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Does the Rally in Stock Markets imply a Revival in Economies?

Post hoc, *non ergo* propter
hoc!

As a general rule, assets markets anticipate economies. The causal mechanism is not complicated: it's not one of wealth affecting community psychology, nor of prescient investors being masters of the universe! It is instead a simple matter of chronology. Credit conditions influence both securities' valuations and economics demand—the first with a short lag (about three months), the second with a longer one (perhaps three quarters).

The economy and markets
have responded predictably
to changes in money.

The process is illustrated in the current cycle: during 2006, monetary conditions were getting progressively less accommodative and, in early 2007, had probably become slightly restrictive¹. On schedule, securities indices began to retreat around the middle of the year. And, on schedule as well, the pace of economics activity slowed from the start of 2008.

But the extent of the
changes has been a surprise.

The surprise related, not to *timing*, but *extent*. The changes in credit had been mild, but the reaction of markets was severe, that of economies savage. Why the responses should have been so extreme on this occasion is something that is not fully understood. There are times when a given stimulus provokes a *minor* reaction; others when it generates a *major* one. This variability² causes the fore-caster untold difficulty: he may know when something is going to happen, but not how violently.

Both in the tightening phase
and the loosening one.

In the current cycle, for instance, central bankers had no inkling of the forces of retrenchment they'd un-leashed³ until late summer 2008. Some of them (as usual) reacted slightly more quickly than others⁴. By autumn, though, all had recognised that they were in the midst of extraordinary events. All thereupon reverted to monetary easing. They did so urgently and boldly. They slashed interest rates almost to zero and deliberately expanded liquidity at a pace well beyond the "transactions needs" of the community.

A mild economics upturn now looks likely.

More or less on schedule (spring 2009), asset valuations began to rise. And it's probable that economics activity will do likewise in the coming autumn. Already, levels of inventory seem to have picked up; final sales can be expected shortly to follow suit.

But there are anxieties nevertheless.

The surprise, once again, is that the response of the markets and the economies has been so muted. Arguably, it's justification for anxiety. If a barely perceptible touch on the credit brakes should have been sufficient to stop the vehicle in its tracks, but an unprecedentedly vigorous opening of the credit throttle not enough to resuscitate the engine, there might be something seriously amiss with the vehicle. In such circumstances, it'd be impossible not to draw parallels

Is another depression on the cards?

In those periods, it was all but impossible to return economies to equilibrium. There was persistent excess supply. It hung, depressingly, over the economy. And there was nothing the authorities could do, neither fiscally nor monetarily, to lift demand commensurately⁵.

Would the authorities notice, if it were?

There were, of course, business cycles. And, when an upturn occurred, it was normal for observers to mistake *periodicity* for *secularity*. That made the disappointment, in the slowing phase of the cycle that occurred a couple of years later, all the keener.

Probably not.

Is there a parallel with the current situation? Might central bankers once again confuse medium-term oscillation with longer-term trend? Might they think the excess supply has been laid to rest merely because of a temporary inventory rebuild? Might they add to the economies' subsequent weakness by tightening credit prematurely? Yes, of course they might. Like the Hanoverian Kings in any earlier period, they seem to find it extraordinarily difficult to abandon old falsehoods, or adopt new truths⁶.

Most therapies don't work

The monetary cure seems to be losing its effectiveness.

What should properly worry central bankers and politicians is that monetary excesses, though they may neutralise the forces of deflation *temporarily*, seem not to be able to do so *permanently*. In the previous cycle, in the early years of the current decade, economic debility⁷ was successfully fended off, but it returned, more ferociously than ever, a few years later. Is that pattern to be repeated again? Is the monster insatiable? Is depression certain; only its timing optional?

Are there any alternatives?

If the problem is caused by an imbalance between supply and demand, the former being excessive in relation to the latter, the solution requires either that the one be reduced or the other increased. Thus far, the authorities have focused on the second option. They've tried to boost spending by encouraging borrowing.

Sadly, no.

That remedy seems to be getting progressively less effective. Consumers and businessmen are getting wary about borrowing, even at low nominal interest rates. And lenders are becoming cautious. In many parts of society, there is a strong desire to clean up balance sheets; to pay down debt; and to limit spending, Macawber-like, to income.

Worse still, easy money prompts misbehaviour.

There's another problem. When credit gets excessively easy, when its availability becomes many times higher than that which can be absorbed by "responsible" parts of the community, it's inevitable that "irresponsible" alternates emerge. Their use of the funds may temporarily buoy activity, but will ultimately cause problems.

In the past, insurance companies . . .

In the late twenties, it was American and European insurance companies, acting inappropriately, that caused a difficulty. In the late nineties, it was Japanese insurance companies that did so. In the early years of the current decade, the malefactors were issuers of secondary mortgages.

... and mortgage bankers have been the culprits.

And the miscreants next time? It doesn't much matter. Whoever it is, the bottom line will be the same: there'll be official embarrassment; self-serving politicians and central bankers will assert their blamelessness; fatuous regulators, blinking incomprehendingly, will be given more powers to do more irrelevant things! And, crucially, in their anxiety to restrict the activities of the *bad guys*, the authorities will limit those also of the *good guys*! Industrialists and retailers will suffer; consumers and pensioners will be impoverished. Aggregate spending will plunge, and depression lour once more.

Next time; who knows?

In other words, at this stage of economics developments⁸, it may be impossible to square the circle by lifting demand—the costs of doing so having become progressively higher; the benefits progressively smaller. That being the case, equilibrium may only be possible via reduced supply. Ah, there's the rub!

