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Things Fall Apart

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This note is a combination of a recap and some personal observations on markets.

The US Stock Market has been a Lagging Indicator of Recession

The recession in the US is finally here. As far as I am concerned the very recent behaviour of the US stock market – particularly the collapse of the transports and the retail stocks, combined with the new lows in homebuilding and various financials – makes this clear. Belatedly, the stock market is confirming the message that has been present in the bond and real estate markets for some time. I was too early – far too early – in calling this recession, making me look stupid. Those economists who are still claiming today that recession will be avoided will end up looking far more stupid.

In my view the tardiness of the stock market in discounting this recession has extremely important implications. Equity prices have held up unbelievably well even as the economy has been seriously weakening, earnings have begun to decline and, last but not least, there has been a huge credit crisis. Understanding why this has been so is the key to understanding what will happen next.

To recap on the normal relationship of the stock market to the cycle, I produced a number of notes looking at different aspects of this in 2006 and the spring of last year. Specifically, I looked at interest rates and the yield curve, the investment cycle and profits. One table, which I repeat over the page, showed that the current cycle has been the only one in the past 50 years in which the stock market failed to turn negative, in terms of the year-on-year change, within a year of completion of the interest rate up-cycle. At the beginning of this year the stock market has turned negative year-on-year but this is now 18 months since the end of the tightening cycle and already into the interest rate easing cycle.

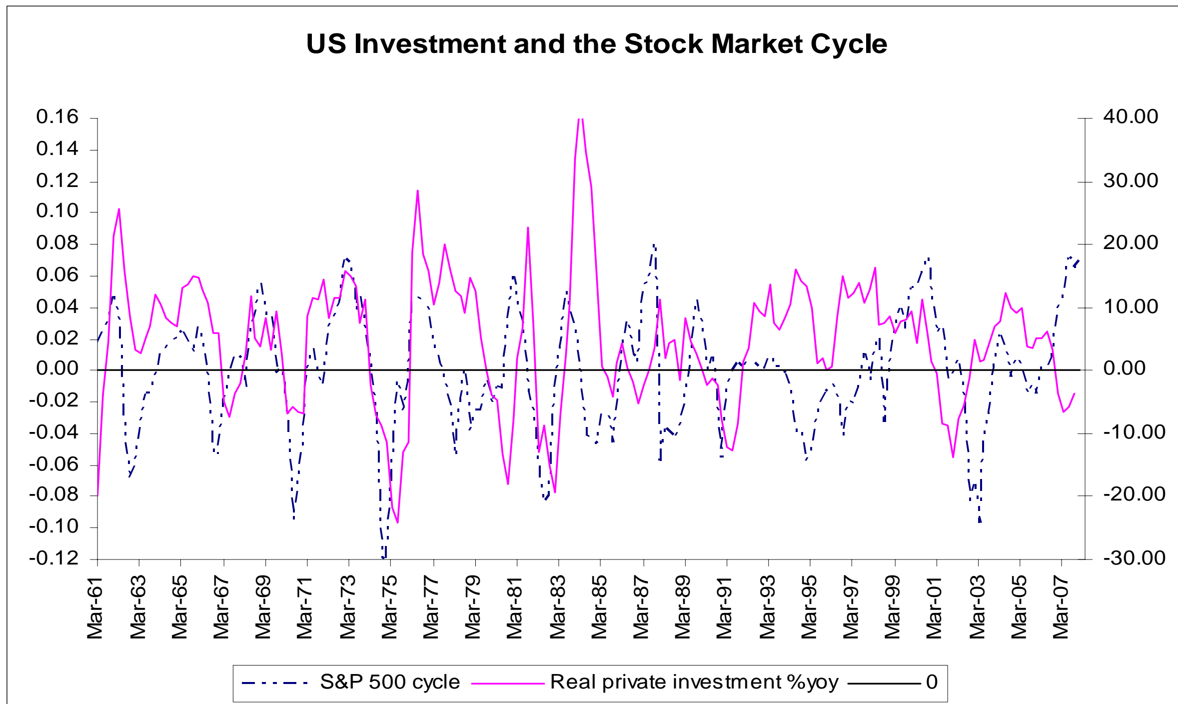
The chart below the table, which is updated, compares the cycle in the stock market – as measured by the difference between the logarithm of the S&P 500 and its centered four year moving average – with the annual (i.e. year-on-year) change in total real private investment. The chart, which I also showed in one of the earlier notes, shows that prior to the last 10 years the stock market cycle tended to be fairly coincident with, or led, the investment cycle, but in recent years it has tended to lag. Now the stock market has been diverging completely from the investment cycle, which went negative at the end of 2006. (This includes housing).

