

Chapter Ten

1999: INVESTORS IGNORE THE WARNINGS OF A MAJOR MARKET TOP

1. Introduction

Writing the history of the financial markets is an interesting and fascinating learning experience. The historical events gradually disappear and become confused as historians debate the various aspects of why and how they took place. The only tangible residue is the amount of data that has been collected. The proper use of these data is an important tool to recreate history, the part of history that really matters to investors. It sounds like a presumptuous statement. This, however, is the overriding reaction that one has when revisiting these important years.

This is not Monday morning quarterbacking. The author, in his investment publication *The Peter Dag Portfolio Strategy and Management*, because of the important signals examined in this chapter became bearish in mid 1999 when the S&P 500 was 7% from the top it reached in 2000.

One of the themes of this book and of the previous book *Profiting in Bull or Bear Markets* is that some economic and financial patterns repeat themselves with reliable regularity. Investors should use them to develop an investment strategy based on the risk present in the marketplace using the stock sectors that perform best in that environment.

In 1997, the economy was strong and peaked late in the year. This peak was anticipated by slower growth in MZM, a weaker dollar, and by the flattening of the yield curve. Slower growth in sales relative to inventories confirmed the weakness of the business sector. Business had to cut production to bring inventories in line with declining growth in sales.

Because of the strong economy, commodities were firm. High real short-term interest rates, however, kept inflation and bond yields under control. They began to decline as soon as the economy started to lose momentum toward the end of the year.

The strong growth of the money supply, accompanied by a firm dollar, was anticipating the next upward phase of the business cycle. The stock market was strong, reflecting stronger growth in the money supply, stable commodities, interest rates, and inflation.

The economy remained weak in 1998 as the business sector continued to reduce inventories. Toward the end of the year, however, business sales began to grow faster, signaling a pick up in the economy. The strong and protracted growth of the money supply was finally having its desired effect.

In 1998, inflation, commodities, and interest rates declined in response to a weak economy. The stock market responded well to this environment, except for a sharp correction in the fall months.

In 1999, the business cycle picked up again, as in 1997. Let's see how, why, and the implications for the financial markets.

2. Leading indicators

The leading indicators, because of their long lead-time, do not influence the current economic environment. They have an impact on the business environment of the following year.

The sharp and decisive peak in the growth of the money supply in 1999 was certainly not going to influence the current year. The trend of MZM was going to impact unfavorably the economy in 2000 and beyond. The growth of MZM peaked at a torrid 15% pace in the first quarter. This is exceptional growth, considering its long-term average pace is close to 7%. In other words, 1998 and early 1999 experienced exceptional monetary stimulus which was reflected in the fanatic euphoria in the economy and financial markets.

One has to wonder what the Fed was doing and looking at. They have the tools to control the money supply. In 1999 and 2000, however, the markets took over and overwhelmed their action and policies.

The dollar recovered following the sharp decline that took place in 1998. It declined again quite visibly toward the end of the year. The yield curve steepened considerably.

Credit spreads declined sharply, mirroring the action of the growth of the money supply and of the dollar. They declined from the high levels reached in 1998, suggesting that credit conditions were becoming normal again. Spreads did in fact decline to the lower end of their historical range. This level was not seen again as of this writing (2004). Financial risk was well above average after 2000, creating a background of uncertainty for the financial markets.

The leading indicators were almost unanimous in anticipating slower growth in 2000.

What do you learn from the *leading indicators*?

1. The decline of the growth of the money supply points to deteriorating economic conditions 12-18 months from a major peak.
2. The weak growth of the money supply is confirmed by a weak dollar.
3. The trend of the dollar tends to anticipate the trend of the growth of MZM.
4. A sharp decline in the dollar in 1998 warned of an incoming peak in the growth of the money supply in early 1999.
5. The yield curve leads changes in the business cycle by a few months. In 1999, the yield curve and the business cycle moved almost in synch.
6. The change in the steepness of the yield curve is used to refine the forecast made with the growth in MZM.
7. The change in credit spreads follows closely the growth of the money supply.

3. Coincident indicators

In 1999, the economy finally responded to the record-breaking growth in monetary aggregates from 1997 to the end of 1998. The ISM indexes bottomed at the end of 1998 and kept rising to well above 55 in 1999.

