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Insights

MTB INVESTMENT ADVISORS

INFORMATION OVERVIEW AND PATTERN RECOGNITION

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Walking Backwards Into the Future

Today wealth is shifting from developed to emerging economies. The dollar's role as the world's reserve currency is being questioned. The composition of U.S. GDP needs to change focusing more on tradable goods and services. Health care needs to be reformed. The leadership position of the U.S. economy is being questioned. We have lived beyond our means for too long. Furthermore, the sustainability of the global rally in stocks is being questioned. Any sustainable rally will need to be fueled by the stabilization in global credit markets and the U.S. economy. But surely the past can provide us with some clues as to how the next few years might unfold.

In the fall of 1967, Norman Mailer and Marshall McLuhan participated in a debate that was part of the Canadian Broadcasting Corporation (CBC) show *The Way It Is*. In this lively debate, which is available in the CBC archives, many topics were covered including the Vietnam War, effects of the first satellite in space, the age of information, and the consequences of the new electronic age. In this interview, Dr. McLuhan hypothesizes that "faced with information overload we have no alternative but to revert to pattern recognition."[1]

With the development of the Internet and the explosion of cable television the quest for any investor is not so much getting access to information, but how to interpret all the information available. Thus unknowingly proving Marshall McLuhan's hypothesis, a day does not go by without some top-down researcher suggesting that the markets are following the pattern set in the 1930s, the 1960s or any particular time period for that matter. The mistake that many researchers make is that their research assumes that history repeats itself perfectly, which it does not. They are taking bits and pieces of the past, just as quilt makers take different pieces of fabric, to construct a forecast of the future. This exercise will help investors anticipate developments that may lie ahead. The upshot is, as Marshall McLuhan puts it, that we look at the present through a rearview mirror. We walk backwards into the future.

The Rise of Declinism

A major theme that seems to be propagated in the mainstream media is that the global financial crisis, and the housing bubble to be more specific, will spell the end of the period when the United States of America was the leader of the global economy. Declinism is now in fashion. As a species, we tend to think in narratives and the two competing narratives of today are tragedy versus rebirth. Thus, declinism is just a manifestation of the tragedy narrative, which seems to arrive every ten years or so, with the economic growth of China and the emerging markets replacing the U.S.A. as the lead characters in the play. It has been suggested that the 21st century is China's century just as the 20th century was the American century, and the 18th and 19th centuries were the British centuries. This may be the case, but following Dr. McLuhan's advice, let's look at the past to see if we can find any patterns that can help us interpret the vast amount of information on this topic so heavily discussed today.

In the 1950s America was enjoying the fruits of the post World War II boom. However, in 1957

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economic growth started to slow, the Dow Jones Industrial Average failed to surpass its high set in the spring of 1955 and in the summer a 20 percent correction began. Then, on October 4, 1957 it happened: The Union of Soviet Socialist Republics, the U.S.S.R., won the first round of the space race. The Sputnik satellite was launched. How soon we forget the response we had to this achievement. Paul Dickson's book *Sputnik: The Shock of the Century* explores the parallels between then and now. In short, the Sputnik satellite forced the U.S. to place a new priority on research science.[2] One of the offshoots of this refocus was the development of microelectronics, which helped the United States become innovative in computers and the Internet.

The key point is that out of a perceived economic and political crisis, the United States economy was able to refocus and redeploy resources to ensure its economic prosperity in the future. Therefore, in the past we have shown the ability to refocus, adjust and maintain our leadership position in the world. The rebirth narrative lives. Our response to the shock of Sputnik was to plant the seeds of the information technology age. To be sure, adjustment processes take time. Yet the stock market started to rally in 1958, which lasted until 1973. Yes there were significant corrections in 1961, 1965, and late 1968 into 1969, but the intermediate term trend was up.

In the summer of 1979 President Jimmy Carter gave a speech titled *Energy and the National Goals – A Crisis of Confidence.* In his speech President Carter suggested that the country was experiencing "a crisis of confidence."

> "The erosion of our confidence in the future is threatening to destroy the social and the political fabric of America…."

