

Market Fundamentals Begin to Bite



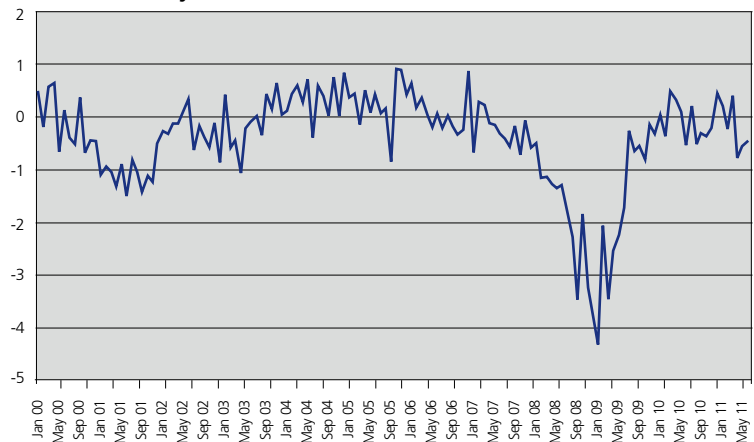
In the week ended August 14th, we witnessed the wildest market roller coaster ride since the collapse of Lehman Brothers in 2008. For me, there were few surprises as economic principles and market fundamentals began to bite.

Since the Lehman bankruptcy, I have argued that the best that the United States (and Europe) could hope for was a growth recession. Recall that a growth recession in the U.S. is one in which the economy's growth rate is positive, but below the long-term real GDP trend rate of 2.8%. Last week, the markets finally caught up with this gloomy reality.

One reliable metric that tells us what is happening is the Federal Reserve Bank of Chicago's National Activity Index. The index is a weighted

Chicago Fed National Activity Index

Last Data Entry: June 2011



Source: Federal Reserve Bank of Chicago

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average of eighty-five monthly indicators. A value of zero signals that the economy is growing in line with long-term trends. Positive and negative readings signal above and below trend growth rates, respectively. As the accompanying chart shows, the U.S. is firmly in a growth recession mode.

Many thought that the unprecedented Keynesian fiscal stimulus delivered by Washington, D.C. would create a boom. Not me. Indeed, I have argued that fiscal deficits of the magnitude we have experienced would create a crisis of confidence and put a lid on any economic snap back.

It turns out that the standard medicine prescribed by the Keynesians is little more than a fiscal factoid. This can be seen by comparing changes in the government's fiscal structural balance with the economy's output gap, where the output gap is the difference between the actual and the trend level of GDP.

In the accompanying table, the first column records the fiscal structural balance. When it is negative (positive), a fiscal deficit (surplus) exists. The second column in the table is the output gap. When the gap is positive (negative), actual output is above (below) the economy's potential. The third and fourth columns record the changes in the fiscal structural balance and the output gap, respectively. A negative (positive) change in the fiscal balance implies a fiscal stimulus (consolidation), and a positive (negative) change in the output gap implies an economic expansion (contraction).

If the fiscalists (Keynesians) are correct, we should observe an inverse relationship between changes in the budget balance (the third column of the table) and in the rate of growth in output (the fourth column of the table). From 2001 through 2016, as projected by the International Monetary Fund, the U.S. economy does not behave in the way that Keynesians have asserted and proselytized. Indeed, the number of years in which the economy responded to fiscal policy in an anti-Keynesian fashion was more than double those in which the economy followed the Keynesian dogma.

What fiscalists fail to admit is that money

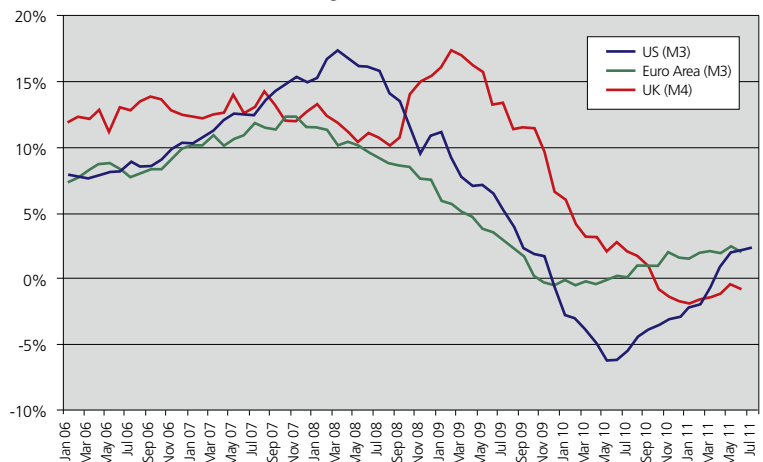
Do Fiscal Stimuli Stimulate? (United States)

