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Economic Outlook

Wall Street Is Dancing Again

By John H. Makin

Wall Street is dancing again to the music of a sharp rise in stock prices. The question that remains is whether Main Street, currently languishing in a sad world of job losses, unavailable credit, and weakened balance sheets, will get to join the party. To put the question more precisely, will the "adverse feedback loop" that saw a financial collapse last fall that crushed the real economy work in reverse, so that a financial bounce boosts the real economy in coming quarters? The jury is still out on this important question.

The Bounce in Stocks

The music is playing again on Wall Street. Reminiscent of then–Citigroup chairman and CEO Chuck Prince's comment in July 2007 that when "the music is playing, you've got to get up and dance," U.S. stocks have risen by more than 50 percent from their March lows—one of the sharpest percentage increases since the Great Depression. Even Citigroup stock, which traded at about $50 a share in early July 2007, when Prince made the "dance" comment, is up more than 300 percent to about $4 a share from its March low of just below $1 a share. Like many other security-price bounces, the percentage increase from the floor is impressive but still leaves us a long way from the ceiling.

Asian stocks, led by the Chinese market, have risen by even more than U.S. stocks, and corporate bonds have been rising sharply as well. Even as Japan continues to struggle with deflation, its stocks are up by nearly 50 percent from this year's trough. Now the Obamaesque Democratic Party of Japan (DPJ) is taking over the Japanese government, promising better treatment for the middle class and less control by Japan's dour-faced bureaucrats. Japan also has a great deal riding on the emergence of a positive feedback loop since its economy is languishing while deflation accelerates.

I suppose one way to gauge the future path of this market would be to try to estimate or discern how many of the "new dancers" have been pushed into the market just because everyone else is dancing as opposed to being drawn in by the pleasing sound of the music, that is, by the economic outlook. My guess is that while earnings have helped, especially for banks where income statements look reasonably good as long as you ignore balance sheets, a hefty majority of investors have been pushed into the market. Those people will likely run for the door as soon as they hear a sour note from earnings reports despite the music pouring forth from equity sales boosters, most of whom really need a good year to remain in business. In fact, they need a strong year as much as President Barack Obama needs a health care bill to pass Congress. Without it, their economic future looks bleak. But just needing something does not always make it happen—just ask Richard Fuld and the folks at Lehman Brothers.

Right now, momentum and liquidity are driving more and more investors to ask themselves, why not get up and dance? "Too big to fail" is still a ruling concept, and while accommodative monetary policy settings and free money at zero percent interest rates have not helped banks start lending again, they have pushed them to buy more financial assets. The free money has been more than

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enough to push investors helter-skelter into stocks and corporate bonds with some Treasury notes thrown in for good measure. The much-touted collapse of the U.S. bond market, which was supposed to have accompanied soaring deficits, has not occurred, largely because private borrowing has virtually disappeared. Instead we have seen a surge in government borrowing that has been easily absorbed by global investors looking for safety and moderate returns. Falling inflation has helped by boosting real returns on bonds.

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The dollar is dropping, but that is just a sign that the United States is exporting a little deflation to our friends in Europe and Japan who are busy taking bows for not risking nonexistent inflation. At the Federal Reserve Bank of Kansas City's Annual Economic Symposium in Jackson Hole in late August, European Central Bank (ECB) president Jean-Claude Trichet took a bow for having boosted interest rates in August 2008 just before the Lehman Brothers collapse. The applause was tepid to absent.

Deflation Risks Grow

Few seem to have noticed that deflation is actually a bigger risk than inflation. Central bankers and financial amateurs do not see deflation as much of a risk. After all, they reason, if inflation is bad, then the opposite—deflation—must be good. That is like saying if overeating is bad then starvation must be good. If Keynes—now much lauded by many for having been the author of anti-cyclical policy—taught us anything, it is that deflation is really dangerous. Economies die from it just like people die from starvation. Just ask the Japanese, who are now well into a second decade of economic stagnation. Rapidly falling prices shrink the economic pie and make everyone want to hold idle cash, that is, avoid spending. A rush into cash is a recipe for lousy earnings that, in turn, will collapse today's highly inflated stock prices.

Perhaps the folks who are snapping up longer-term Treasury notes fast enough to push yields down by over half a percentage point in a month in the face of massive new supply are thinking that 3.75 or 3.5 percent on the safest asset you can buy will look awfully good, especially if inflation keeps dropping. For those who have not noticed, the core Consumer Price Index inflation rate (excluding tobacco and owner-occupied rent) is now rising at a rate of less than 1 percent, close to the low of 0.73 percent that prompted deflation fears in 2003. Meanwhile, the Taylor Rule on the Federal Reserve's website is calling for a –1.3 percent federal funds rate—about 1.5 percentage points below the current twenty-five basis-point level.

