

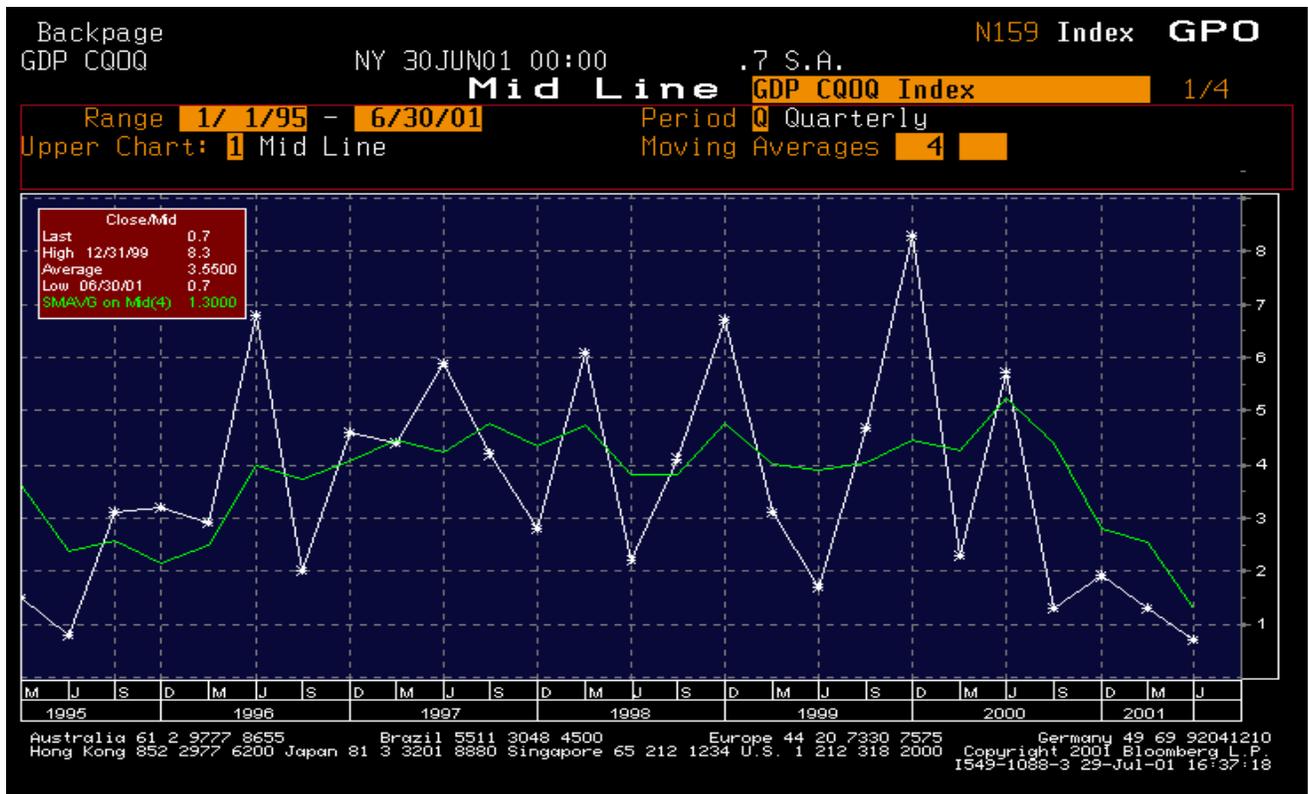
ECOMENTARY^ô

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Going Forward or Backing Up

At this point in the cycle, the essential question for investors is whether the economy is moving forward or backing up? Only by making a decision on this central issue can an investor have some confidence in his individual investor strategy. Let's look at some of the key factors. First, where has GDP been and what is its likely course moving forward? In figure 1, we display a chart of the real quarterly growth rates for the U.S. economy and a four-quarter moving average of those rates. Clearly, the economy reached a cyclical peak somewhere between QIV1999 and QI2000. From then on, despite the market averages waiting until March of 2000 to peak, the economy began going through a deceleration cycle of positive growth at reduced rates. With the clairvoyance that rear view mirror economics brings, obviously, one's investment strategy should have changed. If you were a tech bull, you should have bundled into your bear rug. If you loved growth, you switched to value. Getting that course change correct made all the difference to performance. Stock selection was important, but without noting which way the wind was blowing, you would have been in rough seas.

