

Economic Recovery, of Sorts

See my earlier article A Return to Boom and Bust, where I argue that product and asset markets will be driven by liquidity and leverage and monetary policy in the short to medium term due to the extraordinary circumstances we find ourselves in in the aftermath of the bursting of the great credit bubble. Monetary policy will be accommodative and reflationary to the extent that price and output must rise. That is the condition that central banks will target. The result? If I am right, then the following is likely to happen:

- Industries with ample spare capacity are likely to grow in real output terms, for example the auto industry. One would expect the top line growth in car sales to see robust recovery at the industry and company levels. Prices are likely to remain depressed.

- Asset markets are likely to continue to rise until central banks turn off the tap or signal that they will turn off the tap. Markets will thus be very sensitive to liquidity and policy and less so to fundamentals. Equity and credit markets are likely to continue their recovery. Given that fundamentals are unlikely to recover at the same rate, this will lead quickly to overvaluation.

- Real estate markets that are capacity constrained are likely to see robust recovery. Prime residential and office in major city centres are likely to recovery first and strongest. Areas where there is room for capacity growth will likely see that growth in capacity instead of price increases. Given that this is liquidity driven, it is unlikely that rental will rise in line. Rental yields are likely to see significant compression.

-Commodities which are capacity constrained are likely to see substantial price inflation. Oil and energy are examples of such markets. Commodity markets with spare capacity will see strong top line growth.

Economic growth will likely be supported by the aggressively reflationary monetary policy. However, in the short term, liquidity driven markets will lead to inflation in some product markets and overvaluation in many asset markets. The recovery will likely also be very sensitive to policy and to policy signals. Given the level of excess capacity in many industries and at the aggregate national levels, it is hard to see broad inflation. Energy costs could become a concern later in the year. The current rally in risky assets is likely to continue with news driven volatility as such news pertains to expectations about central bank policy. Fed watching will become important again. In 1Q 2009 I asked if inflating a credit bubble was the right response to the bursting of a credit bubble and argued that any recovery would end with the Fed once again taking away the punch bowl. Amidst dire sentiment at the time, I thought that a relief rally was likely and likely to be powerful but that it would not last. It has at least outlasted my expectations. The analysis was, in my view, correct. The conclusions I made then were looking too far ahead, seeking a bear case. But the analysis, in my view, remains. The downside risk from policy reversal is significant, since many asset markets have become or will become very much overvalued.

In the meantime, the trend is your friend. In equity markets for example, Mid June was crucial in that the market was consolidating and failing to break higher. By the end of June it seemed that the market had run out of steam. It didn't fall, however, but broke out on the upside. I have lots of fundamental views, but I don't argue with the market, and remain cautiously, if a little fearfully, net

long.