> "For the first time in the history of our country a majority of our people believe that the next five years will be worse than the past five years…. and the willingness of Americans to save for the future has fallen below that of all other people in the Western world…. "

> "We remember when the phrase 'sound as a dollar' was an expression of absolute dependability."[3]

During the next five years the S&P 500 rose from a level of 102.74 to 149.03, while the dollar index, the DXY, rose from 87 to 139. In fact, the dollar appreciated to a point that world economic leaders agreed to sign the Plaza Accord on September 22, 1985. The goal of the Plaza Accord was to depreciate the U.S. dollar in relation to the Japanese yen and West Germany's deutsche mark. Furthermore, the composition of U.S. GDP continued to shift away from manufacturing towards a more service-based economy. The savings rate however, after a brief period of appreciation from 1979 until 1982, continued its long march downward. But more importantly, we were beginning to see real green shoots in the information technology space. Economies take time to adjust, but in the instant gratification society that we live in, we want the adjustment process to be completed yesterday. Furthermore, looking back on the period of the late 70s and early 80s many label this period as the beginning of the bull market phase that lasted until 2001.

Readjusting to the Changing Global Environment

When the adjustment process does not happen quickly enough we revert to declinism. Declinism has a cycle. It seems that every ten years or so the United States' position as a leading innovative economy is questioned. The tragedy narrative grabs hold of our psyche and affects how we invest. However, if history is a guide, stock markets can appreciate in value even if the economy is going through a painful adjustment period.

The past has shown that we can adjust; history suggests that the rebirth narrative is just as likely or even more likely to happen. As investors we must focus on how our economy will readjust to the changing global environment. Global imbalances need to be addressed. A framework for balanced global growth needs to be agreed upon. Spending nations need to save more and saving nations need to consume more. Policies for unwinding imbalances must be agreed upon, exchange rate differences are key. China is now the focus. China is now a competitor for global resources and its economy is also the source of the majority of the excess capacity in the global economy. But an economy whose growth is predicated on labor arbitrage and artificial exchange rates also needs to adjust and yet we don't have any evidence that the Chinese economy can. To be sure, the visible hand of the centrally planned economy will attempt to facilitate change. China's economy needs to consume more, save less, introduce a health care system, and make sure that wealth creation migrates from the coastal provinces to the interior provinces. Those who subscribe to the declinism theory have already proclaimed game, set and match in China's favor. On paper they may be right, but as many sports fans know, the game still needs to be played.

Deflation –Making Sure It Doesn't Happen Here

The bursting of the credit bubble created a deflationary environment. The global economy has excess capacity and shrinking demand. To stimulate aggregate demand the Federal Reserve has had to cut its policy rate to zero. Zero interest rates provide a unique situation when one considers monetary policy called the liquidity trap. In 2002 a speech entitled *Deflation: Making Sure "IT" Doesn't Happen Here* Chairman Bernanke points out the well known fact "that when the Central Bank's policy rate falls to zero — its practical minimum — monetary policy loses its ability to further stimulate aggregate demand and the economy." He goes on to suggest alternative policy responses that they can use to stimulate aggregate demand and stop deflation, all of which are somewhat inflationary. In fact, Chairman Bernanke states that "it's worth noting that there have been times when exchange rate policy has been an effective weapon against deflation."[4]

A striking example from U.S. history is Franklin Roosevelt's 40 percent devaluation of the dollar against gold in 1933-34. The economy grew strongly, and by the way, 1934 was one of the best years of the century for the stock market." Paul Krugman in a 1998 paper entitled *It's Baaack: Japan's Slump and Return of the Liquidity Trap* concluded that when faced with a liquidity trap the central bank faces a "credibility problem — but it is the inverse of the usual one…monetary policy will in fact be effective if the central bank can credibly promise to be irresponsible, to seek a higher future price level."[5]

The key take away from the above research is that policies that are used to stimulate aggregate demand encourage inflation. Furthermore, the continued slide in the U.S. dollar will eventually stop this period of deflation and usher in a new period were rising prices and interest rates are the norm. So within an academic framework, we can surmise that inflationary policies and the devaluation of the dollar may be seen as a solution to the problem of deflation and would to some extent stimulate aggregate demand.

