Should We Take A Second Look at Japan?

Can the stock market rise when the economy is faltering? As long as monetary conditions are exceptionally loose, the answer is yes. But there are limitations.

Corporate profits in the US have rebounded from 2009 lows. GDP growth has recovered albeit not as robustly as one would have expected given the concerted effort of the Fed and Treasury to reflate the economy. It would have been very disappointing if profits did not recover and the stock market didn’t rise.

But now TALF, TARP, PPIP and QE have taken risky assets off private balance sheets onto public balance sheets. This has taken the form of direct purchases by the Fed, or purchases by Treasury funded by issuance of treasuries purchased by the Fed. In the last year, commercial banks began to load the boat with treasuries as well, as the yield curve afforded sufficient carry and roll down, a strategy which is very capital efficient under Basel rules. The resultant effect has been that risky assets such as MBS, ABS which were formerly in private hands are to a significant extent now in public hands. Private holdings of US treasuries has risen significantly. Alarmingly, public holdings of US treasuries has also surged. In the jaws of the crisis of 2008 I suggested a wholesale exchange between the government and the private banks of US treasuries for asset backeds. Its taken 3 years and an rather convoluted route but we are largely there. Where do we go from here?

The idea behind TALF, TARP, PPIP and QE was to stabilize the banking system, to encourage bank lending and to stimulate a moribund economy. If the Fed was exogenous to the banking system then the banking system is stabilized. Bank lending, however, has been slow to recover as banks have preferred to lend to the government. The economy has not recovered as much as would have been expected given the scale of stimulus. Under QE, nominal output in each market tends to grow. This, however, includes asset markets. Where output has been constrained, prices rose, implying inflation whether goods price or asset price inflation. Where output is not constrained, real output has risen. QE has worked to a certain extent but it has created acute inflation across goods and assets in unexpected areas.

Under QE, equities suffer, but they suffer far less than bonds which in turn suffer far less than cash, in real terms. As QE tends to be inflationary and debase the currency, gold and commodities did well. In nominal terms, everything rallies, except cash. For this reason we have seen a bull market in equities lasting over 2 years.

It is therefore not surprising that while emerging markets equities peaked in November of 2011, as they started raising interest rates to address inflation, and European equities drifted higher until February 2011 with the ECB maintaining a hawkish stance until it raised rates in April 2011, the US equity market barreled ahead shrugging off the Japan Quake, MENA revolution, high oil prices and sovereign debt crises in the Eurozone.

As we come to the end of QE2, which officially ends in June 2011, volatility has returned to markets in equities, commodities and credit. Markets it would seem are being required to stand on fundamentals once again.

While economic growth appears to have bottomed across the globe, although I would argue, possibly not in the US, the relative growth rates are divergent. Emerging markets are on a tear while Europe and the US are recovering less robustly. The fundamental equity trade therefore is to be overweight Emerging markets and underweight developed markets.

On top of this, the US is behind the curve in addressing inflation. The US breakevens have been rising steadily since Sep 2010 and still US inflation is underpriced in the markets. The ECB has been more hawkish to the alarm of peripheral Europe. There are limits to how vigilant the ECB can be even as European inflation picks up. Then we have India and China, countries which were very early in addressing inflationary pressures because the inflation was originating from commodities and in particular food which constitutes large shares of their consumption baskets. From the looks of things even though they were early in addressing inflation, the problem will persist and rates will need to not only head higher but stay higher for longer.

There is one country which could benefit from a bit of inflation, and which is currently engaged in quantitative easing. The earthquake, tsunami and subsequent nuclear crisis in Japan has required the BoJ to maintain and operate a policy of stimulus and quantitative easing. History has taught us to be skeptical of any recovery in Japan driving equity market recoveries. This situation is a little bit different. I argue for stronger equity markets in Japan because the economy is weak, the quake fractured more than rock and dirt, it fractured Japanese manufacturing. I argue that because of that weakness, the BoJ and the government will need to print more money and will need to spend more money to rebuild.