	Levels of (as a % of Potential GDP):		Changes in (as a % of Potential GDP):	
	Fiscal Structural Balance	Output Gap	Fiscal Structural Balance	Output Gap
2001	-0.1	-0.4		
2002	-2.9	-1.5	-2.8	-1.1
2003	-3.7	-1.5	-0.8	0.0
2004	-3.2	-0.5	0.5	1.0
2005	-2.3	0.0	0.9	0.5
2006	-2.0	0.3	0.4	0.3
2007	-2.3	0.0	-0.4	-0.2
2008	-4.7	-1.8	-2.4	-1.9
2009	-6.8	-6.0	-2.0	-4.2
2010	-7.5	-4.8	-0.7	1.2
2011	-8.1	-3.7	-0.6	1.1
2012	-5.7	-2.7	2.4	1.0
2013	-4.4	-2.0	1.3	0.7
2014	-4.3	-1.4	0.1	0.6
2015	-4.8	-0.9	-0.5	0.5
2016	-5.3	-0.4	-0.5	0.5

Sources: International Monetary Fund, *World Economic Outlook*, April 2011 and Author's Calculations. Notes:

1. A negative (positive) change in the fiscal structural balance implies a fiscal stimulus (contraction).
2. A positive (negative) change in the output gap implies an economic expansion (contraction).
3. The output gap is the difference between the actual level and the trend level of GDP.
4. The fiscal structural balance is the difference between revenue and expenditure in a cyclically normal situation, with the business cycle midway between a boom and a recession.

Global Broad Money Annual Growth Rates



Sources: Shadow Government Statistics, Bank of England, European Central Bank and Author's Calculations.

Perspective

matters. Well, if money matters, why has the U.S. economy failed to boom? After all, the high powered money (monetary base) produced by the Federal Reserve has exploded since the Lehman collapse. The answer is shown in the accompanying chart of broad money measures. For the U.S., the rate of broad money growth sank like a stone and was contracting, until recently. The picture is similar for the United Kingdom and the euro area. And as broad money goes, so goes the economy.

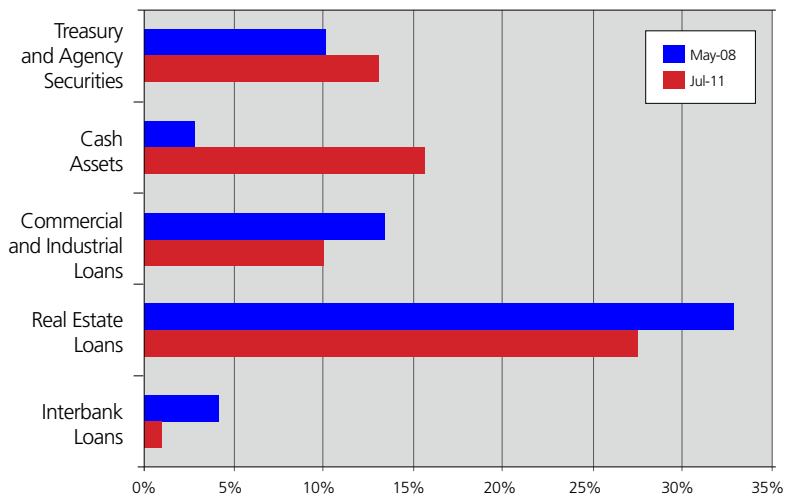
Why did the broad money growth rates collapse? After Lehman, the chattering classes seemed to start chanting on cue: the bankers did it. Instead of pointing their accusatory fingers at the real culprits – the world’s central bankers – the chattering classes came down hard on the commercial bankers (some who, in fact, deserve a trip to the woodshed). Never mind.