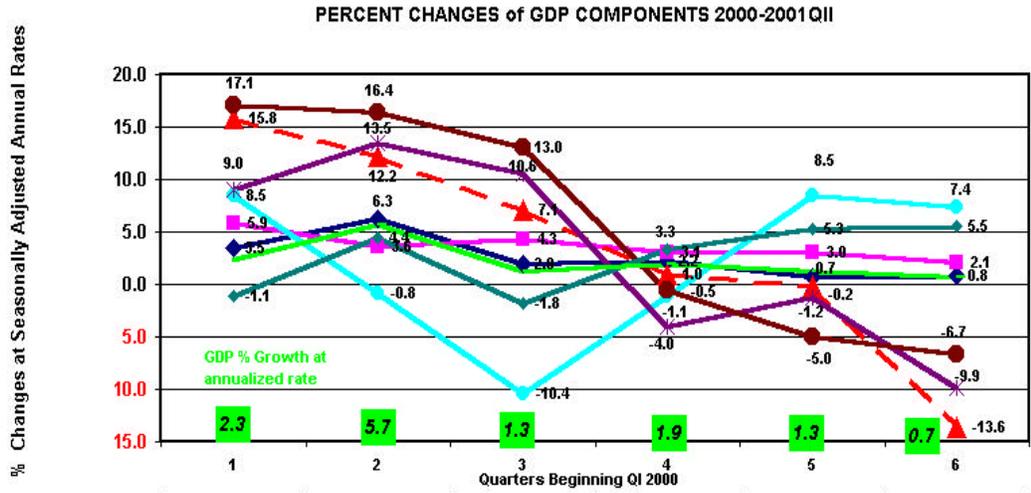
Figure 1. REAL GDP GROWTH BY QUARTERS



A top down approach ignores the composition of GDP, but depending upon your stock selection, the composition of GDP can make a great deal of difference. The Bureau of Economic Analysis of the Department of Commerce produced its preliminary GDP report for the second quarter 2001 last week and revised many of its components of GDP for the prior years. Some of the surprises have made economists "feel" better because

it appears that the data are more consistent with what economic theory seems to predict. For example, it was hard to reconcile the fall in the equity market (and the prediction that savings should rise due to declining equity wealth) with the apparent negative personal savings rate. Some of that ambiguity has now disappeared with an indication of positive and rising personal savings rates as wealth deteriorated from the market crash. More importantly, we now have better insight into how the various components of GDP have fared since the cyclical peak somewhere between the QIV1999 and QI2000. Y2K will henceforth be the acronym for **What Took** as in **“What took...you so long to recognize the wall?”**

In Figure 2. below, we have challenged your visualization process, by trying to graph **all** the major component changes in GDP in terms of their quarter to quarter changes (in real terms).



	Q1	Q2	Q3	Q4	Q1	Q2
Gross domestic purchases*	3.5	6.3	2.0	2.2	0.7	0.8
Personal consumption expenditures*	5.9	3.6	4.3	3.1	3.0	2.1
Nonresidential fixed investment*	15.8	12.2	7.1	1.0	-0.2	-13.6
Residential investment*	8.5	-0.8	-10.4	-1.1	8.5	7.4
Exports of goods and services*	9.0	13.5	10.6	-4.0	-1.2	-9.9
Imports of goods and services*	17.1	16.4	13.0	-0.5	-5.0	-6.7
Government consumption expenditures and gross investment*	-1.1	4.4	-1.8	3.3	5.3	5.5
Gross domestic product*	2.3	5.7	1.3	1.9	1.3	0.7

Figure 2: GDP Components 2000-2001QII

The quarterly growth rates over the period are given in green on the horizontal axis and coincide with the Figure 1 above. What are shown in Figure 2, however, are the components of GDP and their quarter-to-quarter changes in percentage terms. Gross domestic purchases peaked in Q2 2000 (as we might expect) and have steadily decelerated quarter by quarter.

What held up domestic purchases were personal consumption expenditures. While expanding at rates below those experienced during the “boom,” domestic purchases have still expanded albeit at somewhat slower rates. Clearly, the **wall** was non-residential business investment (fixed investment and inventory).

