



Portfolio Strategy Service

#24 Hard Or Soft Landing?

#25 The High-Tech Revolution In The US of @

#26 The US Economy's Mega-Trends

#27 10,000 In 2000

Topical Study #28

LIQUIDITY STORY IS WILDLY BULLISH

February 12, 1996



Dr. Edward Yardeni
Chief Economist

I. Too Much Money Chasing Too Few Financial Assets

The monetary policies of the G7 industrial economies are very stimulative. The unweighted average of G7 three-month interest rates fell to 4.2% during the week of February 7, down from 6.0% one year ago (Exhibit 1). This stimulus isn't working as intended by the central bankers in Japan, Germany, and the US. Notwithstanding the sharp drop in interest rates, the G7 economies are in a recession (Exhibit 2).

For example, the three-month Euro rate for Deutsche mark deposits has plunged from a 1992 high of nearly 10% to under 3.5% recently. Yet the January unemployment rate calculated for the total German civilian work force, including the self-employed, was a record 10.8%, up sharply from 9.9% in December (Exhibit 3).

In the United States, the Federal Reserve cut the federal funds rate by 75 basis points since last summer; yet the composite index of business activity compiled by the National Association of Purchasing Management (NAPM) fell to a post-recession low of 44.2 during January (Exhibit 4). During the past 40 years, it fell below 45 only eight times and in seven of those occasions economic growth fell to zero or less.

Rather than boosting their faltering economies, rate cuts provided by G7 monetary authorities are driving up global equity prices and the price of gold. Easy money is likely to drive stock prices still higher around the world. Down the road, it also risks creating a big speculative bubble in global financial markets.

II. Money Makes The World Go Round

In my Topical Study #27 titled *10,000 In 2000*, I argued that the same secular trends that drove the Dow to 5000 in 1995 would probably propel the Dow to 10,000 by the year 2000. (See also my Topical Study #18, *Dow 5000*, May 9, 1990.) I'm starting to think that the Dow could hit 10,000 well ahead of schedule.

If this happens, other G7 stock markets are also likely to have huge gains. Furthermore, as long as interest rates remain low in the G7 economies, stock markets in emerging countries will also move higher. Let's review the recent performance of stock markets around the world:

- 1) The World stock index, compiled by the *Financial Times*, rose to a record high during the week of February 8. It is up 22% over the past 52 weeks (Exhibit 5).
- 2) The *FT's* North America stock index is at a record high, with all new highs in the US and Canada. It is up 33% over the latest 52 weeks (Exhibit 6).
- 3) The *FT's* Europe stock index is up 17% from a year ago to a record high, with new highs for Germany, the United Kingdom, and the Netherlands (Exhibit 7).

4) The Latin America stock index has rebounded over the past year nearly back to the 1994 record level led by Mexico's stock prices, which are back in record territory (Exhibit 8).

5) The *FT's* Pacific Basin stock index is still well below its 1989 record when Japan's stock prices peaked and started to crash. On the other hand, Singapore's stock index is soaring in record territory, and Hong Kong's index is fast approaching its previous 1994 record peak.

III. Easy Money Fuels Financial Asset Inflation

Stimulative monetary policy can stimulate four different kinds of economic activity:

- 1) Real spending on goods and services.
- 2) Price inflation for goods and services.
- 3) Price inflation for real assets.
- 4) Price inflation for financial assets.

Previously, I've argued that the end of the 50-Year War of Modern Times—i.e., World War II followed by the Cold War—unleashed structural deflationary and recessionary forces in the major industrial economies. (See the January 29, 1996 issue of *WEA*.) Therefore, the G7's monetary stimulus isn't likely to stimulate much real growth or revive price inflation for goods and services.

If so, then the G7 central banks' monetary policy is raising the level of the global pool of financial liquidity. This liquidity can remain in liquid assets. If it does so, then the monetary authorities are in a "Liquidity Trap." This has been Japan's problem during the first half of the 1990s.

Alternatively, the liquid assets can be used to purchase real or financial assets. In this case, the monetary stimulus is "trapped" in the asset markets. Currently, financial assets are appreciating in value much faster than real assets. There is relatively little interest in real assets because many speculators—especially in farm land, commercial properties, and oil wells—were burnt not too long ago.

Financial assets are looking more and more attractive as the inflation rates for goods and services and for real assets fall closer and closer to zero in the major industrial economies. The unweighted average CPI inflation rate of the US, Japan, and Germany is currently down to 1.3% from 4.4% at the start of the decade (Exhibit 9). In the US, the NAPM price index dropped to the lowest level since July 1991 during January, with 38% of purchasing managers reporting paying lower prices—the highest percentage since 1949 (Exhibit 10)! Clearly, investors and speculators will continue to pour money into financial assets as long as they perceive that they can get a much better return than by betting on CPI inflation.

In the US, stocks have clearly outperformed both the CPI and home prices:

1) Since the start of the current decade, the US consumer price index is up 21% while the S&P 500 stock price index is up 81% (Exhibit 11).

2) US stock prices have outperformed the median value of existing homes for several years (Exhibit 12).

