The State of the Debate

By **Richard B. Hoey,** Chief Economist of Mellon Financial Corporation

Second Quarter 2002

Who's Winning the Debate?

Issue 5

Mellon

There is a major debate between the bulls and the bears on the U.S. economy and the U.S. markets. This is a status report on the debate between the optimists and the pessimists about the U.S. economy and the U.S. markets.

Who's Winning the Debate?

In the great debate between the optimists and the pessimists, so far there has been a mixed verdict. The pessimists have been most correct on a set of issues which involve the new economy bubble in valuations and capital spending. Their skepticism about accounting quality, exuberant valuation metrics and the absence of capital discipline has been warranted. In addition, the cyclical decline in corporate profits was severe in the recession, as the skeptics had anticipated.

However, there are a number of other issues where the optimistic case prevails. There was a major debate about the effectiveness of monetary policy in changing the trend of the economy. In the event, monetary policy did succeed in reversing the economy from recession to recovery. The optimists were right: the Fed wasn't "pushing on a string." Neither a low savings rate nor a negative wealth effect from the recent stock price declines halted the expansion of consumer spending. Housing prices have risen rather than fallen. Measured by the peak-to-trough decline in real GDP, the recent recession was the mildest of the postwar period. All the worries that a high current account deficit in the U.S. would generate a dollar plunge have so far come to naught. Evidence for an upward shift in long-term productivity growth continues to accumulate. Continuing disinflation appears more likely than either a major upsurge in inflation or a drop into deflation.

So far, the optimists have prevailed in most issues of the debate about the U.S. economy, while the pessimists were largely correct about those issues directly impacted by excessive exuberance about the new economy. The jury is still out on some key issues, including the valuation of the broad market averages and the trend of the dollar.

Pushing on a String?

The pessimists argued that Federal Reserve easing would fail to reverse the recession into a healthy recovery. One argument made was that zero interest rates had failed to generate economic recovery in Japan after the Nikkei bubble a decade ago. Therefore, the argument went, monetary easing in the U.S. would fail to trigger U.S. economic expansion because of a negative wealth effect and capacity overhang in the aftermath of the boom.

We took the optimistic view in our second quarter 2001 State of the Debate Report entitled "Pushing on a String?," arguing that the Japanese precedent would not recur and that Federal Reserve easing would succeed in stimulating the U.S. economy. A part of the thesis of the pessimists was that the consumer debt burden was so high and the shock of the bear market on consumer confidence would be so severe, that consumer spending would not respond to low interest rates. That thesis was tested by the auto company offer of zero-rate financing after the September 11 attacks. Consumer spending on new automobiles surged, proving that this portion of the bear case was wrong.

From a broad historical perspective, the "pushing on a string" case made by the pessimists always had low odds of success. "Pushing on a string" has been often forecast but rarely observed. Those rare occasions in history when it has occurred have been when the net worth of the banking system was lost — the 1930s in many countries and the 1990s in Japan.

There have been three instances in the last half-decade when monetary policy skeptics have argued that monetary policy would prove ineffective. In 1998, the thesis was that Fed easing would fail to

(continued on page 2)

sustain economic expansion. In 2000, the case was made that Fed tightening would fail to slow the technology and telecommunications boom no matter how high interest rates went. In 2001 and early 2002, the thesis was that Fed easing would prove ineffective in stimulating economic expansion. The lesson of the last half-decade is the same as the lesson of the last half-century: monetary policy is extremely powerful, even though it works with a lag.

Recession – A Mixed Verdict

The pessimists argued that the U.S. would face a prolonged and severe recession. However, the recent recession was the mildest of the postwar period, as measured by the peak-to-trough decline in real GDP. This was due largely to strength in housing and consumption. At first glance, it appears that the optimists were correct about the mildness of the recession. Some even argue that it was only a growth recession, not a full-scale recession.

