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MAS070202

The Irrelevance of Macro

The following note was sent to key clients at 6:30 PM on July 2, 2002.

I have not been writing for investors lately because the "expertise" of an American macroeconomist-even if there is no real macro theory-is really limited to understanding and sometimes forecasting what is going on in the US economy and perhaps the global economy. Our presumption is that knowing where the global macro economy is headed has something to do with stock prices. In the long run it does because the "weighing machine" analogy and what is being weighed is future earnings and earnings growth does depend upon the growth of the economy to a large extent. As we know, however, in the short run the Market is a Voting Machine, to use the other portion of Warren Buffet's favorite analogy, and in the past several months, it has been voting NO, resoundingly! But voting in this manner always run to excess and surely this one will be no exception. The run-up to the fear of July 4th adds to the clatter. I suspect buying out of the money calls by 11:30 tomorrow may turn out to be valuable, if there is no Al Queda incident. Friday should see some mean reversion with a bang! Whether a rally will hold is another thing...but we will get further macro data evidencing growth in QIII shortly

Market participants are now rushing for the exits. They rush because of distrust and confusion. They don't know what to make of past corporate earnings or what to believe about corporate earnings in the future. Belief and trust are fundamental to dealing with uncertainty and we now have a suspension of both throughout the capital market. In effect, the market has lost its measuring stick. The question I have been asking is 'for how long have companies been manufacturing earnings?'

I have no idea how to forecast when valuation will reach such an extreme level that some of the stouter hearts will begin to buy with some regularity. So far, evidently, that is not the case, and no macroeconomist has a worthwhile 'theory' that will guide one sufficiently on this point. Buying into fear takes more than guts because no one can tell you when the falling knife will finally hit the floor. It will be a rash act for those that summon the courage. We will hear only of the ones who bought at the last moment. The rest will have to bail once again and will not admit their early timing of the market change For sure, it will stop long after it should have stopped, which according to what I believe about the global economy, was prior to today's debacle. Does it change my somewhat optimistic view that the world economy and the U.S. economy have bottomed out? Does it suggest that I now have to line up with the Double Dippers? Does it suggest that we are about to have a very solid SH 2002 and an even better 2003? The real issue to me is the implications for aggregate demand of this persistent and calamitous drop in equity prices. Should it change our forecasts?

This is the troubling aspect of the current malaise---the backdoor causality between equity values and expenditures. For consumers, who make up 63% of aggregate spending, equity values probably don't count sufficiently to justify Stephen Roach's widely quoted fear that the consumer will retrench violently. It is true that personal consumption in relation to income has declined recently, largely due to weaker auto sales, and the implied savings rate has risen, but don't be misled by quarterly variations. The wealth effect in the large is perhaps 5 or 6%. Secondly, much of the average householder's wealth is in his house. Therefore, even a 30% decline in equity values engenders less than a 10% drop in wealth for the 'average consumer," and if housing prices continue to rise and the wealth effect is 5/6%, there will not be much pressure on consumption. If, on the other hand, unemployment continues to rise, the principal source of spending power (income) is significantly reduced. Under those circumstances, we should expect a consumption slowdown. It is also likely that a better informed and news-sensitive public will react negatively to the doom and gloom scenarios coming from Wall Street. Therefore, we might wish to reduce our forecast of forward consumption until the market begins to turn upward, but the underlying data from the business sector shows reasonable sales, expanding

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production and (slowly) rising nominal wages. It is not an either-or proposition, but on balance, the double-dipper case is clearly the outlier.

Investment spending by business is something else in my view, because the "managerial class," is much more involved in stocks. Unfortunately, we don't really have a reliable theoretical connection between investment spending and stock market performance (valuations or changes therein). Lower equity values do raise the cost of capital so that there should be some diminishment or slowing of capital spending. But again, interest rates for certain borrowers are as low as they are likely to be for many years in the future, provided the smaller, younger companies are not rationed-out. We do see 'tiering' and the credit spreads suggest the possibility of a '"credit crunch." However, so far, we are not seeing much of that. In fact, if the data from QII are correct, it would appear that business has again run down inventories, causing some slowing of growth of GDP in QII, but also setting up the need for 2H expansions in production in order to make up for insufficient inventory. The ordering data on durable goods is not explosive, but it is not going backward either. On balance, it is a positive. The recently announced return to 0% financing for autos will accelerate demand, putting more pressure on inventory rebuilding.

Government spending is a bit less clear because of falling tax revenues---particularly at the State level. There is some retrenchment in State and Local spending due to balanced budget requirements, but that Is countered by the Federal bulge which will not let up in the run-up to the election. And, we should expect that more, rather than less, will be spent at the Federal level for terrorism, health care plus the usual array of pork barrel inspired special schemes. Congressmen may mouth-off about the current account deficit, but the fear of the foreigner not financing the balance of payments deficit will not put off any Congressman who wishes to point to what he has done lately for his constituents.