IV. No Shortage of Liquidity

Of course, the simplest explanation of why stock prices are soaring in the US and many other stock markets around the world is that there are more buyers than sellers. In the US, money is pouring into equity mutual funds at a mind-boggling rate.

Total net equity fund sales were a record \$29.3 billion in December alone. That's up from \$15.0 billion in November and the \$11.0 billion average monthly pace during the first 11 months of 1995 (Exhibit 13).

December is historically the strongest month of the year for money flows into equity funds. Reinvested year-end dividends usually inflate December figures, so it is useful to examine flows minus reinvested dividends. In December, flows into equity funds excluding reinvested dividends came in at \$19.0 billion, up from \$14.3 billion in November and only \$5.4 billion in December 1994.

These inflows are especially amazing in light of the fact that money is also pouring into liquid assets! During January, our Weekly Liquidity Counter rose \$27 billion to a record \$3.2 trillion. Over the past 52 weeks, it rose a whopping \$301 billion even as the Dow rose 1500 points (Exhibit 14).

Over the past year, savings and money market deposits are up \$29 billion. Small and large time deposits are up \$147 billion. Money market funds held by individuals and institutions are up \$86 billion and \$41 billion, respectively (Exhibits 15 and 16).

V. Demographic Sweet Spot

During the second half of the 1980s, I wrote several Topical Studies which predicted that the aging of the Baby Boomers would be very bullish for bonds and stocks. This theme has worked very nicely. Indeed, the recent massive inflows into stock mutual funds suggest that the demographic story has never been more bullish.

Over the remainder of the 1990s, I believe that the US economy is entering a golden period for both personal income and saving as the Baby Boomers age into the top-earning 45-54 year age group (Exhibits 17, 18, 19, and 20). They are currently 32-50 years old. They will be 36-54 years old by the year 2000.

During 1993, there were 22 million households headed by a 35-44 year-old. The next biggest group at 21 million households was headed by an individual 65 or older, followed by 20 million households headed by a 25-34 year-old.

In fourth place were the 17 million households headed by a 45-54 year-old. By the year 2000, this group should be in first place or second place with over 20 million households. *Since older workers earn more than younger ones, there will be more households at the top end of the income distribution relative to the age of the household head than ever before.*

In the year 2000, when all the Baby Boomers are 36-54 years old, there will be about 75 million people, or half the adult population in the top earning segment of the age distribution. They should account for 60% or more of all income at the start of the next century, up from 51% in 1993.

Undoubtedly, Baby Boom workers will continue to save some of their income in 401(k) retirement plans. More of the money pouring into stock mutual funds represents 401(k) contributions. According to the Profit Sharing/401(k) Council of America (PSCA) in Chicago, the participation rate of workers who qualify for 401(k) plans soared to 67% in 1993 from 57% in 1988, the latest figures available. This self-directed pension money comes in with clockwork regularity. The PSCA estimates that the amount of money in the plans grew more than 47% from 1993 to about \$700 billion in 1995!

