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What's Wrong on Wall Street: Double Dip or a Confidence Crisis?

Today's Richmond Fed survey confirms what all of us now recognize: Q2 growth is slowing and Q2 is going to be a much different affair than Q1. One issue to focus on is whether Q2 will be a good barometer for 2H02. More importantly, how will 2003 play? The behavior of Q2 seems likely to be more in line with what we had in mind very early this year. We were suspicious that we would get the 3.5 to 4% growth story highly touted by many analysts who felt that Monetary and Fiscal Policy moves would be the story for the year. We were suspicious that business investment would rebound although we underestimated the consumer's positive response to tax cuts, low interest rates and the ability to 'refi' the mortgage. That suspicion, however, still remains.

We underestimated the strength of Q1's rebound--although as it has turned out---Q1 GDP growth was more an **inventory rebound than an investment restart**. If a sharp cut in the growth rate of GDP is counted as a Double Dip, then the Double Dip has begun. Conventionally, however, a double dip features an absolute decline in growth. That still seems unlikely. However, if our analysis is correct, the slower pace of Q2 and prospects for 2H growth that are less impressive than some of the more optimistic analysts in January and February could portend something more serious. If a 'growth recession' turns out to delay rapid declines in the unemployment rate and a much less springy bounce in corporate profits, GDP growth could stagnate. Stagnation would have increasingly severe consequences.

Today, the market nearly took out the Nasdaq 100 low of September 19th (1088.96), but is this merely the market's forecast that there is less growth ahead than had been predicted by the optimistic calls of January and February? Is a dreary market simply forecasting that corporate profits are going to be much weaker than had been hoped for earlier?

We do not see GDP beginning to go negative and dragging down corporate profits to the extent implied by the whipping that stocks are now taking. We believe that a true **Crisis of Confidence** has emerged. Who to believe and what to believe haunt consumers, business and foreign investors as well as the much beaten-up domestic investors. What is at issue is a loss of faith in some of the institutions that lie beneath all of this market turbulence. What has changed since the lows of September 2002?

Eight days after the Twin Towers/Pentagon attacks, investor confusions manifold. The economy had taken a hit of unknowable magnitude and the response pattern, both economically and geopolitically, was obscured by our lack of fundamental knowledge on the mechanics of terrorism. Little was known by the public concerning the potential scope of terrorist attacks, and the consumer

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economy was having an economic infarct, a seize-up in purchasing as consumers confronted this new uncertainty. Travel had stopped, consumer spending was interrupted and the prospects for the future were completely ringed by uncertainty and insecurity. This added to the business sector need to reduce already bloated inventories. The inventory overhang predominated in both consumer and producer durables. Domestic demand was suspect and the future course of government policy was still undetermined, even though the Fed had cut 50 basis points off the Federal Funds target bringing the target down to 3%. The focus of markets was first directed to the payments system. Would there be enough money and credit to allow markets to work?

The Fed pumped in massive amounts of liquidity to insure that no financial interrupts would occur. That provided some breathing space. As bad as the Tech-Telecom bust would become in another three or six months, the outlines of the tech-wreck were still not fully perceived. It was unclear how much economic stimulus would be needed. Yet, the Government seemed to show no lack of resolve in bringing to bear its heavy monetary and fiscal guns in order to offset the terror-induced shocks to aggregate demand. Some economists questioned whether the Government would do too much, even if inadvertently, but there was a high degree of confidence in the political unification that seemed to point the way to rapid policy shifts to fight the recession. Afghanistan was still a geography question, and we were in the midst of the anthrax scare. Still, there was reasonable confidence in our governing institutions.

The market bottomed and began a remarkable climb. It seemed to do so on the basis of recognition that Government policy response was immediate, forceful and confident. Equity holders still held beliefs that the U.S. economy was a powerful engine, a perfect partner to forceful actions on the foreign policy front.

Compare that environment with what we know today. Notwithstanding the terrain and the distance and the high level of 'go-it-alone' toughness shown by the U.S. to do something about Osama bin Laden, it appears that we are suffering a higher level of **uncertainty** now than in the first few weeks following 9-11. That uncertainty comes despite what is truly reasonable economic performance and reasonable prospects that the economy will perform well in the future, if not brilliantly, as it moves forward. Economic policy has been remarkably forceful and timely with aggressive monetary policy being supplemented by extremely aggressive fiscal policy (two tax cuts plus substantial spending increases). At the same time, no doubt as a result of these forceful policy actions, since the shock of September, consumer behavior has been very supportive for a 'restart' of the U.S. growth engine. Q12002 was not just an inventory rebuild story. The manufacturing sector has rebounded, consumer confidence has grown and unemployment, while continuing at high levels in comparison to the boom years, is not inconsistent with patterns of growth and employment in the pre 1997 era reaching aback into the 1980's. So far, at least, no true Double Dip has emerged on the growth frontier. Not so on the equity market. There is an evident "waterfall" pattern to the three major stock indices, with the NASDAQ being the most pronounced.



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The underlying malaise that has crept into the equity market is also apparent in several macro-economic data series. One can see it in the lack of follow through in business investment outside of the immediate need to slow down the rate of inventory decumulation (or to actually begin re-stocking). Businessmen express various degrees of skepticism over the robustness of the recovery and there is no evidence that two of the major drivers of the preceding Boom (telcom and tech) are back in gear. Liquidation of inventory and modest order recovery is still much the order of the day.

