The Market That Cried Wolf

Your loyal correspondent, an avid scuba diver, used to take frequent trips on a boat whose cabin entranceway was graced with a sign promising "free beer tomorrow." We investors have been regaled over the past two quarters by a similar evergreen promise of "good earnings tomorrow." For the most part, we've taken the bait, looked out over that mythical valley, sought visibility, and generally stayed the course while navigating the stormy seas and treacherous reefs on the *SS Mixed Metaphor.*

This past week provided no shortage of disappointments for the faithful. From British telecom giant Marconi to Advanced Micro Devices to EMC, everyone got in line to confess the obvious about the second quarter and offer little hope for the remainder of 2001. Technically, the major indices, the S&P 500 in particular, look as if they're only one good huff-and-puff from testing their March 22, 2001 lows; if the institutional bellwether breaks 1154 by the time you read this, just turn out the lights. How could this be happening, weren't we promised "the lows are in place," and "the worst is behind us?"

A Measure Of Growth

We are now being assured the environment isn't one of an actual recession, no, we're in a profits recession. Eventually profits are the natural consequence of top-line revenue growth; you can only go so far in cutting costs. Let's take a look at one ratio, the one between the NASDAQ 100 (NDX) and the S&P 500 (SPX), that has had a pretty good track record in this space for calling some economic twists and turns (see "High Rates And A Strong NASDAQ Don't Go Together," December 15, 1999, and "Stock Divergence May Breed A Dormant Market," August 8, 2000). A quote from this last piece is offered:

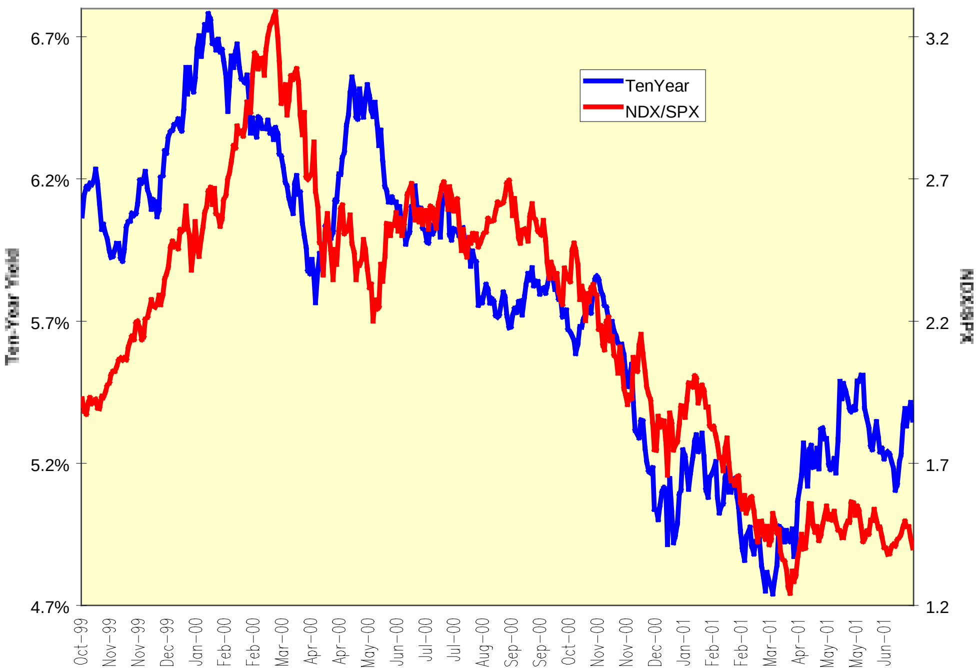
> Maybe the Fed will succeed in bringing about its vaunted "soft landing," whatever that is. However, they certainly succeeded in ending one of the great investment booms (stock market bubbles) of all time, an action whose ultimate consequences are still uncertain. That's our Fed: Ready, fire, aim.

This ratio's predictive power derives from two principles. First, a period of high interest rates should favor value stocks over growth stocks; the effective duration of the slower-growing and higher-yielding value issues is much shorter than those of firms whose paybacks will be further in the future and whose current dividend yields are either low or non-existent. The tremendous and expanding gap between growth and value prior to March 2000 didn't mean this principle disappeared, it simply was overwhelmed by very high expectations for future profit growth.