Perhaps, like DDT, the magic has ended.

It's bound to be a slow process. Reductions in capital spending will eventually reduce capacity, but it'll take years, possibly decades. And, in the meantime, demand will fall more than supply—exacerbating the causal imbalance⁹. That's why depressions, when they occur, last for so long¹⁰.

How long do depressions last?

Only the depression of the thirties proved to be an exception to the rule. It lasted for just ten years. Why? Probably because of the war. The conflict affected virtually the all of the advanced economies. There was huge expenditure on non-productive investment at home (armaments and transports etc.) and simultaneously huge destruction of productive investment overseas (enemy factories etc.). It was this which returned supply and demand to balance.

Longer than anyone dares admit.

It nevertheless took a protracted period of hostilities to do so. How long would the imbalances have otherwise lasted? Nobody knows. But very possibly another couple of decades. How long, therefore, assuming that the age of conventional warfare is past, might the world's current debility last? A frighteningly long time!

Security Valuations

Bad economy, but good stock market?

So what are the prospects for asset markets? Ironically, they may be quite good. The initial shock of economic fragility is negative, but the subsequent accommodation to it is relatively positive. In the tussle between labour and capital, excess demand favours the former, excess supply the latter.

Low inflation and low interest rates.

That's reflected most obviously in pay settlements. In depressions, they fall sharply—causing the ratio of personal income to corporate profit to soften significantly. And, despite lower incomes, savings rise.

In gilts we'll trust.

Government bonds are major beneficiaries. Public borrowing may be worryingly high and issuance therefore brisk, but attractive real yields and the absence of alternative opportunities generate favourable returns. Treasury bonds become the asset of choice for most investors.

Later, in equities as well.

Equities follow suit. Improving profitability (often aided and abetted by the establishment of cartels¹¹) gives the businessman the capacity to increase dividends. Typically, equities yield a good deal more than government bonds. They tend to be regarded with a degree of residual suspicion, but routinely outperform other assets by a wide margin.

Conclusion

The economics are not good.

Nothing is certain in economics. But the bottom line is that there is a much higher risk of depression that the consensus is currently prepared to acknowledge. Not necessarily in the immediate future, but perhaps in the next decade.

Governments are even worse.

What we can forecast with a good deal of confidence is that the authorities (central bankers, politicians, regulators *et al*) will miss the warning signs. What can also be forecast is that, after the event, they'll implement policies that'll be exceedingly expensive and completely ineffective.

But there's money to be made.

We're on our own. Pursue investment policies that are low risk rather than high risk. Opt, initially, for government bonds rather than corporate ones. Later, when a degree of stability has returned, probably depressed stability, move into equities.

- 1 The authorities were fretting about inflation. They thought they were operating in a period of excess demand; they saw commodity prices climbing and reacted by restricting credit availability. Happily, the extent of their restrictiveness was moderate.
- 2 It's not wholly unpredictable. The response has been "negative" (demand falling sharply on tightness and rising shallowly on expansiveness) for some time. And it's been getting worse. In the previous cycle, for instance, economies slowed markedly on relatively minor interest rate hikes in 2000; and quickened only reluctantly on sizeable interest rate reductions in 2001 and 2002. Likewise, in the cycle before that, responses were generally disappointing.
- 3 According to published data, there were substantial quantities of liquidity available within the economies. It was in the hands of bankers, and not being lent to small and medium sized companies. The latter were deemed by the former to be too risky. On the point of failure, the companies took the only course open to them: they liquidated inventory. They deliberately cut production to levels well below sales. They survived, but at the cost of a huge reduction in GDP!
- 4 The Fed, on this occasion, as on previous ones, was the first to notice the impending disaster. The ECB, as always, was the last to do so.
- 5 Interest rate cuts seemed not to work. Arguably, that was because there was a delay before action was taken. By then, consumer sentiment had become exceedingly negative and inflation had gone significantly negative (making the real interest rate penally expensive)!
- 6 It's rather worrying that many central bankers and virtually all investment bankers are fussing about "exit strategies"! They say that they fear the re-emergence of inflation. Really? By comparison with the misery caused by depression, that stemming from inflation is insignificant.
- 7 Greenspan, almost singlehandedly, lifted world demand. He did remarkable things to the monetary environment causing the consumer to start spending again. But the remedy didn't last. Some argue even that his near term amelioration will have made the longer term deterioration worse.
- 8 Is there a longer term cycle? Was Kondratiev right? Do things repeat themselves every sixty years or so? We don't know. We haven't enough data. But it does look as if economies swing alternately between excess supply and excess demand. All that's uncertain is whether the periodicity is regular or irregular; whether it's forecastable or not.
- 9 In the early years of reduced investment spending, the loss of demand consequent upon the displacement of workers from the capital goods sectors will be larger than the loss of supply. In short, the forces of depression will, for several years, be intensified rather than moderated.
- 10 There is no reliable data, but, judging by newspaper reports and the private correspondence of businessmen and trade unionists, it looks as if there was a depression in the years following the Napoleonic wars. It lasted for decades. There was another in the closing decades of the nineteenth century. It too lasted for decades. Japan's current anaemic is in its nineteenth year; and there is no sign of early respite. Only that in the thirties ended relatively quickly. Because of war? Probably!
- 11 Politicians are frequently conned by businessmen (the recent banking fiasco, for instance). The latter says that, in order to preserve jobs, it'll be necessary to subvert the rules of competition. Nobody will suffer (the foreigner possibly excepted), lies the businessman. The politician concurs.

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