Financial Markets and the Economy

By Brian Fabbri
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Stock markets around the world are surging but economies are not.

The direction of an economy’s stock market has long been considered a good barometer of the health of that economy. Over the past several quarters stock markets throughout the world have been rising rapidly while the economies of the developed world have been stagnating and the growth in the economies of the developing world have been decelerating rapidly.

Another very good market barometer of economic activity is the price of commodities. The relationship between global industrial production and virtually any broad index of commodity prices has been highly positively correlated over long periods of time. It still is: commodity prices have been falling for almost a year and the growth in global industrial production has been subsiding. Therein lies the contradiction between the soaring prices of stock markets and the dismal performance of the underlying global economies.

This financial enigma can be understood by examining the behavior of major central bank policies.

The biggest central banks in the world have been expanding their balance sheets at an unprecedented pace since the 2008 financial crisis. A glance at the second chart reveals that this unprecedented growth in central bank assets is occurring throughout the developed world (the US, UK, Japan, and EU). For example the US Federal
Reserve has increased its assets fourfold over the past 5 years, from $830 billion to $3,200 billion. The Fed’s asset purchases expand the US banking system’s reserve base. Given the present 10 to 1 reserve ratio, these increased reserves could multiply money creation enormously. The fact is money creation hasn’t proceeded at this extravagant pace because business loan demand has not expanded rapidly. This however could quickly change once the economic outlook improves.

![Growth of Central Bank Assets in past 7 Years](image)

The intention of central banks is admirable and understandable: they need to stimulate aggregate demand in their respective dormant economies. Their Herculean efforts reflect their frustration with only middling results following years of money and asset creation.

**Austerity-oriented Fiscal Policy contradicts monetary policy**

Their frustration results from the negative nature of fiscal policy in each of their economies. Present fiscal policy in all of these economies is creating a contractionary impact on each economy’s growth. In the US the Congressional Budget Office has estimated that the fiscal drag implied from this year’s fiscal budget would reduce GDP growth by 1.5% to 3%.

Fiscal austerity imposed by European leaders upon most of the EU members has dragged all European countries into their second round of recession in less than 4 years. As a result, macro policy is working in opposite directions because austerity oriented fiscal policy is offsetting all, or more than all of the positive effects from expansionary monetary policy. This negative fiscal counter weight has become a serious dilemma for monetary policy makers and it has led them into creating too much monetary creation.

**Inflation in financial prices, not goods**

The inevitable consequence of too much money creation is a rising price level. However, while economic growth is subdued because of tightening fiscal policies, inadequate domestic demand, and suppressed business expectations for future economic activity, money creation’s effect on the general price level for goods and services is negligible.

Instead, most of the central banks’ monetary creation has poured into financial assets rather than real income producing assets. Because the central banks purchased massive quantities of longer-
term government bonds in the past several years, bond yields have tumbled down to unattractive levels. Central banks had already lowered money market rates down to minimal levels draining investment away from money market funds. Consequently, investors quickly altered their traditional diversified approach to investment and allocated proportionally more funds to higher risk equities, and real estate assets. Cheap surplus funds pushed asset prices substantially higher than they would have been especially relative to the feeble growth of their economies.

Moreover, in this increasingly interconnected world money created by central banks in the advanced economies is easily distributed throughout the world. The money created by advanced economy central banks is flowing to emerging markets, thus boosting stock indexes and real estate asset prices everywhere. Cheap and abundant liquidity is creating asset booms in many parts of the world. Often we acknowledge the role of animal spirits in asset price appreciation, but this time incremental price performance is attributable to surplus liquidity. Many economies in Asia have recently experienced surging real estate prices in recent years forcing local governments to impose strict regulations limiting local housing demand.

**Aggressive Monetary policy widens the wealth gap**

Of course present owners of financial assets think these policies are wonderful and hope that the party continues. But these aggressive monetary conditions have not helped the workers and unemployed who have no assets. Thus the rich get richer and the poor poorer. Aggressive monetary policy in the present global circumstances is widening the wealth inequality gap everywhere.

However, when liquidity creation stops and the central banks begin raising policy rates and shrinking their balance sheets, the global asset accretion party will end. All interest rates will rise, liquidity will contract, and the surplus liquidity-driven equity markets will become quite vulnerable. Then no one will be happy.

*For more information, please contact camri@nus.edu.sg*
## Key Indicators Table (As of 30 Apr 2013)

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<tr>
<th>Index</th>
<th>Level (LC)</th>
<th>%1MO (LC)</th>
<th>%1MO (USD)</th>
<th>%1YR (LC)</th>
<th>%1YR (USD)</th>
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<th>Level</th>
<th>%1YR</th>
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<tr>
<td>S&amp;P500</td>
<td>1597.57</td>
<td>1.93%</td>
<td>1.93%</td>
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<td>16.89%</td>
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<td>FTSE</td>
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<td>NIKKEI</td>
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<td>8.01%</td>
<td>48.32%</td>
<td>22.36%</td>
<td>10YR BUND</td>
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<td>HANG SENG</td>
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<td>2.03%</td>
<td>2.06%</td>
<td>11.78%</td>
<td>11.75%</td>
<td>10YR SPG</td>
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<td>STI</td>
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<td>10YR SGS</td>
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<td>US ISM</td>
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<td>YEN</td>
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<td>EU PMI</td>
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<td>CMCI</td>
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<td>Oil</td>
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<td>CHINA IP</td>
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Source: Bloomberg

## Appendix

**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 (CMCII)

**Oil**: West Texas Intermediate prices, $ per barrel (CLK3)

**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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