Barrington Research Associates, Inc.

Economic Analysis • Equity Research • Investment Banking

MONTHLY ECONOMIC REVIEW ***Alexander P. Paris, CFA***
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Summer of Discontent

Investors have been noticing lately that what Greenspan has been telling them right along just might be true. While the economy has been seeing some signs of slowing in spots, it is still too soon to conclude that the moderation will be sustained or that it is sufficient to reduce inflationary pressures. We had warned earlier that economic data over the summer would not be decisive and that the Fed would keep investors guessing right up to the next Fed meeting, making for a difficult summer. The 5.2% second quarter bounce in GDP, for example, was well above the 3.5% consensus forecast. Though the strength was a little deceiving, it was still disturbing to Fed-watchers. It is not clear yet if the consumer slowdown will persist in light of sharp rebounds in consumer confidence back to near recent all-time record highs. It had certainly been looking like housing activity would be exerting a drag on second half economic growth, but even there, sales of existing homes have been rebounding for the past two months. Investors are also finding out that, even if they get their slowdown in the economy, there is a price to pay in lower earnings growth. Although second quarter earnings were still up nicely, warnings by many companies about future growth have been increasing. We would still bet on a soft landing, but investors will be kept guessing for a while yet.

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Tracking the Slowdown: Recent Economic Trends

The second quarter GDP report was a good example of the challenge investors are facing in determining what the next Fed move will be. Instead of the expected deceleration from the 4.8% first quarter growth, GDP growth accelerated to a 5.2% annual rate, clearly too high to suit the Fed. But was it really a reflection of underlying private sector demand? An increase in **inventories** added 0.99 percentage point to GDP growth, a sharp reversal from the first quarter when they reduced GDP growth by 1.76 percentage points. Was the accumulation intentional and a sign of growing confidence? Or did inventories bulge because of lower than expected demand, suggesting the need to liquidate inventories in the third quarter? We suspect it is the latter since much of the increase came at the retail level. Also, **real final sales** (GDP less the change in inventories) increased by 4.2% in the second quarter, still healthy activity, but down from a 6.7% increase in the first quarter, reflecting the deceleration in demand most economists expected. Real **federal government spending** also had a very dramatic reversal to a 17.5% increase in the second quarter from a 14.2% decline in the first. Though adding to the GDP, it is not indicative of underlying private demand. So, looking at the report in more detail, there are several reasons for believing that the Fed may be succeeding in slowing private sector demand.

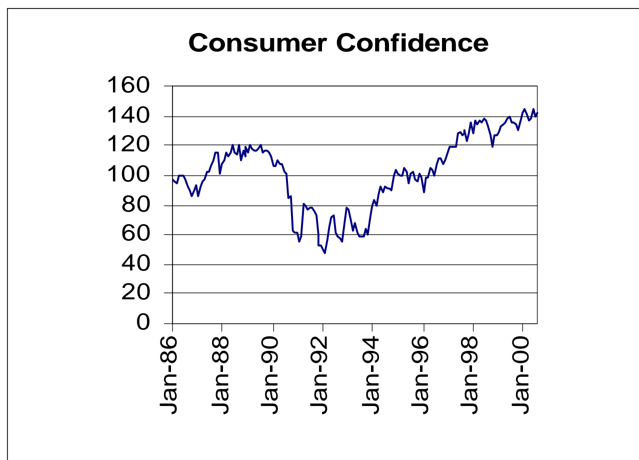
The other major contributor to the GDP increase was **real nonresidential fixed investment**, which increased by 19.1% in the second quarter. As we have been reporting, business capital spending has remained at a fairly strong pace throughout the first half, so this part of the report was not surprising. Spending on nonresidential ***structures*** rose at a 13.0% rate compared to 21.0% in the first quarter. ***Equipment and software*** spending rose by 21.0%, compared to 20.6%, as technology investment continued at a strong pace while industrial spending was sluggish. While this investment also increases the GDP, much of it is the kind of spending that will help hold inflation down and stay the Fed's hand from further rate increases.