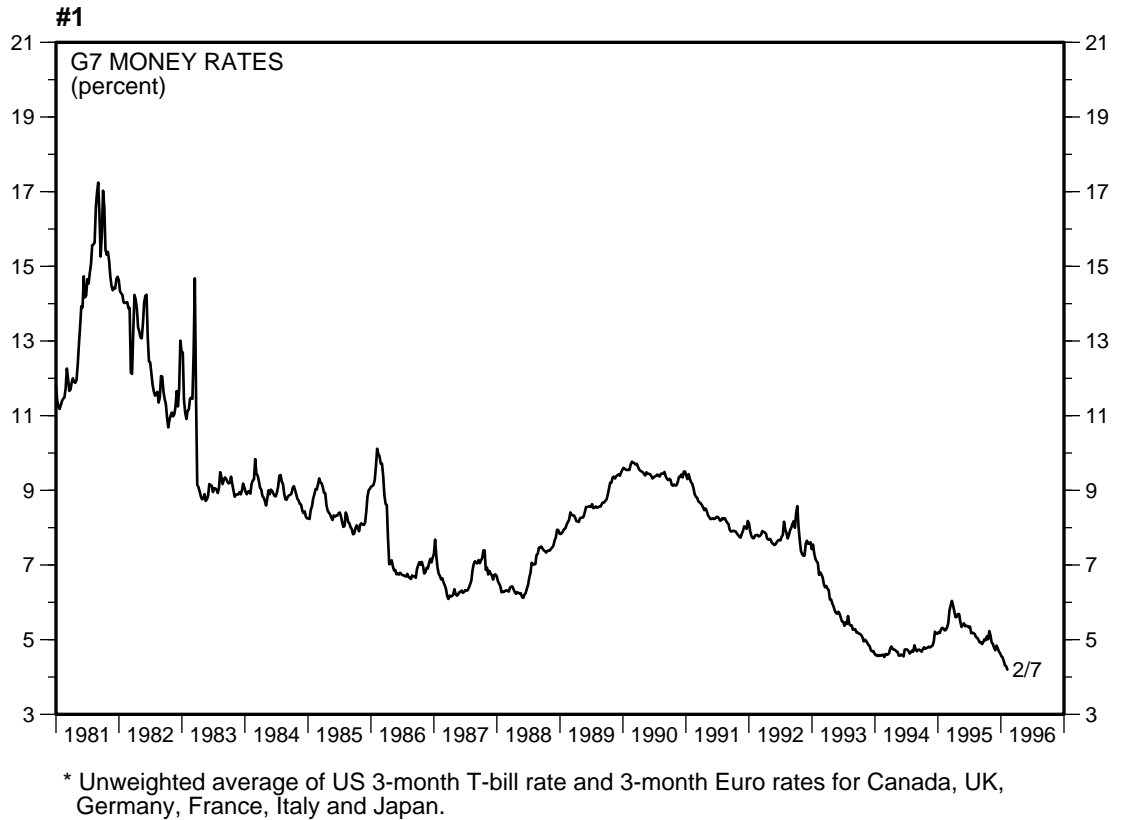
VI. Big Returns Come With Big Risks

What could go wrong? Very low interest rates in the G7 economies might trigger a business cycle rebound with inflation moving higher again. It has always happened in the past. Why wouldn't it play this way again? Perhaps the structural forces of deflation and recession aren't as powerful as I've argued. Cyclical monetary stimulus might prove to be even more powerful than I expect. If so, then interest rates will be moving higher again once a recovery gets in gear. This would snuff out the global stock and bond market rallies very quickly.

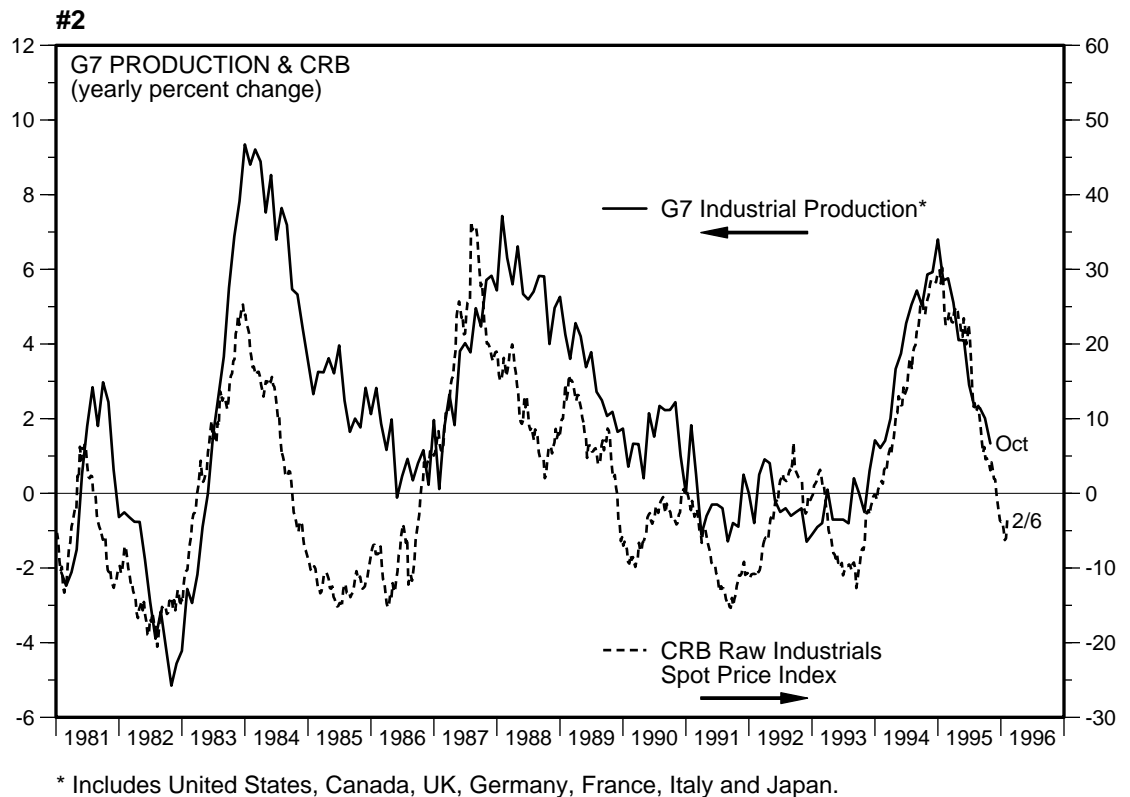
Another possibility is that soaring stock prices might eventually stimulate economic growth if higher asset values boost consumer and business spending. Again an economic upturn could push up interest rates and cause stock and bond prices to fall.

- G7 Recession -

Despite falling and historically low interest rates, G7 economies are in recession. Easy money is boosting financial asset values rather than real economic activity.