Under the surface, however, the bears were partially correct. There was a severe corporate profit recession despite the mild decline in real GDP. There were a number of reasons for this. First, on a global basis, the world recession was relatively severe because there was simultaneous economic weakness nearly everywhere in the world. Second, there was a large buildup of costs in the prior boom because of the expectation that the boom would continue. Third, there was a breakdown in capital discipline during the boom with respect to some forms of capital spending, especially in the telecommunications sector. Fourth, because of low inflation, corporate revenues were weaker than would normally be expected during such a mild decline in real GDP. Because the pessimists were right about the cyclical vulnerability of corporate profits, there was a full-scale bear market in stocks, discounting that corporate profit decline.

Given the unusual pattern of the recent recession, our view is that both the optimists and the pessimists were half-right.

Productivity Trend Improves

The productivity growth outlook has been a major battleground between the bulls and the bears. The bulls have argued that an upward shift in trend productivity growth has raised the growth potential of the U.S. economy and would permit a combination of strong economic growth and moderate inflation.

The bears have made three arguments: (1) the upward shift in productivity was a statistical mirage and has not actually occurred; (2) to the degree there is an upshift, it was limited to the technology manufacturing sector; and (3) any productivity acceleration was cyclical and temporary rather than permanent.

Our view is that the bulls have won the productivity debate. We believe that the evidence shows that there has clearly been a broad-based upward shift in trend productivity growth. The improved productivity performance persisted through the recession, confirming that it was not merely a cyclical improvement. Productivity appears to have improved somewhat in the old economy, not merely in the technology manufacturing sector.

Trend productivity growth in the U.S. appears to have shifted up to about 2.5%. Added to the roughly 1% annual uptrend in hours worked, the implication is that the supply capacity of the U.S. economy can grow at more than 3%. The upward shift in trend productivity growth is a favorable basis for future economic expansion and moderate inflation.

Inflation, Deflation and Disinflation

The pessimists tend to expect extremes of inflation or deflation, while the optimists expect a benign disinflation that supports moderate interest rates and a relatively high price/earnings multiple.

There are a small number of high inflation bears. They tend to key on the lagged effect of rapid money growth, expected rises in energy prices and the risk that a major dollar decline would create inflationary pressures. Because of the downtrend in inflation over the last two decades and the recent cyclical decline in inflation, there is not widespread fear of a major inflation upsurge.

There are a larger number of deflation bears. True deflation is a negative economic environment. The collateral value underlying bank loans declines sharply, undermining the health of the financial system. The real burden of existing debt rises during a deflation. Trade protectionism tends to surge as a defense against deflationary shocks. We believe that the odds of deflation have dropped sharply in recent months. The Fed did not repeat the restrictive policy it had in the 1930s or the similar mistake of the Bank of Japan a decade ago. The Federal Reserve eased monetary policy very aggressively in 2001. We believe that this was a successful anti-deflationary policy. The bears' case for deflation was a much more plausible risk a year ago than it is now.

The optimists anticipate a disinflation which should be largely benign. There should still be a cycle in inflation, but the center of gravity of trend inflation should be a low positive inflation rate. Benign disinflation permits easy monetary policy, moderate interest rates and a dampened business cycle. On current evidence, disinflation appears much more likely than either an upsurge of high inflation or a plunge into deflation.

The Dollar

The bear case on the dollar has certainly been premature but there is still a risk that it may eventually prove correct.

There are two pillars of the dollar bear case. First, the U.S. has a rising external debt as its current account deficit persists. U.S. imports greatly exceed its exports, and the current account deficit as a share of GDP has been trending higher. The U.S. external debt keeps rising as this annual deficit persists. The dollar bears have been correct that the annual current account deficits would continue and trend upward as a share of U.S. GDP.

The second pillar of the dollar bear case is that foreign investors would become increasingly reluctant to invest in dollar investments as the external debt of the U.S. grew. This has not yet occurred. One reason is policy credibility. U.S. regulatory policy has fostered free markets and U.S. monetary and fiscal policy has been proactive in stimulating economic expansion. In contrast, Japanese macroeconomic policy has been ineffective and European macroeconomic policy has been passive. So far, investors appear to have greater confidence in the economic prospects of the U.S. than Japan or Europe. This high confidence in the U.S. relative to other major countries can change either by a drop in confidence in the U.S. outlook, a rise in confidence in the foreign outlook or a combination of both. An improved foreign outlook would support a favorable trend in the world economy while a deteriorated U.S. outlook would probably contribute to an unfavorable trend in the world economy.

