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When the going gets tough, the tough start gnashing!

We admit having something in common with Barton Biggs ---we're gnashing our teeth, too. **There is a vast disconnect between the market and what we perceive is the most likely course of the economy.** Economists have little expertise in "out of sample" phenomena, and the disconnect between this equity market and the **most likely outcome of the economy's relatively modest recession is palpable.** Nearly all economists are standing by their recovery calls, although some recognize the current slowing could escalate into a more serious economic downturn. Either the majority of economic forecasters are very wrong, and have missed a major fork in the road, or market players are fixated incorrectly on a 'half-full glass' vision of the economy. **'Sell the rallies' has taken on the fetish quality of 'buy the dips' of the late 1990's market.** What we cannot explain is why the prospects of recovery seem so faint to strategists and perhaps to the business sector that is only slowly beginning to make new investments.

Barton Biggs doesn't claim to be an economist. Since he sometimes draws scorn despite repeatedly denying that he is a card-carrying economist, we won't revile him with that appellation. He is a 'strategist,' which means he uses a wider variety of disciplines to tell investors where markets are going...claiming all the while that he does not formally prognosticate on the economy. **His 'gnash' today focuses on an out of sample nightmare....a massive meltdown in asset values (equities and real estate), confronting policy makers and investors with choices they do not wish to make.** At the end of this dark vision, the reader is let off the hook by his confession that his "bearded prophet of the apocalypse" is merely a synthetic creature, "an imaginary composite representing no one I know." The problem is not that his source of revelation is synthetic---since each of these sentiments can be found in today's market. The problem is whether this revelation is the basis for a good forecast? Readers can judge for themselves.¹

Consider that of the four major components of GDP, personal consumption continues to expand, even if at slower rates than its zesty performance of Q4 2001 or Q1 2002. Similarly, government expenditures seem to growing and efforts to take some of juice out of the increased spending-lower taxes environment are failing as we proceed to the fall election. Furthermore, both Euroland and Japan are expanding (albeit slowly) as is much of non-Japan Asia. Some of the oil price 'worries' we had as recently as last month seem to be rapidly dissipating. OPEC now confronts a growing Russian oil presence and non-OPEC countries continue to expand their production capability. Gasoline prices are falling, as is the price of natural gas. The U.S. government continues to spend while corporate cash flow is being assisted by recent (even if non-permanent) corporate tax cuts. **If you believe those basic economic trends will persist, then corporate earnings should be rising sharply in the future.** If the market is a vast discounting machine, something must be out of whack, since rising expected earnings and falling equity prices implies that the equity risk premium must be rising by leaps and bounds. The latent question posed by Biggs' seer is why?

If the equity market merely slumbered as it allowed the U.S. economy to grow, it would be understandable...particularly since business investment spending is still not geared up sufficiently to 're-balance' our dependence on consumers and government deficits. **The equity market is not slumbering...it**

¹ "The Bearded Prophet of the Apocalypse," Morgan Stanley European Investment Perspectives, 05 29 02.



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is being trashed...not uniformly, but certainly in many of the areas that led the growth parade of the 1990's. To what are we to attribute such a puzzling performance? It is almost the reverse mirror image of what happened in 1999 and the first few months of 2000. Remember, that was the period when Greenspan constantly bemoaned the vanishing equity risk premium and the dangers implied by a low risk premium.

What is different now, as opposed to then, is that the market fears a 'low growth' environment as opposed to the late 1990's vista of the Long Boom. Because of the prior excess, valuations have to be trashed. Booms turn into Busts. That is the legend of 'common sense' business cycle analysis. A second aspect of the problem is that Terror is now an everyday fact of life. In the 1990's Terror was a foreign event! The third element is trusting the numbers—or its eroding absence---the Enron legacy,

Terror bespeaks uncertainty---worse, unquantifiable uncertainty. We do not know where it will next appear nor do we know how serious it will turn out to be. The early illusions of rapid success in Afghanistan have given way to a deeper understanding that our vulnerability to attack is likely to be a long-term issue. It is particularly important in this recovery because so much of the burden of recovery has been borne by consumers.

It is a curious consequence of the very active policy measures that have been used to defeat this recession that so much doubt has arisen over the strength and timing of recovery. Dropping interest rates to record lows has stimulated both housing and durable goods consumption, yet that serves to underscore the "vulnerability" of recovery to the consumer's continued purchasing. Second, low interest rates have evoked the 'fear' that when interest rates do finally rise, it will trigger a housing collapse, undermining the very strength of consumption that was used to fight the recession. Barton Biggs has his "informant" lighting a match under every new house and condo! His informant never seems to ask the obvious question: why will interest rates rise? **They will rise in response to recovery, not as might appear, for mere whimsy.** The long delay by the Fed and a constant reiteration that they are prepared to 'overstay' the hand in order to insure recovery has paradoxically emphasize to the market that there are **risks to the recovery sequence. This plays well into the Pharaoh's Dream sequence that makes up much of the market's everyday thinking.** Seven good years were supposed to precede seven lean years, and during the good years, the wise saved their extra bounty. Biggs' savant lays heavy emphasis on underfunded pensions and other sources of wealth that will prove to be illusionary. It is Pharaoh's Dream, nonetheless. Alas, our consumers did not save and now they must, undermining future consumption.

How do we know that will not happen? The real answer is that we cannot be sure that consumers will not change their secular pattern of spending and start on a saving binge, particularly as other sources of wealth (pensions and net equity in housing) take some hits. But, if we think that very active monetary policy and extremely active fiscal policy has in all previous cases ultimately moved the economy out of recession and into recovery, why so much doubt this time?

The consequences of Enronitis and the continuing accounting cleanup have taken their toll, along with the new environment of Terror. Enronitis and its cleanup is exposing some of the treasured myths of the nature of the 'game.' It always was a casino, but now we fear we cannot calculate the odds. But if earnings grow, so do stock prices. What is different is what the investor thinks he knows about earnings. He is finding out that in an equity boom, there are huge incentives to manufacture earnings. It has made many balance sheets suspect. It is the equivalent of Economic Terror---you never know where the next bomb will go off---maybe in your portfolio.

The sign of a Bad Market is Bad News makes the market go down and Good News is ignored---exactly the reverse of the late 1990's. The answer to when the market starts reviving is when most of the Bad



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News is out. When will that be? Recovery has a way of pushing up better stories and recovery is taking place. Is it slower than the market hoped for? Yes, if we use the first quarter as a barometer. Is this a good prediction for the rest of the year? **Only if you think this time it's different!**

Or, as our famous financial guru said, "You can observe a lot by just watching."

We're different from Barton. Our prophet (Yogi Berra) is hardly a synthetic creation!