

Unintended Consequences

EXPECT CONDITIONS FOR THE ECONOMY and the stock market to get better and the good times to last longer than widely anticipated. Forget any worries about a semiconductor industry downturn starting in 2005. This is going to be a strong and broad-based global economic recovery that is only just now getting started. Expect even Europe to surprise with strength this year.

Before someone labels me a crazy optimist, I would like to point out that I did not become bullish on the stock market until my August column of last year, and my March 2002 column predicted a tough year for the economy and semiconductor industry when many experts thought we were in a strong economic recovery.

Back in early 2002, prevalent wide-eyed optimism worried me, while today all the caution I now hear about long-term prospects makes me the one who is quite optimistic. There is logic to my contrarian outlook, however, that goes beyond merely thinking the opposite of the prevailing opinion, and this logic can partly be found in the law of unintended consequences. The very nature of how the economic cycle works currently favors a more positive outcome than is anticipated.

BETTER TIMES

So what is different in the economy this time versus early 2002, the last time most economists proclaimed we were in a recovery, or 2000, the last time corporate profitability was comparable? One big difference is inventory-to-sales ratios. From retail to manufacturing, reported U.S. inventory-to-sales ratios are at record lows. Although inventories have risen (an economic positive), they have not risen as fast as sales (another positive). In November businesses held only 1.35 months of inventory at current sales rates. Executives are behaving cautiously, and keeping a tight rein on spending. This is why productivity remains high and we have yet to see strong employment gains (although I expect employment will strengthen relatively soon).

A key to sustainable growth is precisely the type of cautious executive outlook that this three-year downturn has created. It took all that time for business inventories to get to the point where there was no slack and for leading-edge capacity in the semiconductor industry to be nearly maxed out. The very doubts people have about the strength and duration of this economic upturn will have the unintended consequence of

strengthening and extending it by keeping a lid on inventories. Conversely, it was faith in hyper-growth in 2000 which unleashed the unrestrained corporate spending that consequently created a recession. Although this time may be different than 2000 or 2002, it is not that different from the early stages of most economic expansions.

ENJOY THE RIDE

My advice is to relax and enjoy the ride. There will be plenty of time for worrying later. The law of unintended consequences means that if everyone is worrying about the next downturn or a muted recovery, you don't have to, because they will be pursuing defensive behaviors that preclude one. On the other hand, when most folks aren't worried about one... well, you get my point. The same also goes true for the stock market, where investor caution translates into cash on the sidelines that will propel stock prices higher all the way into 2005 at least.

Unfortunately there is an exception, as expectations for semiconductor stocks have become anything but muted. As much as I hate the use of this term, I currently worry chip stocks may need to grow into their current valuations, so I am going to switch my semiconductor exchange traded fund recommendation (SMH) to a software recommendation (SWH). There is also a difference between a prolonged market decline and a short, sharp correction. It would not surprise me in the least to see an over eight percent correction as early as this current quarter and I would be shocked if we got through this year without one. Given my outlook, however, I would look on such a pullback as a buying opportunity. ☺

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