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United States Sector Rotation Report*

Economics & Financial Markets

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Thinking that Technology can lead the Recovery is Both Illogical and Indefensible

Microsoft (MSFT) and Amazon (AMZN) reported today after the close. Microsoft's profits fell 29% on weaker computer sales, with revenues falling y/y for the first time since 1986. Amazon similarly reported after hours with lower second quarter earnings, but higher sales. Both stocks were down significantly in after hours with both down about 7% from their close. Alexei Oreskovic from Reuters asked if "Microsoft raises specter of doubt on tech recovery." After a blowout day and two weeks of daily gains in the markets, everyone is looking for a down day on Friday, and a slight stall of what we have been calling the recovery trade. This report will question the logic of thinking that Technology can lead the initial stages of this recovery.

Figure I: Traditional Sector Cycle Theory as Reported by Fidelity Investments

Source: Fidelity Investments, Products Division

*See last page for Analyst Certification and Important Disclosure Chats in this report are created by Authors

If we believe that the economy is in the late recession phase, or maybe even early recovery then according to conventional wisdom Financials and Consumer Cyclicals both durables and nondurables are the traditional location for the next wave, which is off the bottom and into the early recovery phase. In the table above during the early recovery phase Transportation as well as Technology stocks would appear to be the place for the early recovery investments. In fact we argued last week that the recession is likely over.

This recession however, has not been the traditional recession and the traditional recovery may not be the norm in this recovery either. There are two factors that have thrown the traditional recovery pattern into chaos and that is the extent of damage to the financial sector, and secondly the impact of gasoline on the consumer and transportation. We will argue that this recovery will be lead by basic materials and primarily construction materials given the conditions on the ground of this recession. This recession has been the most severe and housing has experienced the most severe downturn in modern history. The consumer is struggling with high unemployment, nearly 10%, and still relatively high gasoline prices, which will affect the technology space, which ultimately needs a strong consumer to participate. Transports similarly are still reeling from high gasoline prices.

The Case Against Consumer Discretionary and Transportation

For the past two years we have argued that the financial crisis was co dependently caused by the housing crisis and the high price of gasoline that put undue pressure on the household. We had argued that the economy had become unbalanced and the consumers difficulties in managing their personal budget or disposable income, was at least in part caused by the high price of gasoline. This in turn put additional pressure on the household ability to pay their mortgages bills.

The concern that we have with the Obama Administration's focus on only one aspect of the co-dependency is that the second component has been largely ignored, and it may even turn out to have been a more critical cause of the recession of 2008, than the financial crisis. Professor Hamilton has argued that:

> "The implications that almost all of the downturn of 2008 could be attributed to the oil shock is a stronger conclusion than emerged from any of the other models surveyed in my Brookings paper, and it is a conclusion that I don't fully believe myself. Unquestionably, there were other very important shocks hitting the economy in 2007-08, most notably the problems in the housing sector. But housing had already been subtracting 0.94% from the average annual GDP growth rate over 2006:Q4-2007:Q3, when the economy did not appear to be in a recession. And housing subtracted only 0.89% over 2007:Q4-2008:Q3, when we now say that the economy was in recession. Something in addition to housing began to drag the economy down over the later period, and all the calculations in the paper support the conclusion that oil prices were an important factor in turning that slowdown into a recession." (James Hamilton, "Causes and Consequences of the Oil Shock of 2007-2008," Paper presented at the Brookings Institution's April 2009).

All through 2007 and 2008 we strenuously argued that the high price of crude would ultimately bring the economy into a recession. We argued that the energy crisis was at least a codependent cause to the financial crisis. When the consumer could no longer pay their mortgage bills due to the high price of

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gasoline, the financial crisis was exacerbated. The risk models had not anticipated the level of struggle by the homeowner, which would result from their inability to manage their household budget.

Many models had used the distinction designated by the EIA and endorsed by the Federal Reserve that the correct measure was average income, whereas we at SISR argued that medium income highlighted the plight of the household better. When gasoline was $4.17 we showed that over 8.2% of the medium households budget went to gasoline alone. Unfortunately, the nature of the regulations that are currently being proposed by the Administration and Congress are addressing only one part of this codependency.

In the past 30 months alone we have seen the price of crude go from $70 a barrel to $147, back down to $30, and now back up to $72. In the past 5 months we have seen crude increase from $30 to $72 and again we are seeing that segments of the economy are beginning to struggle, particularly the consumer. As the price of crude went from $30 to $72 the price of gasoline has followed in tandem. Over the past three weeks as the markets weakened the price of crude had fallen below $60 per barrel, but in the past week, as the markets have appreciated the price of crude has again strengthened, with gasoline following in tandem. Our concern is that crude and gasoline with rise sufficiently as the markets and economy gets stronger to prevent the consumer from having sufficient free discretionary expenditures to have the consumer discretionary sector lead the economy out of the recession.