The picture is very similar when we look at profits. The chart on page 3 shows the year-on-year growth in national accounts profits. (Here I use domestic pre-tax profits, but all the various

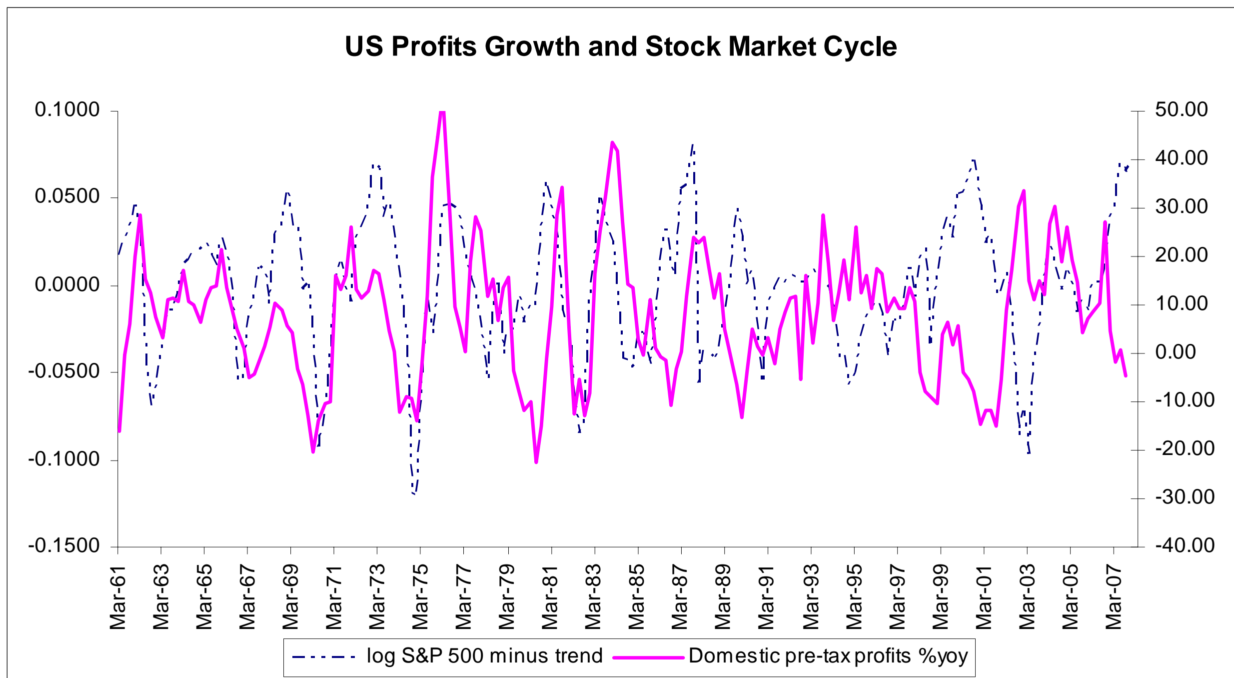
national accounts profits measures move together when looked at in terms of year-over-year growth, so it makes little difference which measure is used). In the chart profits growth is

Tightening cycles (first month is the low on funds)	increase in funds rate	S&P500 yoy change at worst point during or within a year of the end of the interest rate up-cycle*
May 1958 - Nov 1959	340 bp	-8.2% (Jul 1960)
Oct 1967 - Aug 1969	530 bp	-26.0% (May 1970)
Feb 1972 - Jul 1974	960 bp	-41.4% (Sep 1974)
Jan 1977 - Apr 1980	1300 bp	-12.8% (Feb 1978)
Jul 1980 - Jun 1981	1000 bp	-10.1% (Nov 1981)
May 1983 - Aug 1984	300 bp	-8.6% (Jun 1984)
Oct 1986 - Mar 1989	400 bp	-20.7% (Aug 1988)
Jan 1994 - Apr 1995	300 bp	-2.3% (Jan 1995)
Jun 1999 - May 2000	175 bp	-22.6% (Mar 2001)
Jun 2004 - Jun 2006	425 bp	+3.0% (Dec 2005)