Furthermore, there are at least three new sources of anxiety that don't come from the normal Macro Arena

(1) the War on Terrorism has no clearly defined dimensions nor does it have a recognizable "exit" for the U.S. Even overthrowing the Taliban ---an ostensible first goal of the expedition in the early days---has not eradicated the threats to U.S. security. That means the economic costs can be and are now, 'open-ended,' while the amorphous nature of a non-state enemy makes it difficult to produce even a definition of victory. Without an exit definition, it is hard for markets to define "closeness" or the 'timeliness" of an end to investors underlying anxieties.

(2) There is growing suspicion in investment circles that the U.S. has fallen into a 'go-it alone' posture and such allies as the U.S now has may not allow for the creation of a well-defined base of support for further anti-terrorism campaigns. Iraq is on the agenda, but who will be an ally if the going gets really messy? Consider the obvious 'strangeness' of current U.S. anti-terrorist bedfellows, Russia and the U.K. Turning an erstwhile enemy of some 80 odd years into a reliable and dependable ally for peace is as much a psychological battle for investors as it is for geopolitical strategists. The counterpart to this peculiar threesome is the highly critical 'rump' of NATO allies in Europe that is clearly disaffected with American policy toward Israel. The French are noisy, but they have supporters throughout the European Union. American analysts read a daily dose of how critical Europe is of U.S. policy, in particular, with respect to U.S. policy in the Palestine/Israel controversy. If the Israeli's cannot define an "exit," how then can the U.S. certainly cannot define an exit for its anti-terrorist campaign that clearly now involves the U.S. alliance with Israel?

(3) The Enron affair has become a rallying cry for all the critics of a wide-open capitalistic system. That the accounting profession has stumbled is an understatement. More menacing is the suspicion surrounding corporate data. No set of corporate numbers can have an inviolate claim to credibility at this point in time. Nor have the purveyors of securities escaped disclosures of substantial improprieties in using dubious numbers to market securities of ultimately dubious firms. The distrust aspect goes under the slogan of improving Corporate Governance, but the upshot is that if the current accounting numbers cannot have credibility, the future becomes even more murky and uncertain.



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Markets believe it is better to be surprised by the upside. In the meantime, even if all the suckers are broke, keep selling. Until there is credible evidence that we have come to the end of our travails, it is hard to motivate the longs in the market.

One last item on the Dirty Laundry list is the dollar. Long ago Greenspan opined that an indefinite imbalance in payments for the U.S. was an impossibility or to paraphrase Herbert Stein, 'a trend that can be broken, will be broken.' The dollar has eroded (Euro was .8364 on July 5, 2001 and .9267 on September 19, 2001. The Euro rose to a new high at .9482 today and parity looks to be within reach. If there is a momentum play, it is to short the dollar.

During the summer and fall last year, the inflexibility of European Monetary policy was palpable, while the U.S. ability to use both tools (monetary and fiscal policy) in the U.S. made the world dollar-optimistic. Today, a rising Euro reduces the inflation risk in Europe and gives their monetary policy more traction. Europe may not be a capitalist paradise, but equity risk is a relative issue. The uncertainties noted above make worldwide investors see a weaker dollar as a way out of their current uncertainties. The U.S. economic environment is not lousy, but the environment has too much uncertainty. Thus, the dollar has greater downside risk. Strictly on the corporate economics, a stronger dollar is a plus for corporate earnings in the aggregate. More exports, less imports and perhaps a more attractive pricing power environment. But, in the short run, foreigners may well wish to hold less U.S. equities and American investors who feel it is time to follow the flow could join them. This is another aspect of the disconnect between likely GDP growth and equity price movement on U.S. stocks. If the wealth effect works contemporaneously, consumption could be threatened.

In short, the risks of a secular double dip have grown, in spite of obvious economic progress in halting the recession and beginning the recovery. This is not the same kind of double dip feared earlier this year, but if equity markets get trashed daily, those who were right, even for the wrong reasons, will gain credibility---SIMPLY BECAUSE THE RESULTS TURNED OUT THAT WAY and LARGELY IN SPITE OF THE REASONS THEY GAVE AT THE TIME FOR THE DIP.

Earlier and frequently, we have written that a Valuation Crisis is underway. Ultimately, that will produce a 'cure,' because as equity values decline, more and more opportunities of gaining from the long side will occur --- provided of course that investors can regain their confidence that the numbers mean what they are supposed to mean. The TYCO shocks of the past two weeks have replaced our concerns over Enron, but they have done nothing to restore our faith that audited numbers mean what investors think they ought to mean. On the contrary, even more suspicions have been aroused.

The apparent U.S. success in apprehending an Al Queda operative sent to do further damage within the U.S. with a dirty bomb has given investors the 'willies' once again. It underlines the connection between globalization and vulnerability. Globalization was the watchword of the great boom. Fear paralyzes forward-looking investment decisions. The creation of a massive



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Department of Home Security underscores these fears. It is hard to design a quick Macro cure for that kind of insecurity.

IN SHORT, POLITICS HAS TRUMPED ECONOMICS AND GEOPOLITICS HAS TRUMPED GLOBALIZATION. A great deal was changed on 9-11. Much more has changed during 2002. If a Wall of Worry is necessary for a rally, the Wall is building. We are not sure that it will be sufficient...yet.



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