

Economic Views for Investors

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29th January 2010

Virtually all markets have fallen in each of the last fifteen sessions!

Why have the world's equity markets fallen so steeply in recent weeks? Had the indices previously run ahead of fundamentals? Or were fundamentals not living up to expectations? Probably neither. The most likely explanation is that monetary conditions were being tightened.

That signifies tightened credit?

Many of us had not expected such a development. We'd argued that the fragile state of the world economy would stay the hand of the monetary hawks. They'd not dare mop up excess liquidity, we thought, until GDP growth rates had risen to something close to their potential.

Who done it? The Chinese, almost certainly.

It looks as if that reasoning may have been wrong. We paid too much attention to the sensibilities of the Fed, the BoJ and the ECB and too little to those of the PBC (China's central bank). It was probably the latter—its assessment of the risk of inflation rising, that of recession falling—that tightened the credit screw and withdrew the fuel that had previously been firing the enthusiasm of the investor.

Is there more to come?

Possibly. But the BoJ and ECB might loosen in compensation.

Will the PBC continue to act in this way and, if it should, how would other central banks react? Nobody knows the answer to either question, but a good deal is likely to depend on the economics numbers. If China's should stay as strong as they appear to have been recently, it's possible that the central bank will maintain its relatively austere posture. Equally, if Europe's and Japan's should stay as weak as they've been in the last few weeks, it's likely that the ECB and BoJ will stay accommodative; it's possible, indeed, that they'll loosen further to compensate for the Chinese tightness.

Currencies, in that event, will be very volatile.

In that event, it'd be currencies that bore the strain. The yuan would rise; the yen and euro fall. Is Beijing currently signalling its acceptance of that outcome? Does it see currency accommodation as the least bad of its unattractive options? Maybe so. It might think that a touch on the credit brakes will do more to contain bubbles than provoke crashes. It might calculate that enhanced levels of foreign direct investment, coupled with ambitious public spending programmes will lift activity by almost as much as tighter credit and stronger currency will lower it!

The euro is the most vulnerable of the majors.

Tokyo and Frankfurt will not demur. Both want to realign their currencies but aren't sure how to. They know that dollar exchange rates are irrelevant, but that yuan ones aren't (in the areas in which they specialise, competition from the US is mild; but from China, intense). Optimally, the yen might fall 20%, the euro 40%: the benefit to GDP being large (1%?); the detriment to inflation small (1/2%?).

Unsurprisingly, it's coming apart at the seams.

For Germany, of course, there'd be the additional advantage of lightening the burden imposed by peripheral members of the euro. Attention is focused at the moment on Greece, but the outcome there will set the precedent for difficulties in many other countries. Germany, the paymaster, will have to decide how it wants to play things.

Germany's attitude is crucial.

It knows that its generous rescue of the Eastern Länder took a generation, and permanently changed the economy's growth characteristics (from moderately fast to disappointingly slow). Will today's politicians be as selfless with non-German slackers? Will voters want them to be?

Whatever happens, though, Greece is due some misery.

Greece has two options: it can stay in the monetary union or it can leave. Neither is attractive. Staying, it sacrifices any remnant of political sovereignty or popular democracy (policy being set for it by Brussels bureaucrats and Frankfurt bankers; the preferences of voters counting for nothing). Leaving, it provokes a huge crisis (a sizeable devaluation, a re-scheduling of its euro-denominated debts; and an exclusion from international debt markets for a generation).

It'll be interesting to see how the cradle of democracy reacts.

In either event, of course, there'll be economics privation and political humiliation. Who'll be blamed? That's not clear. But the people who deserve to be are those who rushed through monetary union without a thought. Everybody knows that currency unions that are unassociated with political unions fail. Why, then, was the euro proposal allowed to go ahead? Why didn't the Parliaments (national or federal) control the Executive?

Indices will bounce again, but not yet.

Near term, investors are going to be scared. Indices will retreat. But valuations will recover as it is appreciated that money will stay fairly loose and profits quite strong.

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