* Based on monthly close data



compared with the same measure of the stock market cycle (i.e. log S&P 500 relative to trend). The chart also shows that prior to the last 10 years the stock market cycle tended either to be coincident with, or somewhat in advance of, the profits cycle. Over the past 10 years, in contrast, the chart shows the stock market cycle as almost inverse to the profits cycle. I would prefer to see this as the stock market lagging the profits cycle. We know that in the late 1990s the stock market was in a bubble, during which investors ignored the deterioration of national accounts profits, to their cost when the stock market collapsed over 2001-2.



The collective message from the charts and tables I have shown here and others that I have shown in previous notes is that the US stock market 'should have' been declining from the second half of 2006, if it had conformed to the historic pattern of previous business cycles. But it is worse than that. As I have noted often, the bizarre buoyancy of the stock market has itself supported the economy, primarily because of the important influence that the stock market has on the personal savings rate. In my note of December 29 on the financing of US imbalances, I discussed how the strength of the stock market had made it possible for the personal sector to continue to compensate, in aggregate, for a low, or zero, savings rate by selling shares.

I believe that probably the only other time when such a marked divergence between the stock market and the key economic cycle indicators has occurred in the past was in 1929. What the two periods (the late 1920s and now) have in common is the use of leverage in financial markets and in the economy. In both periods the excessive use of leverage was part and parcel of a credit bubble.

I think the importance of recognizing this at this stage is to be aware of the way that the stock market could behave as the 'unwinding' begins in earnest. Despite everything that has happened, the fact that the carry trade remains largely intact and the fact that stock markets have yet to correct very much tell us that de-leveraging has not occurred on a substantial scale yet. In 1929,

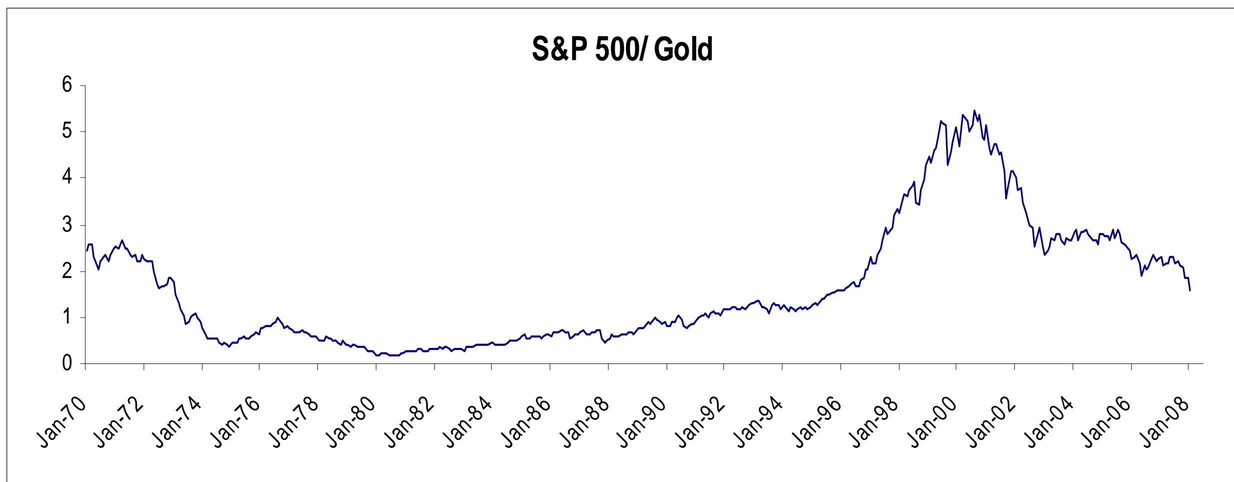
market participants were shocked by the waves of massive selling that overcame the attempted market support operations, as speculators and investors were finally forced to de-leverage.

