TrendMacrolytics

Donald Luskin, Chief Investment Officer
David Gitlitz, Chief Economist

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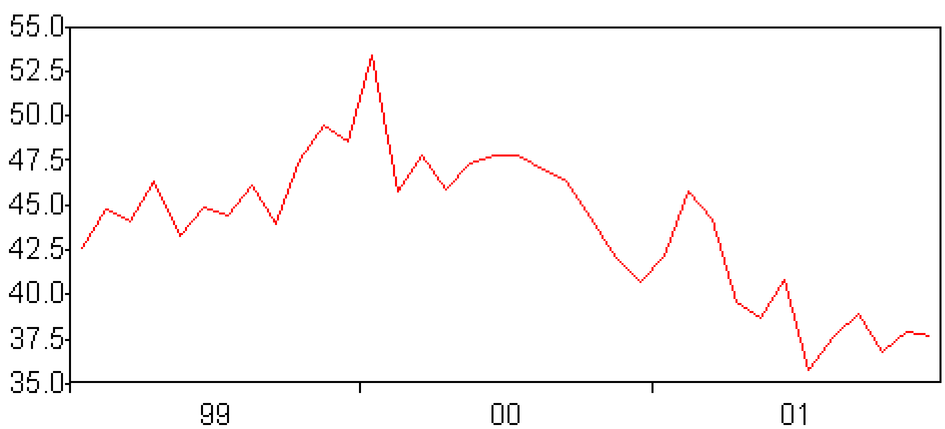
A Green Eyeshade Recovery

Wednesday, January 9, 2002
David Gitlitz

Amid the steady drumbeat of assurances that recovery lies just around the corner, there indeed are good reasons to believe that a *technical* end to recession might not be far off. At the outset, we would emphasize that indicators of market-wide risk preference that we monitor as signals of forward growth prospects suggest that conditions remain inhospitable to a restoration of robust rates of economic expansion. An analysis of those variables will be forthcoming shortly.

Nevertheless, strictly from a bookkeeping perspective, it's not difficult to construct a scenario under which the economy emerges from recession fairly quickly. Inventory liquidation accounted for an average decline of 1.3% in the annualized real GDP growth rate in the first three quarters of last year, and indications are that it took an even bigger chunk out of the fourth quarter. But the inventory drawdown is unlikely to be sustained much longer, and a leveling off would eliminate one of the major negative factors in the GDP tables. The manufacturing purchasing managers' survey released last week by the **Institute for Supply Management** (formerly **NAPM**) showed that while inventory cuts accelerated slightly last month, the rate of reduction has clearly bottomed out (see the chart below).

ISM Manufacturing Inventories, index seasonally adjusted



Similarly, the capital investment depression concentrated in high-tech equipment and software took an average 0.92% out of GDP growth in the first three quarters of last year, but more recent indications suggest the worst could be over. New orders for computers and electronic equipment, after collapsing by some 36% through the first nine months of the year, rose on net by some 1.7% the last three months, the first positive three-month growth rate in a year. Under the math of national income accounting, simply having the inventory and high-tech capital goods

http://www.trendmacro.com
don@trendmacro.com
dgitlitz@trendmacro.com

325M Sharon Park Drive #325
Menlo Park CA 94025
Phone 650 429 2112
Fax 650 429 2112

42 Forest Drive
Parsippany NJ 07054
Phone 973 335 5079
Fax 973 335 8016

components no longer subtracting from growth would be enough to turn last quarter's reported 1.3% *contraction* to a positive growth rate of close to 1%.

By the standards of the second half of the 1990s, however -- when GDP growth averaged more than 4% -- a puny 1% growth rate, if sustained for any length of time, would in practical terms be nearly indistinguishable from recession. In fact, for all the recent data suggesting that the economy might at least be bottoming, it remains an open question whether the encouraging reports of the past few weeks represent a strengthening of underlying trends as much as a continued bounce off post-9/11 lows. No question, the economy has rebounded impressively from the September 11 shock. But new orders for all durable goods, non-auto retail sales, industrial production and capacity utilization all remain below pre-attack levels. Recent data, moreover, was skewed higher by such temporary factors as deep discounting at retailers and zero-interest auto loans. To that extent, the recent boost can be seen in part as a moving forward of future consumption, which likely will be given back in the form of somewhat weaker activity the next few months.

The likelihood of a slow slog back toward vibrant economic health reinforces our view that long-term Treasuries at current yields continue to present appealing value. While it's a fallacy that faster growth is an inflation threat and therefore an *ipso facto* negative for Treasuries, the market has no choice but to factor into its expectations the likely response of **Fed** policymakers, given the central bank's proclivities for macroeconomic fine-tuning. Thus, the long end of the yield curve has had difficulty sustaining its rally footing over the last several weeks, given the volatility of expectations regarding the Fed's likely stance going forward.

The view here remains, however, that the Fed likely will be reluctant to move aggressively to reverse its rates cuts at the first hints of growth (see "One Wild Ride," December 10, 2001). Indeed, the round of speeches yesterday by an assortment of central bank officials questioning the consensus forecasts for a resumption of expansion this quarter seemed intended to signal the cautious stance being adopted by the Fed. While the last rate cut of this cycle might well have already been seen, this Fed is likely to have a light finger on the rate-hiking trigger in the early stages of whatever recovery lies in store. With eurodollar futures still priced for a funds rate as much as 150 basis points higher by year end, the upside potential in bonds appears compelling. Clearly, a rally of at least 50 basis points from current levels of around 5.5% on the long bond seems within reach over the next few months. TM