Chapter Nine

1998: SOARING MARKET AVERAGES HIDE A MAJOR TOP

1. Introduction

The casual investor has difficulty to relate the financial markets to trends in business activity, commodities, interest rates, and inflation. The reason is what happens today is the direct result of events that have taken place some time ago. For instance, the trend of the dollar and changes in the growth of the money supply precede movements in the economy by 12-18 months.

Often commentators say the reason for a rising stock market is the strong economy. This is wrong. A rising stock market, accompanied by a strong injection of liquidity, anticipates a stronger economy sometime after 12-18 months. In other words, a strong economy follows a strong stock market. In Wall Street parlance the market is a discounting mechanism.

1998 is a typical year to emphasize this point. The economy was turning weak. Yet, the stock market was very strong. According to the conventional wisdom, stocks should have been weak.

Investors need to look forward. The only way to recognize what will happen is to analyze the three sets of indicators as we have been doing in this book. The behavior of the leading, coincident, and lagging indicators helps to recognize what has really happened and what will take place in the financial and business cycles.

2. Leading indicators

The growth of the money supply MZM continued to soar in 1998. Growth exploded from close to 10% at the beginning of the year to a torrid 15+% by mid-year. It is important to remember that the average long-term growth of MZM is 6-7%. This is the average growth rate of the economy (3% real growth and 3% inflation), close to the average growth in income, in earnings per share, and capital appreciation of the stock market. 15% growth in MZM, therefore, was anticipating very strong growth in business activity because it was well above anything experienced in recent times.

Investors need to review the trends of MZM to predict what is going to happen next. The growth of the money supply MZM bottomed in 1997 and kept rising until 1998. The behavior of

the money supply was suggesting that the economy would start improving toward the end of 1998 or in 1999 after the typical 12-18 months from the bottom of growth of MZM.

The strong dollar in 1998 confirmed the rising trend of the growth of the money supply. It reflected the inflow of foreign capital to be invested in the US financial markets and in the economy. This was excellent news. It suggested that our system was attractive as an investment because it had the right combination of elements to make it grow and generate profits.

In the second half of 1998, however, the dollar tumbled and remained low. The trend of our currency suggested that some elements of our "new economy" (as was described then) were changing. It was anticipating a change in the trend in the growth of MZM in 1999.

The yield curve remained flat with the difference between the yield on 10-year Treasury bonds and the rate on 13-week Treasury bills close to 0.5%. This is a very low value given that this spread averaged 1.5-2.0% in recent times, as the Fed was pursuing a tight monetary policy.

The low differential between long-term and short-term interest rates suggested that the lenders had little incentive to lend given the low spread between the two interest rates. Lenders borrow at the low rate to lend at the high rate. The incentive was not in the 1998 structure of interest rates. In 1992-1994, the last time the Fed forced real short-term interest rates well below 1.4, reflecting an aggressive easing monetary policy, the spread between short-term and long-term interest rates ranged between 2.5% and 3.5%. This range was later surpassed after 2002, another period of aggressive easing by the Fed.

The yield curve, in other words, was saying the economy could not strengthen because there was no incentive to lend due to unfavorable monetary conditions. It is important to remember that the lead-time of the yield curve is only a few months, usually less than six months. Because of the short lead time the yield curve is a timelier leading indicator of the economy. The yield curve was saying that business activity was not going to improve in the near term.

A practical use of the yield curve is as a refinement of the forecast made using the growth of the money supply and the dollar. The growth of MZM provides a long-term forecast. It pointed to a stronger economy toward the end of 1998 or early 1999. At the end of 1998, however, the yield curve remained almost flat, suggesting that strength in business activity could not happen anytime soon.

In 1998, an important development took place, which went totally unnoticed by the financial press. This development, however, was the red flag cautioning about the possibility of a financial debacle. This view was often repeated in the service *The Peter Dag Portfolio Strategy and Management*, edited by the author.

For the first time since 1955, the credit spread computed as the ratio between the yields of low grade and 10-year Treasury bonds jumped to 1.6, above the historical range of 1.20 and 1.45. This is significant because the markets were saying that credit risk was rising to levels not

seen since 1955. After 2000, these levels were surpassed again, reaching the historically high and dangerous level of 2.0. The bubble was fully inflated.

The high credit spread reached in 1998 was a warning for investors to become more cautious. It was saying that the financial conditions of medium to lower credit quality companies were deteriorating to rarely seen levels. This trend suggested prudence because the financial markets usually correct sharply high levels of credit risk.

What do you learn from the ***leading indicators***?

1. The strong growth of the money supply points to improving economic conditions 12-18 months after a major bottom.
2. The strong growth of the money supply is confirmed by a strong dollar.
3. The trend of the dollar tends to anticipate the trend of the growth of MZM.
4. A sharp decline in the dollar warns investors that times are changing and it is appropriate to become more cautious.
5. The yield curve leads changes in the business cycle by a few months.
6. The change in the steepness of the yield curve is used to refine the forecast made using the growth in MZM.
7. The change in credit spreads is a cyclical phenomenon. When business increases its borrowing activity, credit spreads increase, and vice versa.
8. Credit spreads moved within a range of 1.20 and 1.45 since 1955.
9. An increase in credit spreads above 1.45 reflects severely deteriorating financial conditions.

