



The Ennui Economy

Webster's defines ennui as "a feeling of weariness and dissatisfaction." What is a more apt description of the behavior of stock prices? Or, as a colleague put it to me the other day, 'this is a market designed to do the maximum damage to everyone.' Staying short since early December, 2001, going on



vacation and ignoring economists and policy makers would not have made you weary or dissatisfied.

When economists, including this one, wrote about the Great Disconnect between the economy and the market, it was because the "fundamentals" didn't look so bad late last year and even more so early in the spring when both monetary policy and fiscal policy were operating in a coordinated manner. What has gone wrong? Why the dissatisfaction? Why are investors both weary and wary? Knightian Uncertainty! That is the uncertainty that is not quantifiable. It clearly differs from risk, which can be measured and traded! The market doesn't like the new uncertainties and it constantly sells off the occasional rallies. The market is weighing!

The New Uncertainties

The Graham/Bufet adage is that the market is first a voting machine and only later a weighing machine. In this case, the market has been weighing appropriately. The market didn't like the **new uncertainties**, and it has repeatedly sold off, in spite of the transitional 'good news.' It continues to be haunted, in spite of better values.

Geopolitics is no longer our friend. The collapse of communism in the Soviet Union and the East Block, as well as the consistent move to the market by China, underpinned an optimistic outlook by investors world-wide.



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As world security improved, defense budgets went down and technologies, often buried for security reasons emerged. The Internet is the most obvious example, but it spawned a huge boom in technology and telecommunications. Friendly geopolitics probably came to an end just as the Great Boom was reaching its peak, but 9-11 left no one doubting that the world had changed, perhaps forever. The Iraq controversy only serves to underscore the uncertainty the unfriendly geopolitics has unmasked. Many have remarked that 9-11 was the 'end of innocence' for the United States. Innocence implies a kind of certainty. That is now gone.

The Rise of Political Risk

As the Great Boom came to an end, political risk was rising around the world. A few examples would include the fall out from the *Intifada* and Terrorist campaign in Israel; the coup and counter-coup in Venezuela; the collapse of the Argentine financial regime and the spillover effects on Brazil's election; the peculiar French elections of 2001, during which a extreme 'nationalist,' in effect put in a conservative, Gaullist regime and now the spillover into the German election campaign. Germany is now at odds not only with the United States, but with the other members of the EU. In China, there is a succession controversy, and a potential flare-up in the Taiwan Straights, once again, while the process of unification on the Korean peninsula has been made much more difficult with the 'axis of evil' references from the White House. There is an active anti-terrorist campaign in the Philippines; more upsets in Indonesia; significant saber rattling on the Indian sub-continent involving two nuclear powers; continuing fighting in Chechnya. Finally, there is Iraq, unbent if still bloody, with a firm commitment by this Administration to cause a change in regime. Will it spill into other countries in the Middle East? No one is certain, but until the military campaign begins, any conjecture is negative to the market.

The Perceived Failures of Markets

The end of the Great Boom, ushered in an unparalleled **corporate governance** scandal that has ensnared one company after another. First, it was the accounting at Enron and the ultimate conviction of Arthur Anderson for obstructing justice. Since then, WorldCom and other telecoms have been shown to have either fraudulent or highly questionable accounting. The scandal has widened with the disclosures of a Merrill Lynch/Enron "trade," that appears to be fraudulent and the latest, still emerging scandal, concerns Citibank. Heads have rolled and the tumbrels will surely fill with more as the scandal deepens. What is significant here is that the **faith in markets** to produce desirable economic change has been winnowed away. When the California energy crisis first emerged, the State of California charged that there had been fraudulent practices used by energy companies to raise to the price of energy to the single, monopoly buyer constructed under the deregulation scheme. The renegotiation of contracts for long term energy supply confirms that some energy companies appear to have "gamed" the market.

During the Great Boom, markets were replacing government as vehicles for governance and change all around the world. The supposed **Asian Miracle** was buttressed on allowing markets to work their magic, and even China made major moves to implement market processes as the drivers for growth. The scandals in Wall Street are generating considerable political pressure to bring back a heightened regulatory regime. For the Bush Administration, this is a setback, but free markets and free trade had already been assaulted by this Administration when it gave in to the Steel Industry and the Farm Lobby. When nominal defenders of markets over government join the anti-market league, you know that a tectonic shift has occurred. The peak of the zeal for deregulation and markets over Government was probably 1998/1999. It has been downhill ever since then.

The Loss of Faith in Economic Policy

While the loss of the budget surplus has created ample political ammunition for the Democrats, it was a sharp reversal from the glory days at the end of the Great Boom. The epiphany of Greenspan's 2000 testimony that the rising budget surplus could impair the conduct of monetary policy was quickly replaced by the loss of the



surplus under the pressures of increased spending, decreased tax revenues (as the Great Boom collapsed) and to a minor extent by the tax cuts of 2001. That the CBO and the Fed projections of surplus had to be revised so quickly, undermined much of the credibility that economic forecasting had gained during the Boom. The new uncertainty haunting financial markets is calibrating the size of the Government's financial demands. As a prelude to a potential military involvement in the Middle East, it is one weight on the uncertainty scale.

