CORE Comments
ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

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Slow Growth but Strong Stocks: What Gives?

By

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On the last trading day of March, the S&P 500 set a new closing record, exceeding the previous high set in October 2007, just before the terrible banking crisis ushered in a serious recession and a huge bear market. Although that recession long ago came to an end in the US, economic recovery continues to be weak, with frustratingly slow improvement in the jobs market.

Fiscal austerity and monetary liberality. Taxation and spending policies by most of the governments of the 'developed' economies (i.e., Japan, the Western European countries, Canada, the US and Australia) have mostly fallen into the thrall of theories about the virtues of fiscal austerity, generally involving higher taxes or lower government spending or both. The calls for austerity have arisen in the context of higher government deficits. Deficits increased, unsurprisingly, in the financial crisis and recession as government tax revenues fell while the demand for unemployment insurance and other social spending rose. As a consequence of the loss of jobs and the declines in the values of homes and stock portfolios in the crisis, the private sector--that is, people and businesses--cut their own spending and increased their savings in an effort to rebuild their diminished assets. As the private sector cut spending and increased savings, the overall economy would necessarily shrink unless government spending took up the slack.

In Europe and among many in the United States, the government deficits--arguably entirely necessary as a response to private sector retrenchment--were considered quite alarming; clamor to cut government spending arose. The situation in Europe has been complicated enormously by the regime of the single currency. In the Euro-zone, the various calamities in Spain, Portugal, Italy, Greece, Ireland and Cyprus required support of the creditor countries of the Euro-zone, led by Germany. The German approach has been to impose fiscal austerity on these countries--higher taxes and sharply reduced government spending--as the price for loans. The cost to the 'peripheral countries' has been ever higher unemployment and contracting economies.

The United States has had less of fiscal austerity than Europe. However, the belief in austerity among Republicans is powerful; Republicans have used their control of the House to thwart Obama administration proposals for various kinds of spending and investment to ameliorate the contractionary effects of high private sector saving.

The countervailing force against fiscal austerity is the easy monetary policy of the major central banks, the Federal Reserve (Fed), the Bank of England, the

European Central Bank (ECB) and, most recently, the Bank of Japan (BoJ). The central banks have engaged in distinct acts: cutting short-term interest rates close to zero, buying government and mortgage-backed securities, and promising to maintain these policies until certain economic targets (e.g., lower unemployment rates in the US) have been met. (In the case of the ECB, it has made a contingent promise to buy unlimited amounts of the bonds issued by troubled countries, but has not yet had to act on the promise.) The Fed has generally been the leader in these actions, but the ECB and the BoJ have in the last year taken dramatic actions with very salutary effects on financial markets.

High levels of private savings, low demand for private capital investment, and zero rates on short-term fixed-income investments have driven capital into investments in stocks and long-term bonds. Thus, despite recession in most of Europe and tepid economic expansion in the US, stocks and bonds have rallied.

The ECB and the BoJ. We have written about the ECB's promise last year to do 'whatever it takes' to preserve the Euro. Before that undertaking, investors were (quite reasonably) obsessed with fear that another financial crisis, akin to that occasioned by the Lehman bankruptcy, would arise from the Euro-zone crisis. As markets absorbed the ECB promise, the fear of systemic collapse in the financial sector gave way to the realization that the ECB would prevent such a crisis. What has followed is an environment with low risk, low growth and central bank assurances of easy monetary policies for a very long time.

The new Japanese government of Shinzo Abe and the new leadership in the Bank of Japan have lit a fire in Japan after two decades of deflation and stagnation. Last week the BoJ announced a program of asset buying on a scale proportionally greater than that underway by the Fed. The explicit target for the BoJ is inflation at 2%, a very far cry from the persistent deflation of the last many years. Japanese stocks have soared in price in recent months (up by more than 40% since Abe made his intentions clear), while the always too-strong Japanese yen has been crumbling (down by 22% since September against the dollar).

The interplay of fiscal drag with radical monetary policies. It is certain that the actions of central banks are distorting markets by driving capital into riskier assets. The distortion is that these riskier assets--including stocks, corporate bonds, and other relatively high yielding securities--appreciate in price more than warranted by underlying economic activity. The aim of the central bankers is that the 'wealth effect' of higher asset prices will translate into greater economic activity and offset the economically depressing effects of fiscal austerity. It is not at all clear that economies are stronger because of central bank actions. But I suspect that, without the assurances of Mario Draghi of the ECB to do 'whatever it takes' and without the ongoing asset purchase programs, economies would be weaker than they are. Moreover, without the programs, it seems certain to me that stock and bond markets would be much more volatile and much lower in price than they are now.

Since January, Core has built a fairly large position (for equity-oriented portfolios) in a fund that invests in Japanese stocks and hedges away yen exposure. Hence, the fund delivers to us Japanese stock market appreciation without the drag of the sharply falling yen. This has been a good investment for us, as have a number of others. Both equity-oriented and fixed income portfolios we manage enjoyed a very healthy first quarter. Hats off to Messrs. Draghi and Bernanke and their colleagues.

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