Where Have All the Good Wads Gone?

By Brian Fabbri
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Before the great global recession

In the years leading up to the great global recession in 2008 and 2009 the average global economic growth rate was 4.3%; and in the in the world’s leading economies: the US, China, Japan, EU, and UK it had ranged from a high average of 10.5% for China to 2.2% for the other biggest economies with Japan’s ongoing stagnation dragging down the average rate of growth. Then economic disaster struck. The debt-bloated growth of the biggest economies suddenly collapsed and the pernicious effects of declining demand spread across the world.

During the golden years of rapid economic growth and relatively fast private debt expansion central banks were pursuing a broad range of policy activities from raising their official interest rates to shrinking their balance sheets (BOJ), or increasing it modestly. For example, in the US the Fed’s balance sheet had been expanding at an average annual rate of 4%, which was consistent with its long-term average annual nominal economic growth of 5.3%.

In the early years of the 21st century, stock prices were mainly recovering from the internet frenzy of the previous decade before the debt crisis set in. Stock markets around the world reflected the vibrant economic prospects during those years; however they all crashed at the onset of the great recession.

Then came the great global recession

Then came the debt melt down. Economic decay set in starting in the US, but it quickly spread to the EU and UK. Japan was in and out of recession and when demand from the West dried up, Japan’s economy fell deeper into recession. China was affected by the crisis as well; however, their economic administrators quickly mounted a colossal defense, which prevented the worst of the global recession crisis from damaging their soaring economic growth.
Economic activity, measured by GDP from the respective peaks in each economy to the trough in activity, declined in all of these economies from -5.6% in Japan to -2.6% in the UK. US GDP contracted by 2.8% in the great recession (see chart below).

The next chart highlights the steepness of their accumulation pace and the enormity of that accumulation. In just two or three years central banks doubled the size of their balance sheets, an unprecedented rate. And, most central banks either kept buying their government’s debt or accelerated the pace of their purchase programs. The ECB and the Bank of Japan continue to be engaged in quantitative easing six years after the end of the recession in the US.

The response by policy makers

Governments needed to help their floundering economies. Most relied on monetary policy to help. Central banks initially lowered their official policy rates quickly and dramatically. Most reduced their policy rate to near zero. Then they began buying up the bad debts of economically strategic, private institutions like banks, insurance companies and some manufacturing companies, and they provided loan guarantees and a flood of liquidity in the money markets. As the crisis worsened and lengthened, the central banks engaged in something new: quantitative easing (see ‘QE Comes and Goes’, Issue 5, July 2013). Their balance sheets began to expand at an epoch-making rate.

The US Federal Reserve finally stopped its quantitative easing program at the end of 2014 after having increased the size of its balance sheet by 514%. Since they ended quantitative easing their balance sheet has gently declined by a mere $4 billion. The Fed now owns 15% of the outstanding stock of Treasury securities.

In Japan the BOJ’s balance sheet expanded by just 46% from the start of their quantitative easing in 2013. However, they continue to purchase government debt at a committed pace. At present the BOJ owns 26% of their government’s 1.3 trillion yen outstanding debt.
What has happened to economic growth?

With the cost of credit at historically low levels and central banks’ balance sheets bloated to unparalleled proportions, one wonders what has happened to the economies of these leading economies: Not much!

Global economic growth has slowed to an average annual rate of 3% in the five years since the global crisis ended. In the US annual growth has averaged just 2.2%. While respectable, it is a significantly lower rate of recovery from a recession than in all previous economic cycles.

Since the end of the great recession, economic activity in the EU and Japan has been anemic. Annual growth rates in Japan and in the EU have averaged only 1% and 0.8%, respectively, in the past 5 years. Policy makers in both regions recently increased the pace of their monetary accommodation because their economies have failed to respond to their (inadequate) previous efforts, and instead they have remained mired in extremely sluggish growth rates.

China’s recent economic situation has been different from that of the Western economies. Economic growth in China has been decelerating from the extraordinary to quite brisk. At the time of the credit crisis in the Western economies, the Chinese authorities responded with an overwhelming degree of monetary accommodation. They provided a torrent of credit to state-owned enterprises (SOEs) and ordered them to invest in their own operations. Consequently, economic growth in China never experienced the cyclical fall that Western economies suffered through. Much of the government’s extended credit, however, was invested in unproductive ventures, which saddled the SOEs with excess debt and little return. The consequences of unproductive and unnecessary investment are now contributing to the swiftly decreasing rate of economic growth in China.

Very little bang for the central banks’ buck

In virtually all countries the prodigious amount of resources thrown at the respective economies by the central banks and government budgets has produced very minimal economic growth returns for such vast policy investments. Of course we could never know how much economic activity would have been lost without these policy moves. Also, we probably should have realized that the recovery rates from a global credit crisis would be exceptionally slow. As Rogoff and Reinhart have amply demonstrated in their extensive investigation of credit cycles, it takes much more time to recover from credit blowups than traditional business cycles.*

Where then did all the money go?

In the majority of the advanced economies, the money created from the central banks’ balance sheet expansion went into stocks!
The following set of charts highlights the close correlation between money creation by central banks and stock market appreciation, irrespective of the speed of economic recovery in the countries’ markets.