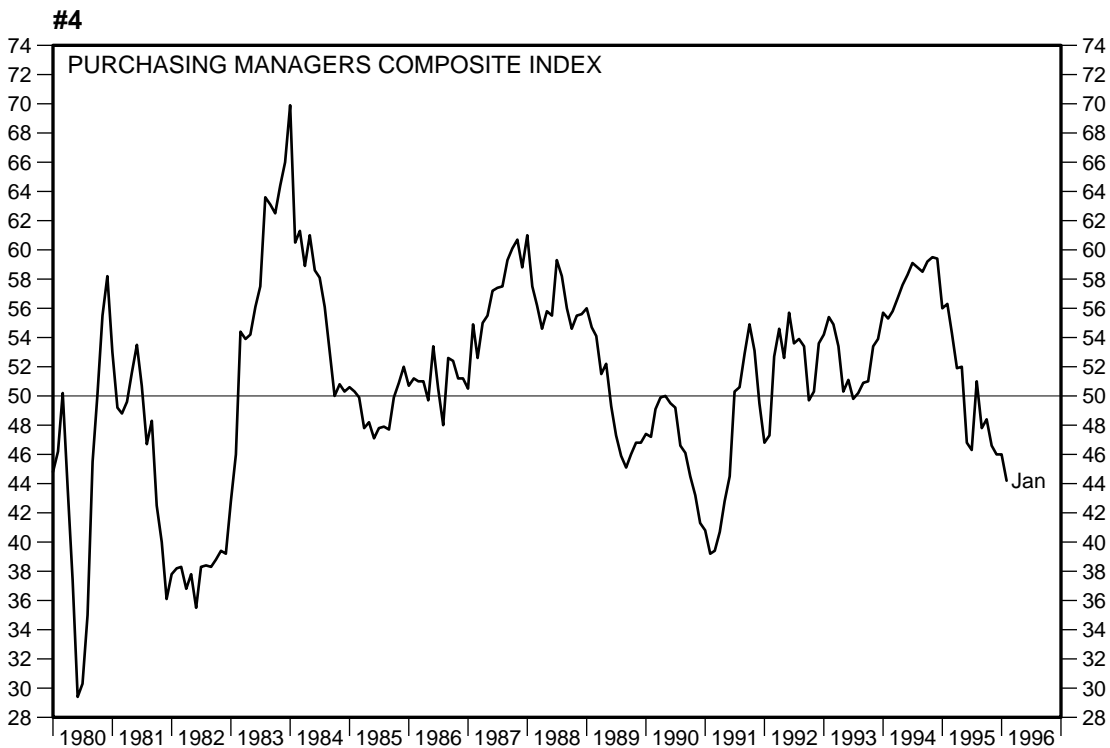
Weakness in industrial commodity prices suggests that G7 economies are in a recession.



- G7 Recession -



German unemployment rate at record high. The economy has fallen into recession despite big drop in interest rates.



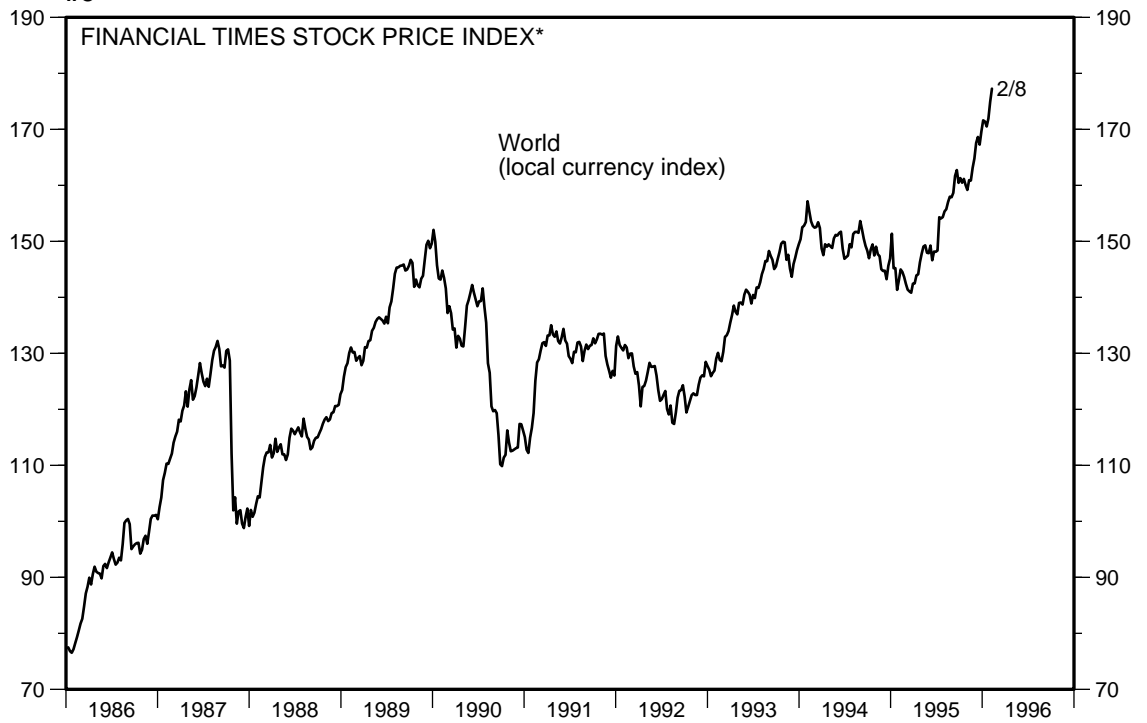
US factory sector is in recession despite relatively low interest rates and solid auto and housing sales.

