



## THIS IS WHY THE MARKET IS BETTER

The list of worries several years back included:

- Double Dip
- Iraq
- Terrorism
- WMD
- Anthrax
- Smallpox
- Deflation
- China's exports
- Japan's banks
- U.S. trade deficit
- Weak dollar
- Strong gold price
- No pent-up demands
- High consumer debt
- Negative wealth effect
- Housing bubble
- Business debt
- Credit crunch
- Credit quality spreads
- Quality of earnings
- Stock options
- Under-funded pensions
- Corporate governance
- Liquidity trap
- Brazil
- Overcapacity
- Under-investment
- Widening federal deficit
- Rising state taxes
- Dow 5000.
- Unemployment and the jobless recovery

Today there is more concern about higher inflation and interest rates than there was in 2003. The Twin Deficits and the housing bubble are still among the latest worries.

One obvious dropout from the worry list is capital spending. During 2003, the economic naysayers observed that business spending was weak, and was likely to remain weak. Nonresidential fixed investment in the real GDP accounts fell 8.9% in 2002 and rose only 3.3% in 2003. However, on a quarterly basis, it started to grow at a double-digit pace during the second quarter of 2003 and continued to do so through the end of last year. It was up 10.6% for all of 2004. During the fourth quarter of last year, it was up at an annual rate of 14.0% with spending on business equipment and software up 18%.

This rebound in capital spending shouldn't have been a surprise since such spending trends to be driven by corporate profits, which really took off last year. Corporate cash flow also received a big boost from a significant acceleration in depreciation allowances, first in early 2002 and again in May 2003. These tax incentives expired at the end of last year. What is surprising is that capital spending wasn't much stronger given the tax incentives.

The biggest surprise of all on this front is that new orders for non-defense capital goods excluding aircraft soared 2.9% to a near record high \$807 billion, at a seasonally adjusted annual rate, after the incentives expired. Most economists expected some weakness early in 2005. This is great news for the forward earnings of companies in the S&P 500 Industrials sector, which are highly correlated with non-defense capital goods orders excluding aircraft.

We have come a long way and survived quite a bit.