Sale of the Century?

We were intrigued by comments made by White House economic advisor Larry Summers in mid-March, suggesting that the U.S. stock market was being offered at prices that made it the "sale of the century" for investors with a long-term perspective.

These comments were made a few days after the S&P 500 had posted a devilishly low intra-day mark of 666:

"One striking statistic suggests the magnitude of the opportunity that is before us in restoring our economy to its potential. Earlier this week, the Dow Jones Industrial Average adjusting for inflation according to the Standard Consumer Price Index was at the same level as it was in 1966. … While there are many ways that one could question the precise details of this calculation, that the market would be at essentially the same real level as in 1966 when there were no PCs, no Internet, no flexible manufacturing, no software industry, our workforce was half as large as today, and our capital stock was a third as large as today, will be regarded (by) some as suggesting the presence of the sale of the century."

This was a compelling observation from one of the world's most influential economists, even discounting the fact that Mr. Summers must now play an official role as a cheerleader for the administration's policies. With many other measures suggesting that stocks in the U.S. and around the world offer attractive valuations, the fact that real stock prices have been trading close to levels last seen more than 40 years ago offers an intriguing reason for optimism amid the unrelenting bad news of recent months.

We did, however, have one nagging thought: We wondered if one of Herbert Hoover's economic advisors could have made a similar statement back in 1931, just ahead of further brutal declines in the U.S. stock market. Unfortunately, the answer is yes. As we show in Chart 1, in October 1931 the U.S. stock market was below its level of June 1886 – 44 years earlier – after adjusting for inflation. So one of Hoover's advisors indeed could have also called it the "sale of the century," noting that the labour force in 1886 was much smaller and that back then they didn't have radios, automobiles, and so on. That didn't stop the market from falling another 50% over the next eight months.

In any event, Mr. Summers's key point still holds. Economic policy is critical to the outlook for both the economy and financial markets. It clearly did not help in the early 1930s that the U.S. clung stubbornly to the gold standard even as many other nations abandoned it, creating a kind of deflationary doomsday machine while it lasted. It is now widely agreed by economic historians (see, for example, Barry J. Eichengreen, Golden Fetters), that the strict monetary regime of the gold

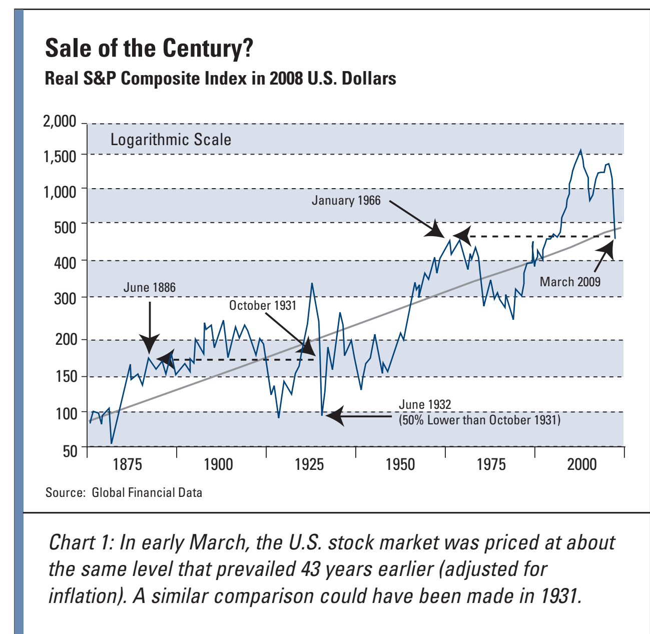
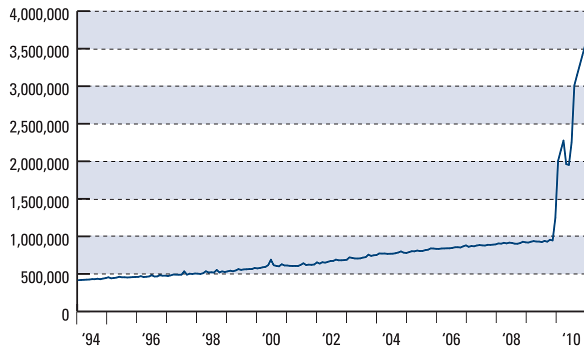


Chart 1: In early March, the U.S. stock market was priced at about the same level that prevailed 43 years earlier (adjusted for inflation). A similar comparison could have been made in 1931.