Business sales continue to rise faster, a trend in place since mid 1998. It was in 1999, however, that they began to grow considerably faster than inventories. This was a classic signal suggesting the manufacturing sector was forced to increase production to replenish inventories. Output had to expand, and indeed, it did increase throughout 1999.

The economy kept growing very rapidly in 1999 thanks to outlandish stimulus deriving from the strong growth of the money supply in 1998.

The strong performance of the US economy, however, had in itself the seed that made the great financial bubble burst. In order to see why and how, investors need to focus on the action of the lagging indicators.

What do you learn from the *coincident indicators*?

1. Business activity was strong in 1999.
2. The ISM indexes soared in response to stronger growth in MZM in 1997-1998.
3. As long as the growth in sales is higher than the growth in inventory, the manufacturing sector is forced to increase production to increase inventories.
4. An improvement in the growth of sales relative to the growth of inventories suggests that the inventory cycle is at the beginning.
5. The beginning of the inventory expansion points to improving economic conditions.
6. The inventory cycle lasts about three years from bottom to bottom.
7. Stronger economic conditions anticipate higher lagging indicators.

4. Lagging indicators

One of the major lessons learned from reading the early books on business cycles published between 1950 and 1970 are three.

1. A rise in the lagging indicators (commodities, inflation, interest rates) is a reliable warning that there are excesses built in the system.
2. These excesses create a negative feedback, forcing the leading indicators (broad stock market averages, growth of the money supply, dollar, and yield curve) to decline, setting the stage for the next business slowdown.
3. The severity of the economic slowdown depends on how rapidly the lagging indicators rise. For instance, a sharp rise in inflation is followed by severe economic weakness. A mild rise in inflation is followed by a mild slowdown.

Let's go back now to what happened in 1999. The economy was strong, as discussed above. This strength was followed by a textbook case of cause and effect relationships.

Inflation rose from below 2% y/y to above 3% y/y. Producer prices rose sharply to above 4% y/y. Because of rising inflation, bond yields of all qualities rose rapidly throughout the year. Commodities were strong in 1999. Short-term interest rates rose from close to 5% to 6% in 2000. Not surprisingly, the growth of the money supply and the dollar peaked, showing little or no growth well into 2000.

The most important impact of the trends of the lagging indicators, however, was on the stock market.

What do you learn from the *lagging indicators*?

1. Inflation rises in periods of strong economic conditions following a protracted rise in the ISM indexes.
2. Commodities rise reflecting stronger demand for raw materials caused by the acceleration in inventory accumulation.
3. Short-term interest rates rise because of higher need to finance working capital requirements due to higher short-term needs for liquidity.
4. Bond yields rise because of stronger demand for long-term demand for money due to increased investment plans.
5. Yields also rise because of rising inflationary pressures.
6. The broad increase in the lagging indicators sets the stage for a weaker economy in 2000.
7. High real short-term interest rates continued to characterize a disinflationary environment in 1999.

5. The stock market

It is a simple rule to follow, yet investors ignore it. The main reason is that it is difficult to accept that investment strategies need to change when the lagging indicators rise. Investors are justified to be aggressive in their investment posture when the lagging indicators begin to decline and eventually stabilize. Investment strategies need to become very defensive and selective after a few months of higher lagging indicators.

1999 was no exception to this simple, yet profitable guideline. By mid year it was clear that interest rates, inflation, and commodities were rising because of the strong economy. They could not decline any time soon because business activity has to decline several months for these

measures to decline. In other words, the lagging indicators were rising and were going to rise even more because of the strong economy. This bearish signal came when the S&P 500 was 7% from the peak reached in 2000. Greed, however, kept investors chasing returns that were surrealistic. If one buys just for the sake of making money, but does not have a rule of when to sell and why, eventually profits vanish and losses mount. This is exactly what happened to the majority of investors when the bubble eventually burst in 2000.

An interesting feature of the market in 1999 was that the advance-decline line was already trending lower since 1998. In other words, the advance-decline line was saying that on the NYSE the number of declining issues was larger than the number of rising issues. A prolonged decline in the advance-decline line is a serious warning that the internal structure of the market is deteriorating. The longer the weakening of the advance-decline line is, the more seriously investors should take its warning. This kind of scenario suggests that a more defensive investment strategy is in order.