Economic Growth on the Horizon, But at What Rate?

To be sure, when growth does reappear, and shall we say growth that is not a temporary growth created by inventory de-stocking or fiscal policy, it will be tepid at best. However, if we use the early 1990s as a guide, health care may provide the growth needed to keep the stock market rally going. Recall, the early 1990s were characterized by the savings and loan crisis, unemployment was rising, and we had a new Democratic president who in his first months in office decided to take on the health care problem facing this nation. When gridlock arrived in Washington and President Clinton moved to the center, the health care sector outperformed the S&P 500 for the next two years. By then the information technology revolution that started with our response to the U.S.S.R. launching the Sputnik satellite, emerged as a significant engine of economic and job growth. Today our President is tackling the health care problem. Once the visible hand (i.e. the government) has done its job of affecting the flow of capital, the invisible hand of the economy can take over and provide investors with opportunities to grow.

When one focuses on the effects of the credit bubble on the supply side, many use the Austrian school as their point of reference. The Austrian school suggests that if credit creation is the root cause of economic growth, then it is unsustainable. Once the credit bubble pops, there is nothing that policy makers can do since their total focus is on stimulating demand. The only way excess supply can be taken out of the economy is through a long period upon which demand is injected into the economy. This may have been true in the 1930s but that pattern may not be relevant today. In the 1990s business managers around the world embraced technology. Thus, managers were better informed of changing market and industry dynamics and were able to respond quickly, and they did; managers reacted swiftly to cut capacity and production. Consequently, those businesses that relied on cheap credit to produce their goods and services were also forced to reduce output drastically. The result was that the supply response to the credit crisis was quick and drastic. Thus, the amount of excess capacity that exists in the global economy may be significantly less than many Austrian school supporters theorize. Marshall McLuhan was right to suggest that we revert to pattern recognition. The trick for investors is to realize that history does not repeat itself perfectly. Again as said earlier in this piece, pattern recognition when applied to investing to some extent looks like quilt making. Bits and pieces from different times in history are taken to construct a view of what the future may look like.

The U.S. Treasury is the Master of Reinvention

To summarize, when faced with information overload we revert to pattern recognition. Additionally, we look at history for clues. We need to look at many different periods of time when building patterns and recognize that history does not repeat itself perfectly. We conclude that during periods where our economy needs to respond to an exogenous shock, we tend to interpret this negatively and label it declinism. If history is any guide, we should take solace in the fact that the U.S. economy has proven that it has the ability to adjust and reinvent itself, a unique trait in modern history. The global economy will continue to evolve, as it has throughout time.

The U.S. and Chinese economies are entering into adjustment periods. The U.S. economy needs to consume less and produce more, while the Chinese economy will need to do the exact opposite. Policies that encourage inflation in the economy and allow for a devaluation of the U.S. currency are policies that are supported by academic research. The key question that needs to be answered is: will Central Bankers embrace these policies? If they do, then the technique of effectively communicating this will be very hard to achieve. The supply response made by corporations to the global economic slowdown may not be fully appreciated by those who suggest that the supply response has not been adequate. After a period of growth generated by inventory rebuilding and upgrading the world's infrastructure, because of the globalization of health care along with the evolution of our health care industry, health care may take a lead role in the market as it did in the early 1990s. To be sure, the adjustment process will take time. However, investors may be too hasty and assume that stock markets only go down when these adjustment periods are upon us. If history is any guide, the opposite is true.

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Definitions

GDP: Gross Domestic Product– a measure is the market value of all final goods and services produced within country annually and is a measure of economic performance.

DXY: U.S. Dollar Index, spot price index tracking the U.S.Dollar currency

The Austrian School: A school of economic thought. The Austrian school derives its name from its Austrian founders Carl Menger, Eugen von Bohm-Bawerk and Ludwig von Mises. Austrian school economists maintain the complexity of human behavior makes mathematical modeling of the evolving market extremely difficult and advocate a laissez faire approach to the economy.

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