Amphetamine Rush?

The American Economic Association tried something different this year at its annual meeting. For the first time ever, the dismal science sponsored a humour forum, which featured a "standup economist" named Yoram Bauman of the University of Washington.

Amid numerous serious talks about the global financial crisis, Dr. Bauman's humorous monologue added a worthwhile biological perspective:

"If I had to pick an animal to describe the U.S. economy right now, I'd have to go with the hamster – like a real tired hamster that's been running around its cage for seven years. Right now, it's exhausted. As a microeconomist, I would say that the hamster needs some rest. Macroeconomists, of course, look at the hamster and say it needs some amphetamines. … I'm sure they're right about the hamster needing amphetamines, but all I can say is that in two years that is going to be one ugly-looking hamster!"

We have all been stretching for metaphors to try to understand this complicated crisis, and the "hamster on amphetamines" metaphor seems as good as any other. This is particularly true now, as markets appear to be at a crossroads, trying to decide whether the extraordinary policy responses to the crisis will yield an extraordinary response, or whether the "exhausted hamster" will stumble badly.

We have taken the optimistic view that extraordinary and unprecedented policy measures had the potential to yield unprecedented results. Accordingly, we are happy to look back at many signs of economic and financial market improvement over the last three months. Not only have global stock markets rallied by more than 40% since early March, numerous other financial indicators have shown dramatic improvement in credit markets as well.

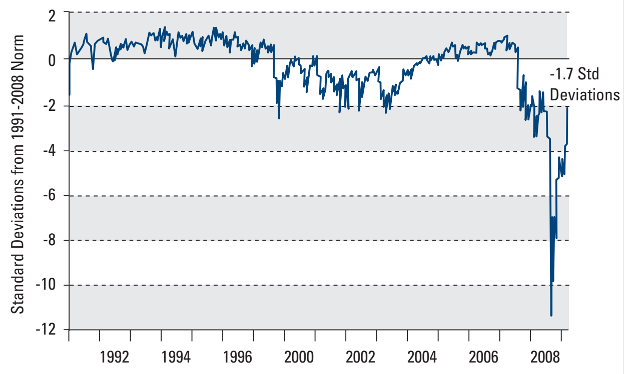
Financial conditions back to "pre-Lehman" levels

Since the recent crisis originated in credit and money markets, we have paid particular attention to an overall measure of financial conditions called the Bloomberg Financial Conditions Index. This index tracks the overall stress in the U.S. money, bond, and equity markets based on a weighted average of 10 financial indicators. It is meant to assess the availability and cost of credit in financial markets and to indicate how broad financial market trends are likely to impact the real economy.

The Bloomberg Index now documents a dramatic V-shaped recovery in financial conditions, with the overall index having experienced an improvement of nearly 10-standard deviations from the low point last October. As shown in Chart 1, financial conditions have more than recovered the ground lost following the Lehman collapse, with the Index

V is for Victory

Bloomberg Financial Conditions Index returns to pre-Lehman level

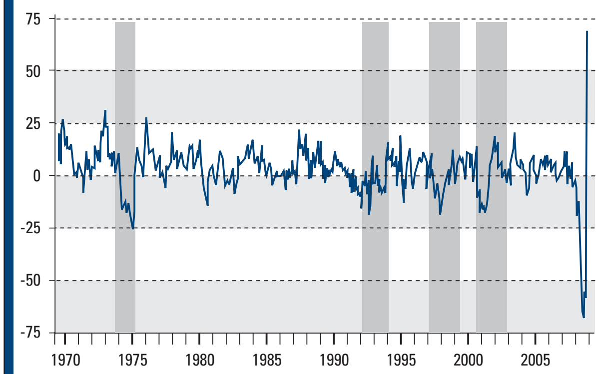


Source: Bloomberg

Chart 1: The slew of policy measures from the Federal Reserve and other central banks has engineered a V-shaped recovery in the Bloomberg Financial Conditions Index for the U.S.

Japan: Industrial Production: Mining & Manufacturing

3-month %Change, seasonally adjusted annual rate



Source: Ministry of Economy, Trade & Industry/Haver Analytics

Chart 2: Japan's industrial output has risen at nearly a 70% annual rate in the three months to May, although the absolute level of output remains extremely depressed.

rebounding from 11.5 standard deviations below normal last October to only 1.7 standard deviations below normal as of mid-year.

To be sure, many markets have not fully recovered and global equities are still nearly 40% below their peak of October 2007. But the slew of policy initiatives pursued by global authorities, including capital injections into banks and bank debt guarantees, have apparently gained considerable traction in returning money and credit market conditions to some semblance of normality.