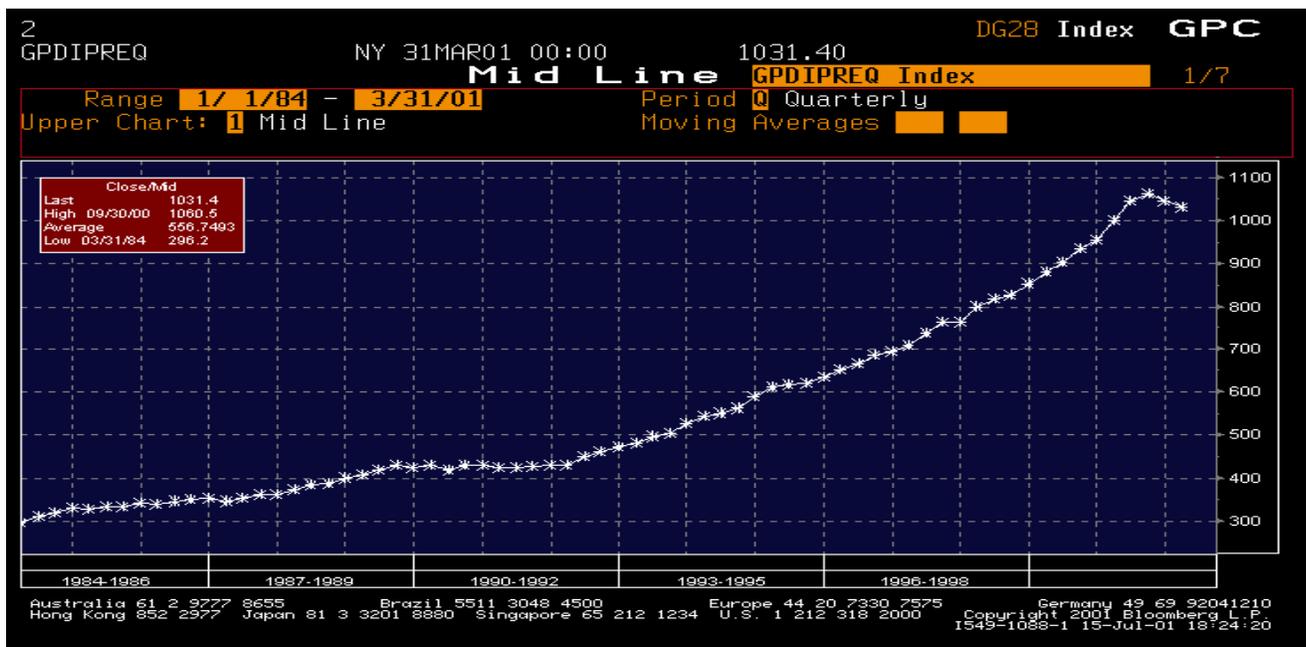
These expenditures have fallen on hard times particularly in the past three quarters. This illustrates the “investment bust” that certainly began by QIV2000 when the rate of expansion dropped to 1.0%, turning negative in Q12001. This bust was the subject of the sharp interchange between Senator Bunning and Chairman Greenspan at the Senate hearings last week. The Chairman was right about the Bubble. You know it when it’s over, but the Senator was right about the Wall. He recognized it when his constituents collided with it! In QII, non-residential investment fell off a cliff with a real rate of expansion of **-13.6%**. It is graphed with a **dotted red line** if you are looking at this graph in color on your screen just so you don’t miss it this time!

The behavior of the foreign trade sector is interesting because it illustrates how “**globalized**” we have become. Export growth peaked in 2000QII and then hit a wall of its own in QIV2000. Imports continued to expand, but at a decelerating rate until QIII2000 when the effects of global supply chain management “shipped” our downturn overseas by cutting orders of business imports of intermediate goods. This may be one of the reasons why our unemployment rate has been rising slowly considering the shock to spending, particularly in the industrial sector. Much of the shock has been borne by foreign plants that have had their orders slashed. Singapore and Taiwan have illustrated this ‘global synchrony’ quite dramatically. It may also tell us how our effective ‘labor supply’ has been stretched and some evidence of the implied moderation in wage rates showed up last week.

If you are an old fashioned Keynesian, you could take some comfort that as the private sector slowed, those well-meaning legislators in Washington managed to find things on which they could spend your tax dollars. Government spending rose in a contra-cyclical fashion. Don’t cheer too much, however, because the Congress will be encouraged into more of the same just as the economy starts its turn-around!

The big story, which everyone now knows about, however hidden it was in QIV from the Fed, was the collapse in business spending. It was monumental and it can be seen by a graphic depiction of business investment spending directly.

Figure 3. Business Investment Spending on Equipment and Software (Index) thru QI2001

