment purchases and are making-do by adding system integration capabilities. If this is a kind of "saturation" or "maturity" in large segments of the IT sector, it also suggests that growth rates of earnings for IT companies are being downsized.

"Enronitis"

If earnings growth rates are being revised downward, there is also the growing issue of the 'quality of earnings reports.' Firms were given huge incentives in the heart of the Boom to posture earnings in the most favorable light. High growth rates mean high multiples. The Capital Market only looked 'forward' and not 'backward.' The obverse now obtains. Everything and every number is suspect. Nominally good numbers are now thought to be suspicious or manufactured (at worst) or unsustainable (at best). CISCO received a welcome reward when it exceeded the Street's best case but subsequently, when the corporate balance sheets were more carefully dissected, CISCO got knocked down again. The hangover from Enronitis continues as the Attorney General of New York battles Merrill Lynch, and Merrill Lynch will not be the last firm to get treated this way.

Signals of Turnaround

The battle is in the forward trenches---capital equipment purchases and other forms of investment spending (such as IT integration). The Fed is likely to know this data first. As the Fed will hear the anecdotes first, we should be watching the FOMC for signs that sustainable, balanced growth has now been achieved. The Fed can then be less accommodative. The Bubble and its Deflation have had many ironies. Maybe, when the FOMC finally raises rates, the Market will rally. The Market will think that the Fed has very good forward signals in order to justify less accommodative monetary policy. That could put a few buyers into the fray.

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