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## There Is More Wrong Than Just Subprime

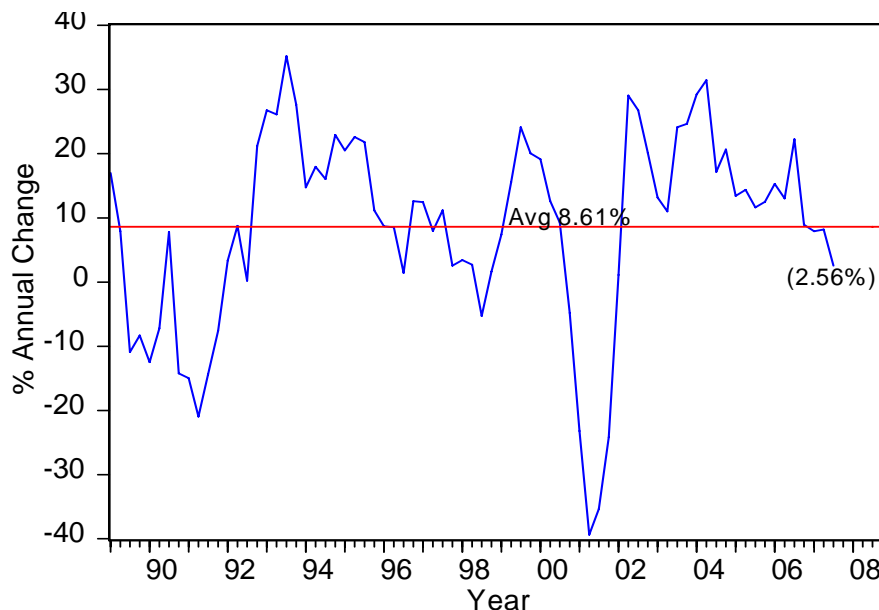
Stockmarkets are supposed to be a leading indicator of the economy. Recent weeks have seen a heavy selloff in US stocks. The newspapers tell us that this is all because of Subprime mortgages. Could there be something else happening as well?

The question is particularly interesting because at the moment there seems to be a belief that the low in the US economy is behind us in the first quarter of 2007. From now on, the US economy is supposed to gradually improve. Is this really what is going to happen?

### Falling Earnings Growth

The first thing is that there may be an entirely different reason than the US stockmarket is falling other than Subprime mortgages. We can get an understanding of this by looking at Figure 1. Figure 1 shows us the year on year rate of growth of operating earnings of companies in the S&P500. This series is shown since the beginning of 1989. In the recent cycle, earnings growth has been particularly strong. For the year to the second quarter of 2004, operating earnings for the S&P500 was growing at 31.4%. As short a time ago as the third quarter of 2006, operating earnings was growing at a year on year rate of 22.2%.

**Figure 1 : S&P500 Operating Earnings Per Share Growth – 1989 to 2007**



Source: ABN AMRO Morgans

That was last year. This year, earnings growth is much slower. For the year to the end of the June quarter of 2007, earnings per share growth was 8.15%. This sounds ok but it is lower than the long term average of 8.61%. The previous quarter saw growth of 7.9%. This is also lower than the long term average. You don't have to be a genius to realise that lower than average earnings growth is going to generate lower than average stockmarket performance. Has anyone seen any of this recently?

**Important disclosures regarding companies that are the subject of this report and an explanation of recommendations and volatility can be found at the end of this document.**

