MAI VIEW

VOL. XVI, NO. XL www.macro-allocation.com AUGUST 11, 2016

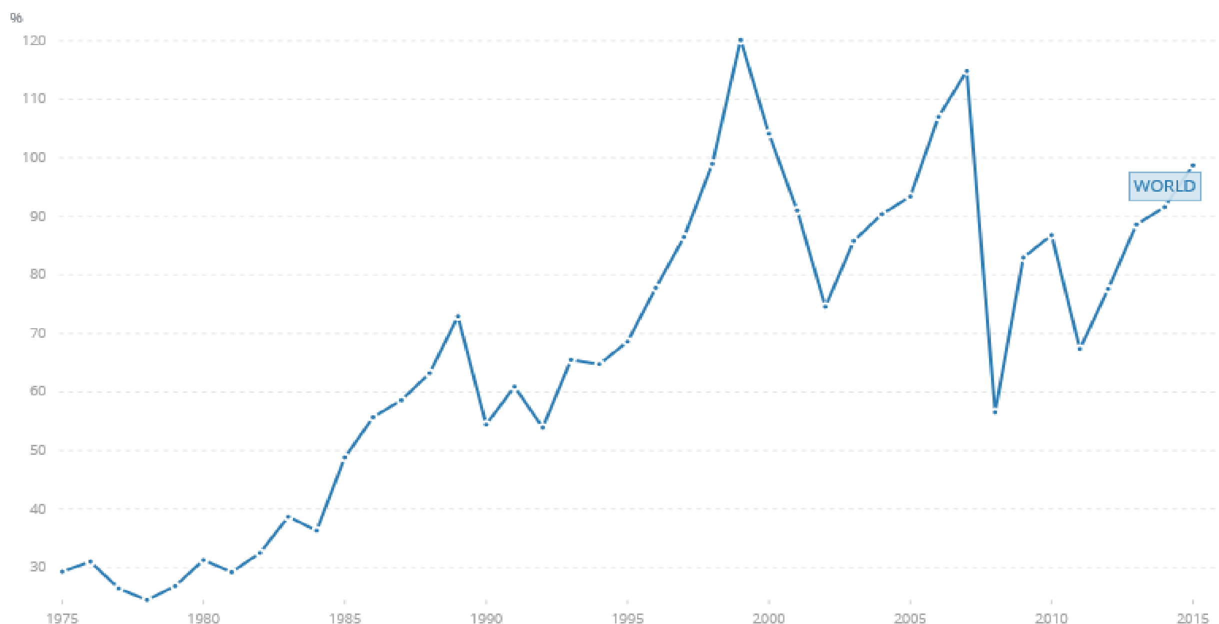
High Cotton

To hammers, everything looks like a nail.
To nails, life's a few hard knocks.
To hard knocks, all are destined to fail
All except markets, the ones with big flocks.

August in the northern hemisphere is a good time for market apathy and not terribly conducive to looking for trouble. Maybe at such times we should question everything and plan ahead; proceed as Noah did, not waiting for rain to build his ark. Or maybe there is nothing obvious to do now? Could the global equity markets accurately reflect serenity ahead? Objectivity demands consideration.

Graph 1 shows the value investors have placed on global stock markets relative to global output from 1975 to 2015 - effectively, how much we value the mechanism for capital formation and pricing (the market) vs. ongoing production that satisfies our needs and wants (GDP). The graph shows there have been a couple times we were more excited about the mechanism than the product, in 2000 and 2007, but on balance we still value the capital forming mechanism greatly. In fact, with the global market cap of equities at about 100% of annual global GDP today, we can conclude that investors are happy to value equities at 10-times annual sales.

Graph 1: Market Cap of Listed Domestic Companies (% of GDP) - World



Source: The World Bank

There are periods when 10-times sales might not prove overly expensive, say, prior to a period of great credit expansion. Is this one of those times? We do not think so and have cited many reasons why, most notably a balance sheet pre-condition of already excessive leverage and a credit-flow pre-condition of terminally-bottoming interest rates.

Table 1 shows how relationships between regional and national GDPs and their equity markets have developed over the years. Nothing too surprising. Equity market caps in the US, Japan, the UK, Canada, the Netherlands, Korea, Australia and France are highest relative to their output today, while the ratio of equity-to-production has risen most in China, the US, Japan and India. The winner and still champion is the US, where aggregate equity has grown an average of 2.5% more than production since 1975.

