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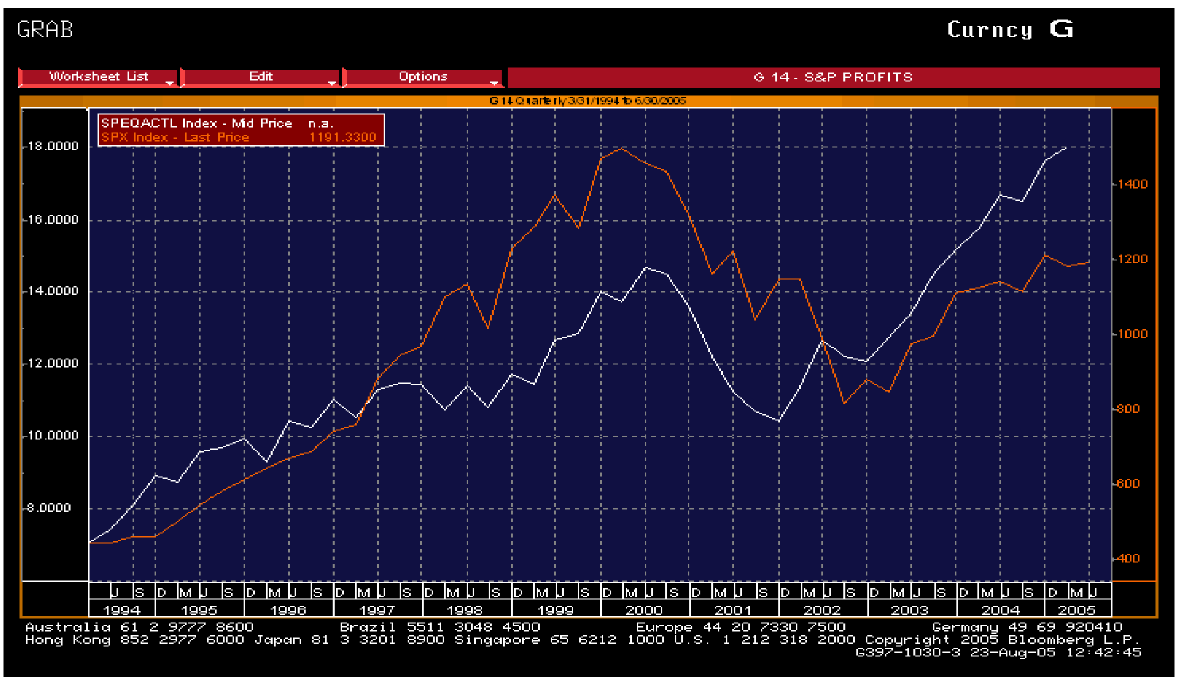
The Doomsday Cult

This piece does not offer any explicit investment recommendation. It merely sets out counter-arguments against doomsday scenarios that have become fashionable in weblogs and discussions. The groupthink that pervades such discussions reminds one of cults. This is ironical because doomsday arguments emerged as a rational reaction to unbridled optimism in global equities markets in 1999-2000. Now, they are in need of a similar treatment themselves. It appears both rational optimism and pessimism eventually become victims of their own momentum.

The note is long but has many parts. You can choose to read the portion that you are interested in. The views are purely personal.

The following chart (inspired by CLSA Research) should convince you that bears are on a weak wicket. It is a chart of S&P 500 Earnings per share and that of the S&P 500 Index itself.



Source: Bloomberg. Inspiration: CLSA. Chart of S&P 500 Quarterly Earnings per share (white line) and S&P 500 Index (red line).

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In the 1990s, the index ran ahead of the growth in earnings and hence set itself up for a correction. Since then, the index has trailed the growth in earnings. This is not a forecast for the index to gallop from here on. After all, there is a reason why corporations are sitting on hoards of cash and are being cautious. The same caution might hold back the index too.

Nonetheless, the point here is that there is no reason to panic and predict the end of the world as we know it, in 2006. Last point is that if the end is nigh for the US economy, the US dollar, stocks and bonds, then there is no hiding place elsewhere globally.

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Economists and Cult leaders – what is the difference?

Most well-reasoned and well-argued Blogs, after a time, become cults associated only with a particular point of view. I find that more fascinating than the breathless predictions of an imminent collapse of the US economy. I wonder if the authors of blogs are pushed (knowingly or otherwise) into maintaining such a stance because of the 'cult-like' following that their original views attract. These followers in turn reinforce the original authors thus locking each other into their entrenched positions. Finally, their behaviour closely resembles the conventional wisdom that they initially set out to challenge which was what was refreshing about them, in the first place. I suppose this is inevitable in human beings.

