

Macro: Equity Markets and Policy

In economic policy there is a difference of view between the US and the rest of the world. As Japan's largest trading partner the US is especially empathic to the deflation scenario that has plagued Japan since 1990. Therefore, US monetary policy is likely to err on the side of being too loose rather than vigilant on inflation.

Europe has a history of hyperinflation and is therefore likely to tighten sooner than might the US. The current focus on the health of sovereign balance sheets strengthens the case for a retraction of quantitative easing and expansionary fiscal policy.

The flexibility of the CNY is likely to reduce the demand for US treasuries and lead to a de linking between US and China monetary policy. China economic policy will be more hawkish on inflation than before.

All these point to the resumption of de risking that began in May that has led to falling markets and a rise in correlations.

This is all backward looking.

The economy and markets have reacted to the financial crisis of 2008 and the subsequent stimulus policies quite predictably. It rebounded and rallied hard as governments printed money thus debasing their currencies and inflating the value of real assets and future claims on the cash flows expected to be generated by real assets, and quite a little relief and hope.

We have seen in past crises like the one in Asia that post the initial decline, 100% rallies are possible and post those, 50% retracements are also possible. Equity markets are technically weak. They may strengthen over the next few weeks as corporate earnings come in reflecting 2Q financial results, but the trend is down. Earnings, however, are not the driver of markets. Liquidity and policy are.

There are many factors that can drive equity markets over time, but there is usually only one or maybe two factors that drive them at any moment in time. Equity markets are likely to continue to fall until weaker economic numbers prompt policy makers to revise their stance on fiscal rectitude and start printing money again. Who will go first? The US has not tightened policy. Australia, Canada and Norway, for example, have already been running tight monetary policy for some time, since 2009. China has been selectively reigning in leverage in particular sectors of the economy to prevent overheating. The commodity countries and Asia are unlikely to loosen policy again soon. The more likely candidates for reverting to expansionary economic policy are the Europeans on the basis that European economies are likely to be weakest.

Germany is exposed to exports to Asia; a more domestic centric China will impact European exporters. Domestic Europe remains weak and disconsolate. Unemployment remains high, balance sheet repair is slow. Spain is in a depression. Greece is insolvent. The PIIGs face a liquidity crisis. The outlook for Europe is poor. Able or unable, Europe will print money. Interest rates will remain low and if anything head to zero. Fiscal policy is constrained which will put even more pressure on monetary policy.

Europe is likely to be the first to resume printing. And the debasement of currency has as its dual, the inflation of goods and services, and assets.