3. Coincident indicators

In 1998, the ISM indexes continued to decline from the 55 level reached in late 1997. This cyclical decline was anticipated by the slower growth in MZM that took place in the 1996-1997 years.

Because of the relatively flat shape of the yield curve, business activity could not improve in a visible way in 1998. The sub-par economic growth was the main feature of the business environment in that year and the shape of the yield curve suggested there was no turnaround in the making.

The growth in business sales declined for most of the year reflecting a more cautious consumer. In early 1998, the growth in business sales declined below the growth in inventories. In other words, inventories were growing faster than sales. This was a sign suggesting inventory growth needed to be cut. The manufacturing sector had to slash production to reduce the rate of accumulation in inventories to bring them more in line with the growth in sales. This was another reliable signal that business activity was bound to slow down, confirming the trend of the ISM indexes.

The good news was that in the second half of 1998 the growth in business sales began to increase again. Toward the end of the year, the growth in business sales was almost the same as the growth in inventories. It was a positive sign for the manufacturing sector and for the overall economy in 1999. Production had to be increased because, as sales were going to grow faster than inventories, business had to replenish inventories to meet the stronger demand.

Investors had to remember that the growth in MZM was already rising for almost 18 months. Any sign that the economy could improve following such an extensive period of monetary expansion, had to be looked at as a strong possibility that the economy was turning around. This pick up in business which began to gather some modest momentum at the end of 1998 was therefore anticipated by the bottom in the growth of MZM in 1997. Investors were justified in beginning to look for signs that the economy would be improving in 1999.

What do you learn from the ***coincident indicators***?

1. Business activity was weak in 1998.
2. The ISM indexes declined in response to weaker growth in MZM in 1996-1997.
3. As long as the growth in sales is less that the growth in inventory, the manufacturing sector is forced to cut production to reduce inventories.
4. An improvement in the growth of sales relative to the growth of inventories suggests that the inventory cycle is close to an end.
5. The end of the inventory correction points to improving economic conditions.
6. The inventory cycle lasts about three years from bottom to bottom.
7. Weaker economic conditions anticipate lower commodities, lower inflation, lower bond yields, and lower short-term interest rates.

4. Lagging indicators

Prices are determined by the strength of the economy and by the policies of the Fed. The main function of the Fed is to maintain a sound banking system. The reason is that without a sound banking system the economy cannot function properly. If the Fed sees developments threatening the soundness of the banking system, it will make plenty of money available for business and consumers to borrow. This state of affairs is reflected by abnormally low short-term interest rates.

Easy monetary policy is reflected by low real interest rates below 1.4, as it happened in the 1970s, in 1992-1993, and after the implosion of the financial bubble in 2000. When the Fed is not concerned about the economy and the financial status of the banking system, it lets short-term interest rates rise as determined by the market. This level of short-term interest rates is close to twice the value of inflation and is typically associated with disinflationary times. This environment was experienced from 1994 to 2001.

The strength of the economy allows investors to predict the direction and intensity of price pressures of various assets. As mentioned before, rising commodity prices across the board, rising inflation, rising short-term and long-term interest rates follow a strengthening economy. These trends, of course, offer opportunities in specific stock sectors and asset classes. They also reflect signs that financial risk is high and rising. They have an important impact on stock prices in general and stock sectors in particular, as we will see in the next section.

In 1998, real short-term interest rates were still well above 1.4. This level reflected a disinflationary environment with the Fed letting the market set short-term interest rates. Any cyclical rise of inflation would be minor under these conditions.

The lagging indicators behaved as one should expect in an environment characterized by a weakening economy. Inflation kept declining and stabilized below 2%. It stayed at around this level for most of the year. There was little or no risk that inflation would rise as long as the ISM indexes were declining and stayed close to 50.

The growth in producer prices (finished goods) declined more sharply than consumer prices. The growth of PPI finished well below zero for most of 1998, down from a peak of about 3% in 1997. In other words, producer prices actually declined in 1998. The advantage of following inflation at the producer price level is that it provides a more visible and timely information about the trends of inflation. The reason is that changes in PPI are more volatile than consumer prices. There was little or no risk that the growth of the PPI and of the CPI would rise any time soon given the weakness of the economy.

Commodities declined sharply in 1998. The weak economy and the slow growth in the manufacturing sector were reflected in poor demand for raw materials and commodities in general. The trend of the business cycle was therefore conducive to lower commodity prices. Their decline further reinforced the disinflationary forces already at work.

Short-term interest rates declined in 1998 because of the weak economy. There was little or no risk for them to rise because the economy was too weak. Business activity was slowing down and the need to finance working capital was waning. The odds of rising short-term interest rates increase after many months of strong economic growth.

Bond yields followed the overall trend of the other lagging indicators. The decline of inflation at the consumer and producer levels reduced the inflation premium built in yields, thus causing bond yields to decline and bond prices to rise.