What about the foreign trade sector? What we hear is the continuing "rant" that the foreigner won't finance our deficit. And that seems to be borne out partially by the capital account. The impact has been to appreciate foreign currencies (largely Euro and Yen) moderately, not with a crash. The trade weighted dollar is moving exactly the way it should in a recession. Dollar depreciation can only help to promote soaring exports. Further, the market seems to have underestimated the strength of the Asian rebound, Japan included.

Europe is sputtering but a positive contributor to world growth. If we take Asia and Europe together as compared to six months ago, it is a net positive. European and Japanese investors may be moving to a wider diversification of assets (causing some further weakening of the dollar out front), but that dollar depreciation will only spur our exports.

In short, when you sum up the factors that bear on the macro economy, **unless one posits that the consumer will suddenly run for cover and that the savings rate is about to shoot up to 8-9%,** I don't think that that the Japanese model of economic recovery represents the likely future of the U.S. at all.

That leaves the accounting scandals which are the current manifestation of a half-decade of "earnings manufacture." In a bust, coming after a time of "cheap credit," and, therefore, excessive capital spending, we usually find many, many economic units loaded up with debt. Some will fail. Household bankruptcy rates also rise as do corporate bankruptcies. We have seen a lot of that in Japan, over the last half decade. More often than not, however, "too big to fail," is the theme in Asia and preventing capital from exiting is national policy. That only slows down recovery. Because of our collateralized lending systems, however, few financial firms are at risk. We won't replicate the Japanese financial disasters, but it is possible that our collateralized lending systems may pinch many weaker borrowers. Again, that is the fear, but not yet the reality, currently.

Still, nine-tenths of the iceberg is beneath the water, surely there will further disclosures of various accounting improprieties. This is the aftermath of earnings manufacture. During the boom, corporate debt rose while equity shrunk. Companies bought back their stock while supporting the managers who benefited from stock option issuance. Special purpose entities mushroomed as specialized collateralized lending arrangements took over the positions of commercial banks who found other ways to lift their earnings. Wall Street has been both a perpetrator and a victim of some of this earnings manufacture. It urged companies to faster growth rates of earnings than their real businesses could produce. It was, as I have said before, Milo Minderbinder of **Catch 22**, buying eggs in Sicily for 7 cents per dozen and selling them in Italy for 5 cents per dozen and everybody winning because everyone had a share. It was not a sustainable equilibrium, and it collapsed. The last acts of impropriety were for companies to manufacture earnings by suppressing liabilities, by selling their output to buyers who could not finance them and then supply the finance, hoping for the best.

As in the case of Japan, there will be scandals here as well. Japan's bust was triggered by excessive capital expenditures during the ***zaitech*** era. Japan maintained its economy (it didn't fall into a steep recession) by suppressing 'creative destruction.' Instead, their institutions of political economy permitted "too big to fail," convoy capitalism and government bailouts and excessive capital did not exit the low return industries. In the U.S. the Fed bailed out the consumer and kept him spending while waiting for a corporate investment revival, including inventory turn-around. 6% real growth followed by 2-1/2 % growth is not a recession, but corporate profits have been slaughtered. On top of what should be a corporate profits crash, we have discovered that many of the previously recorded profits were fictitious. How much 'earnings manufacture' is on the books is not something we know---and the market is assuming the worst.

To me, there are really two curious features of this bust. The first is that never before has a Government operated a two barreled policy gun so early in the downturn. That response staunched what would have otherwise been a steep recession. The second is the brevity of the downturn. judged in GDP aggregates. Even unemployment is modest considering the size of the crash in the stock market and we believe employment trends will go up again in the months ahead.

The second curiosity is the true estrangement between managerial incentives and shareholder value. That is a problem that arises from the "length of the horizon." Many managers are not there for life. They will want to change careers, occupations, etc., but they wanted to be paid by calls on the shares of their own companies. The incentive to 'manufacture' earnings' under these circumstances is huge. Predictably, earnings were indeed manufactured! But that is not the case with non-public, emerging companies, many of whom are owner- operated. Those firms didn't go to the moon during the boom and they are not now headed for the depths in a bust--baring a credit crunch. This may explain why the Russell has outperformed the other indices.

I think we are headed for better employment numbers and June personal consumption seems better than May. The global economy is not a drag, currently, and if U.S. policy is headed anywhere it would be to ease, not to tighten at the present moment. I wish that were not the case because a rise by the Fed would have to be interpreted as a positive event.

We have been writing about this 'disconnect' for several months. It seemed to us the market was being irrational to perform such a disconnect, but then we didn't have the evidence about widespread abuse of the accounting numbers. There is probably more in the way of revelation to come, but I suspect much of the bad news is now out. Were it not so, we would have seen even more announcements than Enron, WorldCom, and Xerox etc. I don't know where this rout will end, but a permanent disconnect between equity valuations and economic growth seems too hard to contemplate. At some point the Market will stop voting and start weighing. Meanwhile, many economists will feel as foolish as this one does!

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