

It's Not The Economy, Stupid

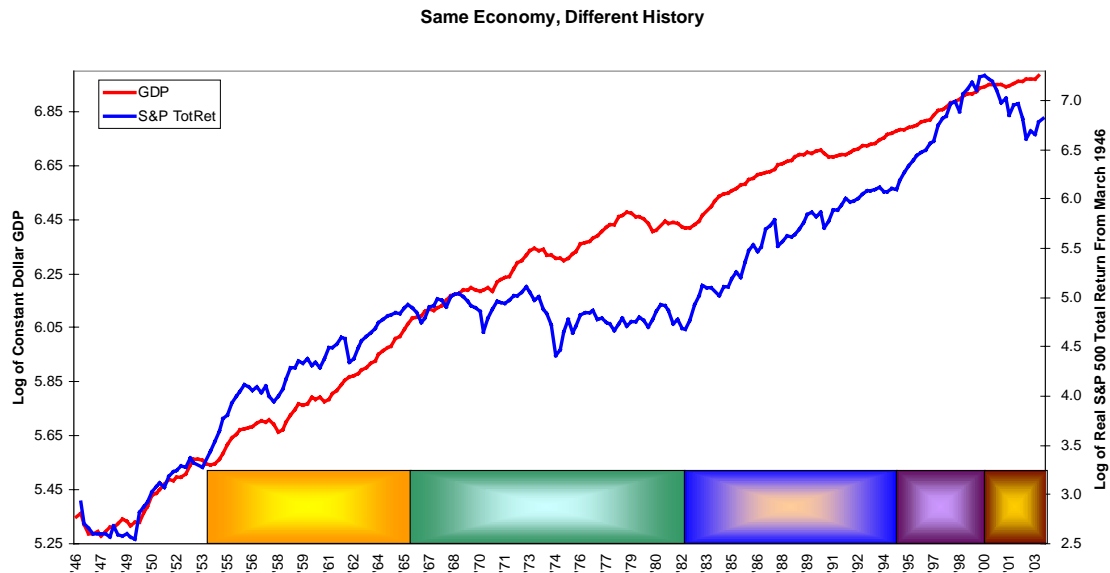
Every trader has a choice whether to be logical and diligent or successful. Foolishly, many choose the former course of action and seek guidance for their longer-term strategies in economic data. After all, what could be more logical than the chain of causality between economic growth, corporate profitability and tradable instruments such as stock and bond futures?

It is all quite entertaining, of course. News crews who used to run down to the floor to get a picture of traders in various states of either despond or euphoria – have you ever wondered why it was necessary to get a different picture each time? – will need a new source for photos of these hooting primates once the last trading floor closes for good. A rich replacement source of stunned looks may be the desks of Wall Street economists, the type who try to call the next datum and almost always get it wrong, leading to those fast market histrionics we all know and love.

Divergences And Differences

The urge to equate economic data with financial markets, stocks especially, is puzzling. Economic data are an imperfect snapshot of what has occurred; financial markets are discounting mechanisms. The reported after-tax profits of American corporations are, as we all know too well by now, artifacts of accounting decisions. Even if we could know this data stream going forward, we would not know either the aggregate risk tolerance of investors or the interest rates they choose to apply to future earnings. Moreover, economic data is discontinuous and subject to revision. Many macroeconomic series are reported on a quarterly basis on a lag of several weeks and then are revised. Financial markets trade continuously in real time.

We can use the stock market as represented by the inflation-adjusted total return on the S&P 500 as an example. If we compare this to the constant dollar GDP since the end of the Korean War, a number of distinct regimes become apparent. These regimes are blocked on all accompanying charts for reference. The notions that the stock market predicts economic growth or that a strong/weak economy is necessary for a strong/weak stock market are refuted by a half-century of data.



The period between the end of the Korean War and the expansion of the Vietnam War saw the total return on the S&P 500 grow faster than did real GDP, and that included bear markets in 1957-58 and again in 1962. The former bear market was associated with a recession, while the second was associated with the aftermath of the Kennedy steel price rollbacks. Inflation was under control in this period.

