

MARKET CALLS

Tech: Back in Harm's Way?

Thursday, April 8, 2004

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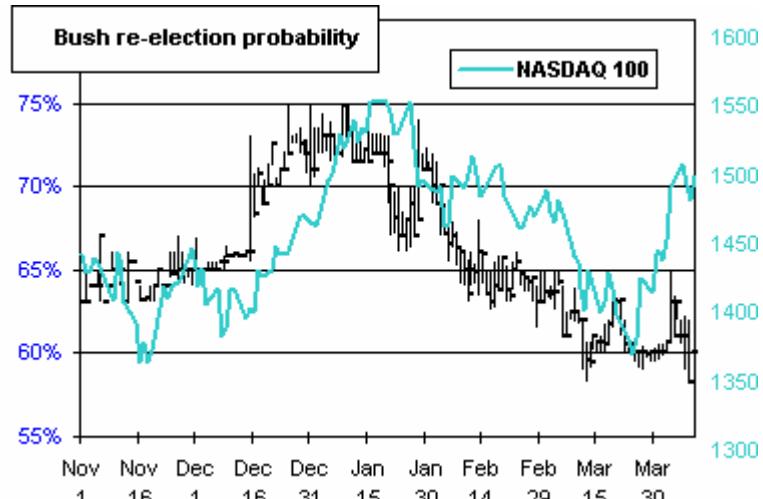
With new political uncertainties and no valuation tailwinds, the tech sector is suddenly not so compelling.

George Bush's re-election campaign has started to get real traction on the economy and jobs -- the number one and two concerns expressed by voters in recent opinion polls. But now the spotlight has suddenly switched to **Iraq**, an issue that had fallen to extremely low levels of voter concern in the same polls. Less than a week after Bush's re-election probabilities soared as high as 65.0% on Friday's payroll jobs report, in the last 24 hours they have fallen as low as 58.1%, according to the political futures contracts traded on **Tradesports.com**. Though at this moment Bush's chances have recovered somewhat to 60.0%, just hours ago they were back down to within basis points of their all-time lows of one year ago.

The drop in Bush's re-election probabilities force us to re-examine our **Model Position long the NASDAQ 100**. First, a brief history. One month ago we pointed out that the rise and fall of Bush's re-election probabilities over the turn of the year had been a reliable leading indicator of the performance of the NASDAQ. Our hypothesis has been that the technology sector is the canary in the economic mineshaft -- the sector most sensitive to the political risk of non-extension of Bush's pro-growth tax cuts (see

"**Tough Time for Tech**" March 8, 2004). We thought then that Bush's chances might be near their low water mark, with the **Democratic** primary season winding down and the economy improving (see "**The Kerry Trade**" March 12, 2004). As that view began to be borne out by breakout in the Bush futures contract, we established the Model Position (see "**The Bush Breakout**" March 19, 2004). As expected, the NASDAQ rallied strongly several days later, and now stands 7.2% higher. We added to the position last Friday as Bush's chances surged in the wake of the payroll jobs report (see "**On Bush and Jobs**" April 2, 2004).

Bush's re-election probabilities have now fallen back to where they were a month ago as a whole new world of political uncertainty has suddenly revealed itself in the escalation of military risk in Iraq. Yet the NASDAQ is 7.2% higher than it was when we initiated the Model Position on March 19, when Bush's chances had already begun to rally. At the same time, the value case for the Technology Sector -- the other reason for putting on the Model Position -- has been somewhat eroded. A month ago the Technology Sector was more undervalued than at any time



since October 2002. But now its undervaluation is less compelling, both because prices have recovered, and because bond yields have risen (our valuation model compares the earnings-yield of stocks to the income yield of long Treasury bonds; so when bond yields rise, equities become less attractive). The slowing pace of consensus earnings forecast upgrades has not been fast enough to support favorable valuations in light of these negative valuation factors.

When the Model Position was initiated, we saw it as a compelling high-probability low-risk opportunity. It is no longer that, and it has come to fruition. So it is being closed.

Yes, maybe we're leaving some opportunity on the table here. Our call is that this earnings season will continue to surprise on the upside. And we can't emphasize enough the potential bullish significance of last Friday's payroll jobs report. First, it eliminates a key negative element of political and psychological risk. But at the same time, by dealing a big blow to the underpinnings of **the Fed's** too-easy-for-too-long monetary policy stance, it raises the odds that the economy and the markets will be spared the worst-case scenario of an inflationary acceleration.

So while Bush's re-election probabilities have fallen back to the lows (which, it must be said, are still comfortably above 50%), there have been positive developments, too. All in all, we are by no means as worried about the Technology Sector as we were a month ago when we first raised the issue of re-election risk. But neither do we find it an especially compelling opportunity worthy of being singled out as a Model Position. **TM**