We believe that this is an extremely critical point for any market participant to come to understand, because the markets today as they were in 2006 and 2007 are currently highly influenced by the price of oil and no reform of the banking system will begin to solve that problems, until Congress or the President seriously takes on the question of crude oil. The current Energy Bill before congress is more of an environmental bill than a true energy bill that addresses the dependency of the United States on foreign oil. No matter how effective and important those regulation may be, it likely will not accomplish its goal of the eliminating of the cause of future recession, like the recession of 2007 to 2009, 2002, 1990, 1980, and 1973 to 1975, which were all caused by the high price of oil.

The Wall Street Journal wrote: “The proposed regulatory revamp is setting out to do what history suggests can’t be done easily – tame the financial system’s tendency to drive itself off a cliff’ (WSJ P. A8, July 23, 2009). In coming weeks we will attempt to prove that Congress may well be fighting to fix a potential future crisis with half a tool set. The Senate and House Banking committees are doing an excellent job; the problem is that the Senate Committee on Energy and Natural Resources and the House Energy and Commerce Committee may not be as cognizant of the importance of Energy in the crisis of 2007 to 2009. The financial sector is the lower hanging fruit it appears, and it is only when the higher hanging fruit is tackled, will the types of business cycles that have dominated the post war period begin to be addressed. More directly, if crude is free to creep up the way it has during this recession it is highly unlikely that the consumer nor will transportation be able to lead the economy out of this recession.

The Case against Technology. This may seem like a difficult argument to make given that from the beginning of the year the Nasdaq is up 25.1% while the S&P is up only 3.8%. But it is also true that the Nasdaq is still down 61% from it all time high of March 2000, whereas the S&P in 2007 has hit an all time highs in 2007. The high for the Nasdaq in August of 2007 was still more than 45% from it all time high. We never quite understood how Nasdaq stock are valued, but that is another issue. The size of the rebound in the Nasdaq we believe needs to somewhat dismissed because of the extreme decline in this index over the past decade, and some credence must be given to the base from which the Nasdaq began

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the year. It is similar to arguing that financial are strong because a bank went from $2.00 to $6.00 for a 200% return, when a stronger company went from $50 to $60 for a 20% return.

During the 1990 Technology boom the technology sector lead the markets because of consumer purchases of new electronic equipment, and even more importantly, because businesses were making huge investments in technology. Today most of the successful technology companies, Apple, Research in Motion are consumer directed and not business driven. If the consumer is not going to lead, as we argued above, we do not see how technology can lead. Technology can only lead if the businesses make major technology investment, and there are some signs in this direction, but we do not believe enough for this sector to lead out of the recession.

The concept here is simple, if the consumer is not the lead; it is going to be difficult for technology to be a leader until this recovery is well under way. We strongly believe that Technology will have its day in this recovery, but, today is not that day. However, we also believe that when it happens it will be a strong recovery closer to the period of the late 1990's than the mid 2000's. The emphasis on alternative energy will have off shoots for technology, and as the middle class get stronger with the help of this administration, the middle class will purchase more goodies like they did in the late 1990's. The day will come when Technology leads, but we are not there yet, perhaps in 18 months, but certainly not for the next year.

Conclusion

For this past month we at SISR have been arguing that construction must become a viable area for growth and recovery. Technology at the end of the first decade of the twenty first century is very different than technology was in the middle of the last decade of the twentieth century.

For a research group like SISR the evidence is stark. In the old days we knew that when semiconductor shipments were up, it was clear where they were going. Today, there are so many semiconductor companies making semiconductors for so many things that the data is almost unusable. Who are the computer makers? Is Apple still a computer maker, how about IBM? What is communication equipment? In the old days it was CSCO systems, today it could be 100's of different products, including GPS systems.

The space has simply exploded, but we will conclude with one simple point: to the extent that technology growth is driven by consumer products, and even with support growth like 3G infrastructure, it cannot take on a leadership role in the markets, until the consumer is stronger and businesses again invest in technology. To the extent that the consumer is not leading this recovery, at this juncture, we find it difficult to believe that a consumer driven technology sector could take a leadership role.

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Price Chart:

A price chart, with changes of ratings and price targets in prior periods, is included above, for all securities covered in this report.

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