The Implied Expectations of the Future Revealed by the Markets Themselves

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The fickle-finger of fate awards far too often go to economists. Harry Truman always said he wanted a "one-handed economist." The field has gotten its bad name largely due to the fact that it involves in-breeding. In other words, economists talk among themselves, while rarely do we ever see anyone with real experience. The same was true in Archaeology. Heinrich Schlieman (1822-1890) was a wealthy German who believed Homer's epic story of Troy was history. He set sail and discovered Troy in 1870 when all the academics called him a fraud maintaining the Iliad was written for children. The book scholars had relegated Homer to bed-time stories without ever once investigating the real world. Schlieman went on to discover even Mycenae with Homer.

The field of economics is not much different. The dominant theories that there is a mythical state of utopia known as equilibrium has destroyed more opportunities and jobs than perhaps even the theories of Karl Marx. Just as George Bush's famous sound-bite cost him the Presidency (Bush 1)("read my lips, no new taxes"), Herbert Hoover's sound-bite was "Prosperity is just around the corner." This is caused by the blindness of traditional economics to see not merely around the corner, but just down the road. There is no more a mythical state of "equilibrium" or some magical strabge attractor that causes the economy to regress to the mean than there is an Easter Bunny laying eggs.

The "flight-to-quality" that unfolds in every economic crisis, to a large extent dictates the length of the economic depression. If capital cannot see a future, it will still respond as in feudal days, crouched in a corner hiding behind the walls of the castle and praising the valor of the landlord.

We often forget that real inflation as perceived by the public is expressed in this dance between fixed-income (bonds) and the stock market. Traditionally, the stocks are perceived to be more risky than government bonds. Therefore, on a good-day, the yield of a stock in terms of its dividend will be greater than the fixed-yield because stocks are perceived to be a greater risk than bonds, we can expect that the dividend yields will run 1-3% higher than government bonds. There will be stocks that pay even higher yields, but that is also attributed to greater risk.

Let us open the door to reality. In a crisis, corporate profits decline as do the stock prices. Capital flees to bonds as the price rises due to demand causing the yield to decline. However, if inflation enters the door, then the concern becomes the value of the currency in purchasing power terms. If the fear of inflation becomes dominant, the decline in the value of the currency, then the flight to quality reverses to assets.

During the late 1950s into the first post-World War II inflationary speculative boom in stocks that peaked in 1966, we saw stocks rise exponentially, but the yields declined. The bonds declined sharply in price, but this caused their fixed-rate yields to rise relative to price. The rise in prices of stocks and the decline in the price of bonds were offset by a counter-trend moving transverse, which was the yield. In other words, the public expectation of inflation was greater than the "official" statistics. This caused the stocks to rise in price forcing their yields (dividends) to decline as a percentage of price, while the bond market declines in price causing the fixed-rate of interest yields to rise relative to the price. This is why interest rates rise in a bull market and decline in bear markets. Central Banks merely effect the rate of change, not the trend.

In the real world, the people illustrate through the free-markets what their "implied" expectations of inflation are at that moment in time. This is better than any poll because most people do not quite understand what they are doing or precisely why. We are dealing with a mob and under such conditions, not everyone may be participating for a particular reason. There can be actions taken for a host of reasons just as the last Presidential election. There were some people who vote only on party lines regardless of who is on the ticket. There were those who voted because of age, race, or just wanted change. You can analyze the reasons and come up with a long list, but they still collectively acted in the same manner.

When dealing with the mob analysis, you cannot reduce this to a single reason. The same reason may cause one person to sell and another to buy. It is the age old difference between the optimist and the pessimist. Both are blown off the top of the Empire State Building. The pessimist immediately says "Oh my God I am going to die!" The optimist can be heard as he passes the 4th floor, "Well so far so good!"

The flight-to-quality is so far to the extremely short-term paper. There are two major trends that will illustrate the future better than any poll. If the capital still stays below the 2 year mark in duration insofar as the bond market is concerned, capital is cautious, but not committed. If the capital begins to spread-out causing even the long-term rates to decline sharply out 5-10 years, the longer-term confidence is starting to collapse. Capital is then hunkering-down absorbing the long-term debt as future economic-recovery expectations dwindle.

It is the hyper-inflation outcome that presents the most chaotic. If the contagion spreads worldwide and causes economic contractions everywhere as it appears is unfolding, then if the governments try to borrow and cannot, the market-forces will begin to anticipate a collapse in public confidence. This would cause the price of bonds to decline and the price of stocks to rise again. This is not a "bull" market as in traditional terms. It is how capital responds to the collapse in government. We would see only in the extreme hyper-inflation of the famous Weimar Republic in Germany (1922-23) in the peripheral economies with the lowest rates in the core economies. This becomes possible if the marketplace sees huge supply of government bonds coming like a tidal wave that will invoke the "implied" inflationary response of a flight to assets. This is the delicate dance of capital as it attempts to maneuver the obstacle course of a collapse in confidence. To move back to assets, capital would be extremely selective and buy only those in which it feels would be a store of value. Gold may explode to the several thousand dollar range in such a circumstance. It has already made the first decoupling move to separate itself from the perceived oil correlation. While gold has declined of late against the dollar, it is starting to rise relative to the ounce-to-barrel ratio illustrating the beginning of the decoupling.

Rarely does government ever understand how to fix an economy. All the theories are antiquated from the days of the gold standard. Keynes did not have a magic formula if you lower taxes to x% and interest rates to x%, all will be better. This has been very much like going to a witch-doctor or a medieval doctor who starts pulling out body parts until the pain subsides. The Investment Bankers have wiped themselves out again with excessive leverage. When you are operating at 50:1 leverage the capital contraction is so severe, government cannot come up with an offsetting expansion of money supply to stabilize the economic contraction. If we do not even understand the mechamism, we will be looking for that "one-handed economist" for a very long time.