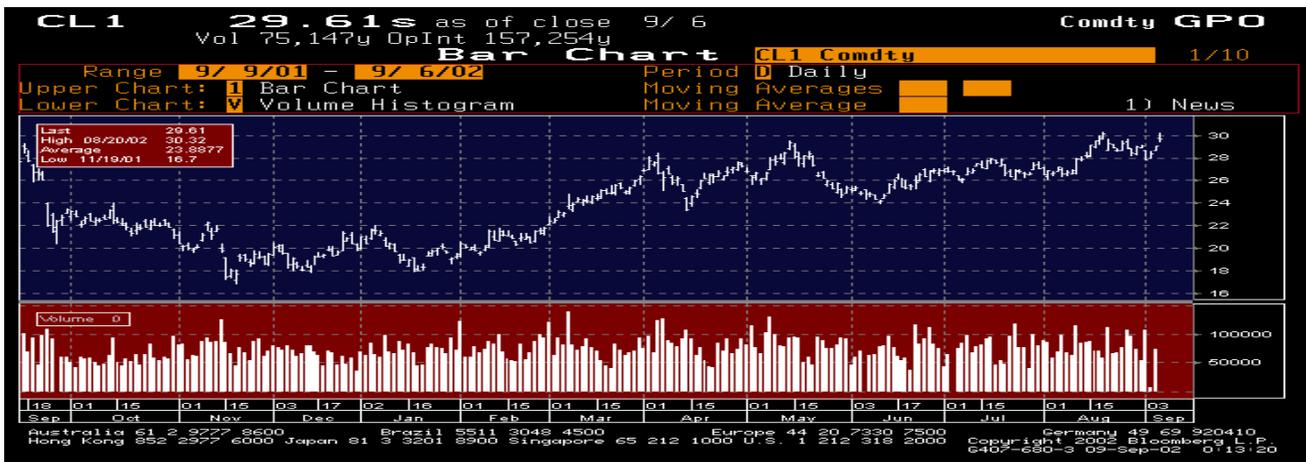
In addition, while the U.S. could certainly use further exports, particularly as an offset to weak private investment demand, the route to export expansion via an exchange rate change, has created an uncertainty as to government policy on the dollar. Strong dollar, weak dollar or no dollar policy is a mantra for more uncertainty. In the guise of answering these questions, there is constant mention of the 'unsustainability' of a large current account deficit. How long will foreign savers supply capital to the U.S. in sufficient amounts that interest rates do not have to rise? The real answer is that no one knows!

At the recently concluded Jackson Hole Conference held by the Kansas City Federal Reserve Bank, Chairman Greenspan defended the policy of the Fed and denied the Fed had the capability to deflate the Bubble. That may turn out to be true, but it is unconvincing. The new 'Great Game' in economic policy theory is whether the level of asset prices is something the Fed needs to watch and to act upon. Many critics have expected a *mea culpa* by Chairman Greenspan for not invoking margin requirement changes to help stem the bubble in asset prices. He denies that, all the while the same critics often wail about a Housing Bubble. However one votes on these issues, what is now being questioned after a long period of being in the limelight is the conduct of monetary policy. Is it done correctly? Should new targets be made explicit? These questions, within the context of succession at the Fed only serve to increase uncertainty in the market.

The Peculiarities of Q3 Growth and Growth Drivers for the Future

A number of professional forecasters have changed their forecast for Q3 GDP, with perhaps a consensus now developing that growth should be close to 3.5% for the quarter. The drivers have been huge auto sales, housing and strong retail sales, at least early in Q3. In addition, Government spending continues to grow. What is missing is private investment demand, in spite of record low interest rates. With the military situation still unclear, but promised, balanced growth still seems unrealized. In addition, while the current account may improve in Q3 because of a slowing of imports (as the likelihood of West Coast dock strike seemed to disappear), Q4 is highly uncertain. Asia is slowing, and with a slow Europe, US export growth is undermined.

War risk is often expressed in a heightened oil price. The uncertainty is how much of a premium is already built in? Prices fell subsequent to 9/11, but the high level of terrorism in the Middle East and the increased





likelihood of a direct military attack on Iraq, has given the Oil Bulls a run in the old corral.

Uncertainty and Market Risk Premia

The economy is 'not so bad,' but the equity market doesn't believe the story. Earlier in the year, this was seen as a disconnect, but now, a clearer picture of the uncertainties points to a perfectly rational market outcome. Portfolio managers and sophisticated investors have concluded that the upside potential for stocks that should stem from better earnings going forward is a "show me the money" uncertainty. They continue to get paid for selling stocks or withdrawing from the market entirely. Just as they were rewarded during the Great Boom by 'buying the dips,' they are rewarded in the Great Collapse by selling the rallies. They evidently wish to wait until corporate earnings are rising sharply and are fated to continue that process. They wish to wait until the White House makes up its mind on Iraq and puts "facts" on the ground. They evidently wish to wait until all the 'bad apples' in the barrel are found and 'all the usual suspects' have been rounded up and convicted! They appear to want to wait until the size of the Government's demands on financial markets are better known and the willingness of foreign savers to finance our excess of spending over saving is more carefully calibrated.

All of that waiting can be subsumed under a scenario of a rising equity risk premium. Worse, it appears that the laggardly quality of business investment spending has frightened physical asset managers. There is no rush to queue up for the latest piece of technology. Pessimism abounds in the Ennui Economy and it is becoming more of a self-fulfilling prophecy. The consumer has carried the load so far. The Market worries that the load is much too heavy.