

May 18, 2003

Stocks Are Looking Up. Bond Traders Look Askance.

By GRETCHEN MORGENSON

HAPPY days are here again. Or at least they must be close.

So says the Standard & Poor's 500-stock index, which has risen 11 percent since March. Certain that an economic rebound is imminent, investors are seizing on shares.

In bondland, however, the view is darker. There, rising bond prices — and the corresponding collapse in yields — signal an economy that is stuck in the mud and unlikely to extract itself anytime soon.

Of course, the stock market is famous for spotting sunshine well before storm clouds disperse. But as oracles go, the bond market has the superior record, alas. Stocks often run on vapors, as they seem to be doing now.

Some money managers say the current market mood is reminiscent of autumn 1999. Internet stocks are racing, the Nasdaq composite is on a tear, and short-sellers are squawking. Nonchalance over stretched valuations, especially in the technology sector, also feels depressingly familiar.

"I just don't buy it," said Eric P. Von der Porten, portfolio manager at Leeward Investments in San Carlos, Calif. "There is little if any economic activity that would seem to justify the run-up."

One propellant for stock prices has been the steep decline in interest rates. Lower rates are good for stocks largely because they reduce corporate costs. They can also drive stock prices higher as investors exit low-yielding bonds for better returns in equities. Since last May, the yield on Treasuries maturing in five years has plummeted more than two percentage points.

But sharply lower rates, at least this time around, have negative implications for stocks in that they signify a sickly economy.

"We have been looking for a postwar acceleration, a bounce in the economy, some pickup in spirits," said Jan

Hatzius, senior economist at [Goldman, Sachs](#). "But I'm not seeing very much of that." He puts the current economic growth rate at around zero and estimates that for the full year of 2003, gross domestic product will grow just 2.1 percent.

Things won't get much better in 2004, either, Mr. Hatzius said. He reckons that the economy will expand by 2.5 percent.

If he is correct, that would mean four consecutive years of annual growth below 3 percent. The last time this streak occurred, he noted, was in the early 1930's.

During those grim years, the economy was shrinking; it is not now. But growth of less than 3 percent cannot produce the kind of earnings sizzle that stock investors want.

Mr. Hatzius said it was taking longer to return to more typical economic growth rates because the economy is still working through the excesses of the 1990's spending and stock market booms. The process is only half over, he said.

The economy will barely inch along partly because corporations and individuals are still getting their financial houses in order. Too much debt was amassed by both, and while companies have been paring, individuals have not. The jobs picture is troubling, too. Mr. Hatzius said nonfarm payrolls might contract in May. That would be the fourth monthly decline in a row, a sequence that has not occurred outside a recession since World War II.

Is it any surprise that personal bankruptcies hit a record 1.57 million in the year that ended March 31? According to the Administrative Office of the United States Courts, these filings are up 25 percent since 2000. In contrast, the number of businesses filing bankruptcy petitions fell 5.8 percent this year.

"People are under pressure to cut their spending relative to income," Mr. Hatzius said. "That doesn't mean spending has to fall, but it puts downward pressure on demand growth." With demand slack, the bounce in the stock market's step may fall flat.