The weak part of the GDP was good news for the Fed. Real **personal consumer spending** decelerated to a 3.0% upward rate in the second quarter, down from a 7.6% rate in the first. Purchases of durable goods ***fell*** at a 3.9% rate, sharply reversing the 23.6% first quarter increase. Consumption of nondurable goods also decelerated to a 3.5% growth rate compared to a 6.0% first quarter increase. Spending on services slowed to a 4.2% annual rate from 5.2%. Real **residential fixed investment** also remained at a more moderate 3.9% gain compared to 3.2% in the first quarter. Other good news for the Fed included the **implicit price deflator,** which slowed to a 2.5% rate in the second quarter from 3.3% in the first quarter.

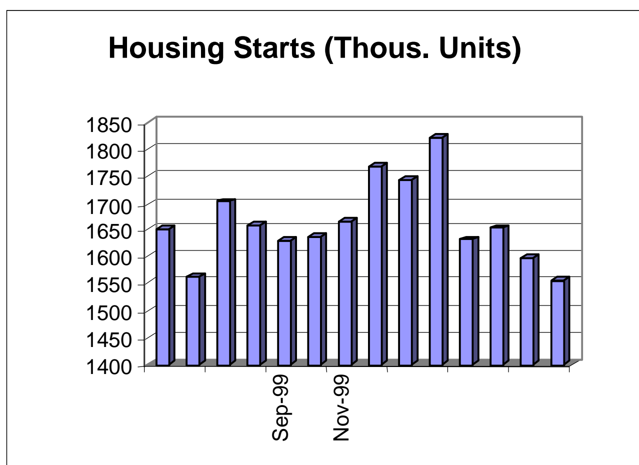
Focus on the Consumer

When tracking the success of the Fed in bringing the economy down into a soft landing, it is important to keep focused on the consumer. It will be the first sector to turn down (excesses there are the most inflationary) and it is the area of greatest attention by the Fed. A downturn there will gradually spread throughout the economy, even to semiconductors and the overall technology sector. Not coincidentally, Nokia and others are warning of a slowdown in cellular phones, computer sales slowed in the second quarter, and analysts are warning of slower semiconductor sales ahead. Slowing the economy, as mentioned, has its costs, which investors are starting to realize.

As described above, the slower consumer spending growth in the GDP report was encouraging, especially in durable spending. If the Fed is convinced it will persist, there is a good chance it will not raise rates again. Unfortunately, the continuing statistics on incomes, jobs and consumer confidence do not yet make a convincing case that consumer spending will remain subdued. In fact, the Conference Board's **consumer confidence** index just rebounded sharply in July, close to its all-time January record high. The University of Michigan measure performed similarly. While consumers are ***talking*** a good game in terms of confidence, their ***intentions*** to purchase cars and other big-ticket items over the next six months have been waning, a good sign that hopefully won't escape the Fed's notice.



Housing construction has been slowing, reflecting an earlier slowdown in home purchases. But activity is still at a historically high level. Sales of existing homes have also rebounded in May (+4.3%) and June (+2.8%), offsetting the 6.1% drop in April. If the recent rate were to be sustained, full year 2000 sales would exceed the 1999 record level. The same mentality behind the rebound could also lead to a renewed upturn in new home sales.

