

BY STEPHEN BRENNAN

Technology A Two-edged Sword

THE SEMICONDUCTOR INDUSTRY IS NOT the only sector of the economy feeling both the beneficial and negative impacts of the remarkable recent changes made possible by technology. For example there has been an astounding rise in the productivity of the U.S. worker, which nearly all pundits credit to increased investments in technology. The government reported that productivity grew at an astounding 8.6 percent annualized rate in the first quarter of this year – a figure that even if cut in half is still impressive.

Such productivity gains were the driving force in the creation of sustainable growth in the 1990s and led to real wealth creation. The sword, however, cuts both ways – and so does technological progress.

PRODUCTIVITY AND PRICING POWER

Rising productivity is why – even as the business climate has improved – the employment situation has worsened. This was the first U.S. recession on record that saw productivity rise, and so far we have seen a “jobless” recovery because companies are successfully doing more with fewer workers. Another benefit of technology is to lower the costs of starting or conducting a business. Technology has both increased information flows and lowered barriers to entry. Add in the role of global capital in creating excess capacity

in a multitude of industries from semiconductors to automobiles during the 1990s, and the net result is nearly zero pricing power for many businesses – even dominant companies like Intel.

Zero pricing power combined with excess capacity is why corporations can increase productivity and lower their expenses, yet still post sub-par earnings. On the positive side, zero pricing power has resulted in low inflation, allowing the Federal Reserve to pursue an aggressive monetary policy while it also has spurred continued consumer consumption as buyers keep getting more for their money. The other side of this particular blade is a continuing earnings recession combined with the risk of deflation. Japan has been in a recession for the last decade as consumers stopped spending due to a combination of a bleak

employment environment and the knowledge that products will be cheaper later.

OPPOSING FORCES

I continue to worry about the risk of a double-dip recession and the negative impact it would have on the semiconductor industry, which I first articulated in my March column.

Economic cycles such as this current one – characterized by new technology, which led to greater productivity and an over-investment in capacity with little pricing power and deflationary forces – have not turned out well in the past. The only factor that has kept the economy afloat has been the U.S. consumer, and if the employment situation continues to deteriorate, we will slide back into recession.

On the other hand, the consumer side has stayed strong, and any significant resumption in corporate spending would likely create a return to sustainable growth. The pivotal question is: Will the consumer fade first, or will corporations start spending and hiring? You can make a plausible case for both scenarios. Personally, I tend to side with history, while listening to the markets. On that note, the recent spike in gold prices is unnerving, since bull markets in gold are historically correlated to secular bear markets in stocks. Also unsettling is weakness in the U.S. dollar. Until we get either a strong, broad-based market rally or a true pickup in corporate spending or hiring, I will remain bearish.

MARKET OUTLOOK

My bearish views on the stock market for this year, especially on technology and semiconductor stocks, has been well documented. As I write this column most technology sectors and the exchange traded funds (ETFs) that track them – software (SWH), broadband (BDH), networking (IGN), the Internet (HHH), wireless (WMH) and telecommunications (TTH) – have been beaten down. As their prices have come down, I’ve become less bearish on these stocks. Currently, it is the pricier areas of the stock market that I believe hold the most risk, and unfortunately that list includes semiconductor stocks (SMH), as well as sectors like financial services (XLF) and consumer counter-cyclicals. ☞

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