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Nasser Saidi: Economics & Governance

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Animal Spirits Redux?

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A perverse and ultimately dangerous mentality is lately characterizing market reactions to macroeconomic news.

On November 6th, monthly data on US non-farm payroll recorded almost 200,000 jobs lost in October, while the unemployment rate reached a 26-year high above 10%, with little prospect of a significant improvement over the coming year. After an initial knee jerk reaction, a mood of euphoria prevailed the following week in global markets (particularly equities).

The explanation offered by traders and asset managers reveals the extent of "animal spirits' driving some if not all investment strategies. Market professionals are euphoric because the worse the economic news, the less likely it is that central banks and governments will withdraw emergency support and mop up the extraordinary liquidity injections required to save the bankers from the consequences of their own excesses. Chiming into this, the chorus G20 Ministers and central Bank Governors (backed by the IMF) stated: '*"the recovery is uneven and remains dependent on policy support, and high unemployment is a major concern. To restore the global economy and financial system to health, we agreed to maintain support for the recovery until it is assured.*" The bottom line is that we now appear to have a 'capture' of economic & financial policy decision making by those same financial institutions that few month ago were begging desperately to be spared the fate of Lehman, promising solemnly that they would behave impeccably from now on.

If this explanation accurately captures the short sighted reasoning behind the market rally since March 2009, it is clear that hard lessons are forgotten too fast in financial markets. In essence we are witnessing the swelling of yet another risky bet on the sustainability of a rally (or should we start talking about an emerging bubble as is clear from the price of gold?) fuelled by abnormal levels of liquidity, herd behaviour and a careless disregard for the economic fundamentals and conditions of the advanced economies, which ultimately determine the value of assets.

With unemployment in 'advanced countries' at record levels and rising and the less visible but equally disruptive phenomenon of the 'discouraged unemployed' dropping out of the labour force, shorter working times and lower pay, it is unlikely that consumption will recover and therefore that corporate profits could grow much beyond the gains that were made possible in the short term by downsizing, layoffs and squeezing the workforce. Market participants are not worried about these troubling fundamentals, considering them minutiae; they are convinced, as they were before the Lehman demise, that as long as they can borrow cheaply from the Fed, then profits will accrue. Value at risk (VAR) models appear to confirm that risks are minimal (but déjà vu, did they not signal minimal risks before the onset of the crisis?), and bonuses will set another record (despite the pompous fuss made at every G8, G20 and G-something meeting to impress a gullible press corps), while regulators can sleep soundly.

Regulators don't seem to be overly concerned. Having been caught unaware and largely unprepared by the successive waves of the crisis from the sub-prime fiasco to the Lehman bankruptcy, have socialized all the losses (at tax payer expense and with no consequences for those responsible, despite the calls for stronger corporate governance standards and practices!) and gone happily back to sleep to the reassuring lullaby on the New Financial Architecture, which, like the fabled unicorn, no one so

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far has spotted and has yet to emerge. Indeed the danger is that with the deep safety net in place, the crisis and its costs will gradually recede in memory, relegated to another (albeit an outlier) statistic on financial and economic crises!

We have a modest proposal. Once upon a time, not so long ago, the Fed and other central banks (with different degree of accuracy and transparency) conducted stress tests on too-big-to-fail or too-interconnected-to-fail banks whose results were key in restoring confidence in the solvency of the financial sector. Wouldn't it be time to conduct another run of stress tests? For example what would happen if the euro dollar exchange rate were to head towards parity? What happens as yields on government bonds increase by 3%-4% to compensate for unprecedented budget deficits leading to a ballooning of public debt? What would happen if corporate profits were to drop by 50%? What would happen if unemployment in the US were to exceed 12% or 15%? How many banks would survive if real estate prices were to fall by another 30%?

On the one hand (as economists love to say) this exercise would remind the reckless and the greedy, that the gigantic bet set up by using a cheaply funded US dollar as a carry currency (courtesy of the Fed and the US taxpayer) could unravel rapidly and viciously. On the other hand, if the stress tests ascertain that a degree of normalcy has been restored, it would then be time to withdraw the emergency support, wind down stimulus policies and let the sun set on the zero interest rate days.

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