Chapter Eight

1997: THE SETTING OF THE FINANCIAL BUBBLE

1. Introduction

1997 was a year when economic growth improved following the lackluster performance of 1996. The ISM indexes improved but economic growth remained within healthy bounds.

This type of environment was caused mostly by developments that took place in 1996. The objective of this chapter is to identify those variables and trends that will drive the economy and the markets in 1997 and 1998.

The focus is to establish the relationships that will continue to repeat themselves in the following years. Once established, these patterns can be used to predict any market at any time.

Like a doctor who reviews the patient's charts without knowing him and can diagnose and recommend a course of action, the investor can develop an investment plan by looking at the right information. The advantage of this structured process is that it can be updated quickly and quickly become an investment tool.

2. Leading indicators

The analysis of the leading indicators, and in particular of the growth of the money supply, is essential to guide investors to the economic environment 12-18 months ahead.

The economic conditions in 1997 were anticipated by trends in the growth of the money supply of 1996.

The growth of the money supply begins to flatten in early 1996 through well into 1997. The sluggish performance of the money supply anticipates slower economic growth beginning 12-18 months after its peak, which took place in early 1996. Investors should therefore expect an economic slowdown beginning in 1997 with the ISM index peaking and then declining.

In 1997 the growth the money supply begins to rise sharply from about 5% to more than 10%, well above the historical average growth rate of 6-7%. A financial bubble was being created, even if economic growth was modest at the time.

This sharp growth in MZM, which began in mid 1997, is anticipating a strong rise in the ISM indexes 12-18 months later. Investors should therefore look for a stronger economy beginning after mid 1998. The decline in bond yields reinforced the idea that the growth in MZM was sustainable.

The dollar is increasing sharply during this time, reflecting confidence of the international financial community in our economy's ability to grow. The rising dollar, in fact, reflects purchases of our currency and inflows of capital in our country. This trend, of course, bodes well for our economy in the future, thus confirming the implications derived from the analysis of the growth of the money supply.

The yield curve does not have the long lead-lags of the growth of the money supply and the dollar. Its lead-lag, as a leading indicator, is just a few months. The yield curve began flattening in the first half of 1997, thus anticipating an economic slowdown in the next few months. This economic slowdown was also anticipated by the sluggish growth of the money supply beginning in early 1996.

The strong dollar and the sharp rise in the growth of MZM, however, were anticipating strong economic conditions with the typical 12-18 month lead.

The important feature of the trends of the leading indicators is that there was excessive liquidity, confirmed by the strong dollar, being injected into the system. A 10% growth of MZM is an extreme value given that the long-term growth of MZM is close to 6-7%.

The strategic value of this information is that the foundation leading to excesses in economic growth, stock prices and commodities was being set. Investors need to note this scenario and begin to plan an investment strategy to take advantage of the developing extreme conditions. However, extremes are also accompanied by higher volatility and risk in the financial markets. It is important therefore to plan an exit strategy to safeguard gains as the markets become too speculative.

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

1. The declines of the dollar and MZM in 1996 were an early warning signal.
2. The average long-term growth of MZM is about 6-7%.
3. Growth of MZM well above 6-7% anticipates a financial bubble.
4. The yield curve has a lead-time of a few months, much shorter than MZM.
5. Take advantage of the coming excesses.
6. Plan for an exit strategy.

3. <u>Coincident indicators</u>

In the mid 1997 the ISM index began to show little or no progress around the 55 level for a few months. Because of what was anticipated by the decline in the growth of the money supply of 1996 and the flattening of the yield curve in early 1997, investors are justified to begin to plan for an imminent economic slowdown.

The sharp slowdown in sales and rapidly rising inventories were further anticipating a decline in production as manufacturers attempt to control rising inventories in the face of slower sales by cutting output.

Investors had enough signs pointing to an imminent economic slowdown. Its importance lies in the fact that slower growth in business activity is followed by declining inflation, interest rates and commodities. These trends have a great influence on the class of assets to be chosen as an investment.

The reason is, as shown in chapter six, that the trend in the lagging indicators has a crucial impact on almost all stock sectors. This relationship provides timely guidelines on when to buy or sell a sector and the level of risk of each sector.