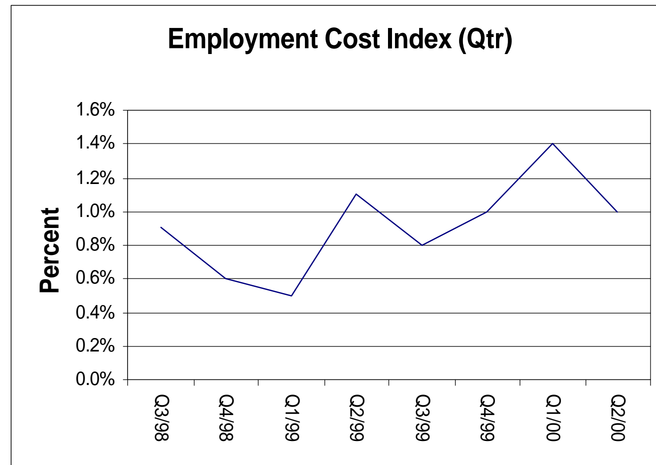


In short, it is still a little early for the Fed to relax, as far as the consumer is concerned. While the news in the second GDP report was encouraging, it turned a little less so toward the end of the quarter. In addition to the comments above, June **retail sales** were above expectations (+0.5%) and May results were revised sharply higher from an original 0.3% decline to a 0.3% increase. **Consumer installment debt** growth also exceeded expectations in the most recent May report.

Other Recent Data

The second quarter **Employment Cost Index** (ECI), the broadest measure of total employment costs and one watched closely by the Fed, did not lend much insight. The 1.0% second quarter increase was below the 1.1% first quarter rise, but the index jumped 4.4% from a year ago, a little higher than the 4.3% year-over-year increase in the first quarter. Benefit costs were up more than 5% from a year ago. While total employment costs did not accelerate much, they are still edging higher and would spurt higher if the economy reenergizes. The ECI report also included hiring bonuses and other non-wage costs for the first time. The

report concluded that these influences were rare and modest, but we suspect, because they may be harder to measure, that they are understated in the report. Consequently, we may see upward revisions in the ECI as the government gains more experience with the numbers.



Earlier in the year, there was some indication that the slower consumer spending was already starting to spread to the industrial sector. We wrote at the time that it was a little early to expect that and some evidence since has confirmed that view. **Industrial production** was up 0.2% in June, and both May (+0.5%) and April (+0.8%) were revised higher. **Factory orders** jumped 4.1% in May, more than reversing the 3.8% decline in April. The preliminary June report for **durable goods orders** showed a very surprising 10% jump, compared to a 0.5% consensus estimate. Almost all of the jump was due to a leap in the very volatile aircraft sector but strength will spill over to suppliers. Excluding the aircraft sector, moreover, all other major sectors also showed modest gains. We should mention, however, that we still have a two-tiered manufacturing market with most of the strength in technology.

In conclusion, we believe the economy is in the process of slowing and the consumer has been retrenching. The leading indicators are pointing to slower economic growth ahead. But it is no sure thing as far as the Fed is concerned. Moreover, if things are slowing down, it is not clear yet whether it is only a temporary moderation to be followed by another surge. Since there is a lag between a downturn in consumer spending and its impact on the rest of the economy, the Fed must decide when the consumer has had enough tightening ***before*** it has evidence of slowing elsewhere. As with its overall inflation-fighting task, it must move preemptively both with the start and ending of tightening policy.