Source: National Association of Purchasing Management.

- Global Stocks -

#5

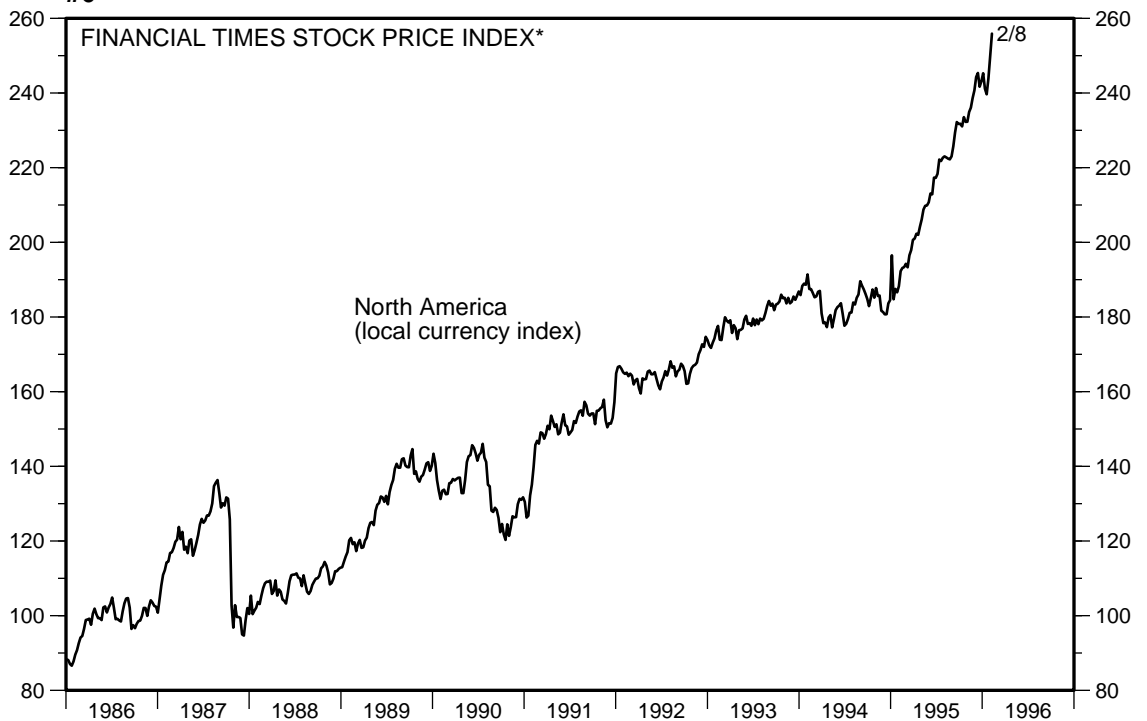
World stock index at record high.



* Includes Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Hong Kong, Ireland, Italy, Japan, Malaysia, Mexico, Netherlands, New Zealand, Norway, Singapore, South Africa, Spain, Sweden, Switzerland, United States, and United Kingdom.

#6

North America stock index soaring in new high territory.



* Includes the United States and Canada.