One who led the charge was Britain’s former Prime Minister Gordon Brown. In the prologue to his book *Beyond the Crash*, he glorifies the moment when he underlined twice “Recapitalize NOW.” Indeed, Mr. Brown writes, “I wrote it on a piece of paper, in the thick black felt-tip pens I’ve used since a childhood sporting accident affected my eyesight. I underlined it twice.”

It turns out that Mr. Brown attracted many like-minded souls, including the central bankers who endorsed Basel III, which mandates higher capital-asset ratios for banks. In response to Basel III (and Basel III, plus), banks have shrunk their loan books and dramatically increased their cash and government securities positions (both of these “risk free” assets are not covered by the capital requirements imposed by Basel III and related capital mandates). The bar chart for the U.S. tells that story and explains why broad money growth has been non-existent or anemic since the post-Lehman panic.

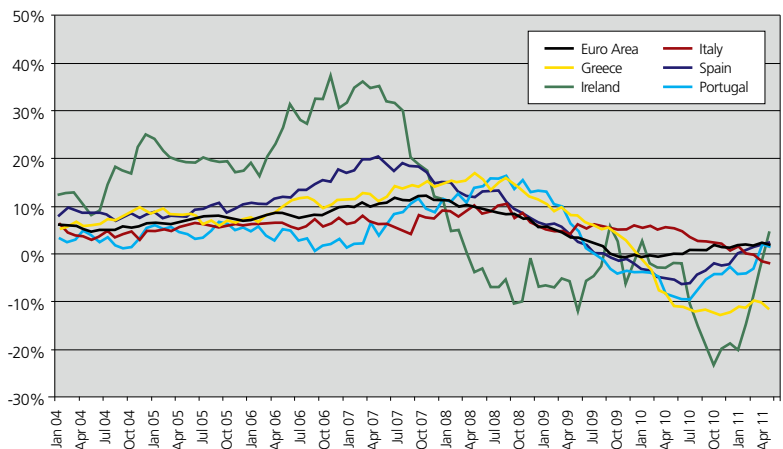
If we reflect for a moment on last week’s market upheaval in Europe, it is easy to realize why money matters (see the accompanying chart). All of a sudden Italy popped up on the markets’ radar screen, as it should have. Italy’s broad money (M3) growth rate had been drifting down and was at dangerously low rates, and then it started to contract. The economy will not be far behind. Slower growth in Italy (and all of Europe’s PIIGS) will knock those gloomy debt burden numbers being kicked around into a

Banks’ Flight from Risk
Holdings of Bank Assets at Commercial Banks in the U.S. (% of Total Assets)



Sources: Federal Reserve Board and Author’s Calculations.

