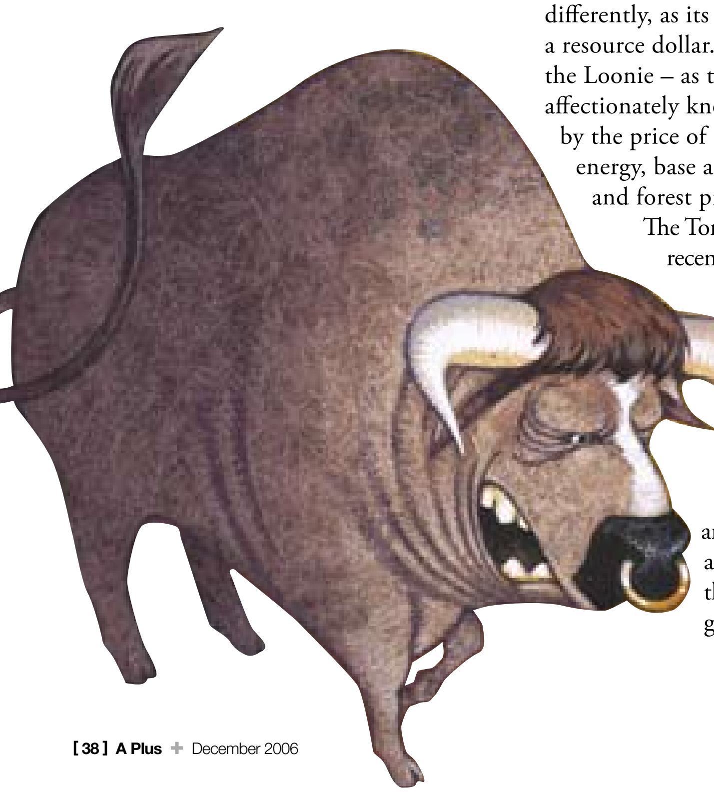
Money moves

Global liquidity is tightening – with repercussions for stock prices and clients' portfolios

By Theodore T.Y. Chen

A common mistake investors make is to equate a strong economy with a strong stock market, or healthy profits with a strong market. For example, during the 1987 stock market crash, the economy was good and corporate profits rising, yet the market dropped 22.6 percent in the United States and 22.5 percent in Canada. Historically, stocks have tended to peak with big earnings. So what is happening now and why?

Worldwide, with a few exceptions, capital markets move in tandem with the U.S. market and international trade is in U.S. dollars. The Canadian market affects worldwide markets differently, as its dollar is essentially a resource dollar. The movements of the Loonie – as the Canadian dollar is affectionately known – are governed by the price of resources, including energy, base and precious metals, and forest products.

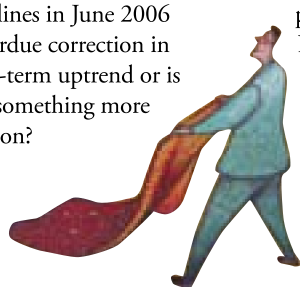


The Toronto Stock Exchange recently completed the longest rise in its history – without a correction of more than 10 percent. Are the price declines in June 2006 an overdue correction in a long-term uptrend or is there something more going on?

Dennis Gartman, an economist and trader, who writes *The Gartman Letter* on the global capital markets everyday wrote on 14 June 2006:

"This is a notion difficult for the young M.B.A.s among us who are taught that earnings drive prices. Those of us who've lived through both bull and bear markets know that earnings have nothing to do with share prices at major turning points. Always, always remember that at the start of the great bull markets of the '80s and '90s, the Dow's forecast earnings were negative... It matters not a whit what the fundamentals are, for in a bear market the good companies are taken lower simply at a slower rate. Just as a bull market takes stocks higher, a bear market takes them lower."

Bull and bear markets are fostered by liquidity, the extra money that finds its way into long-term financial assets such as stocks, bonds or real estate. The central banks of the world control this liquidity. After 9/11, the central banks increased global liquidity, resulting in both strong economic growth and rising asset prices. This global growth also produced the unintended consequences of higher commodity prices and inflation rates. Now the central banks are constricting global liquidity and this has affected stocks in several ways.



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Rising global interest rates

The Bank of Canada rate has increased from two to 4.25 percent and U.S. interest rates have risen from one to 5.25 percent and may rise further.
The higher the risk-free rate rises, the more investors opt for the safe alternative to stocks.

The yield curve has gone flat

In Canada and the United States, short-term rates are roughly the same as 10-year rates. Under this scenario, investment dollars tend to flow to the short-term rates as there is no yield pick-up to invest long term. A flat yield curve tends to curtail bank lending since profit margins on loans get squeezed.

Economist Marty Zweig points out that over the past 52 years, whenever short-term interest rates are 95 percent or more of the value of long-term interest rates (as they are now), U.S. stocks (S&P 500) have lost an average of 11 percent per year. Markets are also concerned that interest rate increases by Federal Reserve Chairman Ben Bernanke will invert the yield curve (short rates higher than long rates), bringing a recession in 2007.

Asian equation

An unprecedented event has been occurring over the past five years as the Bank of China and the Bank of Japan have been creating money to buy U.S. dollars in order to slow the appreciation of their currencies against the U.S. dollar. They have accumulated US$1.6 trillion. This has allowed the United States to get away with unprecedented deficits, both in their balance of trade and in overall budget deficits. Recent evidence has shown that foreigners are slowing their purchases of U.S. securities. If this trend continues, U.S. interest rates will be forced even higher in an attempt to attract foreign capital.

The U.S. consumer may be running out of steam

Savings rates have fallen into negative territory as gas prices and mortgage rates continue to rise. How much longer can the U.S. consumer keep spending?

Recent evidence shows that the U.S. housing market is turning into a bust. Sellers are lowering their prices to compete for buyers. For example, in Phoenix, Arizona, the number of houses for sale has risen from 5,000 to almost 40,000 in one year. Until the central banks again loosen their grip on liquidity, cash is probably the best place for the majority of accounts.

Market participants in Hong Kong are largely speculators rather than investors. They often follow the herd in a bull market, hoping for a quick return in a relatively short period of time. We have the role of advising clients to proceed with caution and to educate them of the signs of possible turning points.

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