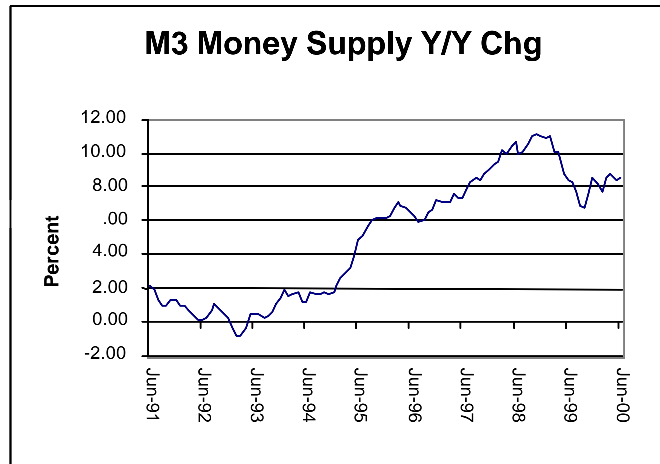
Fed Watch—Down to the Wire

From the evidence so far, we continue to believe that investors will be faced with a confusing economic environment all summer. As we had anticipated, the economic data will be mixed enough and Greenspan will also be non-communicative enough that investors will be worrying and guessing about the next Fed move right up until the August 22 meeting. Actually, the stock market will probably be an important key in the next rate decision unless economic trends become significantly clearer. A strong, speculative stock market would help to sway Greenspan, all things being equal, toward at least one more rate hike because of the feared impact of wealth effect consumer spending. Since we already saw a sizable decline in the second quarter GDP report of the kind of discretionary spending that would have been impacted by a softer stock market, a weak or trendless summer stock market would influence him away from another rate increase.

Sticking with the Game Plan

Greenspan has generally stuck with the game plan since the last meeting of keeping investors in the dark regarding plans for the next meeting. He has continued to indicate that there is not enough evidence yet to conclude that the economy has slowed to a sustainable noninflationary rate and that inflation still appears to be creeping up according to some measures. Where he has admitted signs of slowing, he has also indicated that growth could rebound.

If a soft stock market is his friend in helping to rein in consumer spending, he might have made one slip in his testimony before the Senate Banking Committee on July 20. He mentioned that he saw no need for a prolonged series of rate increases that might risk recession. He also suggested that if current signs of economic moderation continued, the Fed was unlikely to raise rates in August. He even listed some reasons why the moderation in consumer spending might continue—the sideways stock market movement and lessening wealth effect, the dampening effect on consumer spending of higher interest rates, rising household debt, higher energy prices, and the potential saturation of big-ticket consumer durable demand. He also suggested that the rising productivity was not just cyclical, but structural in nature, and that even a 4% unemployment rate won't ignite inflation.



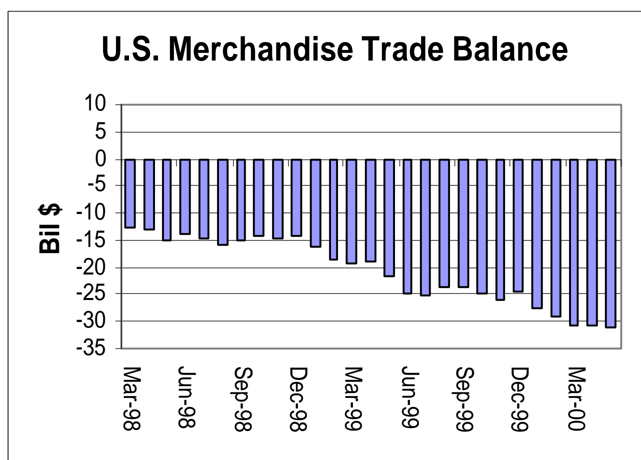
Investors quickly zeroed in on his positive comments while ignoring his other caveats and sharply rallied the stock market. We have not heard any more encouraging remarks from him since and suspect we won't before the August meeting. The money supply chart above, however, is speaking volumes. As can be seen, substantial liquidity has been taken out of the market since midyear 1999, and given normal lags, it should be negatively impacting economic growth by now. The monetary base chart, a good measure of Fed intentions, looks similar.

Oil Prices

The sharp rise in oil prices is also a consideration in Fed policy. While they appear to be out of the news lately, oil prices have tripled over the past 18 months and are still in the process of permeating the economy. By some estimates, it takes up to 18 months before the full effect of rising oil prices on the rest of the economy is felt. Greenspan probably vividly remembers his first try at a soft landing in the summer of 1990. But Iraq invaded Kuwait, oil prices quickly doubled, and the economy went into a hard-landing recession. He is also old enough to remember the devastating effects on the economy of the oil price shocks of the 1970s.