Indeed, they risk aping what happened to Mr. Greenspan. He warned of irrational exuberance in 1996. He quickly backed off and began praising productivity miracles and took the consensus forecasts of rising profitability in the wake of low inflation, as a sign of improving productivity. Consensus opinion in turn drew strength from his productivity mantra. Thus, both sides were reinforcing each other without any external validation.

Let us take the posting by Nouriel Roubini on the crude oil price impact (http://www.rgemonitor.com/blog/roubini/96167) and the responses it drew forth. Yes, surely, crude oil and the housing market are emerging as big risks to the US economy and indeed, to the global economy. The problem with all of these is that why no one attempts to present any alternative hypotheses to the doomsday conclusions that are automatically drawn for the US economy and the US dollar.
Let me attempt some here. I will confess that none of these are presented as being any more likely than the doomsday scenarios. The truth is that no one knows. But, they are hypotheses that need to be taken seriously, in my view.

Before I do so, permit me a digression. One of the responses that Mr. Roubini's posting drew cited an article by one Stephen Schurr at the FT. That article was titled '*America faces a big chill*' and went on to discuss other alternative stock markets. One of them was India.

If one took the trouble to read the author's views on India helpfully available to us in his article published in FT dated August 10th, then one can determine the extent of seriousness one needs to attach to his views on the coming doomsday in the US.

Indian stocks 2005 = US stocks in 1984?

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The author admits that a presentation made by an Indian brokerage house in New York in July/August had struck a very powerful chord in him. The presentation has made a startling revelation that India is in the cusp of a secular stock market upswing similar to the one that began in the US in 1984. As an Indian, I really wish I can have the same amount of faith and trust that Mr. Stephen Schurr has on this view.

Now, let it be said that it is entirely possible that this forecast could turn out to be more accurate than my pessimistic arguments that follow. All decisions about the future are decisions made under uncertainty. But, at T_0, there is no way of knowing it. Investment recommendations have to be analysed, based on their intellectual robustness and not forecasting accuracy which is revealed at an unknown T_{0+T}.

Comparing India in 2005 to the United States in 1984 is intellectual sloppiness. If this point was made in 2002, one could applaud the broker for his foresight and prediction. The Indian stock market – the Mumbai Sensex Index was at around or below 3000. Now, the market is near 8000. In 1984, the US stock market was exceedingly cheap. Today, one could make the argument that India is not overvalued if the earnings prospects for the next four years are as good as they have been for the last four years. But, no one would make the argument that India is cheap as the US stock market was, in the 1980s. The S&P 500 P/E was, perhaps, in single digits in the early eighties. Indian P/E is around 13 depending on what one's 'E' is. Further, the dividend yield on US stocks was much higher than it is in India now. Indeed, the Indian stock market dividend yield is one of the lowest in the world.

The US and the global economy were coming off an oil price shock. Oil prices were well on their way down in the early eighties. Now, we do not know if they have even peaked. The US fiscal deficit was perhaps at 2 to 3% of GDP then. The Indian fiscal deficit is around 10-11% of GDP and there is no sign of any recognition of the problem and impending action.

To be sure, Indian corporate sector has undergone a lot of restructuring. However, in the light of all these profound differences, the question to ask is the direction of risks at current price levels. In other words, are the positives in the price or not?

I leave it to you all to judge and then to decide on the main question of how much you wish to take Mr. Schurr seriously on his prediction of the coming American big chill.

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Wishing a biblical punishment on America

Indeed, if there is an American chill, the rest of the world would catch flu even before America does. What does it say of the collective wisdom or resilience of the world economy if it is so heavily dependent on the economic growth of the American economy derived from one American selling house to the other, as Mr. Krugman has characterised the US economy. Where is the hiding place, ladies and gentlemen, if America is a basket case?

Therefore, before we either predict or wish for America to pay for its 'excesses', let us be very clear that when the tide of American growth goes away, many other nations would be seen to have been swimming naked. That includes many current account surplus countries in the world today.

Indeed, one is curious as to why there is an almost 'biblical' wish for punishment as though we all know what is normatively correct and wrong in economics and public policy and that what M/s Greenspan and George Bush did was normatively so wrong that America had to pay a price for it.

Back in the 1990s during the Asian crisis, economists like Paul Krugman argued that it was not the job of multilateral financial institutions to inflict pain for economic crises to heal. The Bank of Japan did that to Japan in the early Nineties and the results are there for all to see.

Now, it is strange that many appear to perversely wish for such an outcome. I hope I am wrong and I would be glad, if I am.

That brings us to the two main risks for the US and for the global economy: Oil and the US Housing market.

