

# INVESTMENT UPDATE

Double-dip, big bounce, downturn, upturn, melt-down...the great debate continues over the future direction of the US economy. While it's not unusual for investors to be preoccupied with macro-economic issues, we can't recall ever seeing so much attention given to the topic, and such a wide range of opinions about where the US economy is heading, including dire predictions of a Japanese-style long-term collapse.

While showing charts of the NASDAQ superimposed over the Nikkei from peak to trough may sell advertising space in the countless business periodicals lining magazine stands, we see little value in trying to draw parallels between the "miracle" economy of Japan in the 80's and the New Economy of the US in the 90's. Obviously, both countries experienced over-inflated stock markets built more on hope than on fundamental securities analysis. Both stock markets were destined to "revert to the mean", and revert they did. Beyond that, there are too many differences between our government/regulatory institutions, banking systems, population demographics, spending and saving habits and labor markets to conclude that the US economy is heading down the same path as Japan's.

From our standpoint, we prefer to look at what has already been done to get the US economy rolling:

- US monetary policy responded very aggressively to the initial signs of deterioration in the US economy, beginning in late 2000. The Federal Reserve reduced the Fed funds rate eleven times in calendar year 2001, bringing down short-term rates to their lowest levels in forty years. While the current funds rate is very low at 1.75%, the Fed still has some dry powder.

- US fiscal policy has been highly stimulative as well. Even though it may have been coincidental, the current administration's tax cuts and tax rebates occurred nearly simultaneous to the economy's downturn.

Despite the well-publicized losses in the stock market and reports of falling consumer confidence the combined effect of lower interest rates and more after-tax disposable income have encouraged consumers to spend. The automobile and housing markets have been particularly strong.

As a result, the consumer sector (which represents approximately two-thirds of the US economy) prevented the broad US economy from falling into the deep recession that we might have expected following the investment bubble.

But what about the other one-third of the US economy? Why haven't lower interest rates spurred capital investment by corpo-

rations? Part of the explanation can be found in the chart above, which shows the pace of industrial production over the past decade. From the end of the last recession until late 2000 US corporations were making huge investments in their productive capacity; the Fed's index of industrial production increased by more than 50% over this nine-year period. Technology spending alone was growing by more than 25% annually by the end of the decade. Merger and acquisition activity ran high as companies bought up smaller competitors, adding capacity to help meet the demand of their customers. Unfortunately, much of this investment was funded with borrowed funds. By the end of the decade, industrial America found itself productive and modernized—but with excess capacity and deeply in debt.

Many businesses were ill prepared to deal with the inevitable slowdown in aggregate demand



for goods and services that began by early 2000. Many in corporate America had made the mistake of believing that the New Economy would mean a permanent increase in the base level of aggregate demand. Certain debt-heavy industries dependent on high growth (technology and telecom are the most obvious examples) were extremely hard hit by the combination of high debt burdens and slack demand.

In today's environment, low interest rates can do little to help these companies. For many, the low rates are an illusion, as reduced yields on Treasury securities have not translated into lower corporate borrowing costs—with shell-shocked investors demanding wide yield spreads to compensate them for what they perceive to be higher risks, many companies can't get funding within 400 basis points of where the US Treasury is issuing bonds.

Even if weaker credits could issue bonds at low rates, taking on additional debt to fund capital expenditures is contrary to what corporate America is trying to do right now. De-leveraging is as much in style today as it was

considered passé in the 90's. "Balance sheet repair" is the mantra of today's CEOs. Net new issuance of fixed-rate investment grade corporate bonds is projected to be approximately 40% lower this year compared to last.

Issuing new equity to raise capital is equally unattractive right now for many companies. Floating a secondary equity offering when your stock price is depressed dilutes the interests of existing shareholders with a relatively small benefit from the cash proceeds received. Selling assets to raise cash is unappealing as well, as the assets most in demand are the stable, cash flow generating assets that debt-burdened firms can least afford to go without.

How then, can we expect the industrial sector to rebound and help the consumer with some of the heavy lifting? The answer, we believe, lies in profits. Only to the extent that companies

are confident that they will be able to sustain earnings for some period into the future will they once again begin to think in terms of increasing capital investment.

While the earnings environment for many companies continues to be challenging, there are signs that the overall profit picture may be improving. The chart below shows corporate profit growth from the national income data, which removes many of the distortions found in the S&P operating earnings. As this chart demonstrates, corporate profits have been on the rise and are expected to increase by approximately 10% this year (admittedly, over a depressed previous year base).

Beginning in the second quarter of this year spending on equipment and software also began to rise, close on the heels of an increase in profits that began in late 2001. This is a positive development and gives us some encouragement that we might see continued modest increases in capital spending over the next few months.

As encouraging as these signs of strength are, we need to emphasize that these indicators are preliminary. While we're

optimistic, it's too early to predict an imminent broad-based turnaround in profits and capital investment. While there will be pockets of strength, these will be offset by the struggles of the many highly-levered firms working off the debt burden they took on in the carefree, high-growth days of the last decade.

Bottom line: Profits are important right now, and not just for equity investors. Sustained earnings will help weak businesses make the critical investments necessary for their long term health and in the process lift the economic tide. The consumer sector alone cannot support the economy indefinitely.

*This Investment Update, as well as past editions, is available on our website: [www.agincourtcapital.com](http://www.agincourtcapital.com)*