International Considerations

While the U.S. central bank has a history of putting domestic priority needs first, monetary policy cannot be done in an insular vacuum. There is increasing talk that the tight U.S. monetary policy is making things more difficult for Asian economies. Reluctant to follow suit due to the tenuous nature of their economic recoveries, some Asian currencies are weakening again. This is particularly true in Indonesia where the rupiah has fallen 25% since the first of the year. The baht in Thailand, which triggered the 1997-1998 Asian currency crisis, is down close to 7% and the Philippine peso is down close to 10%. It may be premature to even start thinking about another Asian currency crisis, but Greenspan may put the consideration into the hat on August 22 as one reason not to raise rates further. Euroland has also been keeping pace with the Fed's rate increases to protect the weak euro at the risk of dulling the expected European economic recovery that was to help offset the slower U.S. economy.



The U.S. trade deficit also surged to a larger than expected record $31 billion in May, while April's deficit was revised higher, as well. For the first five months, the trade deficit totaled $147.7 billion, well ahead of last year's $92.6 billion and well on the way to breaking 1999's $265 billion record. As evidence of weaker overseas demand than anticipated, U.S. exports fell in May. Consistent with the tighter monetary policy in Europe, the growth there has been export driven and not based on solid domestic demand. As the same time, U.S. imports also slipped as a further indication of slowing demand.

Market Still Adjusting to Realities

The general environment of uncertainty described above has clearly been impacting the stock market, especially the technology sector. It took a long time for technology stocks to finally reflect that valuation reality that rising interest rates mean lower P/E's. Additionally, the further into the future investors have to look to justify the current valuation on a stock or sector, the more devastating the impact of higher interest rates. So, it was no wonder that the technology sector in general, and Internet stocks in particular, were hit the hardest. The current uncertainty regarding the economy and the Fed had added to the pressure with another reality. Uncertainty equals risk and risk means lower valuations.

The Earnings Reality

The most important newer reality to which the technology sector, especially, is now adjusting is lower earning growth. If the central bank of the nation is determined to reduce economic growth to a noninflationary rate, is it so difficult to conclude that the growth in corporate profits will slow, as well? Sounds simple enough, but for a long time, technology investors

ignored that reality, believing that the technology sector could breeze through unscathed. But technology stocks for the most part are also cyclical stocks. If the Fed will ultimately be successful in slowing consumer spending, and it won't quit until it does, it means slower purchases of cellular phones, computers and the array of new digital consumer electronic products. That, in turn, means less demand for semiconductors, other electronic components, and all the other ingredients of the final product. If it gets bad enough, capital spending by the electronics and telecommunications industries will slow, as well.

To drive the lesson home, technology investors have recently been subjected to a number of warnings from such technology leaders as ***Nokia (NOK:NYSE)*** and ***Ericsson (ERICY:NASDAQ)*** that cell phone demand and revenue growth will be slowing in the second half. Semiconductor industry stocks have been hit by pronouncements from Wall Street of slower growth ahead. Computer shipments slowed in the second quarter.

Actually, the shift in market emphasis to earnings concern began in June as we discussed in our July 5 ***Market Strategy Review*** ("A Changing Market Focus"***).*** Our concern had been that investors were so focused on the short-term—what the next Fed move might be—or celebrating its success in slowing the economy and obviating another rate increase, that they were not reflecting the impact of that success on earnings. The market started to correct that oversight in June. Technology stocks were very strong in June, continuing to ignore the earnings reality. But relative strength patterns in the rest of the market were clearly indicating some discounting of lower future earnings growth.

Defensive stocks, those whose earnings are least sensitive to lower economic growth, gained considerable relative strength in June. **Consumer discretionary** spending stocks, on the front line of the Fed assault, were especially weak and were discounting perceived lower consumer demand ahead. **Industrial stocks** were also very weak, with over half of the 20 related S&P indexes in the worst-performing quartile, with absolute price declines of 8% or more. Importantly, the concern is not simply about what the future effect of the Fed policy will be on economic growth. Earnings are already being negatively impacted by higher interest costs due to the higher rates and rising material and labor costs that cannot be passed along due to the tighter Fed policy. Actually, that is exactly the Fed's goal—to make it difficult for companies to pass inflation down to the consumer. As discussed in last month's issue, "Be Careful What You Wish For," before the summer is over investors may even start questioning whether Greenspan can indeed engineer a soft landing.