The second principle is that investors' appetite for risk expands in rising markets and disappears in falling markets; this is a fancy way of saying greed and fear. The absurd P/E's seen in the NASDAQ during the final phases of the bubble reflected a high demand for risk. Let's all be honest and admit that not keeping up with the Jones' portfolio was considered a component of risk in those heady days.

The net effect was that an expanding NDX/SPX ratio indicated risk-seeking behavior. The bond market, here represented now by the Ten-year note and not the long bond, has led the turns in this ratio reasonably well. Note yields move up in anticipation of stronger credit demand, and since higher rates favor value over growth, the SPX begins to outperform the NDX. Let's see where we are now on the ratio.

Relative NDX/SPX Peformance And 10-Year Note Yield

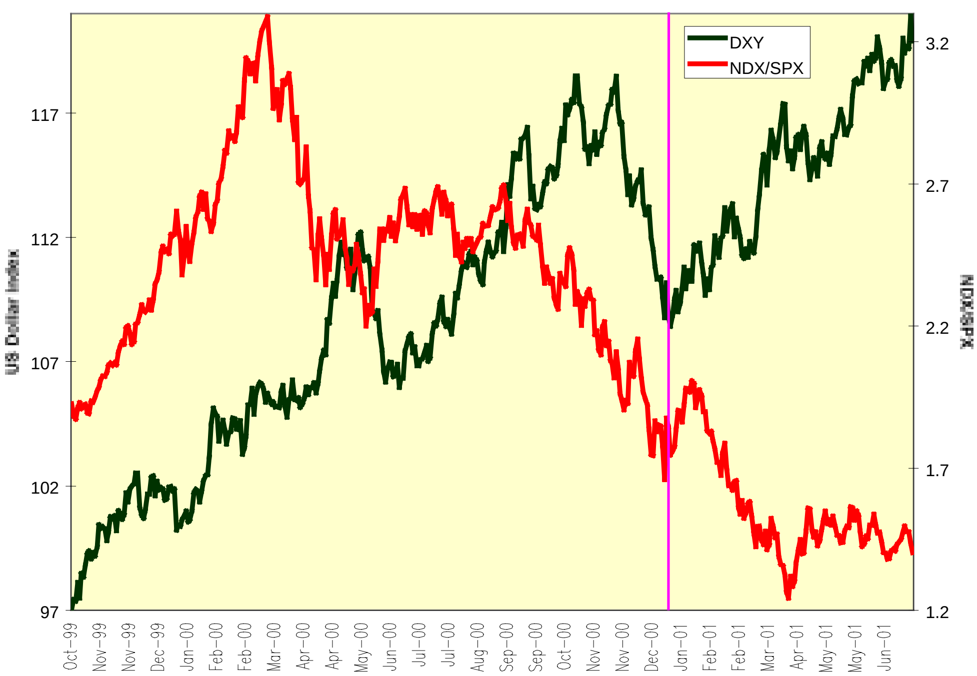


A cursory glance at the chart indicates the jump in Ten-year note yields since the start of the Fed's rate cuts in January has kept the ratio under pressure. The bond market, just like the stock market, keeps waiting in vain for monetary policy to work. These higher long-term rates, the ones that drive real investment decisions, have slowed growth prospects and are likely to make the next move in the NDX/SPX ratio lower, not higher as we all hope.

The Currency Effect

The inability of the Fed to get what it wants extends to the dollar as well as to the bond market. The currency market, too, has bought the promise of future American growth relative to the rest of the world, and the dollar, perversely, is at a two-decade high (see "Confounded By The Dismal Science," July 3, 2001). Traditionally, a strong dollar favored growth over value; technology firms in particular often enjoy a dominant global niche and can sell their wares despite a strong dollar penalty. Value firms, particularly commodity producers, have tended to lose their competitive advantage in a strong dollar environment; witness the calls from International Paper and the like for a weaker dollar.

Relative NDX/SPX Peformance And Dollar Strength



This relationship started to break down in 2000, and has reversed its normal course so far in 2001. The dollar will only weaken when growth overseas starts to accelerate relative to the U.S., and that's simply not in the cards. Right now, the strong greenback remains a distorting factor in the global economy, and this cannot be good for growth and technology relative to value.

Financial markets have three grand segments, stocks, bonds, and currencies. All three of these markets have been distorted, and distorted for the worse, by the Fed's calamitous failures of the past two years. Until a restoration is in sight, we're likely to see the NDX/SPX ratio decline further.