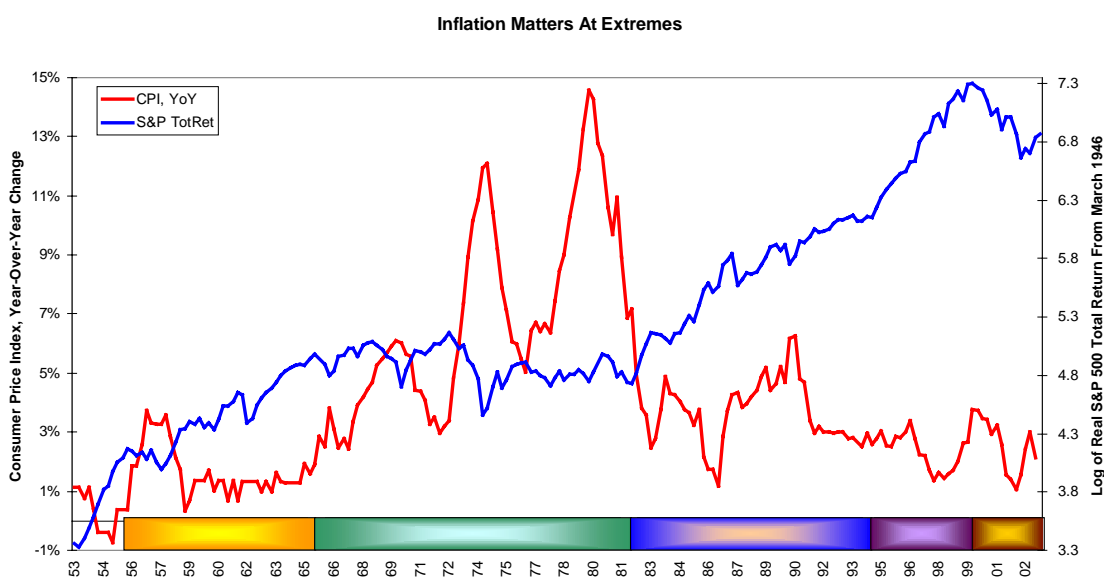
The second regime, that encompassing the Vietnam War, the breakdown of the Bretton Woods system of fixed exchange rates, recessions in 1970, in 1974-75, a double-dip recession in 1980 and two oil crises saw real GDP expand at a much higher rate that did the real total return on the S&P 500. In fact, the pre-tax inflation-adjusted

return on the S&P 500 over the 1966-1982 period was negative, which should be a very sobering realization to those who still regard equities as the most superior asset class. Inflation emerged as a persistent problem during this era.

The third regime began with the successful economic policy mix of fiscal stimulus and tight money under Reagan and Volcker. Real GDP grew over this entire period with the sole exception of the war-induced minor recession of 1990. The real total return on the S&P 500 grew much faster, however.

The last two regimes are interesting to note by virtue of the utter disconnect between growth in real GDP and the real total return on the S&P 500. The equity bubble of the late 1990s and the subsequent bear market both occurred within a GDP environment remarkably tranquil by historic standards. The boom of the dot-com era and the recession of 2001 both were minor ripples in an otherwise straight line. Inflation was subdued and fairly constant through both regimes, Federal Reserve prattle about deflation notwithstanding.

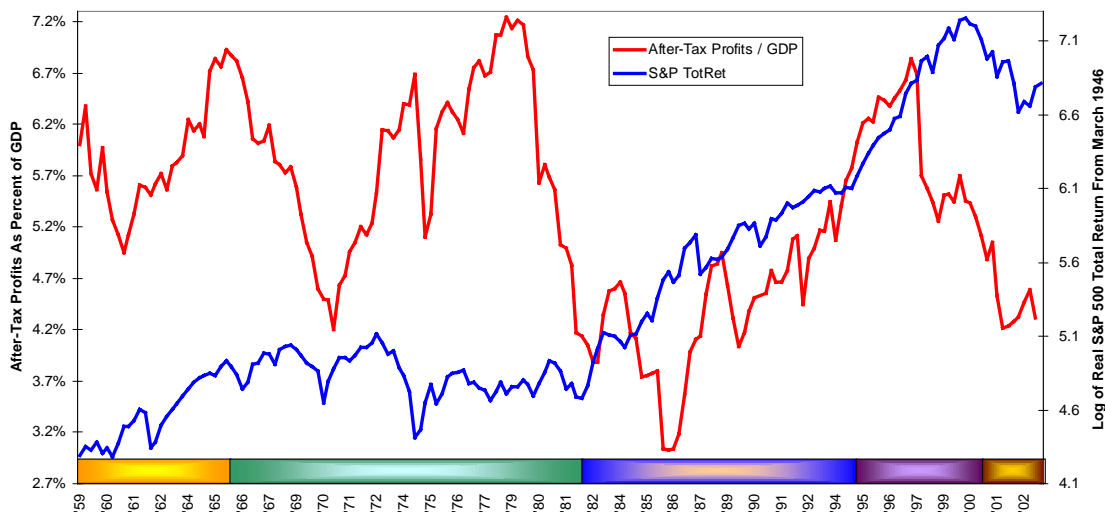
Does the stock market do a good job in anticipating inflation as measured by the CPI? If it does, it is not apparent in the history. Stocks did not lead either the large upsurge in inflation in the 1970s or the subsequent disinflation of the 1980s.



