Flight or Fright: An Economic Reality Check

Shortly after last September's terrorist attacks, I likened our collective quandary to two epic decisions of World War II with completely opposite outcomes. These were the British decision to flee to beaches of Dunkirk, which transformed a military disaster into a moral triumph, and the German decision to stay and fight at Stalingrad, which led to the utter destruction of their Sixth Army.

I concluded at the time "waiting out this siege... makes sense only if you can afford to do so." For several months, all the way into March 2002, waiting out the siege didn't seem like such a bad idea. The economic data were pointing northwards, and that gave hope to the vast segment of the economy not wracked by the problems of overcapacity still plaguing technology and telecommunications.

Then everything went wrong simultaneously. The administration forgot who they were and where they came from, and cooked up ill-conceived tariffs on steel and lumber that served as sharp tax increases. Congress followed suit with a budget-busting farm bill. The war on terrorism degenerated into a very costly campaign of foreign misadventures and increased domestic frictional costs: On a recent trip to New York, I had to pull out my driver's license on no fewer than eight occasions simply to get through the doorways to the day's business.

Monetary policy, which I have always considered a misguided missile – I haven't bothered with Fed-bashing recently; what's the point anymore? – is now penalizing savers in low-risk fixed income instruments and is fueling a 1970s-style over-investment in housing with cheap credit.

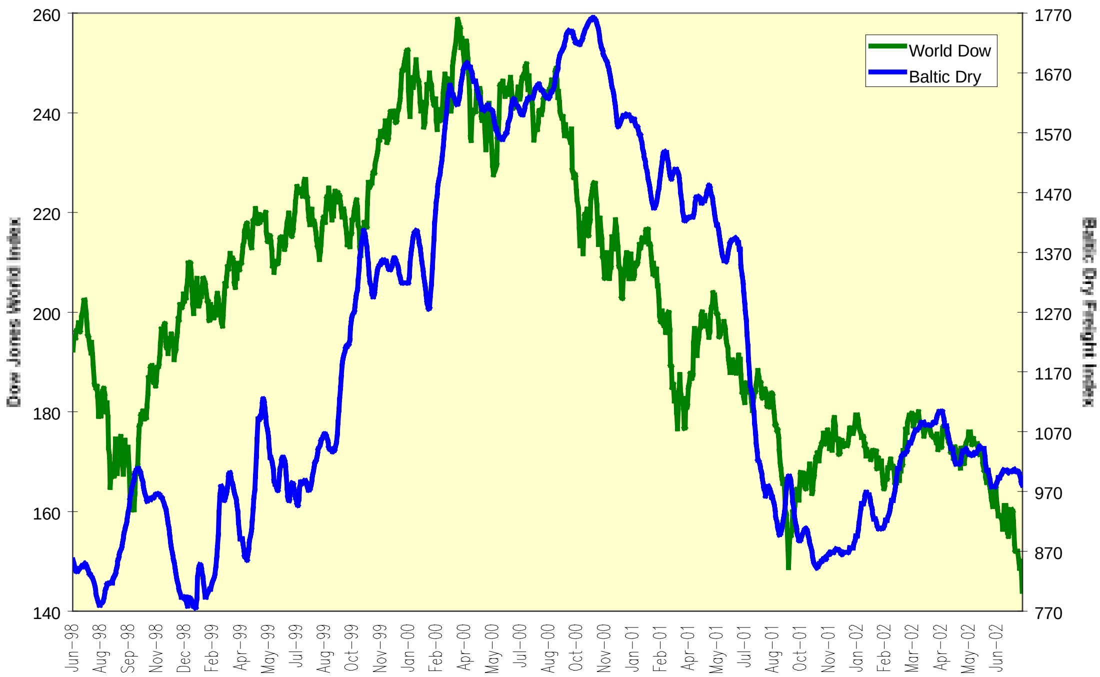
Top all of this off with a daily diet of corporate and Wall Street sleaze, and it is no wonder we're in such a mess. When companies like Johnson & Johnson are called into question, something's terribly off kilter.