If the U.S. dollar is to weaken, it must weaken against other currencies. The yen is a poor candidate for the world's lead currency since the Japanese authorities are encouraging a weak yen to ameliorate the symptoms of policy failure in Japan. It is more plausible that the euro could eventually shift into a bull trend after its prolonged period of weakness.

The U.S. economy is likely to perform well over the next year, which should support the dollar. Longer term, however, the external balance sheet of the U.S. is deteriorating. There is a continuing risk that the dollar bears may ultimately prove correct at some point in the future.

Accounting and Reality

The bears won round one of the debate about accounting quality. There have been accounting restatements of financial statements previously judged to be in accordance with "generally accepted accounting principles." Aggressive accounting was a notable aspect of a number of companies that filed for bankruptcy or whose stock prices dropped sharply. Aggressive accounting was part of a broader pattern of an optimistically tilted interpretation of financial reality during the boom. This is a common cyclical occurrence.

In some cases, it was the analytical rigor rather than the accounting disclosure that was deficient. The bears were correct in arguing that investors who failed to rigorously analyze available information were likely to underperform.

We believe that the risk of accounting problems in the future has dropped. With greater scrutiny, the odds of undisclosed accounting manipulation should drop. Controversial accounting treatments are likely to be more widely debated, with a reduced tendency for investors to ignore these issues.

Valuation - A Mixed Result

Valuation – A Mixed Result

There were two distinct valuation bear cases. The first was that new economy valuations were excessive and would generate losses to investors in these stocks. The second valuation bear case was that the overall valuation of stocks was excessive as indicated by the fact that price/earnings multiples for the broad market averages were high relative to their average level of the last two decades.

With the benefit of hindsight, it is clear that the bears were correct about the valuations of new economy stocks. There were large losses in these stocks, spanning the spectrum from market-dominating competitive winners to speculative stocks with little or no revenue. The outcome has been more ambiguous in the broader stock market. Much of the decline in the broad market indices occurred in the new economy sectors, with a much calmer pattern in the balance of the stock market.

The bear thesis on valuation in the broader market is that the price/earnings multiple for the major market averages is well above its multi-decade average of near 15, and a reversion to that mean is inevitable. The optimists have argued that a higher than average valuation for the major market averages is justified by such favorable fundamentals as lower inflation, lower interest rates and better productivity growth. The optimists argue that with inflation and interest rates at the low end of the range of the last two decades and favorable trend productivity growth, it is reasonable for price/earnings multiples to be at the high end of their multi-decade range.

We tend to agree with the optimists. There was a major uptrend in stock valuations from the early 1980s to March 2000. Stock valuations were very depressed in the early 1980s in an environment of double-digit inflation, double-digit interest rates and a stock market which had been stagnant for a decade and a half. We believe that the multi-decade uptrend in such valuation metrics as price/earnings multiples has been completed. We also feel that current valuations are sustainable because of favorable fundamentals such as moderate inflation, moderate interest rates, favorable productivity and rising profits.

The jury is still out on the debate about valuation in the broad market. We believe that the view that current valuations are supported by favorable fundamentals is most likely to prove correct, but it is too soon to declare the ultimate winner in this debate.

Conclusion

Who won the debate between the optimists and the pessimists? The skeptics were correct about the valuation of new economy stocks during the boom, the vulnerability of corporate profits and the risks of aggressive accounting and poor analysis of available financial information. The bears still have a plausible case about the valuation of the broader market and the future of the dollar, issues on which the jury is still out.

We believe that the optimists have won the debate so far on a variety of fundamental issues: the effectiveness of monetary policy, the contribution of housing and consumption strength in moderating the recession, disinflation, and the upward shift in trend productivity growth. In our view, they are correct about the appropriate valuation of the broad market although that is still a controversial issue.

The struggle between the bulls and the bears never ends. The debate continues.

Mellon

This article represents the general economic overviews of Mr. Richard Hoey, Chief Economist of Mellon Financial Corporation, and does not constitute investment advice, nor should it be considered predictive of any future market performance.

©2002 Mellon Financial Corporation