Table 1: Market Cap of Listed Domestic Companies (% of GDP)

	From		To		Annualized Change
World	29.3%	1975	98.7%	2015	1.7%
East Asia & Pacific	4.6%	1978	102.7%	2015	2.7%
Euro area	15.3%	1975	65.7%	2015	1.3%
Latin America & Caribbean	28.4%	2000	33.6%	2015	0.3%
North America	40.5%	1975	136.7%	2015	2.4%
OECD	29.2%	1975	108.0%	2015	2.0%
Argentina	1.5%	1977	11.0%	2014	0.3%
Australia	28.9%	1979	88.6%	2015	1.7%
Brazil	34.5%	2000	27.6%	2015	-0.5%
Canada	29.2%	1975	102.8%	2015	1.8%
China	31.1%	2003	75.4%	2015	3.7%
France	9.8%	1975	86.2%	2015	1.9%
Germany	10.5%	1975	51.1%	2015	1.0%
India	45.1%	2003	73.1%	2015	2.3%
Indonesia	32.9%	1995	41.0%	2015	0.4%
Italy	58.3%	1999	27.5%	2014	-2.1%
Japan	27.6%	1975	118.7%	2015	2.3%
Korea	7.7%	1979	89.4%	2015	2.3%
Mexico	0.5%	1975	35.2%	2015	0.9%
Netherlands	18.5%	1975	96.8%	2015	2.0%
Russia	62.3%	2009	29.7%	2015	-5.4%
Saudi Arabia	74.3%	2009	65.2%	2015	-1.5%
Turkey	20.3%	1993	26.3%	2015	0.3%
United Kingdom	35.5%	1975	106.0%	2015	1.8%
United States	41.7%	1975	139.7%	2015	2.5%

Sources: Macro Allocation Inc; The World Bank.

Such a distinction is not something to flaunt. The grand secular arbitrage has been to short commerce and buy finance. Diverging capital and output growth over a forty-five year period implies that either past "capital growth" was not actually capital growth at all, because it consistently surpassed production, or that the value of capital today is over-marked relative to the means of production that ostensibly uses it.

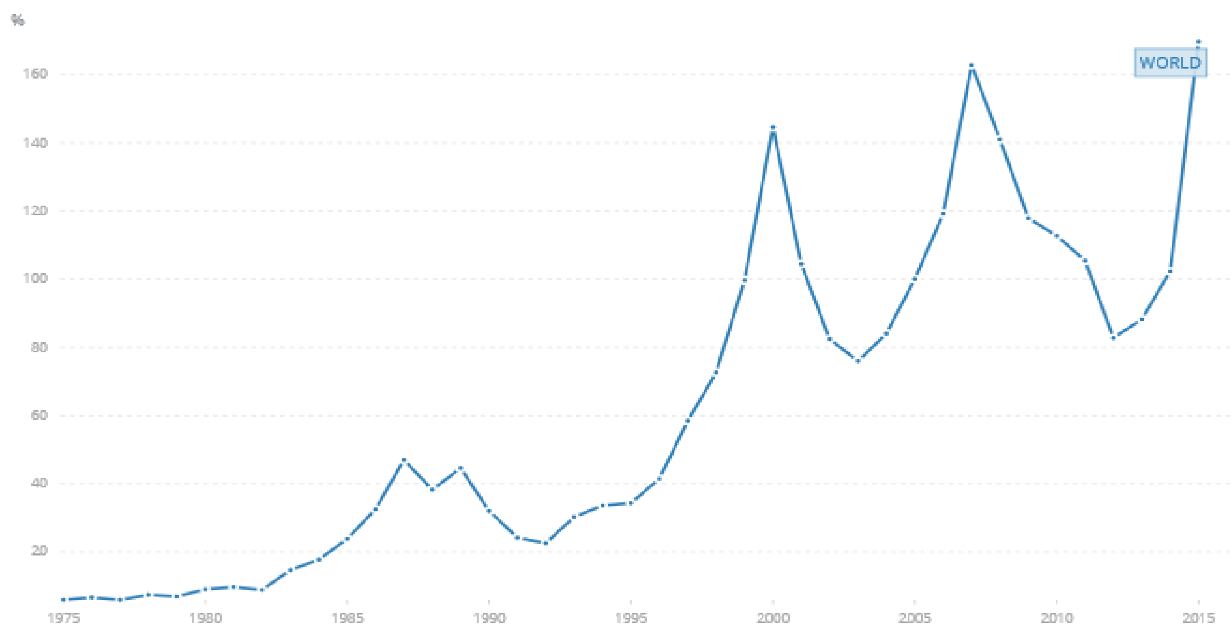
Looking forward, are capital markets that do not really form and price capital sustainable? Or, are we bound to recognize that borrowing to form capital that raises technologically-led productivity is the macroeconomic equivalent of borrowing to buy a depreciating asset like a car? We get what we want now, but it could not be more foolish if there is nothing to do with the savings we cannot reinvest at a higher return.

