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Extended periods of robust macroeconomic growth are healthy for investing

by Paul Conlin

The 2010-2013 economic recovery from the 2007-2009 recession has been weak and even feeble by many historical measures. GDP growth is bouncing around between 1% and 3%, depending on the quarter. Short term interest rates remain at zero, 5+ years after the fall of Lehman Brothers. Long term unemployment is a severe problem, with benefits being extended out to 99 weeks and possibly beyond. And while the unemployment rate itself has steadily fallen, this has primarily due to a sharp drop in labor force participation rates (the lowest since 1978), rather than a return of robust job growth.

The subpar recovery is deemed by many to be a bad thing, and for those unlucky individuals in the vortex of it, it no doubt is. But is it bad for investors, I would say not. Or at least that the alternative is even worse. The investment landscape has changed, in ways I believe most investors are unable or unwilling to face.

The last three periods of robust macroeconomic expansion have all ended badly, all due, I would argue, due to the investment fallout. The 1983 to 1990 expansion resulted in overinvestment in commercial real estate, which caused a macroeconomic shock. The 1993 to 2000 expansion resulted in overinvestment in technology/media/telecommunications, which caused a macroeconomic shock. The 2002 to 2007 expansion resulted in overinvestment in residential real estate, which caused a macroeconomic shock. In all three cases, investors in all asset classes paid dearly when the music stopped playing, and investors in the particular asset class where the overinvestment occurred paid a catastrophic price.

I would argue that the parallels in the three example above are not coincidences, and that there are at least two macro/societal/political events which have caused permanent changes and rendered the old "business cycle" view of the world an anachronism. Investors ignore these at their peril.

1) The revolution in real-time availability of and transparency of financial information causes self-reinforcing vicious circles of new money investment to build and build in favored asset classes until they reach uncorrectable levels.

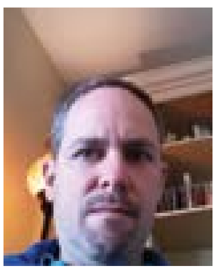
In the 1983-1990 commercial real estate bubble, the worst investments were made at the tail; new money plowed in around 1988 or later is what ended up sustaining the heaviest losses. At the time, retail participation was little, but life insurance company and commercial bank participation accelerated the most at exactly the peak of the cycle, but in such large amounts that the ultimate crash wiped out all the previous years of gains. The late 1990s internet bubble was of course a retail investor phenomenon, with everyone chasing a, in hindsight, small universe of internet stocks, with 1999 presenting the ridiculous outcome of the entire gains in the Wilshire 5000 being attributable to stocks who reported negative GAAP earnings. And the residential real estate boom was a super-bonanza of retail investor participation thru their primary residence, and institutions piling on via derivatives in an asset class they had historically sat out.

The next asset class to outperform on a consistent basis will draw mind-boggling waves of cash, a situation from which there is no graceful exit. (Perhaps we are on the way there in the $17 trillion U.S. Treasury bond market, although I don't get that sense.)

2) The Federal Reserve no longer has the political stomach to engineer a slowdown before the bad stuff starts to hit.
The story of Alan Greenspan standing by (at least non-verbally), intentionally, during both the internet bubble and the residential real estate bubble is now well known. The legacy of the man once thought the greatest Fed Chairman ever has been permanently tarnished. I believe these same instincts were at work in the late 1980s, although he largely has sidestepped blame for this one, if for no other reason

than it was just so long ago. But I would argue that more was at work than the laissez-faire framework of a single Fed Chairman. Ben Bernanke's term, while admittedly in such an odd time as to make broad conclusions difficult, expressed a strong bias towards expansion, with very low regard for the dangerous consequences of putting the foot full speed on the economic accelerator. As recently as January 2014, he has brushed off concerns of damage to emerging markets by stating that "The Fed is not the central bank of the world."

It pains me to say it, but the 19th century Marxists, at least on this topic, were right. Capitalism cannot control itself; it wants too much of a good thing, and won't stop eating until it to too full and has a belly-ache. Slow economic growth is not what ails us. In fact, we should be grateful it is on hiatus.



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