WHICH WAY IS UP ?

As interest rates continue to fall, one notes that industry is not as keen as one would have thought to make further investments in capital goods.

Banks may be *'hungry'* for business, these days, but they, still, pick and choose those to whom additional lending should be advanced.

Banks have seen how easy it is for a company, on Day One, to be considered a good credit risk, only to become another statistic in the portfolio of non-performing loans.

At the same time, industry is reluctant to spend too much more on capital goods because, simply put, industry does not see the consumer in a buying mood.

The wealth effect, having been negative for the past year or so, has made consumers, internationally, very wary about making any fresh commitments.

Of course, in due course, consumers will re-enter the market in order to replenish inventories, but only after the scabs have grown over the open economic wounds of the past year or so.

Nowhere has this fact been more apparent than in Japan where, just last Wednesday, it was announced that orders from the private sector for new machinery had risen about 6.30 percent in April, compared with March.

Japan's Economic and Social Research Institute of the Government's Cabinet Office made it very clear that purchases of new machinery in March were off by about 3.60 percent, compared with February.

Seasonally adjusted statistics of this nature, point the way to the future and, when coupled with senior officials of government, stating that *'the trend in machinery orders is weak … we shall be watching future movements'* – Mr Yoshihiko Senoo, Senior Official, Economic and Social Research Institute, June 5 – there is good reason for concern.

Private-sector spending on capital goods is a leading indicator of how industry views the trend for the next 9 months to 12 months.

Plunging corporate profits and its attendant impact on globalisation have made itself felt, most pointedly, leading to industry, putting on the brakes when it comes to investment in plant and major capital expenditure.

This is to be expected in any economic downturn, of course.

But such a business philosophy must, by its very nature, lead to shortages, eventually.

It will be the innate ability to identify such future shortages, which will lead investors to make the most profits when the present dust subsides, allowing for clearer vision.

Business failures, non-performing loans, dwindling households' liquidity have all conspired to create a symphonic cacophony that nobody wants to hear.

But, out of this cacophony will come opportunities – provided that they can be identified for what they are.

As the US economy re-accelerates – and it must re-accelerate because the US Federal Reserve and the US Government, spurred by massive tax rebates, unparalleled in the history of the country, are determined that it must – strong, long-term prospects in various fields will come to the fore.

Those industries, that have been hobbled in the past year or so but still retain strong balance sheets, having tucked in their financial tummies, during the economic downturn, will emerge as being stronger than ever.

Severe, short-term constraints will be replaced by intermediate to long-term economic planning by dynamic industrial leaders, who will seize the opportunity to rise on their hind legs ... while lesser men waver.

Those companies, that have posted gains, even during the economic downturn of the past year, are the ones to watch, logic appears to dictate.

Those companies, that produce key investment goods and services for businesses, as opposed to those industries, producing goods and consumer-related investment goods, are likely to be the ones to watch.

There is, without question, a great deal of over-capacity in **I**nformation **T**echnology (IT): Many of the start-ups will go to the wall before long.

Many of the companies, listed on The Growth Enterprise Market (The GEM) of The Stock Exchange of Hongkong Ltd, are terribly suspect.

Even those GEM-listed, IT companies, which have been boasting of having earned profits for so many consecutive quarters, must be looked at with a view to asking this question: Are those recurrent profits, which will continue?

Or are they just one-offs, which are unlikely to be repeated in the quarters to come?

Creative accounting has tended, in many cases, to mask the quality of earnings of many companies in the made dash to try to catch the *'public bus'*.

But the overcapacity in IT is likely to be short-lived, in any event, because the *'bad'* companies will go to the wall, leaving the companies, that have something to say, to sweep the fields, cleanly.

Inventory levels will be depleted because they cannot stay, gathering dust and rust.

In addition, the march of IT is such that unless companies move inventories, they will have to consider making huge provisions for slow-moving stocks.

Servers, network systems and computer software of all types, all have very short shelf-lives, leading to a high rate of obsolescence: Thus, such items need to be replaced with state-of-the-art technology, relatively quickly.

As more financing becomes available, thanks to lower interest rates, IT companies will, undoubtedly, replenish inventory levels with the newest products.

But as the major economies of the world improve, rock-bottom interest rates will rise, leading to consumables, becoming more expensive to households.

For this reason, housing starts are unlikely to lead the way in any sustained recovery.

The same logic would appear to hold true for motor-car sales and the like.

Where there is likely to be a good deal of immunity to these factors is in IT and telecommunications since both of these industries are considered fundamental and essential, unlike yesteryear when such items, as the mobile telephone, was considered a luxury.

It is highly likely that sales of durable goods, motor cars, housing starts etc will moderate to further lower levels before they recover.

In the long term, however, competitive pressures, internationally, will force the private sector to spend in order to stay competitive.

While this spending may well mean that, initially, profit margins will be thin, the requirement to spend is not one that is a voluntary act, but one that will be mandated in order for a company to stay abreast of the pack.

If it does not do this, it will, most certainly, die.

Continuing innovation may well lead to just remaining in place in the world of IT, but without continuing innovation, there is no way forward.

This is something that Mr Bill Gates's Microsoft Corporation, the largest computer software company in the world, learned some years ago.

Lucky for Microsoft, the makers of Wordstar, WordPerfect and their ilk, were not up to the task – and these companies left the field for Microsoft.

The continued necessity for businesses to spend on IT and IT equipment, in order to remain competitive in the fast-changing world of the 21st Century, will not fade away, as does a lady's eye shadow.

All this points to a rebound in this ever-changing industry, once businesses can afford to buy IT products; and, banks see their way clear to lend to such businesses.

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