

FINANCE ◀

Why markets will fall

Andrew Smithers

Expect a major world recession to start towards the end of 1999. It will be set off by the end of the Wall Street bubble. As share prices fall American households will seek to save more, not only because they will have less money for their retirement but because they will have smaller incomes. Employee stock options have been adding 1% or more of gdp to household incomes and a similar amount has been generated by mergers and acquisitions, which were running at 20% of gdp in the first half of 1998. This was double the rate of the previous year, which was itself a record. The m&a bubble will collapse with the market.

As the stockmarket falls, personal savings will rise. This is not really surprising, given they fell to only 0.2% of disposable incomes in June 1998. This compares with an average of around 6% over the past 20 years and 15% in Japan. As savings rise so consumption falls and as the trade deficit will continue to expand rapidly, corporate investment and profits will decline sharply. This will lead to a vicious circle, with poor profits causing the stockmarket to fall and the falling stockmarket leading, via higher savings, to even lower profits.

The psychology of American investors today is very like that of Japanese investors during their bubble. In the late 1980s investors were convinced that Japan had the strongest economy in the world based on the best technology and the best management techniques. Other countries were seeking to learn both. Investors have the same faith today about America as they had about Japan in the 1980s. The key difference was that Japanese management believed in long-term planning and never sacking anyone, while the current American fashion is a ruthless approach to hiring and firing. This difference will mean that the end of the American bubble will have a much faster impact on the world economy than occurred when the Japanese bubble burst.

The American stockmarket is hugely over-priced. This can be shown from the "q" ratio. This is the comparison between the value the stockmarket places on corporations and the amount it would cost to replace all their assets at today's prices. The theoretical validity of this measure was first demonstrated by a Nobel Laureate, James Tobin, in 1969. At that time there was, however, no data available to test it. Since then, however, the data have been collected and two Cambridge economists, Donald Robertson and Stephen Wright, have confirmed that the theory stands up by rigorous statistical testing of the data. This is exciting, as the sequence of a theory being postulated and then found robust under testing is more usual in the physical sciences than in

economics. It is also worrying, as the data show the market in June 1998 was well over twice its equilibrium level and has about a 75% chance of falling over the next year.

It was the insight of Maynard Keynes that recessions are caused by the wish to save being greater than the wish to invest. As both have to match up in the event, this disequilibrium has to be resolved and its resolution leads to recession. This prevents companies and individuals from realising the saving they hoped to make. A Keynesian view suggests that the world economy is in very poor shape to withstand a Wall Street crash. Japan saves around 30-35% of its gdp and cannot profitably invest anything like this in its slow-growing economy. Furthermore, this slow growth is no short-term cyclical aberration, but is the economy's likely long-term path. Japan's working population is falling and very slow growth is likely while this continues. The country's intentions to save will thus be hugely in excess of any likely investment for many years to come. Meanwhile, the rest of Asia is suffering from a cyclical savings surplus of such severity that a rapid recovery is improbable. "Euroland" has a steady savings surplus shown by its persistent current-account surplus, so only the profligacy of the English-speaking peoples has provided the balance to absorb the excess savings of the rest of the world.

Wall Street's rush to the stratosphere has thus been the major driving force behind the world economy. This could not be more unfortunate, as all the past bubbles have been followed by major and often prolonged recessions. The problem is that recessions set off by asset price falls do not respond readily to falling interest rates. This should cause no surprise. As stockmarkets fall, the cost of equity capital rises sharply and banks become less willing to lend. The overall cost of capital rises, therefore, even if interest rates fall sharply.

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