

Will the Roller-Coaster Ride Ever End?

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Not anytime soon, thanks to a persistent deflation-reflation cycle. So buckle your seat belt.

It is not a stretch to liken the stock market action of the past decade to a roller coaster. Let's call it the deflation-reflation ride—a cycle of debt deleveraging and asset price deflation leading to central bank reflation (QE1 and QE2) and asset price inflation. There seems to be no flat ground. It has been all up or all down.

We have seen this cycle play out twice since 1998: first among corporations in the early 2000s and more recently among consumers. Soon it will be governments. In fact, this is happening in Europe, as well as in the United States at the state and local government level.

Where did this deflation-reflation cycle come from, and when will it end?

The Internet bubble ride

First we had the Internet bubble during the late 1990s, which followed the Fed's reflationary response to the Long-Term Capital Management (LTCM) hedge fund liquidity shock. This so-called tech bubble was fueled in part by the era of "creative" accounting, which eventually brought the P/E ratio on the S&P 500 up to 48 (which was three times the historical norm). Then the bubble burst and the S&P 500 declined some 53% from March 2000 to October 2002 as corporate valuations plummeted back down to earth. This decline was further compounded by 9/11, as well as several major accounting scandals (Enron, WorldCom).

The Fed responded to this downturn with aggressive monetary easing. Then-Fed-Chairman Alan Greenspan lowered short rates to 1%, steepened the yield curve, and brought real (inflation-adjusted) rates below zero. Then, in 2003, the globalization boom took off, lifting emerging market stocks and commodities, as well as almost all U.S. stocks (especially small caps). In fact, by my analysis, in 2003 an incredible 98% of all stocks went up.¹ And so another thrill ride was under way, from late 2002 to late 2007, driven by global growth and ample liquidity.

This liquidity surge was the result not only of an easy Fed but also of a significant relaxation of bank lending standards. This was, after all, the era of "no-doc" lending. The result of easy credit and rising home prices was a housing bubble in the United States.

The housing bubble ride

By 2005, the market's volatility had plummeted, creating a sense of complacency among investors, and with it a great buildup of debt among banks and consumers. But then the music stopped and the housing bubble burst, and down went the roller coaster, again. The S&P 500 lost some 57% from October 2007 to March 2009, as a massive deleveraging took hold among banks and households, which nearly brought the financial system to its knees.

But then, in 2009, the Fed and the rest of the world's central banks responded once again, only this time not just with lower rates but also with quantitative easing. As a result, liquidity soared and growth came back, thanks also in no small part to a massive fiscal stimulus by China. Once again the roller coaster went up, with the S&P 500 rallying some 100% from March 2009 to May 2011.

Then, six months ago the roller coaster turned down once again, on weaker growth, a retreat of the liquidity wave, and a debt crisis in Europe. The S&P 500 declined some 20% in the span of only a few weeks. Global markets declined even more.

Will the ride stop?

The irony is that investors have had to endure these massive swings in stock prices for over 10 years, and right now have little to show for it. Today the stock market is more or less where it stood a decade ago, and almost any other asset class has beaten stocks over this time frame, from bonds to gold to cash. The action is frustrating enough to make even the most seasoned investor consider giving up on investing in stocks.

Why are we stuck in this deflation-reflation spiral? In my opinion, the past decade or so has been part of a major unwinding of debt, first among corporate balance sheets, then among households, and now among governments. Whenever deleveraging takes place, it is by definition deflationary. Balance sheets are literally being deflated, either through liquidation or an erosion of value. Stocks and other risk assets don't like deflation (but Treasuries do). Earnings go down during deflation, along with stock prices. But then the central banks have responded when the pain gets to be too much to bear, and balance sheets and asset prices eventually get reflat again. It's the cycle of reflation and re-leverage (eventually) leading to bubbles, which then burst, leading to a spiral of deleveraging and deflation. Deflation-reflation: That is what this cycle is all about.

Which begs the question: When can we finally get off this roller coaster and go back to the good old days of investing, when a well diversified portfolio could achieve reasonable returns in up markets, while helping to protect downside risk in down markets?

I think it won't likely happen until all this debt has been purged from the system. The corporate sector has already done this, and today companies are lean and mean and flush with cash. Since 2008 it has been consumers who have been purging themselves of debt, either by choice through higher savings or by force through layoffs and foreclosures. Some progress has been made, but in all likelihood more time will be needed for the cycle to fully run its course.

This leaves the government. Since 2010, it has been the state and local governments that have been going through fiscal austerity, driven by the unwinding of fiscal stimulus and a reduction in tax revenues. Now with the Super Committee trying to come up with a deficit reduction plan, chances are that we will have some form of fiscal austerity at the federal level as well.

And, of course, we all know about the debt deleveraging in Europe.

The combination of a still-retrenching consumer and now potentially a retrenching government suggests that the forces of deflation and deleveraging are going to be with us for some time to come. This suggests further downside pressure on risk assets. However, offsetting these deflationary forces are more and more hints from the Fed that some sort of renewed reflation effort may be coming, most likely in the form of a QE3 consisting of large-scale asset purchases of mortgage-backed securities.

And it's not just the Fed. The Bank of Japan has committed to more asset purchases, as has the Bank of England. And even the historically hawkish-sounding European Central Bank (ECB) has been buying Italian debt and has been expanding its balance sheet. On top of that, Brazil has been cutting rates, along with Australia, and now even Indonesia.

So it is entirely possible, if not likely, that a new reflation ride is starting, which could lift stock prices all over again. In fact, I suspect that the sharp rally in the stock market since October 4 is due to this renewed perception that the Fed is about to become proactive again with its monetary policy.

So the deflation-reflation cycle continues. Hopefully, we are embarking on another reflationary wave now, but until imbalances have been worked off, the cycle will likely continue. Some day it will come to an end and markets will become stable again. But my guess is that it won't be anytime soon. In the meantime, the roller-coaster ride continues. Right now there are few good options, and you need to have realistic expectations regarding returns and volatility. In these times it makes sense to have a diversified portfolio and an investment plan that you are comfortable with and can stay with throughout the roller-coaster ride.

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1. Source: FactSet, FMRCo.

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