Do Profits Matter?

Stocks are a claim on corporate earnings, so it should stand to reason that they would rise in anticipation of earnings growth and vice-versa. Nothing appears to be further from the truth: If we take the Commerce Department's report of after-tax corporate profits as a percentage of GDP, we find the relationship to be counterintuitive. Profits as a percentage of GDP appear to lead real total returns on the S&P 500. Profitability peaked at the end of the third quarter of 1997, two and one-half years before stocks peaked, and profitability turned higher at the end of the first quarter of 2002, just in time for a 28% drop in S&P 500 total return over the next two quarters.

Not On The Same Page

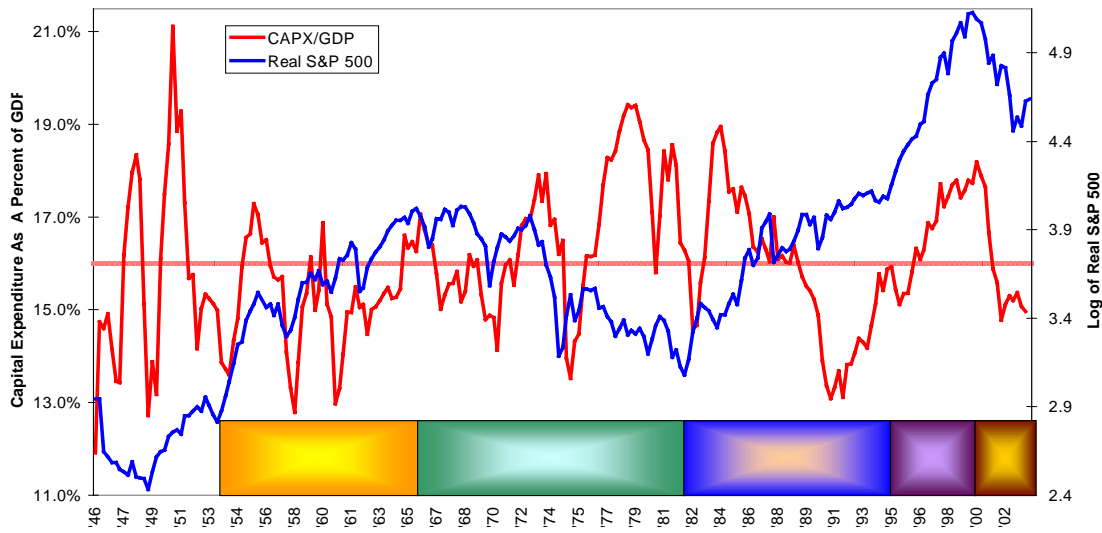


The reported after-tax profit series was quite strong during the bull market of the early 1960s, but it was also quite high during the forgettable 1970s and quite low during the early stages of the 1980s bull market. These discrepancies can be explained both by the odd effects of inflation on corporate accounting – accounting profits exceed economic profits when the value of fixed assets and inventories rise – and by the tradeoff between new and existing plant and equipment.

James Tobin, a late Nobel laureate in economics, created a measure now referred to as Tobin's Q, which is the ratio of the market value of capital to its replacement cost. A Q-statistic greater than 1.0 indicates stock prices are overvalued relative to the replacement cost of their underlying assets. This should lead to new stock issuance – think of the wave of initial public offerings during 1999 and 2000 – which should finance the expansion of physical capital stock and lead to both overcapacity and lower stock prices.

While Tobin's Q cannot be tracked in real time or even with a reasonable lag, we can depict its mechanisms by taking the ratio of total capital expenditures to GDP. Capital expenditures have averaged 16.0% of GDP since 1946. Periods of below-average investment tended to be followed by strong stock markets, as represented by the inflation-adjusted S&P 500; a major exception to this tendency occurred in the inflationary late 1960s and early 1970s. Periods of above-average investment tended to be followed by weaker stock prices; once again, an inflation-related exception occurred in the disinflationary early 1980s.