It's The Market, Stupid

To a very great extent, the market is as important to the economy as the economy is to the market. Let's update one of my favorite indicators, the Baltic Dry Freight Index, a barometer of the world's ocean shipping activity (for the many readers who have inquired, this is available on Bloomberg as BDIY Index <go>; the Baltic Exchange Web site is www.balticexchange.com).

Over the past four years, this index has lagged the movements of the Dow Jones World Index. We almost can say it confirms the World Dow like the Transports are supposed to confirm the Industrials. Right now, it is poised to move lower once again in response to the sharp move lower in the world's equity markets. If you believe that lower freight rates are consistent with increased economic activity, write down why and I'll send it to the Royal Swedish Academy for Nobel Prize consideration.

Sailing Off Into The Sunset

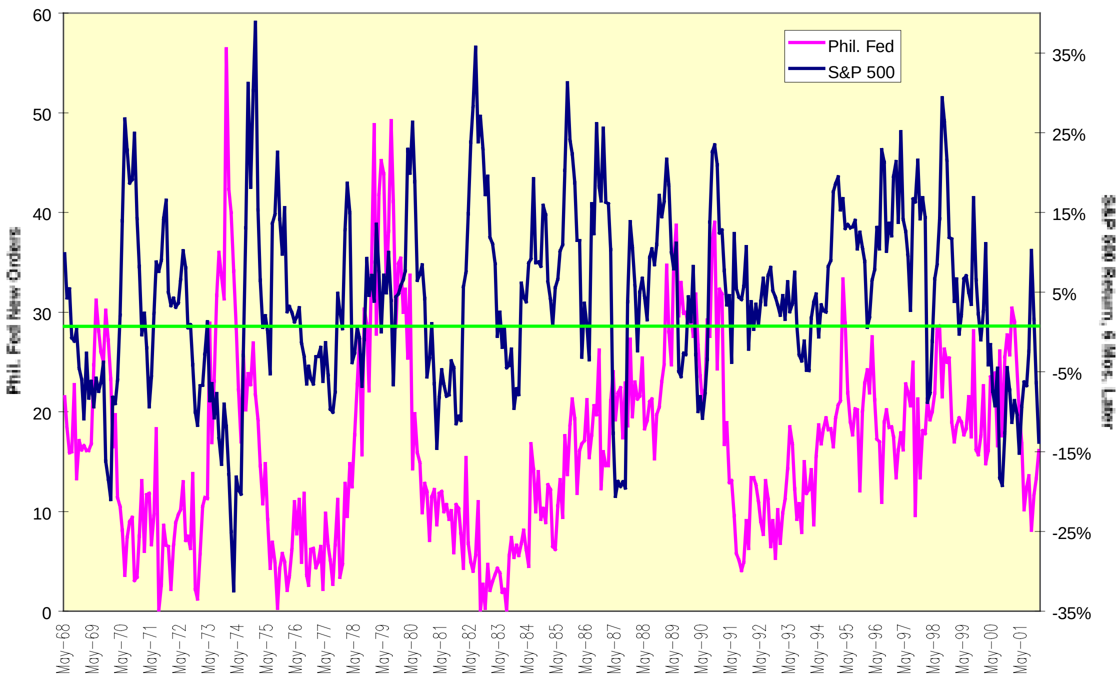


The Philly Phlop

If the first American city to be unearthed by future archaeologists is Philadelphia, they surely will derive a distorted picture of our civilization, and they won't get half the tourist trade Pompeii does. Better they should start digging in Las Vegas. So, last Thursday when the Philadelphia Federal Reserve released its monthly business forecast for the next six months' new orders, what happened? They came to the podium and cleared their throats and announced, timidly "Ladies and gentlemen, there won't be any new orders six months from now." The Liberty Bell was not the only thing in town with a loud, quivering crack.

But, going beyond the simple parable that in a bear market all news is bearish, is this index a decent forecaster of where stocks will be in six months' time? Not at all: If we compare the Philly index to the return on the S&P 500 for the next six months, we see no leading relationship whatsoever. In fact, a weak negative relationship exists. Why? First, a decreasing percentage of the American economy has been linked to manufacturing over the past 35 years. Second, the stock market is a leading indicator, and it would be nonsensical to suggest that one region's factory orders can lead a national market that in turns leads profit growth by six to nine months.