There are two types of companies listed on the NYSE: operating companies and financial issues such as Exchange Traded Funds (ETFs). The advance-decline line therefore is not a complete assessment of how the “operating” companies are performing. The action of the advance-decline line, however, should be considered as another tool to assess if there are investment opportunities on the NYSE. For instance, in a period of sharply lower broad market averages, a rising advance-decline line points out to investors that more issues are rising than declining, signaling investing opportunities. Investors should then use other tools to find which stocks are strong.

The important feature of the behavior of the market was that the advance-decline line was declining through 1999 and the S&P 500 kept soaring. The reason for this dichotomy was that the averages were being dominated more and more by the hysterical bidding of technology stocks by greedy and myopic investors.

The obvious divergence between advance-decline line and the S&P 500 was suggesting that the market was becoming narrower and narrower as the year progressed. In other words, it was becoming increasingly more difficult to find rising stocks in an environment totally dominated by the technology fever.

Strong stock market in 1999

1. A weak dollar reflects the lack of confidence of the international investment community in our economy.
2. A weak dollar suggests foreign investors are selling the US currency to invest capital outside the US. This is a vote of concern for the economy in the long term and for the stock market in the near term.
3. The decreased confidence in the prospect of the economy is reflected in a slower growth in MZM, reflecting a decrease in liquidity.
4. Decreased liquidity is conducive to a weak equity market.
5. Short-term interest rates were rising.
6. Inflation at the consumer and producer levels was rising.
7. Commodities were rising.
8. The strength in the lagging indicators created a negative environment for equities.

6. Conclusion

The investment environment in 1999 became unfavorable. A strong economy, slower growth in the money supply and a weak dollar accompanied by rising inflation, interest rates, and commodities were the classic signals telling investors to be cautious in spite of rising market averages.

The lessons learned from analyzing historical financial data and business cycles are:

1. Investors should be aggressive in their investment posture when inflation, interest rates, and commodities decline.
2. Investors, however, need to be very defensive and adopt a selective investment strategy in order to preserve their capital when inflation, interest rates, and commodities rise.

The business cycle sets in motion powerful forces when it transitions from periods of steadily improving economic conditions and then transitions to a period of weakness. The typical patterns that have emerged from the analysis presented in previous chapters are the following.

- **Phase 1 of the business cycle.** The economy strengthens from a period of slow growth. Its pace is still slow, below its long-term average. Inflation, bond yields, short-term interest rates, and commodities stop declining. They are likely to move in a narrow range for several months as the economy gains momentum. The growth of the money supply continues to rise as the dollar remains firm. The stock market is still strong, but its appreciation takes place at a slower pace than in Phase 1.
- **Phase 2 of the business cycle.** The economy is strong and growing at well above potential. Inflation, bond yields, short-term interest rates, and commodities start rising. The growth of the money supply eventually peaks before the end of this phase as interest rates continue to rise. The dollar begins to sputter and then declines. The stock market is now growing at a slow pace and begins to decline before the end of this phase.
- **Phase 3 of the business cycle.** The growth rate of the economy peaks and begins to decline under the pressure (negative feedback) of rising interest rates, inflation, commodities, and overall business costs. Inflation, bond yields, short-term interest rates, and commodities lose considerable momentum. They are likely to move in a narrow range and they eventually begin to decline toward the end of this phase. The growth of the money supply and the dollar continues to decline. The stock market remains weak and very selective.
- **Phase 4 of the business cycle.** The economy slows down below its long-term trend. During these times, investors can expect inflation, bond yields, short-term interest rates, and commodities to decline. The growth of the money supply begins to grow rapidly as the dollar strengthens in the first half of this phase. The bear market in equities bottoms and stocks start a new bull market before the end of this phase.

Investors need to change investment strategies when the business cycle moves through the various phases. Each phase presents investment opportunities and risks. Specific strategies need to be implemented to take advantage of what is happening using stock sectors that best fit the trends of each phase of the business cycle. For instance, bank stocks should be bought when the economy weakens and interest rates decline. They should be sold when the economy is strong and the odds favor higher interest rates ahead. See Chapter 7 for specific investment strategies to use with stock sectors.

The investment environment in 1999

The investment environment in 1999 was unfavorable to financial assets. The following trends drove the investment strategy and the selection of the most attractive stock sector (see Chapter 6 and Chapter 7 for details).

- a. The dollar was weak.
- b. The growth of the money supply was declining.
- c. The economy was strengthening.
- d. Inflation was declining.
- e. Commodities were strong.
- f. Short-term and long-term interest rates were rising.
- g. The economic conditions were unfavorable for stock prices.