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The Double Dip Déjà Do: "A nickel ain't worth a dime anymore"

When I was growing up, Yogi Berra was a fixture on those wonderful Yankee teams that made life in Brooklyn miserable. Now, he is a most quoted philosopher for financial pundits.[1] Everyone knows 'it's déjà vu all over again,' and so it is with the famous Double Dip. It is the Double Dip all over again!

Steve Roach, Morgan Stanley chief economic guru, waxed his bowstring and loosed a few more arrows on the probabilities of a Double Dip for the U.S. economy going forward. His argument rests on the absence of pricing power, bloated costs and still-depressed profit margins.[2] Roach worries a lot about deflationary pressures and the seeming absence of 'pruning the excesses of labor expenses. In some ways, this is a red herring since if productivity continues to soar, even if worker compensation in the national income accounts doesn't retreat to prior recession trough levels, there is a certain irrelevance in that statistic. Unit labor costs are falling because compensation is rising much less fast than productivity. At the same unit price of output, that has to translate to higher actual corporate profits.

Second, "labor" is just not "labor" even if in the national accounts, compensation appears to be equivalent to the 'cost of labor.' Why? Because a 'unit' of labor today has a lot more human capital embedded in it. To see this more clearly, ask yourself whether a 'worker' today is more 'skilled' than his counterpart a decade ago? How many 'workers' could operate a modern IT system 12 years ago during the last recession? We make many of the same products we used to make, but they aren't really the 'same products.' A house is not a house any more when it is wired up with modern security, information and complex lighting systems. My advice is don't get caught up on the intrinsic meaning of items in the national accounts and hope to derive an answer to whether corporate profits are on the rise. They are on the rise, even if we are not sure how the S&P will report them after its latest change in standards. The issue, though, is profits, or more precisely, the valuation of those profits.

Roach is right to concern himself with how quickly corporate profits rise and it is wise to ask whether during this recovery, profits will rise to the 'peaks' of the 1990's. They may not. The problem may not be the level to which Corporate Profits rise, but how the equity market will treat those profits. Ok, Yogi, say it again. "A nickel ain't worth a dime anymore." That is a valuation question, not a question of a Double Dip.

In fact, stock traders ought to be a lot less interested in how GDP responds this next quarter or two. They don't get paid on forecasting GDP. They get paid on figuring out how individual company profits are going to change and what's in those profits. Call it Enronitis plus S&P's reform, but let's face it, these are issues of

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[1] In the Forbes Book of Business Quotations, Buffet is mentioned only once while Berra gets seven citations. There is an issue of valuation here. It reminds us of the famous story of the reporter who asked Babe Ruth why he was paid nearly four times more than the President of the United States. "I had a better year!"

[2] Stephen Roach, "Global: The Case for the Double Dip, **Weekly International Briefing**, Morgan Stanley, week of May 20, 2002

valuation not GDP prognostication.

The second element in Roach's case is the capacity of the consumer to sustain the level of purchases that has given the economy the kick that it has, with the business sector still chanting another Berraism. "It ain't over 'til it's over." But sooner than most doubters think but perhaps not fast enough for the cockeyed optimists, the business sector **on average** will begin to spend more. It will spend if for nothing else in order to raise internal efficiencies **particularly in a weak pricing environment!** Business has no choice if it wants to improve profits. It must improve efficiency (productivity).

Roach is on his strongest ground when he looks at the massive rise in consumer durables purchases in Quarter IV last year that has sustained itself right up through the most recent numbers. Consumption is rising at better than 3%, largely on the back of durables purchases. Yes, it is true the Consumer can quit, but so far he has not. Roach is clearly a believer in another of Yogi's famous principles of finance: "When you come to a fork in the road, take it." Note the proviso: first find a fork!

Finally, what about the vulnerability of the U.S. economy to another shock, particularly **if** we have a "low growth environment?' Roach starts his attack with the following statement. **"If GDP growth remains close to the 'stall speed'—a 1-2% pace in my view—then the economy lacks its normal cyclical cushion and it doesn't take much of a shock to trigger renewed recession."** This is hardly kosher for the Double Dippers, because **if** we presume a sufficiently large shock, of course, the economy could run into trouble. Of course there would be, by assumption, less of a cushion. That does not tell us that we will get such a shock, and it doe not follow from the other causes cited above. What did Professor Berra tell us in the last finance lecture? "If you don't know where you're going, you'll end up somewhere else."

We do not know where we are going, but not because the Double Dip is about to fall on our heads. We do not know where we are going because we have lost our valuation metrics. We are going through a 'downsizing' in valuation, and we are not sure when and where that process will stop. The key question to ask is how much earnings will be worth in the post Enron, post S&P, post 9-11 world to come? We think that earnings will be worth less, but not because of a forthcoming Double Dip in GDP. It is because we have popped the bubble.

It is time to turn away from what can go wrong with this recovery and try to put a handle on valuation. Yogi told us what to do. "You can observe a lot by just watching." Unfortunately, he did not tell us exactly how to do it.

I cannot imitate him, so I won't copy him…anymore.

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