The Federal Reserve has cautiously joined the upbeat crowd, with Chairman Ben Bernanke declaring September 15 that the recession is probably over, while noting that the recovery will be tepid. Let us hope he is correct—at least about the recession being over. Recall that in August 2008, while the Federal Reserve was not joining the ECB and raising interest rates, its statement after the August Federal Open Market Committee meeting was more concerned about inflation than growth. That was probably understandable in view of the sharp run-up in energy prices that had occurred, but it also ought to serve as a cautionary note that the world can change very rapidly, as it did after the September 2008 Lehman Brothers collapse.

Negative to Positive Feedback Loop?

One of the big lessons we learned in the financial crisis (as discussed in last month's *Economic Outlook*) is that a rapid turn in financial markets can, through feedback loops, produce sudden drastic effects on the real economy in either direction. Yes, we all know the acute phase of the financial crisis that began last fall is over. The demand collapse it occasioned has moderated with help from massive monetary and fiscal stimulus applied globally. Producers have stopped cutting inventories and production has stopped falling, and, in a few places, there have been some sequential improvements. The most dramatic production boost has occurred, however, in the auto sector, in which substantial yet temporary government subsidies have helped clear out what had been large inventories of unsold 2009 models.

Likewise, in China an extraordinary fiscal stimulus on infrastructure and capital, along with monetary stimulus, have led the way in an effort to boost domestic demand sufficiently to produce 8 percent growth despite the collapse of exports. The Chinese effort will succeed, but the global impact will be deflationary, with the substantial

risks already noted. Building more redundant capacity in China may fit China's needs to absorb redundant labor, but it adds to global excess capacity at a bad time.

The pressure of excess capacity on the traded-goods sector was dramatized by Obama's imposition of 35 percent tariffs on U.S. tire imports from China. Citing a sharp drop in employment in the sector and a concomitant sharp rise in U.S. tire imports was all the president needed to do under the U.S. International Trade Commission rules in order to seek relief through higher tariffs. The fact that employment was falling in the tire industry because of a global economic collapse, while tire imports have been reduced by the movement of much tire production capacity to China, was not taken into account when the president undertook the risky initiative of imposing tariffs on China's exports at a time when China's export sector is very weak. We can only hope the protectionist initiative Obama has undertaken does not gain momentum, but in view of the negative pressure on many traded-goods industries in the United States and abroad, the chance of a cascade of protectionist measures has been substantially increased by his risky initiation of what usually turns out to be a negative-sum game.

In the United States, for the time being, a combination of government-sponsored mortgage financing and ongoing Fed purchases of mortgage-backed securities has stabilized the housing market at prices 35 to 40 percent off their highs. Beyond that, during the second quarter, tax cuts and rebates bolstered disposable income, although consumption still subtracted 0.7 percentage points from annualized –1 percent growth overall. During the third quarter, U.S. growth will be enhanced by nearly 4 percentage points because of a sharp reduction in inventory liquidation tied, in turn, to auto purchase subsidies. Overall growth should rise to an annual rate of 2.5–4 percent depending upon the contributions of net exports, government spending, and auto-boosted consumption as offsets to weaker investment. That said, Main Street is still hesitant. Subsidies for auto and housing have been necessary to sustain anything like positive growth and may be disappearing soon.

It is not clear what will sustain positive fourth-quarter U.S. growth as the boost from auto sales and fiscal stimulus fades. Optimists are counting on a rebound in consumption, which would require a lower saving rate given the extreme continued weakness in incomes and spending growth implied by weak labor incomes and cumulative wealth losses. Some of the optimists hope for enhanced support from net exports. That may be difficult to obtain given the rising global excess capacity in the traded-goods sector. The sharp rise in the U.S. trade deficit in July is an ominous sign.

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The strong application of policy-induced life support for global demand has resulted in sequential (month-over-month or quarter-over-quarter, not year-over-year) improvements in spending that, in turn, have led producers to boost output for sale in the fourth quarter. With no new demand stimulus, save for the hoped-for positive feedback loop from financial markets, it is not clear that we shall avoid a rebuilding of inventories by the end of the year. Beyond that, rising deflation pressure and falling core inflation rates in most countries portend a return of excess supply conditions in most markets.

Dance Close to the Door

This suggested outcome is gloomier than the consensus, but it is far from implausible. As already noted, the Taylor Rule section on the Federal Reserve's website calls for a negative federal funds rate tied to the rising level of unemployment and falling inflation rates, both symptoms of a weak real economy notwithstanding the strength in financial markets. Beyond that, the Fed's internal model to gauge quantitative easing measures calls for an expansion of its balance sheet to $4–$5 trillion from its current approximate level of $2 trillion. In other words, especially in view of the constraints on fiscal policy tied to massive debt accumulation, the next expansionary policy move, should it be necessary, would be a further expansion of the Fed's balance sheet. Targeting its federal funds rate "lower for longer" is the least the Fed will need to do.

Sustained growth—now widely assumed to be coming—will require a positive feedback loop running from steady improvement in the real economy back to continued increases in asset values and then back to the real economy. While such an outcome will eventually mark a return to sustainable global economic recovery, it may be premature to assume steady movement along that path is imminent.

So, get out on the floor and dance if you like the idea of owning more financial assets, but as a good friend recently said to me, "do your dancing close to the door."