- Global Stocks -

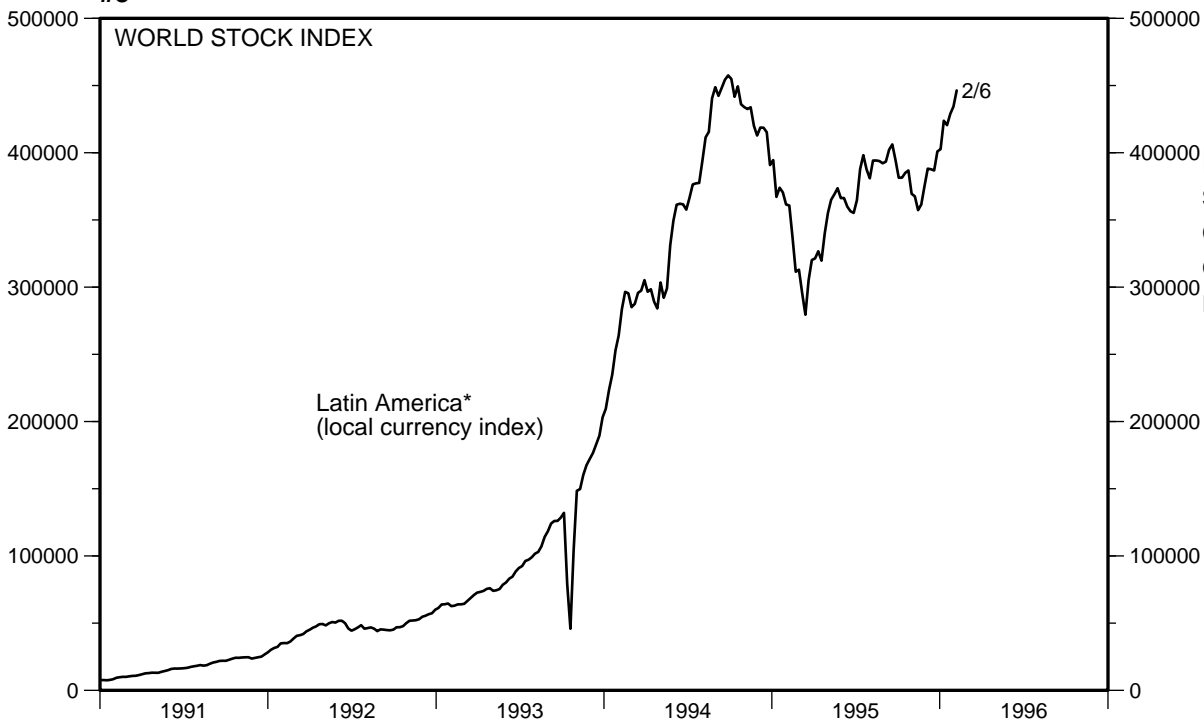
#7



Europe's stock index just rose above previous all-time record.

* Includes Austria, Belgium, Denmark, Finland, Germany, Ireland, Italy, Netherlands, United Kingdom, Norway, Spain, Switzerland and Sweden.

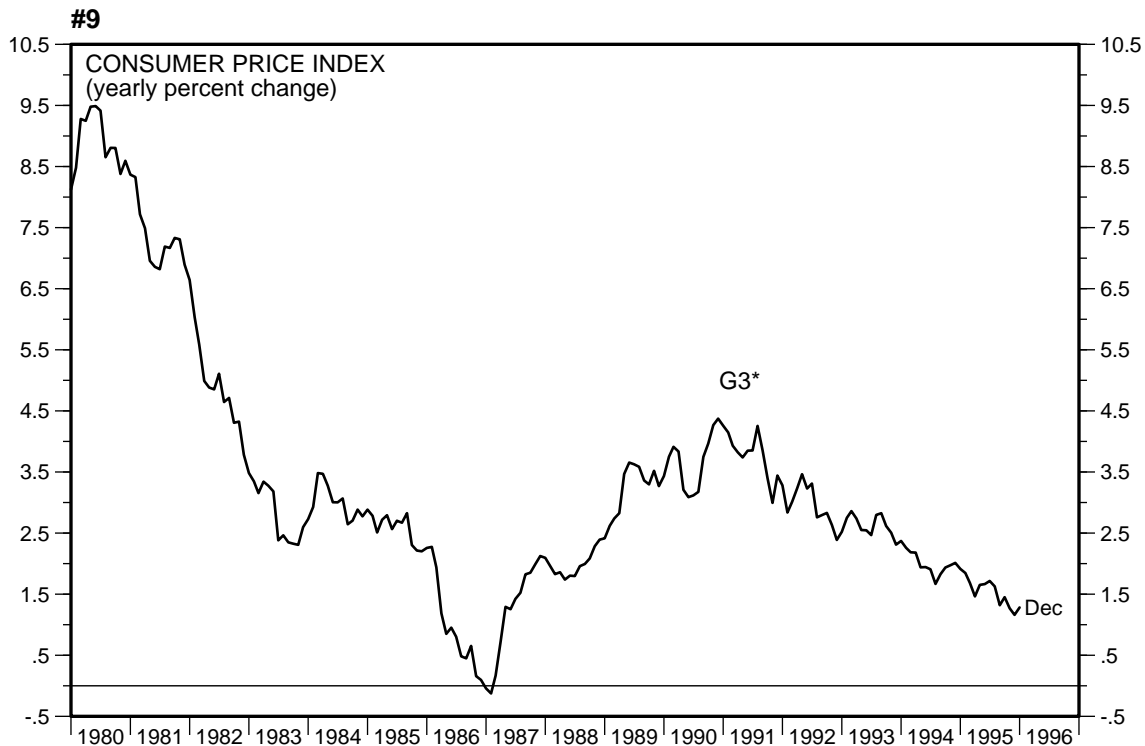
#8



Latin America stock index on the verge of making new highs.

