SRI-KUMAR GLOBAL STRATEGIES

From the desk of Komal S. Sri-Kumar, Ph.D.
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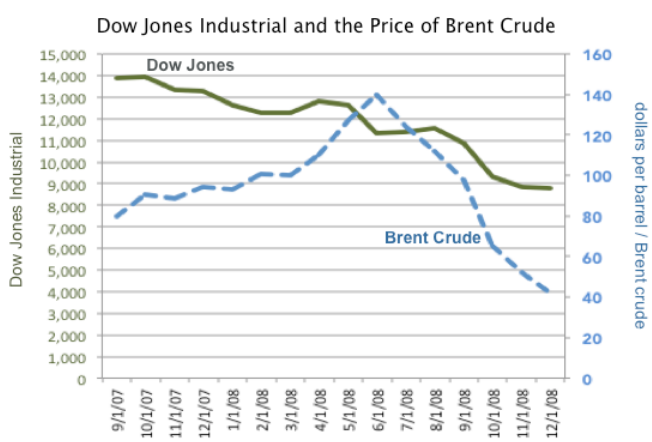
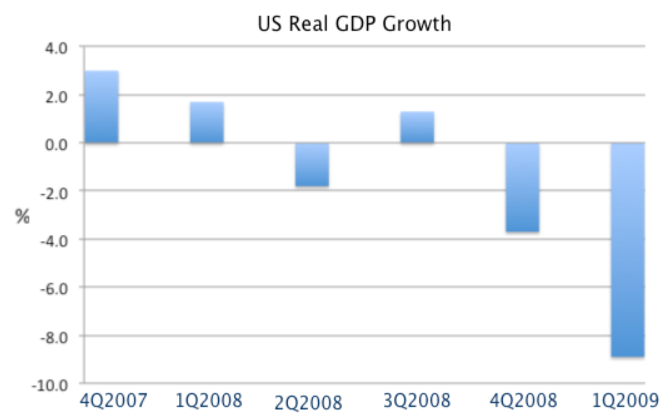
Markets and the Economy: The Ongoing Disconnect

Global equity markets have surged during the opening weeks of 2013 even as fundamental economic weaknesses persist. Are the markets suggesting that fears of a renewed economic slowdown are overblown, or do markets have a shortcoming in being an able predictor of future economic activity?

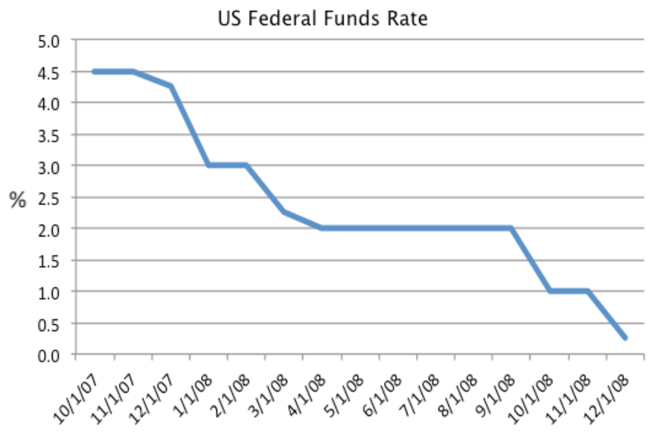
The recent disconnect between market strength and economic weakness led me to compare the current situation with November 2007 when I did a piece "Where is the U.S. Recession?" (attached separately.) My conclusion then was that despite temporary signs of strength, the US economy was likely to go into recession. (The National Bureau of Economic Research, the unofficial arbiter of US recessions, subsequently decided that the recession began in December 2007.)



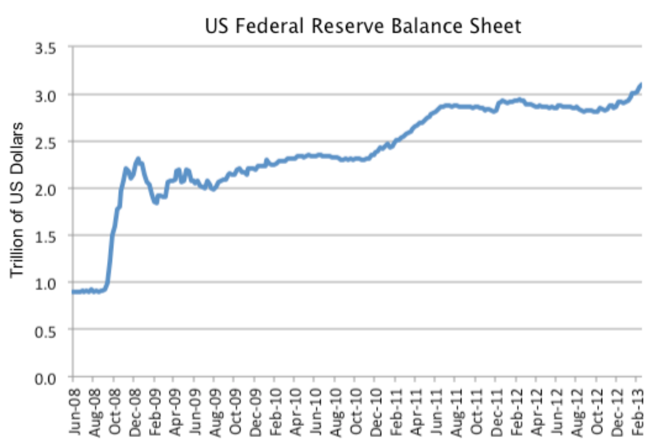
The recession call was not an easy one. The Dow Jones Industrial Average ranged between 13,000 and 14,000 in the final months of 2007, roughly where the index is trading now. And the surge in oil prices continued into mid-2008 - - when the US economy was already in the thick of recession - - to $135 per barrel for North Sea Brent crude causing a large investment house to project a $200 price as the next stop. The surging price of crude, and the still high equity prices, were seen by the consensus as a sign of global economic strength - - just a couple of months before the bankruptcy of Lehman Brothers, and a sharp contraction in US GDP.



The strength in equities and in the energy market in 2007 and 2008 could not prevent US real GDP growth from going deeply into negative territory - - a decline in output of almost 4% in the final quarter of 2008, and of over 8% in the first quarter of 2009. The easy money policy during the final years of the Greenspan Fed, and the reduction in the Federal Funds target rate to near-zero in late-2008 by the Federal Reserve led by Ben Bernanke, worked to delay the appearance of a recession but could not forestall it!



The Federal Funds target rate continues roughly at the same low level. With no sign yet of a strong economic recovery despite four years of low interest rates, the Federal Reserve's policy is focused on increasing its balance sheet through the purchase of bonds with newly printed money. The Fed's portfolio has more than tripled from $892 billion in June 2008 to $3.1 trillion this month. With planned purchases of Treasurys and mortgage-backed securities totaling $85 billion per month, the balance sheet will top the $4 trillion-mark by the end of 2013.



The Fed hopes that by keeping interest rates low, and by assuring growth in liquidity through repeated bouts of quantitative easing, it can discourage consumers from staying in near-cash assets. The released funds, in the Fed's expectation, would be directed at higher consumption and toward riskier assets such as equities, thereby helping the economy recover.

While the first part of the Fed's hopes has been met - - the market is up sharply since QE began at the end of 2008 - - the economy has yet to post robust growth after the sharpest recession in recent history. The immensity of the monetary easing has repeatedly delayed an economic downturn but, as in 2007 and 2008, cannot prevent it from happening.

And one final thought: In addition to its twin-mandate of economic growth with a manageable inflation rate, the Fed now has an unstated objective of keeping bond yields low. A sharp increase in bond yields, whenever it occurs, will both increase the US fiscal deficit and worsen the downturn.