Although 1997 and 1998 were plagued by many global disturbances of major significance, trends of asset prices and interest rates could have been predicted by looking only at business cycle developments and ignoring the historic hype presented in the press and based on the spurious and self-serving actions of the Fed. The point is that successful investment strategies are developed by focusing on the relevant economic and financial trends, not on emotions derived from the events of the day.

The decline in the lagging indicators that took place in 1998 can be viewed from two distinct viewpoints. Their decline is in response to deteriorating economic conditions; they therefore are the results of negative trends in the economy affecting the whole system --- from businesses to consumers. Their decline however sets the stage and is the prerequisite for the next economic rebound. The increase in inflation, for instance, reflects a burden for consumers because it reduces their real income, thus having a negative impact on sales. Rising inflation also represents an increase in costs for businesses, forcing them to cut these costs (raw materials, interest rates, and wages) to maintain profitability, thus causing and reinforcing the economic slowdown.

When the lagging indicators decline, it is a sign the excesses built in the system by the previous cycle are being wrung out, thus setting the stage for improved income in real terms and strengthening profitability for business. The decline in the lagging indicators, therefore, is important evidence that the stage was being set in 1998 for a stronger economy in 1999. Investors must recognize the importance of the trends of the lagging indicators because they have superb predictive capability for the economy and the financial markets in general.

What do you learn from the ***lagging indicators***?

1. Inflation declines in periods of weak economic conditions following a decline in the ISM indexes.

2. Commodities decline reflecting weaker demand for raw materials caused by the slowdown in inventory accumulation.

3. Short-term interest rates decline because of lower need to finance working capital requirements due to lower short-term needs for liquidity.

4. Bond yields decline because of weaker long-term demand for money due to reduced investment plans.

5. Yields also decline because of declining inflationary pressures.

6. The broad decline in the lagging indicators sets the stage for a stronger economy in 1999.

7. High real short-term interest rates continued to characterize a disinflationary environment.

5. The stock market

In 1998, the S&P 500 soared from close to 930 to about 1200, for a gain of 29%. This type of performance skewed investors' expectations of future market gains. It was quite common then to hear non-professional investors expect a capital appreciation of at least 20% per year. This view of how rapidly markets could grow was the foundation of the coming financial bubble. It was encouraging investors to buy because of the huge rewards lying ahead and of the fear of being left behind. The fact that the historical returns of the equity markets were about 9% (6% capital appreciation and 3% yield) was ridiculed as analysts were speaking of a "new economy." People ignored the traditional methods of valuing stocks and market risk.

A weakening economy, followed by a sharp decline in the lagging indicators (inflation, commodities, short-term interest rates, and bond yields) and accompanied by soaring money growth, as discussed in detail above, was the perfect recipe for soaring equity markets.

At major market peaks, when risk reaches its zenith, investors are faced with exactly the opposite scenario: a strong economy, accompanied by rising commodities, rising short-term and long-term interest rates, rising inflation, slower growth in the money supply, and a weak dollar.

The sharp decline of the dollar that took place at mid-year suggested that something was not perfect. International investors were moving money away from the dollar denominated area. Meanwhile the advance-decline line peaked in the first half of the year. The decline of the advance-decline line, in the face of soaring market averages, was an important and crucial barometer that suggested that the equity markets were becoming more selective.

The decline in the advance-decline line and the weakness of the dollar were two developments that needed to be followed closely because they were both signaling emerging risk. Sectors attractive at this stage of the business cycle were those that benefit from stable inflation and lower interest rates.

Strong stock market in 1998

1. A strong dollar reflects the confidence of the international investment community in our economy.
2. A strong dollar suggests foreign investors want to hold dollars and invest them in the US. This is a vote of confidence for the economy in the long-term and for the stock market in the near term.
3. The increased confidence in the prospect of the economy is reflected in a stronger growth in MZM and in overall liquidity.
4. Increased liquidity is conducive to a rising equity market.
5. Declining short-term interest rates, weak commodities, stable or lower inflation, and lower bond yields create an environment favorable to equities.

6. Conclusions

1998 was the perfect year for the equity market. The economy was weakening because of the slow growth in the money supply that took place from 1996 to 1997. Commodities were declining because of decreasing demand due to slower growth in the manufacturing sectors and reduced need to build inventories. Short-term interest rates were heading lower due to the scaled down need of financing working capital. Bond yields were also declining due to the lower inflation premium.

As business activity was deteriorating, liquidity was increasing at a faster pace fueling the stock market and anticipating a stronger economy in 1999.

The investment environment in 1998

The investment environment in 1998 remained very favorable for 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 strong.
b. The growth of the money supply was rising rapidly.
c. The economy was weakening.
d. Inflation was declining.
e. Commodities were weak.
f. Short-term and long-term interest rates were declining.
g. The economic conditions were favorable for rising stock prices.

In spite of this perfect environment for stocks, the only fly in the ointment was the lack of progress of the advance-decline line. It suggested that the market was becoming more selective and risk was beginning to rise from very low levels.