<u>What do you learn from the ***coincident indicators***?</u>

1. The peak and decline of the ISM indexes was anticipated by slower growth in MZM, a weaker dollar, and by the flattening of the yield curve.
2. Slower growth in sales relative to inventories confirmed the weakness of the business sector.
3. Business had to cut production to bring inventories in line with declining growth in sales.
4. The weakness in the ISM indexes is anticipating lower commodities, lower inflation, lower bond yields, and lower short-term interest rates. These developments are crucial in selecting the most profitable sectors (see Chapter 6 and Chapter 7.

4. <u>Lagging indicators</u>

In 1997, all the lagging indicators behaved as expected, responding to weaker economic conditions.

Inflation peaked at around 3% and began to decline. Commodities (spot and futures) peaked and went through a sharp and prolonged correction. Bond yields followed the same pattern. Short-term interest rates also displayed a downtrend.

All the lagging indicators behaved exactly as they should as the economy weakened. They declined because demand for goods and services decreased, thus placing downward pressure on prices of goods and money.

These were important trends, critical in choosing the stock sectors that would outperform the overall market.

One gauge, however, needs special mention. The level of real short-term interest rates (the difference between the rate on 13-week Treasury bills and inflation) rose sharply in 1997 and moved well above the crucial level of 1.4. This trend signaled, without any doubt, that the economic and financial environments were characterized by a strong disinflationary bias.

<u>What do you learn from the ***lagging indicators***?</u>

1. The lagging indicators decline after the ISM indexes begin to decline.
2. Inflation peaks after the ISM indexes decline.
3. Commodities peak after the ISM indexes decline.
4. Bond yields peak after the ISM indexes decline.
5. Short-term interest rates decline after the ISM indexes decline.
6. High real short-term interest rates are disinflationary and amplify the above trends.

Investors should therefore emphasize those asset classes and stocks that would benefit from declining inflation, commodities and interest rates. The table at the end of chapter six summarizes some of the sectors that benefit from this environment.

5. <u>The stock market</u>

Stable short-term interest rates, displaying a mild downturn, declining inflation and bond yields, a rising dollar and higher growth in the money supply are the perfect recipe for rising stock prices. This is exactly what happened in 1997.

Investors should therefore follow an aggressive strategy in those stock sectors that typically outperform the averages during such times. Invest gradually and establish your positions. Investors, however, should always keep in mind that the reason for becoming aggressive in stocks is due to the favorable configuration of rising leading, declining coincident and declining lagging indicators. This relationship of the three sets of indicators has to be monitored regularly. It is important to keep the eye on the ball because the tendency and creeping greed is to follow the stocks and the great gains and disregard the fact that the dynamics of the three sets of indicators may be signaling rising risk and the need to reduce your exposure to the sectors you selected.

The time to be concerned about the outlook for the stock market (leading indicator) is when short-term interest rates and commodities rise (lagging indicators). Short-term interest rates, however, rise after a strong and protracted period of economic growth (coincident indicator). But in 1997 the economy just began to slow down. The implication was that short-term interest rates were going to remain stable or decline for several more months because they rise only after several months of strong economic growth.

The lagging indicators could not rise for a while, justifying aggressive investment in equities and selected stock sectors.

<u>Strong stock market in 1997. Why?</u>

1. The dollar was strong.
2. The growth of MZM was rising.
3. Short-term interest rates were stable or declining.
4. Inflation was declining.
5. Commodities were declining.

6. Conclusion

The important development in 1997 is that the economy begins to weaken. The slowdown is likely to last well into 1998 since the growth of the money supply began to rise in mid 1997, and it takes 12-18 months for the increased growth in the money supply to be reflected in a stronger economy.

The trend that needs to be followed closely is the level of the growth of the money supply which finished in 1997 at around 10%. This level is well above the historical average of 6-7%, suggesting that liquidity was growing at an excessive rate to maintain a balanced economic growth and stable financial markets.

The decline in interest rates and commodities, which started in 1997, could not be reversed anytime soon. They rise, in fact, after 12-18 months of rising growth in the ISM index. This environment was therefore very favorable for the financial markets through 1998.

1997 ended with high real interest rates, suggesting strong disinflationary forces were at work reinforcing the idea that the lagging indicators were in a pronounced cyclical decline.

The investment environment in 1997

The investment environment in 1997 was 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.