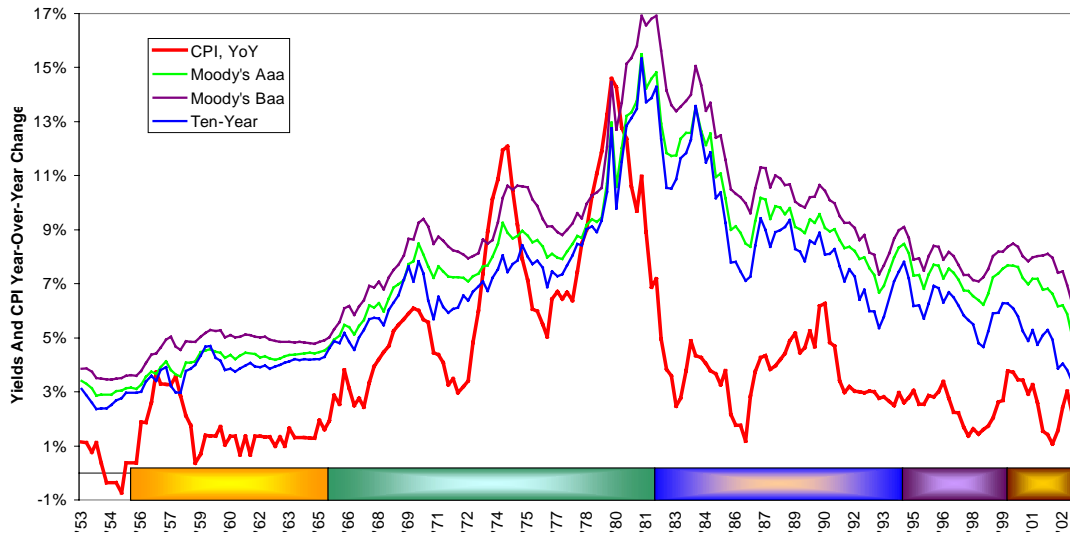
An Inconclusive Relationship



The Economy And Interest Rates

If macroeconomic data do not provide a clear and consistent guide for equity valuations, then surely they must for fixed income markets, no? If any relationship in the world of finance is alleged to be direct, it is that between inflation and interest rates. Not really: Neither the ten-year Treasury yield nor Moody's yields for Aaa and Baa bonds follow the CPI's year-over-year changes very closely. These yields all lagged behind the rate of inflation in the 1970s, and then remained persistently high during the early 1980s.

Adjustment Lags To Inflation

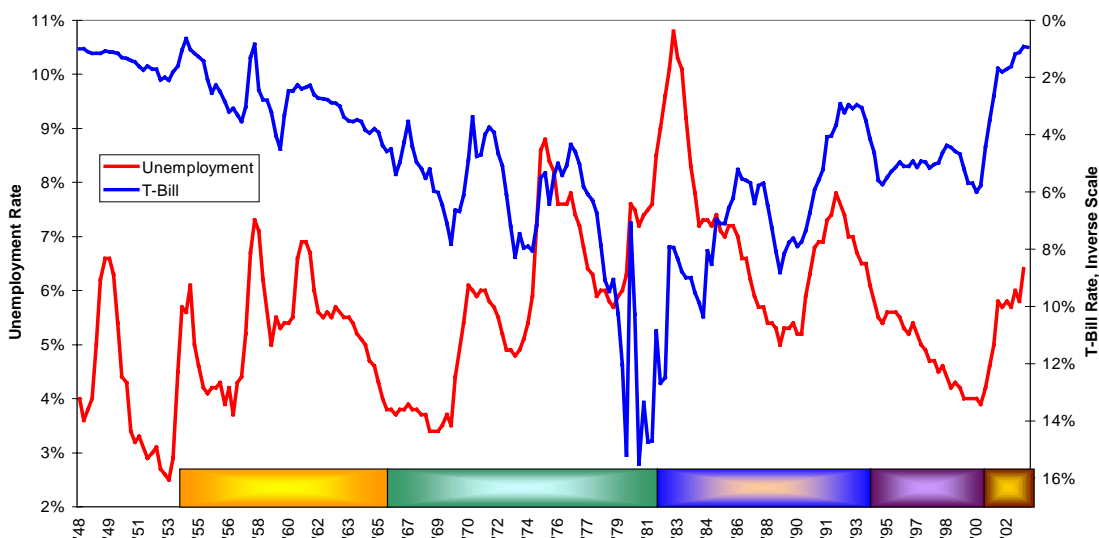


Well, then, if interest rates do not react as they should with respect to reported inflation, then surely they must react to changes in employment data; what event is anticipated more eagerly each month than the Employment Situation Report? The interest rate futures markets tend to capitalize instantly every squiggle in this report as if a policy response from the Federal Reserve will occur. This may have had a tiny bit of validity during the 1979-1987 stewardship of Paul Volcker, but it certainly had no validity whatsoever during the highly gradualist Greenspan years that followed.