During this market decline I have read again and again, particularly from technical analysts, about how the market is 'oversold' and due for a bounce. Up to now, the notion that the market will bounce once it has fallen a bit has been a good working assumption for traders. I am saying that this is only because serious de-leveraging has not yet begun. Once it does begin, the best working assumption will be that there is no such thing as 'oversold', I believe. As discussed in my previous note, I continue to believe that the yen will be a good warning indicator of what will be a frightening change for the worse in market behaviour.

Gold

I have discussed gold a lot but I want to say a little more about gold in this context. There seems to be a high degree of investor bullishness about gold now, with many market participants assuming that we will see US$1,000 very soon. I would be foolish to rule this out completely – anything can happen in the very short run, particularly in a volatile market like gold – but I continue to believe that in terms of time it is near the end of this bull run in gold.

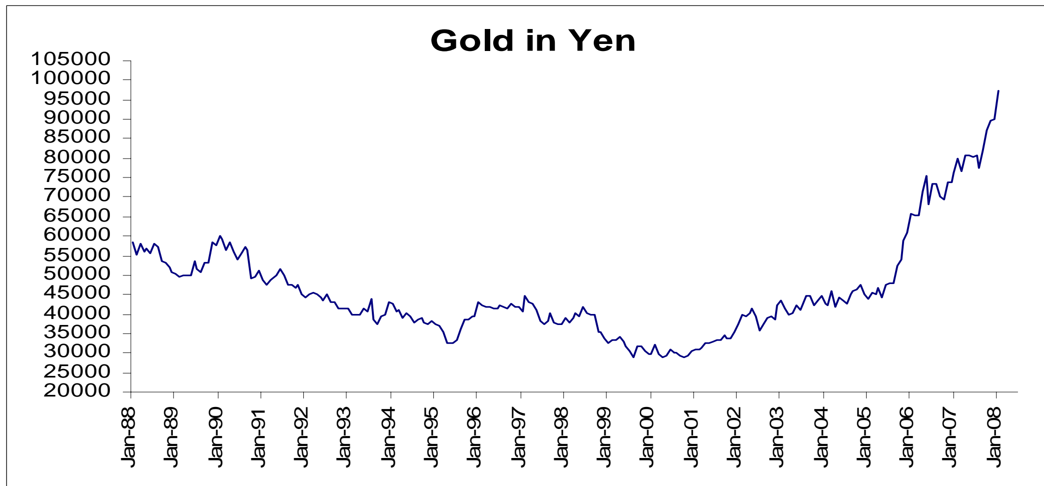
One thing I did have right in my note on gold on November 6 was my expectation that the ratio of the S&P 500 to gold would shortly break sharply to new lows. This indeed has happened as the updated chart, which here goes back to 1970, shows.



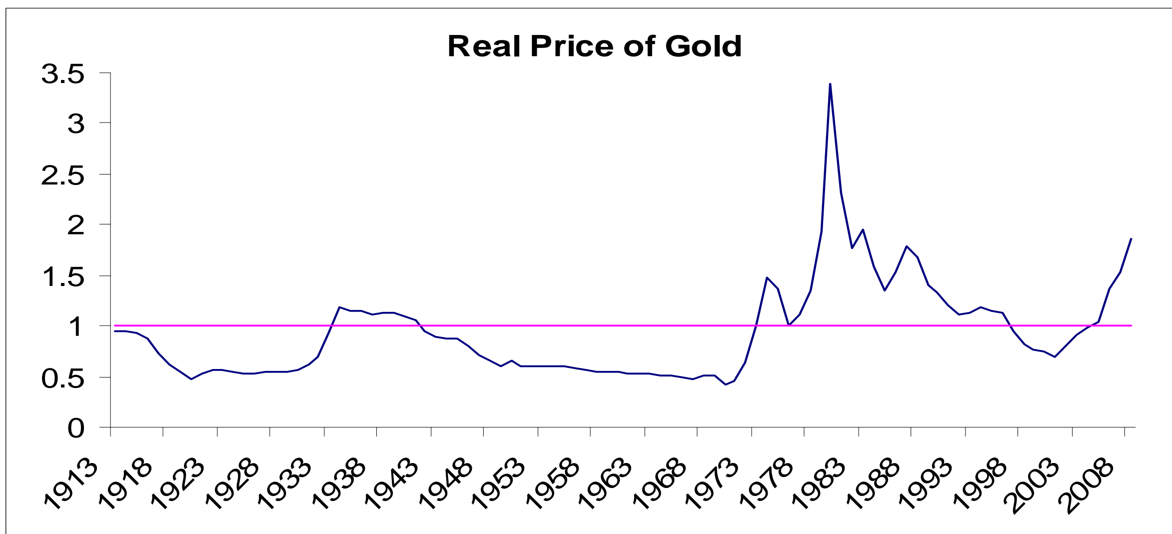
Even though the stock market has declined, the fall in the ratio is still mostly owed to the rising gold price. In itself this is consistent with a monetary inflation, which is increasingly at odds with the message from interest rate and credit markets, property markets and increasingly some other commodity markets and the stock market itself. It is worth remembering the gold price in yen, which I show again in the chart over the page. Contrary to my expectation, the gold price has continued its very steep rise in terms of yen.

