Forecasting Beyond the Credit Crisis: Revisited (Again)

Phil Niles of Butterfield Fulcrum provides an annual check up on his forecast beyond the credit crisis.

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We are almost exactly at the three year anniversary of the collapse of Lehman Brothers and those darkest of days for financial professionals. It is hard to believe how quickly these few years have passed, but given the amount of change we have seen in markets it is not altogether surprising that time has flown by at such a dizzying speed. August 2011 proved to be an especially interesting month, with a United States debt downgrade, heightened economic tension in Europe, revolution in Libya, and Hurricane Irene all contributing to increased volatility and uncertainty.

Long-standing readers of Canadian Hedge Watch will recall my previous articles which forecasted beyond the credit crisis; we are now due for our annual check up to see how things have fared. Given the previous twelve months and the notable turbulence of this past summer, the timing would seem to be ideal. We will start with a quick refresher of our metrics: The Dow/Gold ratio, the Price/Earnings ratio of the Dow Jones Industrial Average, and the money supply in the United States as measured by M1.

Why These Metrics Matter

The Dow/Gold ratio has proven to be an interesting figure over the last few months, as we have seen a great deal of buoyancy in both the numerator and the denominator. As mentioned in a previous article, this metric serves as an excellent proxy for the relative value in the market, since gold is seen as the benchmark store of value. This has proven to be especially true over the last few months, with gold prices soaring to record levels. With both stocks and commodities under the watchful eye of all investors, no examination would be complete without at least a cursory look at this formative ratio.

The Price/Earnings ratio of the Dow Jones Industrial Average is important for a single reason: it represents how much one must pay for a dollar of earnings in the underlying investment. That may sound obvious to even introductory students of finance, but its implication is substantial. Jubilant markets blessed with rosy optimism will gladly pay more for each dollar of earnings, sending this metric upwards. On the flip side, a depressed and downtrodden Mr. Market will not feel too good about future earnings and conversely send this statistic in the other direction. In the end, the P/E ratio is a good indicator of investor confidence in the future of equity markets, always an important indicator.

Perhaps less obvious, the money supply has a solid bearing on the behaviour of markets. Specifically, it is the rate of change of the money supply that we care about, since a flood of money into the economy generally has an upward impact on asset prices. In order to re-inflate an economy, a central bank can put dollars into the marketplace to stir demand and encourage supply. On the other hand, of course, a withdrawal of money can have the opposite impact. The flow of money has an enormous impact on equity markets and, as such, warrants attention.

Our Examination Reprised

	2009	2010
Closing Level of the Dow Jones Industrial Average	9,015.10	10,434.17
The Price of Gold (US $/oz)	843.15	1,239.74
Dow/Gold Ratio	10.69	8.42

Let us start with the Dow/Gold ratio. Sparing the reader the details, our previous examinations from 2009 and 2010 yielded us the following results:

One can see that, between 2009 and 2010, the relative value of the stock market dropped when compared with gold. Given the recent headlines concerning gold and its incredible appreciation, one would expect our ratio to go down further. The results speak for themselves:

	2009	2010	2011
Closing Level of the Dow Jones Industrial Average	9,015.10	10,434.17	11,559.95
The Price of Gold (US $/oz)	843.15	1,239.74	1,832.50
Dow/Gold Ratio	10.69	8.42	6.31

As one would expect, the ratio has again fallen, but not perhaps not by as much as one would expect. Gold prices have been doing almost nothing but surging, so it would be easy to think that the ratio should have plummeted, but this does not appear to be the case. Our previous examination of the Dow/Gold ratio and previous secular bear markets indicated that the ratio tends to bottom out at no less than 5, with the early 1980's featuring a ratio less than to 2:1. As such, history seems to be dictating that, despite gold's meteoric rise of late, there is movement yet to occur in the ratio.

The Price/Earnings ratio is our second metric and should additionally help to gauge investor sentiment about the future of the market. As of the end of August 2011, the Dow Jones Industrial Average featured a Price/Earnings ratio of just less than 13. The ratio as of two years ago? Just greater than 13. Put simply, the ratio has essentially been unchanged from the summer of 2009 to the present day. Using previous secular bear markets as a guide, the Price/Earnings ratio of the Dow Jones Industrial Average has historically bottomed out below 10, even as low as approximately 5. This would seem to indicate that this ratio needs to drop from its current level.