Euro Area and PIIGS Broad Money (M3)
Annual Growth Rates

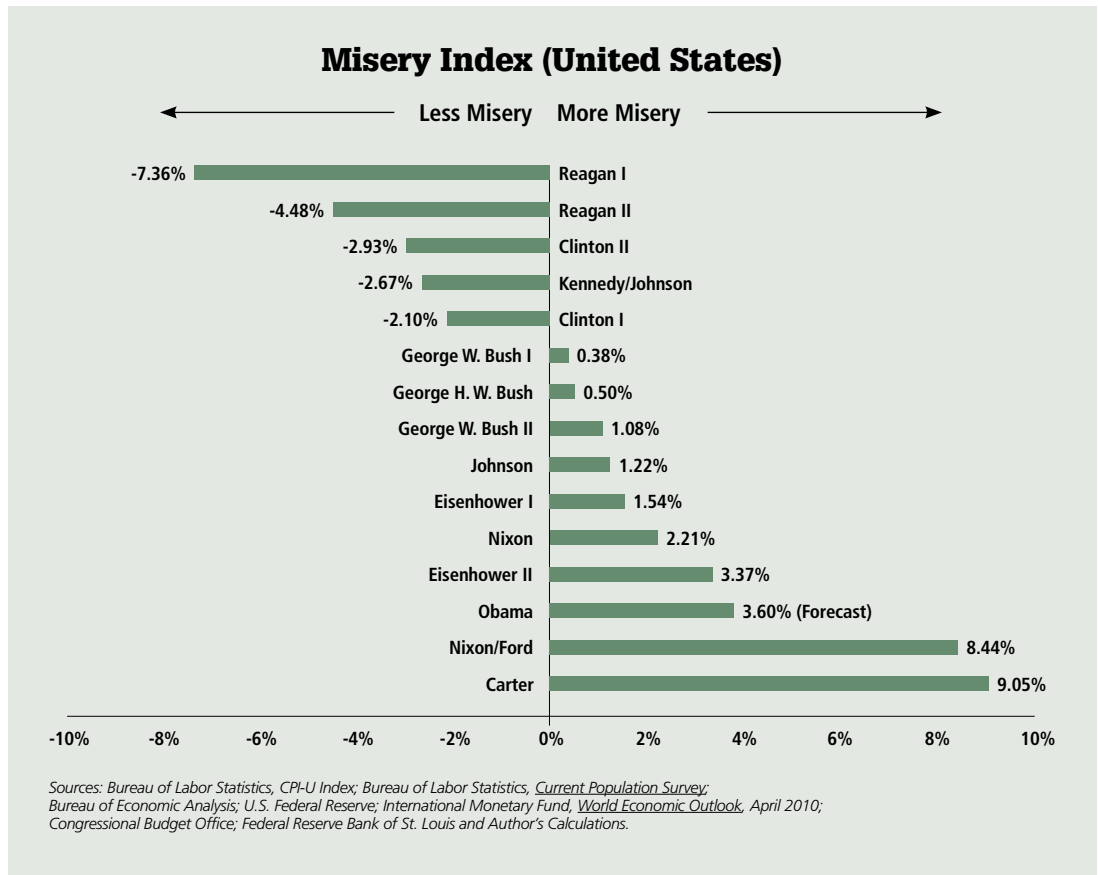


Sources: European Central Bank, Bank of Greece, Banca d’Italia, Banco de España, Central Bank of Ireland, Banco de Portugal and Author’s Calculations.

cocked hat. It is no surprise that the equity markets are nervous.

The same can be said for the political markets. With the volatile financial markets, we observed a plunge in President Obama’s approval rating. It is now at an all-time low of 39%. The President is vulnerable and he will remain so. We have known this since late 2010, when I estimated a Misery Index reading for the President.

The Misery Index (see the accompanying chart) is calculated by adding the difference between the average inflation rate over a president’s term



and the average inflation rate during the last year of the previous president's term; the difference between the average unemployment rate over a president's term and the unemployment rate during the last month of the previous president's term; the change in the 30-year government bond yield during a president's term; and the difference between the long-term, trend rate of real GDP growth and the real rate of growth during a president's term.

I have forecast what President Obama's most likely Misery Index score will be at the end of his current term. This miserable score is already baked in the cake and can be laid squarely at the feet of President Obama's own policy errors and government failure. For a president whose agenda is designed to overthrow the Reagan Revolution, the Misery Index should be a sobering reminder that free markets, not big government, generate prosperity.

What is an investor to do? In the U.S., those

who have followed conventional wisdom have been led down a road to ruin. That wisdom had them believing that over the long run stocks produce the highest returns, that a diversified stock portfolio protects you against loss and that the risk of owning stocks is small if you hold them for a long time.

Well, that conventional wisdom is wrong. While the number of decades in which equities in the U.S. underperform other asset classes may be small, the size of the shortfalls, when they occur, can be huge. For those who are near retirement, the shortfall is devastating; they might not get a shot at making up the loss in their lifetimes.

Diversification is useful, in varying degrees, most of the time. But there are occasions when all stocks dive simultaneously and putting your eggs in different baskets doesn't save you.

Like a broken record, the sages who peddle conventional wisdom are still telling young people to buy stocks because if you have a long time horizon, you do not have to worry about market fluctuations. While this sounds like a reasonable theory, it is wrong, even if you are young. The so-called experts fail to account for the potential severity of the underperformance when stocks fall.

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