No doubt gold bulls – who perceive the rise in gold as the result of inflation that is being further stoked up by central bank actions to rescue the financial markets – would argue that to look at

the gold price in yen is meaningless because it is simply combining the gold price with a currency exchange rate. But this is logically inconsistent. If we view the rise in the price of gold as a symptom of monetary inflation, as gold bugs do, then this surely must apply to Japan as much as it does to the US. The huge and ongoing rise of gold in terms of yen would then imply a very inflationary environment in Japan, which is clearly at odds with all other evidence.



It could be argued that the yen is grossly undervalued against everything and that this is why the price of gold – as well as other currencies – is very high in terms of yen compared to fair value. I of course do not disagree with this. The problem is that the return of the yen to fair value will be associated with de-leveraging that will impact the value of all assets, almost certainly including gold as well. Not all of the rise of gold in terms of yen can be accounted for by the undervaluation of the yen. It is logical to believe that when the yen appreciates against all currencies gold will fall at least somewhat in terms of dollars as de-leveraging takes place. In short, not all of the rise of gold can be explained by actual and prospective inflation. Gold has become overvalued at current levels and, as with stocks, at least some of this overvaluation must be explained by the high levels of leverage that have been employed in global markets.



One rough and ready measure of this is shown in the final chart, at the bottom of the previous page. In this chart I have taken the price of gold (in dollars) back to 1913 and divided it by the US CPI. Then I have indexed this real price of gold such that the level of 1 approximates to a very long run average real price that seems to be consistent with the notion of a fair value around which the real price of gold fluctuates in very long waves. The basis for this is obviously the notion that over the very long term gold tends to hold its value in real terms but does not actually provide any real return. This is consistent with the history of the past 100-150 years.

As it stands the chart implies that gold is now about 85% overvalued. This would put the 'fair price' for gold at about US$470. If we take into account the notion that US CPI data have understated true inflation for some years it would be possible to bump this fair value level up by 10-15%, say (but I doubt much more), so that we could argue the fair value up towards US$550 (at the most). If gold were to fall to US$550 and the yen rise to my estimate of fair value around Yen 85, then the price of gold in yen would be Yen 46,750 per ounce, which is almost exactly where it was in August 2005, right before the almost vertical ascent shown in the chart on page 5 began. I therefore consider that my medium-term forecast for gold of US$600 still represents an overvalued level, and therefore I stick with it.

To return to markets in general, the analysis in this note and the previous two tell me that a market meltdown is coming soon. The last day or two have shown yet again that it is tough to be short when there is a powerful vested interest in the markets not collapsing, including it seems companies and funds who would rather throw good money after bad to prop things up than write off their past investment mistakes. On top of that there are plenty more Fed rate cuts to come, and also rate cuts in the UK and Europe. No doubt there could be more market bounces as these rate cuts occur, or become expected. But I expect that the market falls will become steeper and the bounces will become progressively weaker, and may even cease altogether quicker than might be expected. As I have said again here, the latter will be particular likely to be the case at the point when interest rate cuts in the western economies begin to unwind the yen carry trade, ushering in a more violent phase of de-leveraging. It is difficult to know when exactly that point will be, but I would not be surprised if it is any time now.

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