Even the VIX Index of U.S. equity volatility has returned to a quasi-normal level of 25%, compared to its long-term average of about 20%. Commodity prices have recovered by about 30% since last December, as inflation expectations have normalized as well. Long-term break-even inflation rates on inflation-protected government bonds have generally returned to close to 2%, which is the presumed target of many central bankers.

Will global growth surge in the second half?

The key question now is whether the dramatic, V-shaped improvements in financial conditions will lead to equally dramatic improvements in global growth. We think the answer to that question is most likely yes, which could set the stage for a virtuous circle of further improvement in financial conditions and in the growth outlook. That begs the question of whether the growth response is just the equivalent of an "amphetamine rush," which could still leave us dealing with "one ugly-looking hamster" two years from now. The answer to the second question may be yes as well because of the well-known debt excesses of the U.S. and other developed nations. For the moment, we will leave the longer-term analysis to another time.

Interestingly, one description of an amphetamine rush is "an abrupt awakening." Although global equity markets began to rally in March on rather slim evidence of "green shoots" of growth, there seems to be increasing evidence of an abrupt awakening of economic activity in many parts of the world in recent months. In a June 26 comment titled "Fasten your seatbelts, industry is ready to take off," J.P. Morgan's global economics team said:

"Indeed, the rapid rise in the J.P. Morgan global PMI survey and the rebound already under way in Asian output suggests that a synchronized recovery in global activity is now taking hold. We expect this recovery to take off with a bang. Global industry is projected to retrace roughly one-third of its recession losses by the end of the year, a development that would produce roughly 8% annualized growth during the second half of 2009, rivaling the fastest pace of output gains during the past two decades."

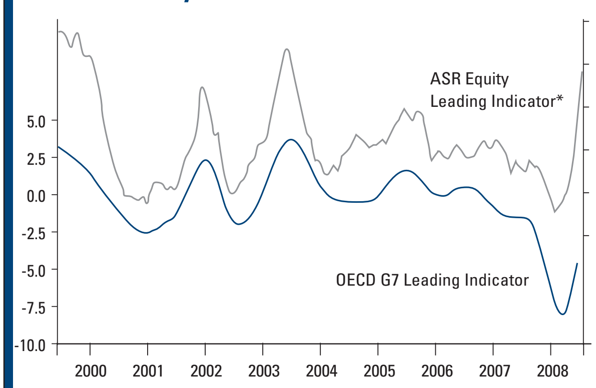
The J.P. Morgan report points to evidence that production across Asia is on track to rise at a 30% annual pace for the second quarter, far and away the biggest increase in its 15-year data series for the region. A case in point is Japan. As shown in Chart 2, Japan has seen its industrial output recover at an annualized rate of nearly 70% in the three months to May following a violent downturn late last year and early this year.

The basic story, as we discussed last quarter, is that output had declined so dramatically relative to final demand that the stage was set for a rebound in output based on inventory restocking. Since inventory dynamics are capable of producing pronounced swings in business cycles, it is not surprising that the inventory dynamics have been most striking in what has become the workshop of the world, namely Asia.

Consensus forecasts for the U.S. economy are still "U-shaped," with negative growth in the second quarter followed by annualized growth of only 0.5% and 2.0%, respectively, in the third and fourth quarters. However, in our opinion, the stage could be set for significant positive surprises if the medication provided by fiscal and monetary policy continues to help stabilize consumption and credit market conditions.

One interesting straw in the wind with respect to the third quarter in the U.S. has been a report from Ward's Auto research service projecting third quarter output of 7.5 million vehicles, as both Chrysler and GM exit bankruptcy and Ford increases production. That would follow a very depressed output level of 5.1 million vehicles in the second quarter. Now do the math: Output of 7.5 million units would represent a 375% annualized rate of increase in the third quarter for a sector that represents about 2% of GDP. That would imply a 7.5% annualized contribution to GDP growth in the third quarter from that sector alone, suggesting more than a bit of risk to consensus forecasts of near-zero growth in the third quarter.

Equity Market Price Signals Point to Global Recovery in 2009 Second Half



Note: ASR Equity Leading Index is based on a long-short basket of global stocks positively and negatively correlated with 6-month changes in the OECD's G7 leading indicator.
Source: Absolute Strategy Research

Chart 3: According to Absolute Strategy Research, the internal price action of global equity markets this year is pointing to a global economic recovery.

