



BEWARE OF THE STOCK MARKET HERD

Optimism in the stock markets is based on not much more than faith in the herd says Sean MacHale, Head of Treasury & Global Markets at HSBC Corporate Banking Ireland.

If there's one thing which has got commentators excited over the last few months, it's the rally in stock markets across the world. Since the trough in the spring of 2009, developed markets have risen by around 60 per cent while emerging markets have more or less doubled. You could almost hear the huge collective sigh of relief as the gloom and despair which threatened to engulf the financial world in late 2008 rapidly dissipated.

For many, however, the rallies are more than just a step back from the abyss. Some policymakers are beginning to think that enough has been done and that now is the time to beat a timely retreat. In the emerging world, big stock market gains suggest there's too much liquidity sloshing around, indicating that the next big problem is likely to be inflation. In the developed world, the gains suggest that the various unconventional policy measures - mostly falling under the banner of "printing money" - have proved remarkably successful. On this view therefore, interest rates should be heading upwards, quantitative easing should be brought to an end, and the life-support measures should be withdrawn..

Those with a trigger-happy disposition might, however, want to think again. Stock markets can be hopeless lead indicators of economic prospects. Even recently, the collapse in markets seen in the second half of 2008 apparently heralded the onset of a Great Depression mark II. Touch wood, it looks like this won't happen. Ultimately, stock markets are good at telling us what people, collectively, believe at any point in time. They are useful gauges of investor confidence. It's undoubtedly the case that investors feel a whole lot better today than they did a year ago. But their optimism is of the crystal-ball variety, based on not much more than faith in the herd. Herds, though, don't always make good investors.

Japan's experience following the onset of its post-bubble crisis at the beginning of the 1990s is a cautionary tale. Many people incorrectly believe that Japan's stock market continuously fell from the onset of its initial decline in 1990. As equities lost their allure, so it's claimed, Japanese savers began to feel worse off. They cut back on their spending, leaving the Japanese economy as a whole, short of demand and, thus, persistently fighting its deflationary demons. In truth, there were occasions when Japan's stock market delivered spectacular gains. Throughout the 1990s, investors had the opportunity to make a killing so long as they were fleet of foot. Between the trough in 1992 and the subsequent peak in 1993, for example, Japan's stock market rose by almost half, a spectacular gain in just one year. Between the trough in 2003 and the peak in 2007, investors parking their money in Japan would have made a gain of 140 per cent.

As a colleague adept at stating the obvious once said to me, "The best time to buy the stock market is when it hits bottom." But buying at the trough is not easy. That, after all, is the period of maximum peril. Having seen a market fall off the edge of a cliff, few investors are happy to jump back on. For every investor who gets the timing right, there are many more who either jump back too early, finding themselves losing their own, and their clients', savings all too quickly, or jump back too late, by which time the market is close to its next peak.



All in all, Japan's stock market has staged eight major rallies over the past 20 years, offering returns for brave investors well into double digits and, on one occasion, in triple digits. These rallies often reflected renewed optimism over the outlook for the Japanese economy. That optimism, however, was mostly misplaced. Each cyclical recovery in Japan's economy was followed by yet more evidence of structural decline.

The wise investor knew not just when to buy the Japanese equity market but also, critically, when to sell. Those who bought and held, following the traditional view that equities are good investments for the long term, would have done very badly indeed. Japan's stock-market performance ultimately has delivered two decades of structural decline interspersed with the occasional moment of false hope.

Believing that a recovery lies just around the corner can certainly be helpful. Japan's experience, however, suggests that such beliefs are hardly foolproof. Japan's real problem was not the lack of policy stimulus, as is so often claimed by complacent Western policymakers, but instead a sudden and unexpected downward shift in the sustainable rate of economic growth. As investors came to terms with this new and depressing reality, they took their money elsewhere, either sending it abroad or, instead, buying safe, but boring, assets such as Japanese government bonds. Lower growth, in turn, resulted from population ageing, the increased competition from China, a lack of political will and an absence of flexibility in labour and product markets.

Fortunately, the Western world doesn't suffer from all of these problems and, where there are similarities, the magnitudes differ. For example, the US's and the UK's populations aren't ageing at anything like the Japanese pace. Nevertheless, there is one theme common to both Japan in the late-1980s and the US and the UK in the early years of the 21st Century: debt.

The Japanese financial system was hobbled by it. The Western banking system doesn't look much better. Japanese companies borrowed too much. Western households have also borrowed too much. While it's true that Western nations have been quick to offer a Keynesian fiscal stimulus which, for many years, Japan chose to avoid, its effectiveness remains unclear. 2010 may well prove to be the year when earlier worries about the health of the financial system and of households will be replaced by concerns over sovereign debt. Tax increases, spending cuts, currency devaluations and sovereign defaults will be the big themes for the coming months. Each of these threatens to limit the pace of Western economic recovery, thereby creating fears of ongoing stagnation.

Don't get me wrong: I would far rather have a rally in stock markets than a complete collapse. But we must be aware that stock-market rallies, on their own, say very little about future growth prospects. The worst economic outcome has probably been avoided; the best economic outcome, however, may still be out of reach. If so, stock markets may struggle to offer the returns in 2010 that they delivered throughout much of 2009.

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