Fed Balance Sheet Heading to $3.5 Trillion?

Total factors supplying reserve funds, end of period (Millions of $US)



Source: U.S. Federal Reserve Board, Trilogy Global Advisors

Chart 2: Recent announcements by the U.S. Federal Reserve system point to a Fed balance sheet that may approach $3.5 trillion by mid-2009, up dramatically from its mid-2008 level.

standard helped turn the recession of 1929-1931 into the Great Depression of 1931-1941 by preventing governments from fighting the recession in a timely and effective manner.

News Flash: These Are Not the 1930s!

It is admittedly rather unsettling that so much economic and market commentary has to refer back to the 1930s as a reference point for the challenges currently facing the world economy and financial markets. In view of the truly horrible economic data posted virtually everywhere in recent months, the current recession is unquestionably the most severe global recession in more than half a century.

In the wake of an estimated decline in global GDP at a shocking annual rate of 5% in the fourth quarter of 2008, international officials now project the first annual decline in global output in 60 years. Recent official 2009 forecasts now differ only in their degree of severity: (1) the IMF expects the global economy to contract by 0.5% to 1.0%; (2) the World Bank projects a global contraction of 1.7%; and (3) the Organization of Economic Cooperation and Development projects a global contraction of 2.7%.

We also believe that most analysts would agree with the key risk to the global outlook as articulated by the IMF: "Delays in implementing comprehensive policies to stabilize financial conditions would result in a further intensification of the negative feedback loops between the real economy and the financial system, leading to an even deeper and prolonged recession." This warning takes on even greater urgency in the wake of the political firestorm caused by AIG's bonus payments. Policymakers now fear that if another financial brush fire breaks out, a populist Congress might just let the fire rage.

Despite such risks, we think it is worth calling attention to a rather obvious fact: These are not the 1930s! Policymakers are not standing by and letting thousands of banks collapse or permitting the money supply to fall by 25%. The G20 nations have announced fiscal stimulus measures worth nearly 2% of their collective GDP for 2009 and nearly 1.5% for 2010. There is no gold standard to prevent central banks from fighting recession with aggressive monetary easing. The U.S. and the U.K. have embarked on radical quantitative easing measures. Central bankers in Japan, Canada and other regions, perhaps even Europe, are moving toward more radical monetary measures as well. Economist Ed Hyman of ISI Group estimates that there have been over 450 recession-fighting policy initiatives announced around the world in the last six months, more than four times as many as in the previous six months. The most telling illustration of how today is different from the 1930s is in Chart 2, which shows the recent massive expansion of the balance sheet of the U.S. Federal Reserve – a trend that is slated to continue in coming months.

Thus, an unprecedented shock to the world economy is being met with an unprecedented policy response, which is a key reason for optimism. It remains to be seen whether the currently planned measures are sufficient to generate a self-sustaining recovery. But we believe that the Fed is determined to continue with both "credit easing" in the form of targeted programs to restore credit flows, and "quantitative easing" in the form of expanding its liabilities (in effect, "printing money"). If the move from a balance sheet of US$800 billion last August to $3.5 trillion in a few months is not sufficient, more quantitative easing should be forthcoming.

An Inventory Boomerang?

We would also note that much of the violence of the global downturn in recent months appears to be rooted in a massive inventory correction. As firms found themselves surprised by the downturn in demand in the fourth quarter, they responded promptly with huge inventory reductions. The corresponding drop in output was clearly exacerbated by a drying up of trade financing, which led to a collapse in global trade. We also saw a synchronized decline around the world in purchases of consumer durables and capital goods as consumers and businesses responded to the massive increase in global uncertainty.

In recent months, however, global output has been falling much faster than global demand, as we show in Chart 3. Even in a world of "just-in-time" inventory management, it appears that many firms have run down their stock of inventories to bare-bones levels. Accordingly, it will not take much of an improvement in final demand to create a boomerang effect based on inventory restocking as the year progresses. Such inventory restocking effects can have surprisingly powerful impacts on output, industrial pricing power, and corporate profits. In other words, the very violence of the downturn in recent months has increased the odds for a V-shaped economic and stock market recovery as the year progresses. That's because it has set the stage for an inventory rebound and has frightened policymakers into providing unprecedented stimulus.

Chart 3: Global output is falling at a much faster pace than retail sales, which could be setting the stage for a surge in inventory restocking once final demand stabilizes.

