A Better Measure for Disequilibrium?

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If the Fed is truly causing a disequilibrium in the markets how can we better measure for that and prepare for it?

Understanding A Disequilibrium Effect

One of the biggest debates raging in financial circles these days is whether the Fed is causing a disequilibrium in the market. That is, is the Fed, through QE, causing distortions that actually exacerbate the boom phase which might lead to an inevitable bust?

A real-time example of this could be Japan where we've seen a 65% equity market rally in just 6 months. Is the economy that much better off in Japan? Is the corporate outlook that much better off in Japan? We won't know for many months or years, but the fundamental underpinnings look weak at best.

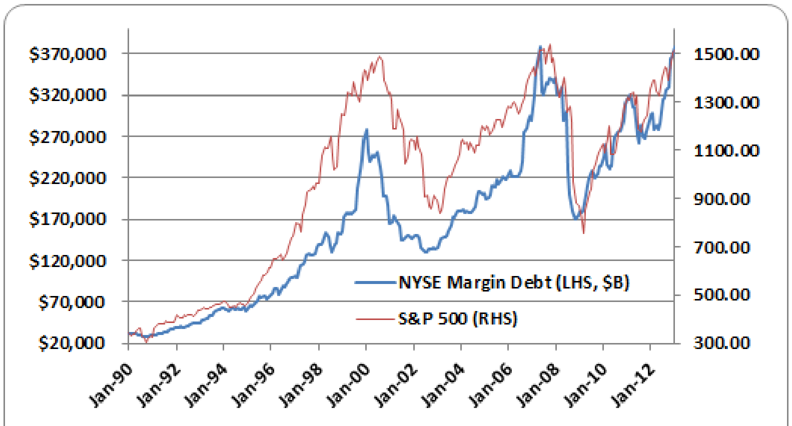
The evidence from QE shows that it doesn't cause inflation or really help the broader economy all that much. In fact, all it really seems to do is cause a portfolio rebalancing effect where fewer outstanding Treasury bonds in the market force investors into other asset classes.

Of course, there's been real economic improvement in places like the USA and I've been quite vocal about that for many years now. But we should still be aware of the potential for disequilibrium as it could create an unusually risky environment going forward. For instance, I presume that fiscal policy and now organic private sector growth are doing most of the heavy lifting in the economy. But most investors believe QE is the primary driving force. So if

> Is there a disequilibrium effect in the markets? If so, can it be measured?.

we entered an environment where fiscal policy tapered off and the private sector became weak (for whatever reason) then QE might be exposed as the weakest link. If this were to occur then we'd experience a substantial downside risk as the Fed would be compromised.

Now, I think it's also important to understand the reality of our credit based economy in this sort of environment. The unfortunate reality of a credit based economy is the potential for a disaggregation of credit. That is, we can have good forms of credit and bad forms of credit. The good credit use includes things like corporate loans that go into infrastructure investment, paying employees, etc. The bad forms of credit include things like taking out loans to speculate on housing or stock prices. The 2003-2007 period in the USA comes to mind….



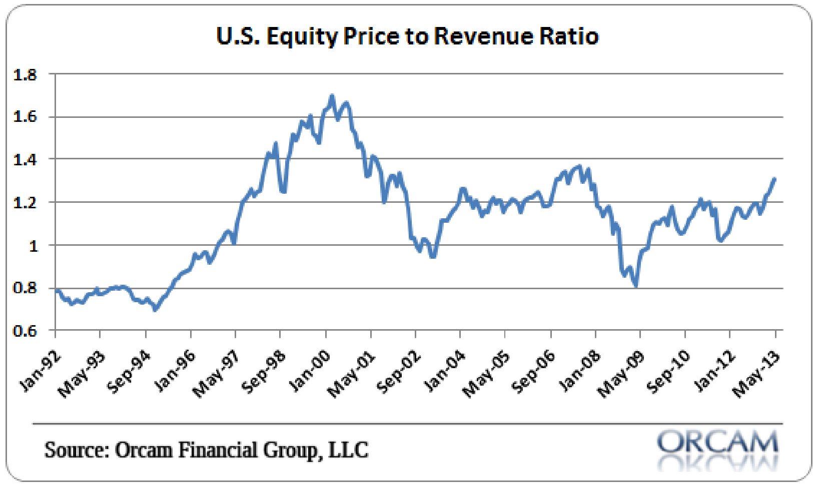
Source: Orcam Financial Group, LLC

One clear sign of this to me is the NYSE's margin debt data. I've discussed this recently and it's gained quite a bit of exposure for good reason. The all-time highs in margin debt show an investor class that has grown increasingly complacent with regards to potential downside risks. In essence, investors are saying "to hell with it, the Fed has my back so I'll leverage up and buy equities. What could go wrong?" Of course, that's the sort of mentality that tends to occur when markets are at their riskiest phases.

But this alone is not a sign of disequilibrium as it could be a coincident indicator. Instead, I prefer to look at market price relative to total business revenues. What we've essentially got here is the corporate top line (which can't be fudged) and the market price (which also can't be fudged). So this is a rather clean way of looking at the state of corporate income statements relative to what the equity market is actually telling us.

So what's the conclusion from this data? As the chart clearly shows, we're at an unusual level in the ratio. In fact, we've only been above this level a handful of times in the last 25 years. So I would say that the markets are definitely pricing in a certain euphoria that might not be sustainable. Of course, the key to forecasting when to move our core strategic piece to a more conservative positioning will be the point where corporate profits are most at risk.

And history tells us that that occurs when recession risk is high. At present, I don't see signs of recession, but we should be aware of the disequilibrium that is building. If history is any guide this sort of level in the ratio is eventually followed by sharp equity price declines. But not until recession (and profit recession) begins.



Although I've been emphatic about hedging the core piece with our tactical view in recent months I think you still need to remain bullish in the core strategic piece. Sometimes you just have to hold your nose and walk into a smelly room. Based on numerous trends the room continues to smell increasingly bad, but there are no signs as of yet that we need to run out panicking.