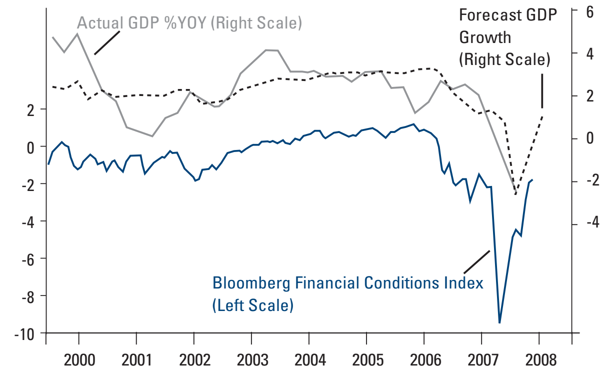
Elementary calculus: second derivatives matter!

We could point to a variety of other evidence suggesting that the odds of a V-shaped recovery are rising for the second half of this year. For example, David Bowers and Ian Hartnett of London-based Absolute Strategy Research (ASR) have screened global markets for stocks that are most positively (and negatively) correlated with six-month changes in the OECD's leading indicator for the G7 economies. The performance of a long-short basket of those stocks can be viewed as a real-time "leading indicator of the leading indicators" based on what the internal action of global equity markets is saying about prospects for global growth. As shown in Chart 3, the ASR index has risen by nearly 80% as of mid-June, suggesting a big improvement in the G7 leading index series in coming months (the latest OECD data is from April 2009). ASR's finding should not be too surprising to market observers who have seen cyclical sectors like information technology and consumer discretionary lead the way this year in global markets, along with resource-sensitive emerging markets.

Likewise, we have done our own statistical exercises using the Bloomberg Financial Conditions Index as a leading indicator for growth, and found that it is consistent with the U.S. posting at least one quarter with an annualized growth rate in excess of 8% – i.e. well above consensus expectations. Chart 4 shows the historical relationship between the Bloomberg Index and year-over-year real GDP growth in the U.S., which would seem to be pointing to a V-shaped recovery.

But enough statistics. What is the story that could justify stronger-than-expected global growth? In our view, there are two relevant stories, both of which involve mind-numbing considerations of "rates of change of rates of change," also known as second derivatives.

Will a V-Shaped Recovery in Financial Conditions Lead to a V-Shaped Recovery for the U.S. Economy?



Source: Bloomberg, U.S. Dept. of Commerce, Trilogy Global Advisors

Chart 4: A simple model of U.S. GDP growth based on the Bloomberg Financial Conditions Index implies much stronger growth this year than called for by consensus forecasts.

We have already touched on one story based on second derivatives – inventories. Inventory levels are measured as stocks, and it is the change in those stock levels that is registered as a flow item in national accounts. When thinking about growth rates, it is the rate of change of the rate of change of inventories that matters for GDP growth accounting. Somewhat counter-intuitively, even if firms are destocking their inventories, it counts as a plus for GDP as long as they are doing it at a slower pace than the previous quarter. If firms move from destocking inventories aggressively to restocking inventories, it can count as a big plus for GDP growth – which is what appears to have happened in Asia in the second quarter.

Another second derivative story has to do with consumer de-leveraging. When consumers took fright after the Lehman collapse amid warnings of Armageddon from top officials, they attempted to pay down debt as rapidly as possible, causing an unprecedented spike in the personal savings rate in the U.S. The savings rate rose from a low of 0.8% last August to 6.9% in May of this year, amid expectations that it was soon headed to 10% or higher. That had a devastating impact on imports into the U.S. and the entire global supply chain.

In a sense, the job of the U.S. Federal Reserve was to relax financial conditions quickly enough to prevent the savings rate from heading immediately to 10% or 12%. That would be to prevent what John Maynard Keynes called “the paradox of thrift,” whereby everyone tries to save at the same time with disastrous results – and lower savings as the outcome. We suspect that the next stop for the U.S. savings rate over the next six months is toward a lower, not higher level. That should provide at least a temporary positive boost to growth. In other words, if consumers continue to de-leverage (i.e. save money to pay down debt), but do so at a materially slower pace than during panic conditions, the result can be a sharply positive boost to GDP, at least for several quarters. It’s the second derivative – the rate of change of the rate of change of consumer debt – that will matter for growth.

In the longer term, we still have to be concerned that the exhausted hamster, which has experienced a sudden amphetamine rush, will have some serious issues to deal with. In the case of the U.S., that will involve a tricky process of de-leveraging in the aftermath of both consumer and government debt excesses. But we believe that unprecedented policy measures are likely to bring about unprecedented economic outcomes. And that suggests that the risks to global growth, corporate profits, and equity markets remain to the upside over the balance of 2009.

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