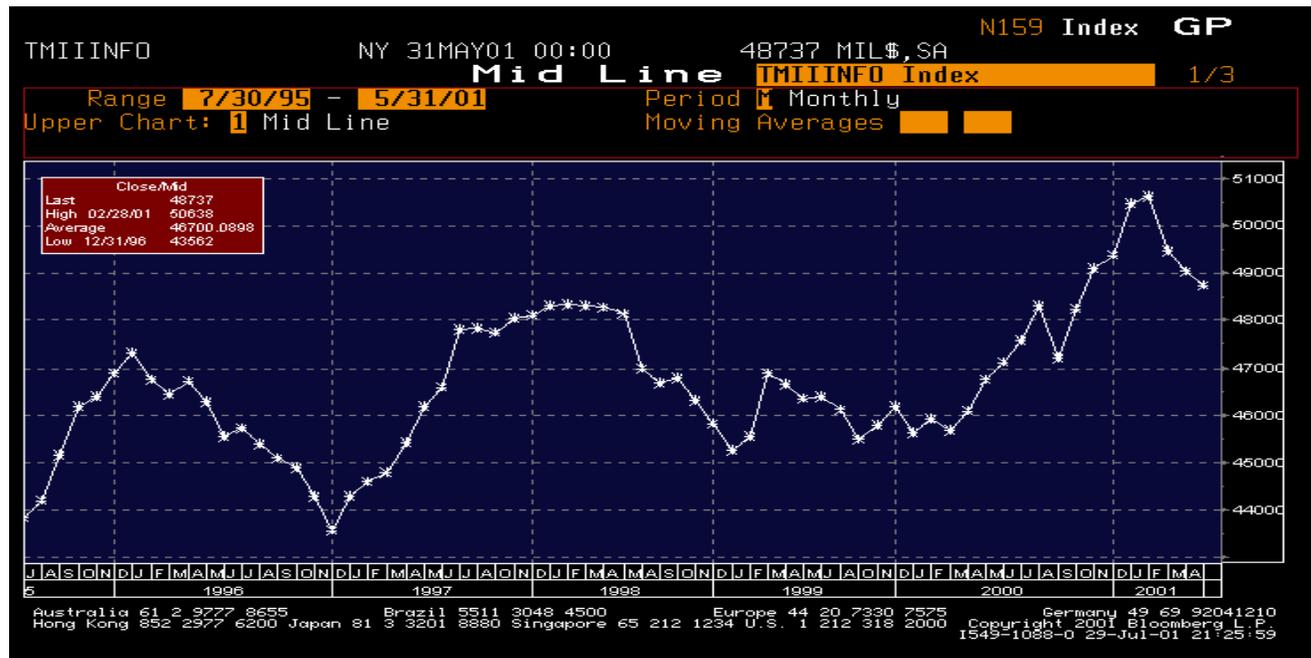


The decline continued (although not show on this graph) through the end of QII. (Using the NIPA data released last week, real investment spending on equipment and software fell 3.83% in QII in real terms). It might not seem like falling off a cliff, but after the huge acceleration uphill, it was. Gross Private Domestic Investment also includes changes in inventories, and we all know they changed course from rising to falling. In the six months from the beginning of 2001, real inventory change was some \$54 Billion. That is a lot of headwind to push the economy through!

Going Forward or Backing Up?

Investors could not be blamed for being fearful and for listening to advice that they should throw in their hand and perhaps find another way to provide for their retirement. A well-known newspaper that prints all the news that's fit to print essentially told us to do that today. The reason was that not only are equity prices down considerably from their 2000 levels, but that profits have vanished and may be hidden for a long stretch. Earnings estimates are too high in the words of the strategists. The critical issue is whether the economy is on the bottom leg of the "L" (which is of unknown duration), or it is troughing in the "U." If you are at the 'bottom,' it is hard to tell the next slope...it just seems very flat. Worse, perhaps it is just a ledge and the economy and the market is poised for another down leg.

Figure 4. Bloomberg Technology Inventory Index



Puzzled? You should be, because if you can't project sales, the absolute level of inventories has to be treacherous, and it appears that is what is driving the core of the technology sector. Poor visibility translates to the inability to determine the optimal stock of inventory. The immediate past is a poor guide because we have been in a downdraft. These data are two months old, and a lot has happened. Over the run-up since 1995, the level of peak inventories has steadily risen as has the minimum levels to which they fall before going up again. There are some indicators that seem to be stopping their deceleration, including NAPM data and the Chicago PM index that reports this week. The Philly Fed index of business conditions, however, took a step-backward this month.

This cycle seems different from other business cycles in the degree that the global economy is dependent upon what happens here in the U.S. This is the lesson of global supply chain management, and of economic integration, compounded by heinous policy in Japan and at the least a clouded policy in Euroland. In short, there are no offsetting sources of growth in the world economy. Added to that, is an oil shock that will continue to erode purchasing power from the household sector and divert cash flow to the oil exporters. In short, the whole world is watching for early signs of a revival in the U.S. while in the U.S., we have banked heavily on housing and retail demand to generate some pull for the capital goods sector.

The Fed is banking on the historical relationship between changes in the rate of growth of monetary aggregates and changes in nominal income. With price levels changes diminishing, that translates into a projection of real growth, but it does not tell us much about the composition of that growth. That was what the discussion last week at the Senate hearings was about: the "channels" of monetary policy.

It is hard to convince most economists that money doesn't count in this equation---except those who have been looking at Japan for a decade. It does suggest that the Fed is clearly not on the sidelines yet for this cycle. Unfortunately, it doesn't tell us how long the bottom of this U or L is relative to the level of equity prices. It does seem to indicate that exposure levels need to be carefully watched because the ascent out of the bottom is likely to be far slower than in previous business cycles...at least for a while!