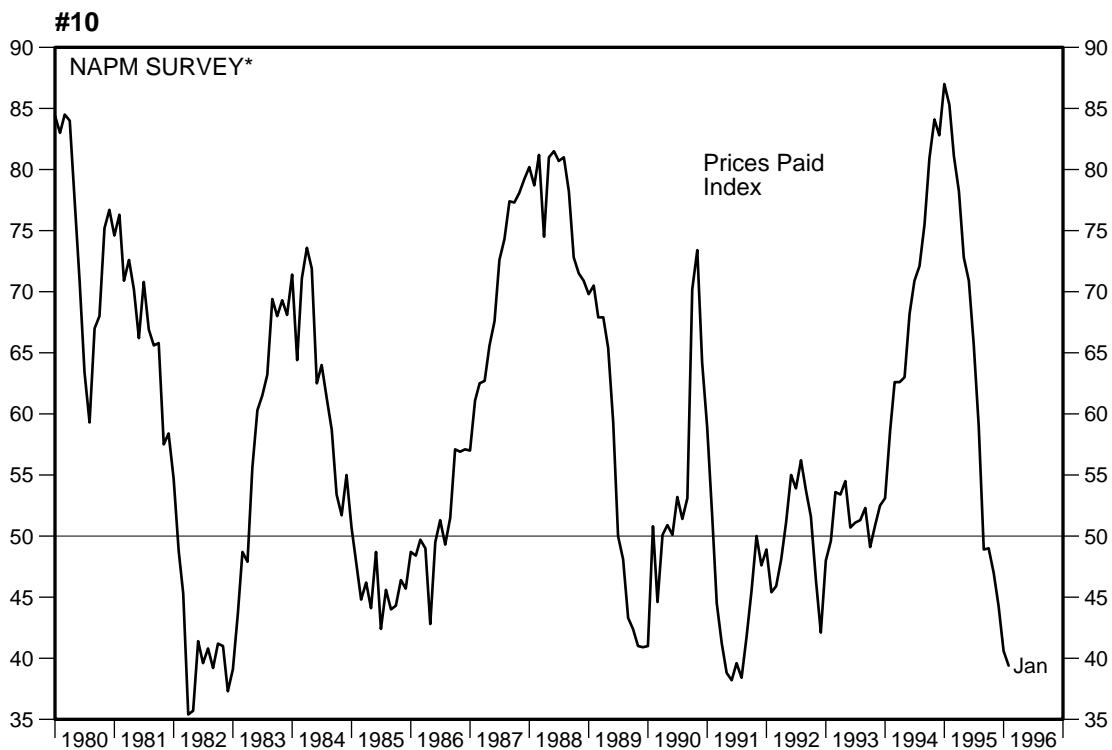
* Includes Argentina, Brazil, Chile and Mexico.
Source: Morgan Stanley Capital International, Morgan Stanley & Co., Inc.

- Inflation -



Inflation in the G3 is near zero.

* Unweighted average of US, Japan and Germany.

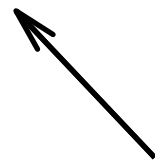
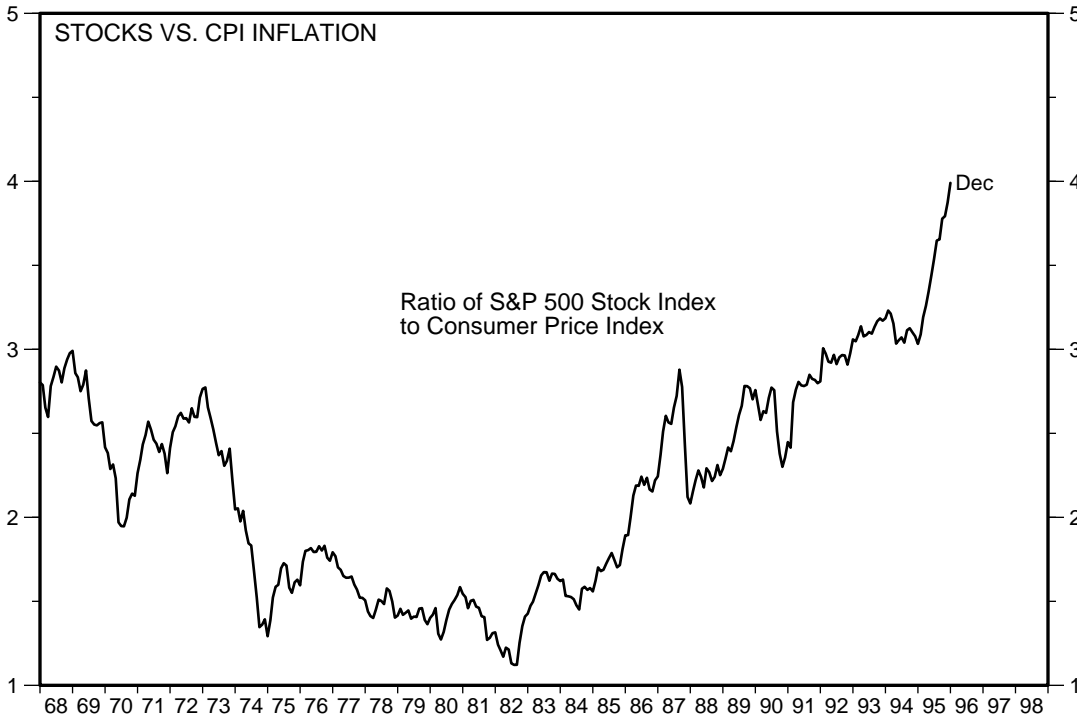


Pricing has collapsed in US factory sector according to purchasing managers' survey.

* Source: National Association of Purchasing Management.