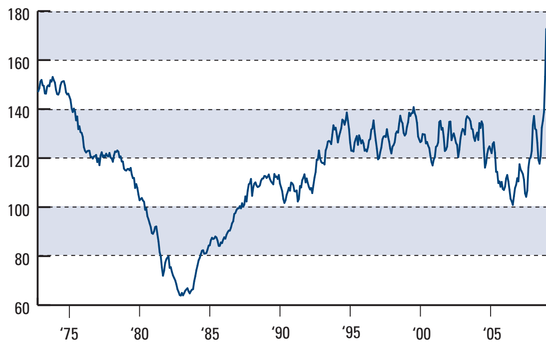
With rates on 30-year fixed mortgages having fallen recently to 4.8%, there is even some reason to hope that the U.S. housing market may finally be close to reaching a bottom. Following months of sharp declines, home prices have become quite reasonable relative to household incomes in many parts of the country. As shown in Chart 4, America's housing affordability index has now soared to the best level in many decades. That should help establish an improvement in housing turnover and a bottom for house prices in the spring and summer of this year. Since the U.S. housing market was Patient Zero of the global economic epidemic, this is good news indeed.

Some other hopeful signs include better-than-expected retail sales and durable goods orders in the U.S. in recent months, a stabilization of business sentiment indicators in Europe, indications that industrial production may rise in Japan, China and other Asian nations over the next few months, and the recent rally in global stock markets, especially in cyclically sensitive sectors like materials, energy, industrials and emerging markets. While none of these "green shoots" provides any assurance of economic recovery later this year, they must all give pause to those who expect a deeper and more prolonged recession (or worse).

But What about the Banks?

Of course the perilous state of many U.S. and European banks remains an important wild card for the global outlook. It is easy to argue that more than $1 trillion of new debt writedowns may be needed on top of the $1.3 trillion that have been announced to date. That would effectively mean that many major banks are insolvent "zombies" that will be incapable of making positive contributions toward global economic recovery.

Composite Housing Affordability Index



Source: National Association of Realtors/Haver Analytics

Chart 4: Housing has become dramatically more affordable recently. Lower prices and record low mortgage rates should help U.S. home prices bottom out sometime around mid-2009.

Accordingly, many influential commentators continue to argue for aggressive programs of bank nationalization. Those who combine a high degree of self-regard for their gift of prophecy with a limited appreciation of financial history also argue for imposing severe losses on bank debtholders – even if that risks another shock larger than Lehman's bankruptcy. Some bolster such arguments with theoretical calculations that suggest repairing the health of the global economy and financial system would require short-term interest rates of negative six percent. In a world where interest rates cannot fall below zero, the argument is that bank nationalization is the only viable option.

In contrast, supporters of the Obama administration's current policy believe that there is a viable substitute for negative interest rates, even if it has the politically unpalatable effect of making financial institutions profitable again. This policy involves massive quantitative easing combined with targeted measures to boost risky asset prices (and lower risky loan rates, most notably mortgage rates). In every other postwar business cycle, massive Fed easing has accomplished this goal through reductions in short-term rates that steepened the yield curve. Such interest rate cuts temporarily penalized savers, but such policies also permitted financial institutions to effectively mint money by borrowing short-term funds at low rates and using those funds to make loans with very generous margins.

In the colourful words of the late economist Hyman Minsky, this process historically permitted "parades of walking zombies" in both financial and non-financial sectors to wake from the dead and enable a resumption of economic growth. Specifically, successful implementation of the Geithner-Bernanke reflation plan should mean a virtuous circle by which bank writedowns are replaced by asset price markups, while downward revisions to economic growth are replaced by upward revisions, and so on. Unless derailed by further political shocks, we believe the global economy is close to a "Minsky moment," where the process of financial shock therapy will have its desired effects. And the more central banks that join in this process, the higher the likelihood of success.

If we are correct in this assessment, it means that stocks should outperform bonds, inflation fears will replace deflation fears, currencies of the most aggressive central banks will weaken relative to the laggards, while all currencies may weaken relative to gold and other commodities. If we are incorrect, then hopeful comparisons of the Obama Administration to that of Franklin Delano Roosevelt may be replaced by more dour comparisons to that of Herbert Hoover. Against that rather binary assessment, in our portfolios we are emphasizing companies that will enjoy operating leverage from a global economic recovery, but have the balance sheet strength to survive deeper and more protracted recession.

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