We should, by bond market logic, expect to see changes in unemployment produce an opposite reaction in interest rates shortly after the data appears. Once again, such a predicted relationship is not apparent in the historic data.

This was especially true during the inflationary outburst of the late 1970s and early 1980s, when T-bill rates surged as part of a deliberate attempt to break inflation; unemployment rose in response. Another major divergence occurred during the late 1990s boom, when T-bill rates stayed flat while unemployment plunged.

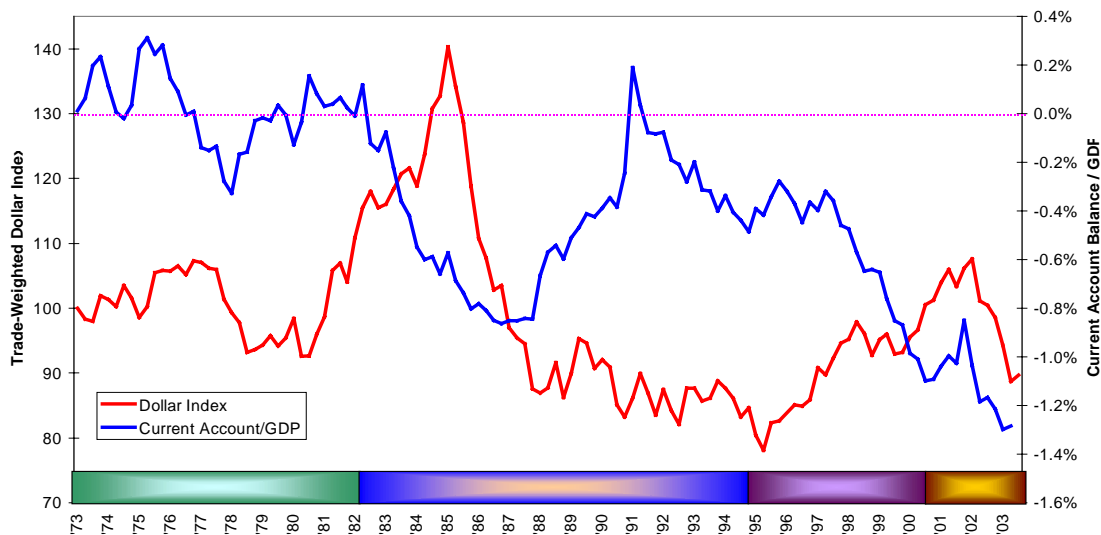
Is This A Leading Or Inverse Relationship?



Any Bang For The Buck?

Another relationship alleged to exist but difficult to establish is that between the trade-weighted dollar and the current account balance; this latter measure of trade includes the flow of services and income payments as well as the more familiar trade in goods. The driving concept behind flexible exchange rates was a self-correcting trade balance wherein a weaker currency would make exports more attractive and imports more expensive.

The Dollar's Strength And Trade Balances



The relationship may have had an effect, albeit a small one, on the momentary restoration of a small trade surplus during the recession of the early 1990s; the dollar and the deficit had been moving in opposite directions for much of the late 1980s. After this, however, the U.S. moved into a permanent and deepening net deficit regardless of the greenback's direction.

Where Have You Gone, Harry Truman?

What can we make of all this? The conclusion is not and should not be that we should ignore economic variables, but rather we should be careful about making instant and short-term trading decisions from long-term historic data. Simple, linear and predictable reactions in markets from the latest government reports are likely to be emotional (and photogenic) reactions unlikely to succeed in the long-term. In the short-term, alas, traders have to get out of the way of the moving train.

Each and every economic environment is different and must be interpreted differently. This has been the downfall of econometric modeling on Wall Street since the first day it was tried: Past relationships do not predict future performance. In the end, Harry Truman's plea for an one-armed economist, one who would not keep saying "on the other hand," was directionally incorrect. The winners in the analysis game never stop at the obvious.