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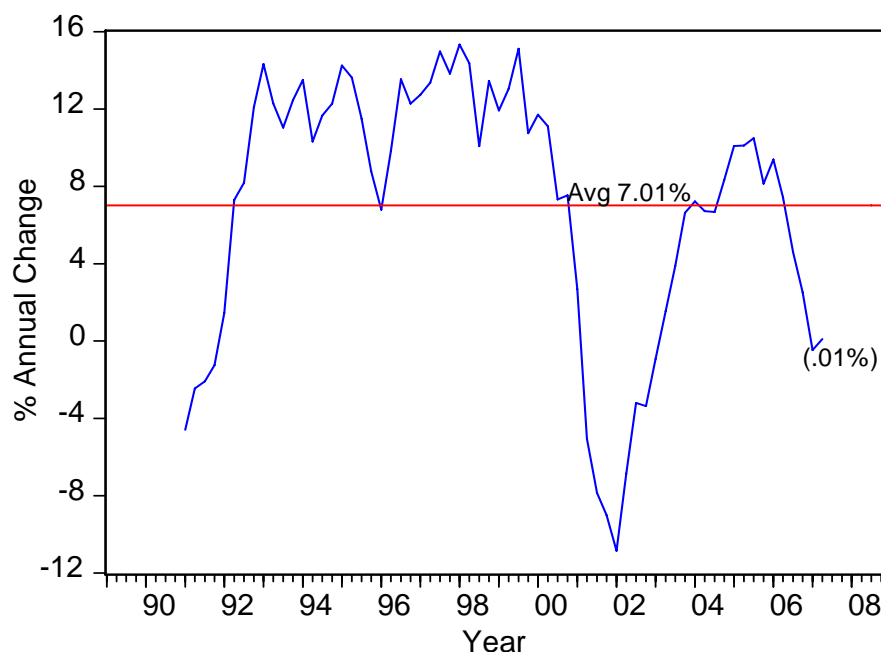
The problem is that earnings growth continues to decline. Based on current estimates, earnings growth for the year to September should be only 2.56%. This is the most miserable number since the first quarter of 2002. Most of you will recall we were in a bear market back then. So maybe the stockmarket is not just being moved by Subprime. Maybe it is also being moved by a sustained move to below average earnings growth.

We started by saying that the stockmarket is a leading indicator of the economy. Well, maybe. Earnings growth certainly is. Since the late 80's, earnings growth has been leading US GDP growth by one to two quarters. This means that the slowdown in earnings growth suggests downward pressure on the US economy in the two quarters ahead. Perhaps the low in US growth is not behind us at all.

### Falling Tech Investment Growth

This poor view of what is actually happening in the US economy is confirmed by what we can see in investment in equipment and software. This is how the US describes tech investment. In Figure 2 we see the year on year rate of change of investment in equipment and software including the figures for the second quarter of 2007. It was Maynard Keynes back in the 1930's who pointed out that that it is investment that supports sustainable growth in an economy. When he was the Governor of the Federal Reserve, Alan Greenspan was fond of talking about the positive effect of tech investment.

**Figure 2 : Real Investment in Equipment and Software  
– 1990 to 2007**



Source: ABN AMRO Morgans

The fact is that in year on year terms, real tech investment growth in the US economy is currently 0.1%. This is as close to zero as you can get without actually falling through the floor. This number is very low compared to the long term average. Since the early 90's, tech investment has been growing a touch of over 7% per year. It has been below that number in every quarter in the last four. There is no way that the US economy can be sustained by this very low level of tech investment.

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What this tells us is that problems in the US economy are not just problems in residential investment. They are not just problems in Subprime mortgages. There is a broader problem of under investment in the US economy.

It is quite apparent that with falling earnings growth and with poor residential and with tech investment, that the US economy must slow down. This is entirely different from the broadly held view that the US economy is recovering on its own and needs no further stimulus.

### **Policy Action?**

In fact, the only way to stop the US economy sliding away into a genuine recession, is to provide a stimulus either in terms of an increased budget deficit or in terms of a significant cut in the Fed Funds rate. Right now, nobody in Congress is talking about the need to stimulate the US economy and nobody quoted in the Fed Minutes is talking about the need to cut the Fed Funds rate. This is a problem.

### **Conclusion**

The selloff in the US stockmarket is telling us that there is a lot more wrong with the US economy than just Subprime mortgages. Earnings growth has fallen below long term average. Tech investment has been far below long term average for a year.

There will be a significant slowdown in US growth unless somebody takes policy action. Right now policy makers are giving an indication that they do not even see that the problem is there.

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