Is The Stock Market Rally Sustainable?

- Inflation is an emerging market problem created in the developed markets.
- Equities are being boosted by factors other than fundamentals, which is fine.
- We invest and spend in nominal terms, it pays to stay invested and it costs to not be invested.
- Uncertainty prolongs trends, consensus ends them. Until bullishness reaches an extreme, the trend will continue.
- Its not useful to think of equities or companies along national lines. Most businesses are global.
- Developed markets have an intellectual property advantage. In trade wars, exchange rates are the first salvo. Intellectual property is the next.

Is the rally in risk assets sustainable? Central banks have held nominal rates at close to zero and thus real rates in negative territory and will keep doing so for the foreseeable future. At the short end they are able to unilaterally declare rates and at longer maturities, open market transactions allow central banks to cap rates using printed money. Fundamentally this is irresponsible behavior being highly inflationary. However, in a globalized world with open capital accounts ultra-loose monetary policy creates inflation not domestically in the weaker economies but abroad, in higher growth emerging markets.

To hedge against higher inflation, emerging market investors need to diversify by investing in developed markets risk assets, particularly the ones operating ultra-loose monetary policy.

Another phenomenon, which we have discussed before, is developed markets, particularly the US ability to generate and monetize intellectual property more effectively than most emerging markets. Falling energy costs at home and rising labor costs abroad are encouraging the re-shoring of manufacturing to the US helping strengthen the USD and reverse current account imbalances.

Another phenomenon supporting equities is the appetite for yield and thus bonds, fuelling high volumes of issuance. Companies are on aggregate issuing more debt to finance dividend payments and more importantly, share buybacks, reducing the float significantly. Institutional investors maintain highly stationary or constant bond to equity allocations and therefore reinvest the proceeds of capital repayments into the stock market further supporting equity markets in a virtuous cycle.

In the US, the housing recovery provides further support to the economy through the wealth effect. House prices are in their 7th month of recovery putting the recovery in its early days as house prices are typically serially correlated with strong momentum factors. The shortest housing bull run has been 6 yrs in duration. Rising house prices are the result of improved employment and wages, higher levels of savings and lower mortgage rates. They also result in improved home equity against which home equity lines of credit can be drawn driving consumption and retail sales.

Is it possible that the world has healed, has latched on to a new growth path, markets have stabilized and are in a new secular bull market? Well, yes and no. Problems remain. Mostly, these problems have to do with debt levels that remain stubbornly high, growth levels which are depressingly low, so much so that any moderate growth looks like a spurt, imbalances have been transferred from one place to another or transformed from one form to another.

Inflation is a problem. But not for the central banks causing it. It hurts those most frugal and it helps those most profligate.
Risk of the shadow banking system in China blowing up is not insubstantial.
The Euro continues to plague us by its existence.
Low interest rates make debt service highly convex and could lead to credit crunches in unexpected faraway lands.

In the meantime, however, we make money in nominal terms, not real terms. With inflation rearing its ugly head, particularly in emerging markets, it pays to invest in risk assets. Just not always those at home. In a globalized world, thinking of assets along national lines is not useful. One has to think as globally as the world.