The role of speculation in oil price

Every one is predicting that oil would go to USD 75 or more. Implicit is the assumption that oil price is efficiently determined and that it reflects the demand and supply balance correctly. The surprising thing is that there is no research into whether speculation has played a part in this price surge. Even though it was accepted that exuberance and speculation could have played a part in the stock market bubble in the late Nineties and in 2000, it is implicitly assumed that the oil market is efficient, despite the fact that the cost production of one barrel of oil is perhaps at worst, USD 10-15, that there are a very limited set of players who set the price, energy trading desks in investment banks have proliferated in recent years and notwithstanding solid evidence that energy companies artificially caused a power crisis in California.

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Is it beyond their brethren to cause a similar crisis in the crude oil market? After all, we live in a world when well known auditing houses with brand names and reputation to protect do not seem to mind compromising themselves. Why is not asked whether there is a similar possibility in the oil market?

John Berry, the Bloomberg columnist, did cite a research in July that pointed to the role of speculation in crude oil. This is what he had to write:

"*Analyst Mike Rothman of International Strategy & Investment, a former oil market strategist at Merrill Lynch & Co., estimates that about a third of the $60 per barrel price of crude is the result of such speculation.*

``Based on a new analysis looking at values of longer dated crude prices, we'd posit a guess that up to $18 to $20 for the current oil price may represent the impact of speculative paper chasing oil,'' Rothman told his clients this week.

If Rothman's estimate is anywhere close to right, this is a case in which speculation has really made a difference in the real world over the past year. In his analysis, ISI's Rothman first plotted the price of West Texas Intermediate crude -- a benchmark measure of oil prices in this country -- against the total level of U.S. crude and refined product inventories. For the period beginning in January 2000 and running through March 2004, the variations in inventories explained more than half the variations in prices, he found.

"Current U.S. oil inventory levels suggest WTI crude prices should be around $25 a barrel,'' he calculated. ``Given underlying issues and concerns about OPEC capacity and demand growth, we certainly are not prepared to argue that the price spread between the $25 model value and near $60 actual is all speculation, but we do feel that a portion is.''

To come up with a figure for that portion, Rothman then examined another long-running relationship -- that between spot WTI crude prices and the spread between the nearby and one-year- out crude futures price.

``This long-dated oil price and the related spread seemed to a reasonable factor to evaluate, given the disproportionate buying pressure we have seen for outer-month oil,'' he explained.

This indicator suggested that the profile of oil futures prices for contracts expiring a year out does not support a current price close to $60 a barrel.

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Instead, from it ``we can infer that perhaps $18-$20 of the current crude oil price reflects the impact of speculative paper chasing oil,'' he said."

Source:
http://www.bloomberg.com/apps/news?pid=10000039&sid=aNVSjwvdb5Os&refer=columnist_berry

I will cite another argument:

Current OECD Consumption of oil (millions of barrels per day - mbpd) is in line with its five year average of around 48 million bpd between 2000 and 2005. Current non-OECD consumption of around 34 mbpd is about 10% more than the 5-year average of around 30 mbpd. However, the price of West Texas Crude is 210% of its five-year average. Doesn't it sound excessive?

Underestimating resilience to crude oil

Perhaps, if this line of thinking is correct, oil price has acted as a wonderful stabilizer of global and US growth in the last five years. It has checked overheating that might have followed in the wake of ultra-loose fiscal and monetary policies in the US and elsewhere. Now, as these tailwinds fade, oil might drop by about USD 20 per barrel in 2006 to help sustain the business expansion.

Further, given much reduced oil intensity it takes a lot more price increase for oil to affect the US economy to cause a full-blown recession. Second, Action Economics research points out that high oil price might trigger enough economic activity in the US in areas such as drilling, exploration, etc., in the US and globally and these are areas where US firms have a large comparative advantage. Hence, they are not even sure if the net impact of higher crude oil price – consumer drag and boost to oil related activities – would be to lower growth.

Really, those of us who are predicting doomsday for the US economy should put our hands on hearts and ask ourselves if we really expected the US economy to be growing at around 3.5% per annum in 2005.

Did any one pay heed to the details of the Philly Fed manufacturing outlook for July reported two days ago? The manufacturing diffusion index was strongly up over June and second, the outlook component was optimistic too. More importantly, nearly three-fourths of the survey participants expected their energy input costs to be higher in the next six months and yet, their outlook for their own businesses was optimistic. Are we ignoring messages that do not fit with our neat comfort zones?

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Perhaps, at the margin, high oil prices restore relative US manufacturing competitiveness. Since much of global manufacturing has migrated to the developing world, it is their manufacturing competitiveness that is under greater threat than that of the US. Therefore, is it a coincidence or something more to it than what meets the eye that the American ISM Manufacturing Index went up in the last two months?

Further, HSBC points out that, in July, the Port of Long Beach in-bound container traffic was weaker and the outbound container traffic was stronger. Is that the case of an economy that has lost competitiveness? This gap between inbound and outbound containers has a close correlation with US trade balance. Therefore, those who are expecting a larger trade deficit for July might be disappointed. Now, I applaud HSBC for pointing this out because their view on the US economy and the US dollar is rather bearish. Yet, they were open to a piece of news that invalidated their premise.