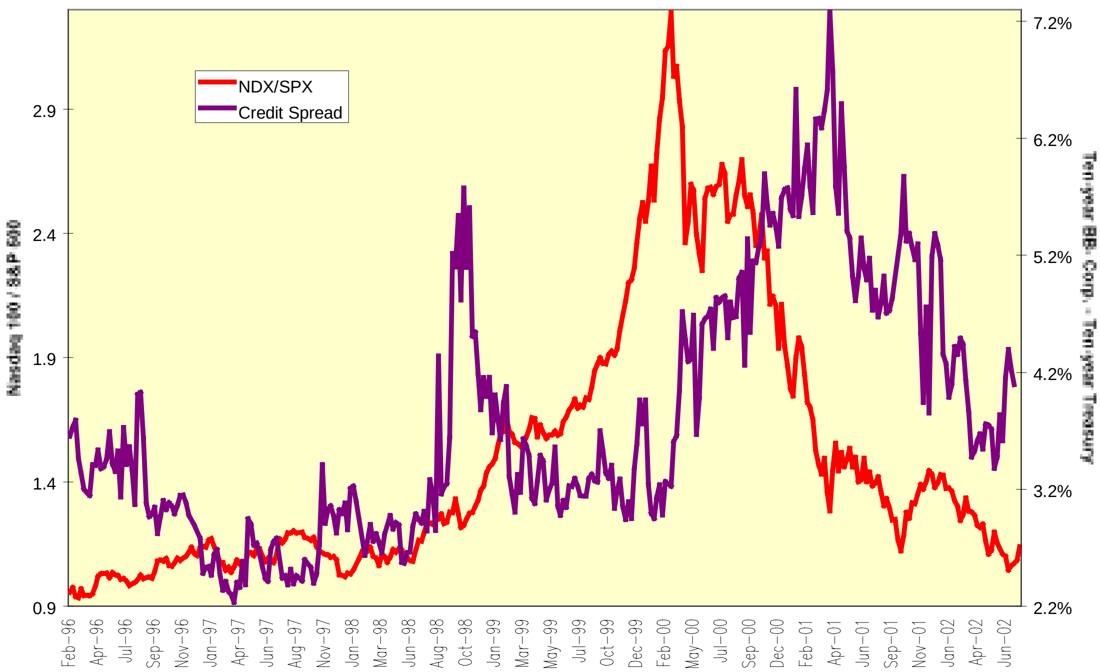
Does It Lead?



My Word Is My (Junk) Bond

Several commentators noted at various points last week that the Nasdaq had ceased falling faster than the rest of the market. This is the sort of hope expressed by someone tied down to the railroad tracks who notes that the engineer polished the cowcatcher that morning. But, the ratio of the Nasdaq 100 to the S&P 500 is a good proxy for the market's acceptance of risk, as is the spread between BB- corporate bonds and Treasuries. Let's see if these two are pulling on the same rope – away from our necks, of course.

Some Lower Risk In The System



While the trend in the declining credit spread for ten-year BB- corporates is encouraging, the absolute level of this spread is not. It is still at levels seen during the Russian / Long Term Capital Management fiasco of 1998 and at the start of the bull market's unraveling in 2000. The implosions of big debtors like Enron and Worldcom will not put creditors in a more risk-seeking frame of mind, either. The decline in the Nasdaq 100's premium to the S&P 500 takes some of the relative risk out of these stocks, but that's not a good sign for the market either. We need to see both declining credit spreads and an increase in the premium paid for the riskier stocks to proclaim that a bottom is at hand.

There's Always Tomorrow

The last two weeks have been a Dunkirk; investors have been trying to get across the English Channel in anything that floats. The forecast from the market to the economy is not good, and conversely, the economic data many have been clinging to are relatively worthless. Our job as traders and investors is to find the winning side, and that still is the short one for the time being.