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Economic Review

By Andrew Hunt

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The turning point

Picking the turning point in an economic cycle is always a task that is fraught with difficulty. Modern economic cycles often appear to extend for longer than may appear rational, while the house price and financial asset price booms that often support the upward phase of any cycle frequently achieve un-dreamt of heights before turning downward. Most forecasters expected the US economy to peak either in late 2004 or early 2005 but, as it transpires, the nine months from mid 2005 until March-April this year recorded remarkably resilient growth rates, particularly if one makes allowance for the effects of the hurricane damage in the Southern States. During this period, and despite rising short term borrowing costs and stagnant inflation-adjusted wages, US households continued to draw down on the equity within their homes and to use the resulting cash flow to finance further strong spending and a further drop in their already low savings rate. Indeed, even during the first quarter of this year, households continued to withdraw equity from their homes even as the housing market began to cool.

We would argue, however, that this continued equity withdrawal, which has laid at the heart of US consumer resilience, was only made possible by the continued buoyancy of the US long term debt markets. The oft-noted "Greenspan Conundrum" of 2004-5 was that, despite rising official interest rates, rapid rates of economic growth, and huge issues of government, corporate and asset backed bonds, long term interest rates (including mortgage rates) remained remarkably low. Hence, consumers were able to borrow at attractive longer term rates throughout 2004-5 despite the Federal Reserve's policy tightening.

We firmly believe, following a close scrutiny of the relevant data, that these low long term interest rates ("the conundrum") were caused by the actions of the world's major commercial banks. It appears that, whilst US short term rates were still lower than long term interest rates (as they were until recently despite the FOMC rate hikes), US commercial and investment banks were prepared to borrow large sums of money (effectively from the US central bank) for short durations and to invest the proceeds into longer duration debt securities, with the result that they were able to capture the favorable difference in yields. Meanwhile, in Japan and Europe, the relevant commercial banks were able to borrow at the record low official interest rates on offer in those areas and to either conduct the same "trade" in their domestic long term debt markets, or to finance their ventures into overseas debt markets.

These seemingly technical and esoteric transactions, colloquially known as the "carry trade", may seem at first sight to be relatively unimportant to many investors but, in reality, these types of transactions implicitly funded perhaps half of all the bond issues in the developed world last year. In essence, the world's commercial banks were "printing money" via their credit creation process and it was this money that flowed into bond markets and thus provided not only the low yields that allowed US (and other) consumers to ignore the Federal Reserve's higher short term borrowing costs, but which also provided the liquidity to absorb the US's massive mortgage

market, the financing for the abnormally large level of flows in emerging markets and even the late 2005 rally in equity markets.

What concerns us looking ahead, is that now that the Federal Reserve has closed the gap between short and long term interest rates in the USA, the US commercial banks have stopped their carry trade activities. Similarly, expectations of rising interest rates in Japan and Europe have led the banks in those countries to also halt their bond purchases, and we estimate that the synchronised withdrawal of the world's major commercial banks from the bond markets has removed roughly USD 2 trillion of liquidity from the global financial system. Consequently, financial markets have moved from a position of having surplus liquidity – which tends to propel asset prices upward – to deficient liquidity, which tends to depress asset prices.

For example, in Japan the withdrawal of the commercial banks from the Japanese government bond market has implied that households, pension funds and mutual funds have become responsible for financing the government's still large fiscal deficit. These "real money" institutions have proved equal to the task, but they have required higher yields to encourage them to fulfill this task and, significantly, they have been obliged to fund their bond purchases by selling down their equity holdings, with an obvious effect on the performance of the local equity market. Similar events have occurred in the USA and Europe. Therefore, despite signs of continued strong economic growth, financial markets have struggled over recent months, simply as a result of the drying up in banking sector liquidity growth that we have described above.

Looking ahead, we would suspect that market liquidity conditions will improve slightly in the third quarter, as net new bond issuance cools for seasonal reasons over the summer, but we would then expect liquidity conditions to deteriorate again in the fourth quarter as government bond issues re-accelerate and thus sap what liquidity there is from the markets.

In this environment, we would expect bond markets to be flat or weak over the summer, with equities tending to perform a little better. However, the outlook for the fourth quarter looks potentially challenging for both asset classes.

Regionally, we would expect European equities to tend to outperform on the back of the still vibrant European domestic economy. US equities are expected to set the global trend but cyclical plays, such as Japan and Emerging market equities can be expected to under perform as rising interest rates and the drying up of liquidity described above causes market participants to downgrade their 2007 growth estimates.

Certainly, we do believe that the fundamental shift in bond market conditions that has occurred over recent weeks will cause not just weaker financial markets but also weaker economic growth, largely through its impact on the all-important US mortgage markets. In time – and certainly by 2007 – the global economy will cool in response to these events but this will result in a welcome reduction in inflationary pressures.

Then, as inflationary pressures cool, we would expect the central banks to relax their

monetary policies in 2007. Thereafter, as short term interest rates decline, the commercial banks can be expected to re-enter the "carry trade" and thus reliquary the financial system, thereby sowing the seeds for a financial and economic recovery. ■

About Andrew Hunt

Sparinvest works with Andrew Hunt, independent economist of Hunt Economics. In his market comments he gives a precise and unreserved analysis of the economic development. As we at Sparinvest do not claim to be able to predict the economic trends, we pass on the market comments to illustrate the degree of uncertainty within the economic future, which at the same time emphasizes the importance of thoroughly diversified portfolios. ■

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