Perhaps the closest example of this special relationship was in the US. As the first of the next five charts reveals, stock prices in the US appreciated spectacularly along with the humungous expansion of the Fed’s balance sheet. Contemporaneously, the US economic recovery has been the slowest on record.

Japan has been another good example

Another good example comes from Japan, where stock prices also improved precipitously after the Abe economic policy initiated the BOJ’s extreme asset accumulation program.

As the chart indicates, stock prices in Japan were largely unchanged in the first years after the economic crisis, and didn’t vigorously begin to appreciate until after the Abe economic policy started.

In the UK, stocks followed BOE asset expansion

The UK stock market appreciation occurred in two waves, and both followed the two episodes when the BOE expanded their balance sheet. In contrast, once the BOE stopped acquiring assets in its balance sheet at the end of 2012, stock prices have continued to rise, but very slowly.
In the EU, the central bank was too inconsistent

As the next chart highlights, the EU stock market index has not been driven by the accumulation of assets by the ECB. In fact, for some extended periods during the past five years, European stock prices moved inversely to asset accumulation. Even the latest central bank decision to ‘do whatever it takes’ and their promise of extensive securities purchases have failed to ignite a rally in EU stocks. Other circumstances have contributed to the cautious behavior of investors, such as the never-ending drama over several countries indebtedness, and their failure to repay their debts.

EU stocks Haven’t Followed ECB

Monetarization in China initially fueled a debt buildup

In China investors did not become excited about stock investment until after the government began to change the rules regarding investments. Stocks soared after the government created the Shanghai free trade zone and Shanghai-Hong Kong Stock Connect, where they coordinated equity investment with Hong Kong stock markets, and liberalized margin requirements.

Chinese Stocks Rose with new regulations not PBoC BS

Chinese stocks failed to respond to massive and steady central bank asset accumulation in the initial years following the global credit downturn. Most of the PBOC’s monetary injections went into debt creation particularly to SOEs, rather than fueling stock investment as it had in the West.

Conclusion: When the central banks stop buying, the party will be over

My casual research suggests that the massive asset purchases by most major central banks in the world coincided with healthy stock price appreciation in their respective economies. To be sure there were exceptions to this, for example, China, where most of the PBOC’s balance sheet expansion went to provide credit for the SOE’s and did not fuel stock price appreciation. Investor confidence in Chinese stocks took place years later when the authorities liberalized parts of the capital markets.
The positive association between central bank asset acquisition and stock price appreciation also strongly implies that once the central banks stop expanding their balance sheets, brisk stock price appreciation will subside.

Consequently, future stock price appreciation will depend more heavily upon economic performance and profit projections than in the recent past gold rush for stock investors in the US, Japan and UK. Moreover, it demonstrates that creating appreciating stock market valuations was an important by-product of the monetary expansion that followed the great recession. Therefore, central banks will have to be very wary of unwinding this appreciation when they begin to undertake normalization of their interest rate policy.

* Kenneth Rogoff and Carman Reinhart
‘This Time Is Different’ 2010 Princeton University Press.

For more information, please contact camri@nus.edu.sg
KEY INDICATORS TABLE (AS OF 12 JUNE 2015)

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Source: Bloomberg

GLOSSARY OF KEY TERMS (Source: Bloomberg, with tickers in parenthesis. In US$ where applicable)

S&P500: capitalization-weighted index of the prices of 500 US large-cap stocks (SPX)
FTSE: capitalization-weighted index of the prices of the 100 largest LSE-listed stocks (UKX)
NIKKEI: capitalization-weighted index of the largest 225 stocks of the Tokyo Stock Exchange (NKY)
HANG SENG: capitalization-weighted index of companies from the Hong Kong Stock Exchange (HSI)
STI: cap-weighted index of the top 30 companies listed on the Singapore Exchange (FSSTI)
EUR: USD/EUR exchange rate: 1 EUR = xx USD (EUR)
YEN: YEN/USD exchange rate: 1 USD = xx YEN (JPY)
CMCI: Constant Maturity Commodity Index (CMCIP)
Oil: West Texas Intermediate prices, $ per barrel (CLK1)
3MO LIBOR: interbank lending rate for 3-month US dollar loans (US0003M)
10YR UST: 10-year US Treasury yield (IYC8 – Sovereigns)
10YR BUND: 10-year German government bond yield (IYC8 – Sovereigns)
10YR SPG: 10-year Spanish government bond yield, proxy for EU funding problems (IYC8 – Sovereigns)
10YR SGS: 10-year Singapore government bond yield (IYC8 – Sovereigns)
US ISM: US business survey of more than 300 manufacturing firms by the Institute of Supply Management that monitors employment, production inventories, new orders, etc. (NAPMPMI)
EU PMI: Purchasing Managers’ index for the 17 country EU region (PMITMEZ)
JP TANKAN: Bank of Japan business survey on the outlook of Japanese capital expenditures, employment and the overall economy, quarterly index (JNTGALLI)
CHINA IP: China’s Industrial Production index, with 1-month lag (CHVAIOY)
LC: Local Currency

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