

BY STEPHEN BRENNAN

# A Tale of Two Economies

THE NATURE OF THE U.S. ECONOMY IS changing. In the 1990s, we had the best of two worlds: strong corporate and strong consumer growth. Then the corporate economy faltered in early 2000, but the consumer economy remained strong. Optimists

pointed out that corporate spending could not stay down forever because of the need to invest, and pessimists warned the consumer economy could not stay strong forever with corporate spending so low. What few people considered was that the optimists and the pessimists might both be right.

If the stock market has seemed schizophrenic lately, it is for

good reason. As the optimists had hoped, corporate spending is in the midst of a true recovery, and stocks linked to corporate spending have been in a bull market since last October. But, as pessimists had feared, tough times lay ahead for the consumer economy, and the bear market for these stocks only ended this March. Just as households have been economically healthier than corporations, we are entering a period where corporations will be stronger than households.

## THE "SLINKY™" EFFECT

This downturn began in 2000 when the same technology stocks that led the market higher pulled it lower. Fears over Y2K computer bugs caused big corporations to spend aggressively on IT, and also led the Federal Reserve to significantly expand the money supply. This added air to the dot.com bubble, which helped these dubious business ventures also spend aggressively on IT. Then, in the wake of Y2K, the party ended, with corporations pulling back on spending, the Fed reducing the money supply and the dot.com bubble beginning its implosion. A vicious cycle arose, where companies reliant

on IT spending cut back in the easiest place possible, their own technology investments.

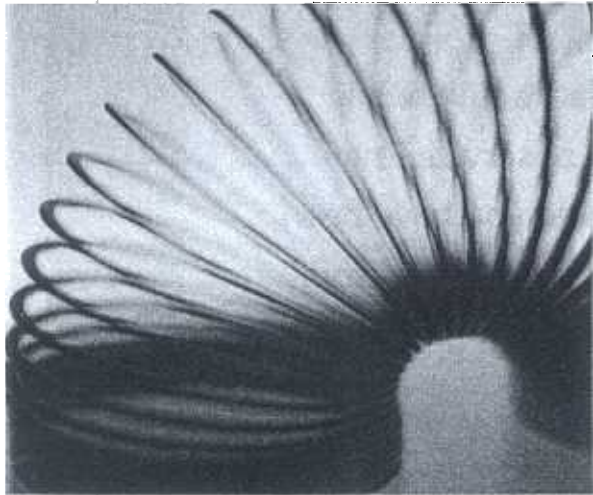
The reverberations did not end there. Technology companies cut fat, but then began to cut muscle in important but underutilized resources, and most recently they have cut to the bone by laying off skilled workers that they need but cannot keep on the payroll if they want to be cash flow positive. Like a Slinky, this motion has rippled across the U.S. economy. Eventually, these cutbacks began to take a toll on overall U.S. employment and consumer confidence, and the consumer economy began to weaken.

## GOOD NEWS, BAD NEWS

The good news is that corporations have cut too far and reduced inventories too much. There is a real potential for sustained growth resulting from these artificially low levels, and that will eventually help the consumer economy. Just as IT spending was easy for corporations to reduce, it will also be easy to increase. The bad news is that hiring and firing workers is the least flexible spending for a company. Just as the last thing corporations did was to cut workers, the last thing they will do as the environment improves will be to rehire workers. In other words, expect rising corporate profitability to be accompanied by an employment picture that stays weak for a while, and a consumer economy that faces some tough times.

As of mid-March, technology stocks are well above their October lows, with the semiconductor index up over 20 percent. Meanwhile, securities that track the retail (RTH) and consumer discretionary (XLP) sectors have recently set new lows. This economic "Slinky" effect was also a global phenomenon. Many world stock markets, including the major European markets, also set new lows in March. In my opinion we are seeing some real turning points in markets, and this will soon also impact the bond market. My March column mentioned that Treasuries might see one last good rally. Hopefully, bond investors have seen such a rally. I would now recommend long-term investors take some profits and underweight Treasuries. ☞

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