It is not that I think that the above scenario has any more chance of occurring than the oil price rising to USD 75 or more per barrel. But, I find it hard to believe that we have all become so intellectually homogeneous to accept the oil price as god's verdict and that everything else has to crumble around that. It is the failure to consider alternative scenarios/points of view - cult-like behaviour – that I am concerned about.

Housing bubble: the case of Australia

On the US housing price and the impact it has on the economy, again, it is readily accepted that it is a bubble. Even Greenspan has almost conceded that. Second, its bust would shower everlasting ruin on the economy. This is amusing.

A study by the IMF for its World Economic Outlook in Oct. 2004 clearly showed that the US housing market was far less fundamentally misaligned than many other markets such as Ireland, Spain, England, Australia, etc. Second, English and Australian economies are slower but, by no means, have they collapsed. The Australian economy has the lowest unemployment rate now than at any time in the last thirty years and its central bank governor has almost described the state of the economy as being in 'Nirvana' (total bliss), thus granting himself an indefinite policy holiday.

Why should it be this way when the end to the housing boom should have caused the Australian economy to come crashing down? I must acknowledge here that even I entertained that thought in 2004. It has not happened. Just this week, Goldman Sachs/JBWere research (*Lifting the Veil on Australia's*

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Household Debt – Evidence from HES, Weekly Commentary, August 16th 2005) provided some vital clues with disaggregated data from Household expenditure survey in Australia. It showed that loan growth was the highest in those age segments that were at the peak of their earnings capacity and hence the servicing of the loans was not difficult and hence delinquency rates were also low. Lower income groups had not extended themselves at all. There might be anecdotal evidences of pain for a family here and a family there based on falling prices but is that a way to analyse the economy? Hence, it is not a surprise that the Australian economy had glided itself into a soft landing on home price correction. It is a different story that it might be more vulnerable to a crash in the Chinese economy than in its own housing market.

Perhaps, similar is the case with respect to the United States. Isn't it possible that disaggregated data would show that the bulk of the housing debt and other leverage occurred in age groups that had the highest income growth and hence there was no threat of macro-economic impact than was commonly feared?

Again, it is not that this benign scenario is any more likely than the other is but the failure to consider such possibilities is intellectually incorrect.

The coming US dollar crash

There is the other tendency to robotically trash the US dollar. The current account deficit hurt the dollar as long as US assets yielded far less. Now with short rates up, it is not the case. There is no theoretical correct model of exchange rate determination.

Indeed, if oil or housing brought down the US economy, it should be good for the current account deficit since American import elasticity of domestic demand far exceeds the American export elasticity of foreign demand. That really opens up another angle.

It appears that crude oil and the US bond market could be acting as automatic stabilizers for one another. When crude oil rises, bond market yields fall, anticipating an economic doomsday. That actually supports housing activity. When oil falls, yields might rise and while that might strain home price valuations, the fall in oil might be so supportive of economic activity in general that the economy might easily absorb the housing correction? In that scenario, American equities and bonds would offer attractive return prospects and thus enabling good funding of the current deficit.

Let us come from a different angle too. If US home prices correct because of economic activity collapsing and employment falling, what is it there to

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prevent a similar fate befalling Ireland or Spain? Indeed, Brad Setser acknowledges that Spain is to the Eurozone what America is to the global economy. According to IMF, Spain's housing boom is far more fundamentally misaligned than that of the US. If Spanish boom were to implode, isn't there a risk of strains in the Eurozone's single policy framework? More friction is likely to emerge between elected governments and the European Central Bank (ECB). Indeed, if recent OECD research were correct, the ECB is barking up the wrong tree when it insisted upon structural reforms under a single (or, fixed) currency framework. OECD empirical study concludes that structural reforms were more likely under flexible currencies and under full employment than under high unemployment or under fixed exchange rate regimes. (*THE EFFECTS OF EMU ON STRUCTURAL REFORMS IN LABOUR AND PRODUCT MARKETS, ECONOMICS DEPARTMENT WORKING PAPER, No. 438, by Romain Duval and Jørgen Elmeskov*)

Hence, with a high price of oil or a US home price implosion, is there no risk of a greater stress on the European single currency? If so, why should investors dump the US dollar in favour of other currencies that represent far more intractable problems? Which economy would an investor put his money on, to bounce back – the US or the Eurozone?

Challenge conventional wisdom – more if we are part of it

I have highlighted three areas where once-unconventional views now risk becoming stale conventional wisdom if the same logical rigour that was applied to challenge the then prevailing conventional wisdom were not applied to itself. Intellectual integrity is hard to earn. Some of the blogs have earned it deservedly but they must realize that it is equally hard to keep it.