At the time of writing in 2010, the ratio stood at around 15.6, meaning that we have seen a drop in the ratio since this time last year. Practically, this decrease in the ratio can come from two sources: a drop in the level of the index or an increase in earnings (or some combination of the two). As one can see from the table above, the level of the index has increased from last year, so the main driver of this ratio decrease is an uptick in corporate earnings. Working the numbers reveals that corporate earnings have increased dramatically from 2010 to 2011, but given the fragile state of the global economy, it is difficult to envision an environment where earnings can continue to increase sufficiently enough to decrease the ratio down to 10 or perhaps lower, which would signal a potential bottom in the secular bear market. This suggests that the level of the Dow Jones Industrial Average needs to drop to get the ratio in line with historical expectations.

Finally, we turn to the money supply. Not surprisingly, given the Federal Reserve's quantitative easing measures and strong desire to jumpstart the American economy, the money supply has expanded over the last twelve or so months. Specifically, it has expanded at a rate of more than 16% since July 2010, an enormous increase by anyone's measure. Recall our graph from the initial examination in 2009:

Change in M1 (% per year)

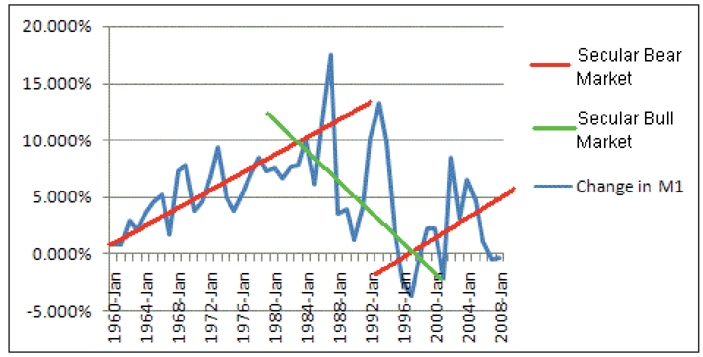

Figure 1: Change in the Level of the Money Supply (M1) 1959-2008 Source: The Author (2009)

Last year, we had about a 7% increase year-over-year in the money supply and now we are up to 16% annual growth. Visually, we can see that we are moving swiftly up the left-hand axis of the graph, effectively to the high point of the last fifty years. This fact bears repeating: the money supply in the United States is growing faster now than it has in a half century (I will leave the implications of future inflation for a separate discussion). Certainly, this should have a profound and positive impact on equity prices, but has it to date?

Recall that from last year's examination to the end of August 2011, the level of the Dow Jones Industrial Average has risen from 10,434.17 to 11,559.95, an increase of just over 10%. While this is certainly a welcome increase, it is relatively mediocre when compared to annual returns on equities for the last century or so. Given the rapid expansion of the money supply, one might expect a far greater increase in equities, but this does not appear to have come to pass, at least not yet. Perhaps there is further upside to come in stock markets based on this increase in the money supply, but it would seem to run counter to our other two metrics.

Conclusion

At the risk of being branded a permanent pessimist, the statistics seem to indicate that there is weakness in equities yet to come. The rate of change of the money supply seems to be the lone bright spot, as its expansion should, in theory, help at least prop up investor demand as well as global economic activity. That being said, the Dow/Gold ratio and the Price/Earnings ratio are only beginning to trend towards the levels seen at secular bear market bottoms. As encouraging as the expansion of the money supply has been for equity investors (not to mention other actions by the Federal Reserve such as rock bottom interest rates), true changes in the secular market trend are signalled by all three of our metrics agreeing, which sadly has not yet occurred.

Ultimately, it remains to be seen whether the efforts of the Federal Reserve's loose monetary policy can counteract the foretold declines. Given the continued fragility seen in the global economy, it would seem optimistic to expect the actions of the Federal Reserve to be a singular driving force in a stock market boom Fortunately for alternative investment managers, even within severe secular bear markets, there are shorter-term bull markets for equity investors to enjoy, meaning there should prove to be plenty of opportunities on both the long and short side for talented money managers. Regardless of the direction of markets over the coming months and years, such a difficult and unique market environment should provide our industry with ample opportunity to demonstrate our ability to generate alpha for investors. *