Two-Tiered Bear Market

We hesitate to use the ***B-word*** at this late date, but it appears that we are in a two-tiered bear market. Over the past few years we've had a two-tiered economy—old economy versus new economy; a two-tiered stock market—technology versus non-technology; two-tiered valuations with record high multiples on the new economy stocks and record low multiples on much of the rest of the market; and a two-tiered market between large and smaller stocks. Why not a two-tiered bear market? The old economy stocks have already been in a bear market for well over a year and are in the process of trying to build a bottom. The bear market in new economy stocks only began this year and that sector is still searching for a bedrock bottom. As discussed above, they have only recently begun to reflect upon the possibility of lower earnings growth,

while still grappling with proper valuations. Actually, this conclusion is not very new on our part. We've already dwelled on the various dualities in the market and economy for some time in a number of publications. We've also talked about the market gradually returning to normal this year.

Old Economy Bear Market: We also wrote frequently that the old economy stocks have already been in a long relative, and in many cases, absolute bear market since the Fed began tightening over a year ago. Their valuations have been compressed both due to the direct impact of higher interest rates and to discounting their eventual impact on the economy and their earnings. This has been especially true for non-technology manufacturing stocks. They already had what amounts to their own recession as they bore the brunt of the Asian economic crisis. They were hurt by lower exports to depressed overseas economies, by the sharp rise in imports because of the strong dollar and by inventory liquidation among distributors and OEM customers during the post-Asian crisis period. More recently, their earnings have been hurt by negative currency translations, higher interest costs and rising material costs. Much of this was going on while the new economy stock market was booming. Investors in the industrial stocks could clearly say, ***We don't worry about a bust, we lost money during the boom.*** So, we don't worry much about Old Economy stocks. Sure, they will come under some pressure from a weak technology sector, which has become a key swing factor in investor sentiment and confidence. But the downside risk in most Old Economy stocks is relatively limited. Most are grinding along the bottom and looking for the right conditions to begin looking over the economy valley. At worst, they may just be boring.

Technology Bear Market

The technology bear market is much more problematic and it is not over. The excesses have been substantial, and as mentioned, investors have only recently been exposed to the possibility that earnings of even the healthy large technology leaders can be pressured in the period ahead. The Internet sector, the area of the most excesses, has already been severely pounded. This has been especially true of the secondary issues. Since there are still no signs of any profits on the horizon for most of them, they are still not cheap by any sense, only cheaper than what they were. We suspect this will be a primary target of tax-loss selling as we enter that season. We also wonder how investors will react to increasing numbers of Internet companies going out of business. One very prominent Internet analyst at a major firm recently estimated that at least 30% of all publicly traded Internet stocks will go bankrupt, or be acquired at $1- to $2 per share and that 75% will disappear. We have frequently compared the Internet bubble to a major commodity top. Both traded up primarily on pure speculative supply and demand with current fundamentals taking a distant back seat. When a huge market rise takes place and a commodity finally peaks, it means that the supply/demand has changed. The tendency of traders is to buy in the first dip with very painful results. Rather, they should have simply sat back and waited for supply and demand to again come into balance, a process that usually takes a long time. That has been our advice with Internet stocks. The very large Internet stocks, such as ***Cisco (CSCO:NASDAQ), Oracle (ORCL:NASDAQ)*** and others have held up much better because they have had earnings, but they are still richly priced and earnings have now been called into question going forward. Long-term fundamentals are still great for many technology sectors, but the market may be challenging for a while yet.

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