Guilty Obsession

The macroeconomic discussion above does not fascinate all investors as much as it does us. Wag-the-dog economics that values finance over commerce has long been a mistress of ours, a guilty obsession, a flirtation that would have been better left alone because…the joke's been on us. Markets remain central to how we perceive the strength of our economies and how economic policy makers judge their success. Equity markets seem to have become more a signaling mechanism than a means to form and price capital, and in politically-dominated world they are even less likely to fall for very long. Perhaps they will fall only when it useful to usher in change?

Graph 2 shows the ratio of stocks traded-to-GDP rather than the market cap of stocks-to-GDP in Graph 1.

Graph 2: Stocks traded, total value (% of GDP)



Source: The World Bank

In 2015 the level of stocks traded in comparison to GDP seemed to make new highs, eclipsing levels from 2000 and 2007. Both prior instances foreshadowed significant market declines. This does not, in itself, signal an imminent global equity market fall. The advent and new dominance of high frequency algorithm trading most certainly is having an impact on volume. However, we are suspicious that such high internal market participation combined with waning end-investor market enthusiasm and increasingly dubious global growth prospects may be signaling official open market operations meant to support equity prices.

Let us not be naïve: global central banks and Treasury ministries talk to each other constantly, officially and, we assume, unofficially. It has been long-established policy for monetary authorities to intervene to manage the exchange value of their currencies and to manage yields on their sovereign debt. How much of a stretch would it be to step in to support equity prices on which a major decline would signal economic peril? Are we to think the BOJ is the only major central bank to have begun qualitative easing by purchasing equity derivatives? If we look back, it seems the performance of the Japanese economy and the actions of the BOJ, rather than being products of an economic model not applicable anywhere else, has indeed been a solid window to the future for other over-leveraged developed economies.

And so it is the depth of summer and the livin' is easy. Catfish are jumpin' and the cotton is high. Underneath, there seems to be a churning, burning, turning angst already simmering among career world savers. The November US elections is increasingly looking like a heads-they-win, tails-we-lose prospect for investors… and economies. What a profoundly ideal event that would be around which a new hegemon political regime could call on governments to save the day and set things right. (Please don't shoot the massager. We only speculate on the future. The political dimension is not going away and its economic model everywhere has always been *to help break it and then fix it*.)

Before governments could "fix things", however, they would have to crystallize public opinion, and how better to do so than by letting equity markets trade freely to lower levels? (I speak more about this and other matters in a recent one hour taped interview here: http://www.zerohedge.com/news/2016-08-10/back-square-one-why-financial-system-needs-reset).

We could then await the onset of pedal-to-the-metal deficit-funded Keynesian infrastructure spending in the US and elsewhere. Zero-coupon perpetual bonds issued by treasury ministries and bought by central banks would fund the whole enchilada. Governments would have half of us dig holes and break windows so the other half could fill them in and repair them. We would be busy and sweaty. GDP would double. The unemployment rate would drop to negative 4% (can it do that?). Why not? Life would move on and systemic leverage would expand even more.

Or maybe we are approaching the end of the line? The final outcome is unknowable because there is never a final outcome. But there are predictable narrative arcs before new chapters begin.

Paul Brodsky
Macro Allocation Inc.

Property Notice & Disclaimer

This document was produced and is owned by Macro Allocation Inc. Copying, reproducing, modifying, distributing, displaying, or transmitting any of the contents in this document for any purposes without the express written consent of Macro Allocation Inc is strictly prohibited. Requests for copying, reproducing, modifying, distributing, displaying, or transmitting any of the contents in this document should be sent to pbrodsky@macro-allocation.com.

Unauthorized use of this document may give rise to a claim for civil damages and/or be a criminal offense. Your use of this document and any dispute arising out of such use is subject to the laws of the state of Florida, United States.

The information contained in this document is for general information purposes only. It is provided by Macro Allocation Inc to Subscriber/Members, and, while we endeavor to ensure the information is up-to-date and correct, we make no representations or warranties of any kind, express or implied, about the completeness, accuracy, reliability, suitability or availability with respect to this document or the information, products, services, or related graphics contained in this document for any purpose. Nothing in this document should be taken to constitute professional advice or a formal recommendation, and we exclude all representations and warranties relating to the content and use of this document. Any reliance you place on such information is therefore strictly at your own risk.

In no event will Macro Allocation Inc, its affiliates, and employees be liable for any loss or damage including, without limitation, indirect or consequential loss or damage, or any loss or damage whatsoever arising from loss of data or profits arising out of, or in connection with, the use of this document.

Through this document you may infer that other sources of information mentioned in it could provide suitable analysis related to issues on which you may act and suffer damages. Any mention or reference herein does not necessarily imply a recommendation or endorse the views expressed or implied by it.

Macro Allocation Inc reserves the right to revise and amend this disclaimer notice from time to time and any revised version will be deemed to be applicable from the first date of publication of this document.