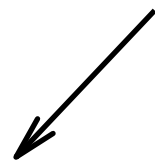
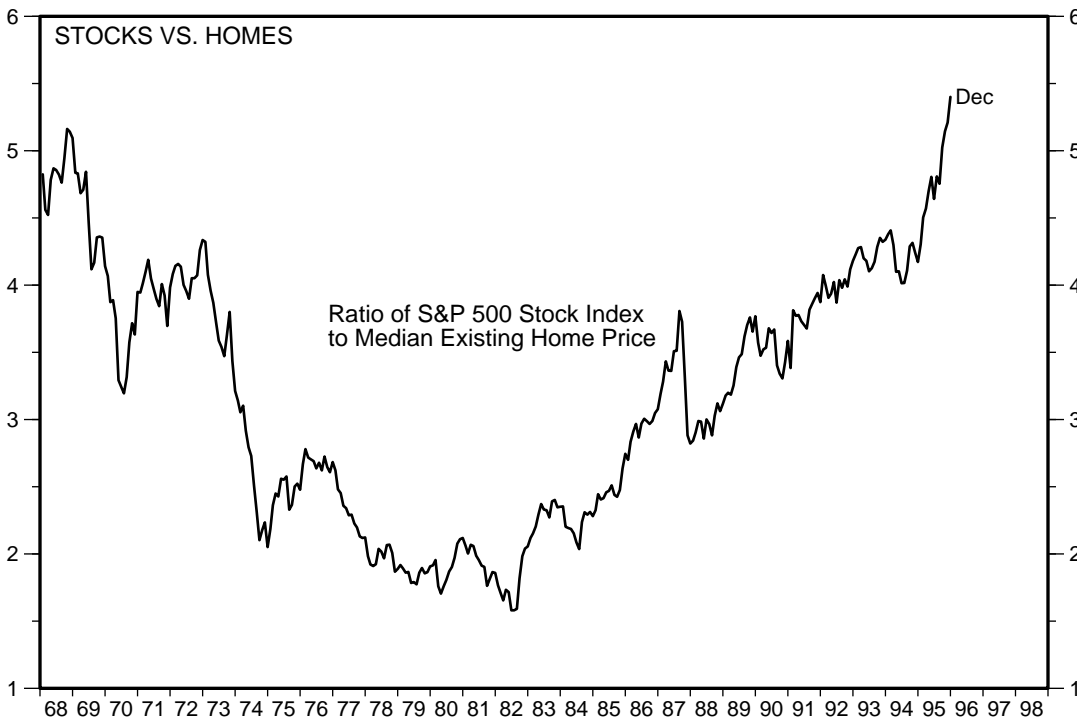
- Stock Performance -

#11

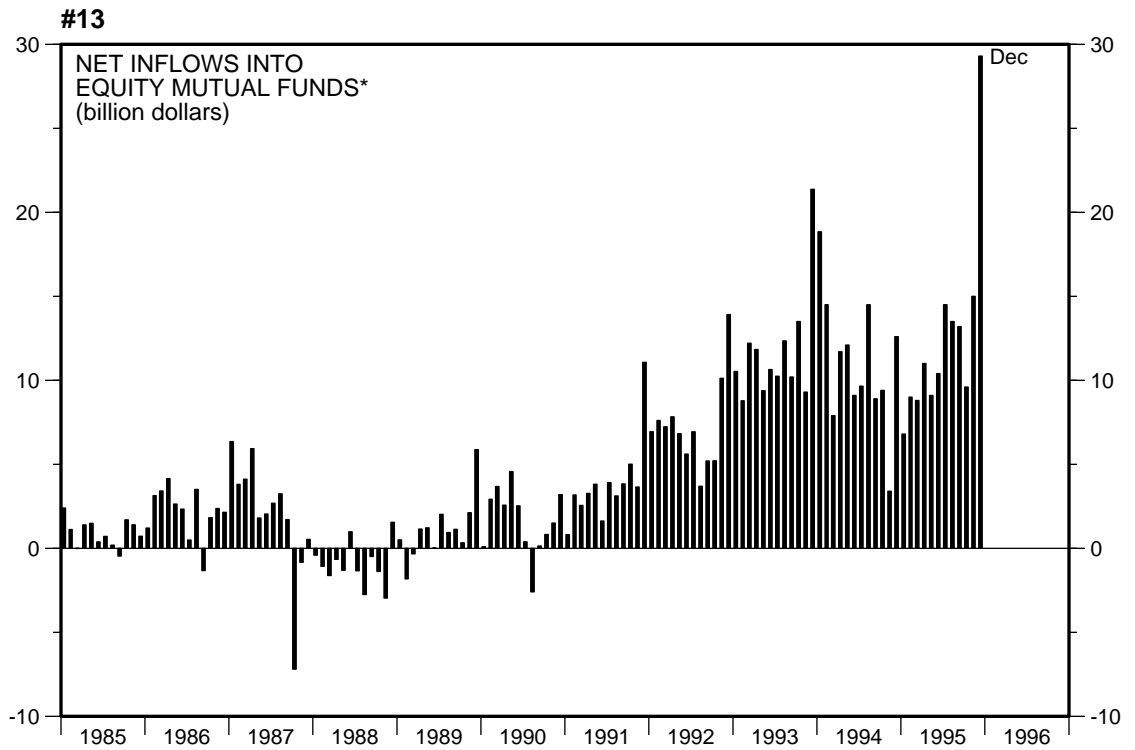


Stocks have outperformed the CPI and home prices since 1982. Recent outperformance of stock prices has been awesome.

#12

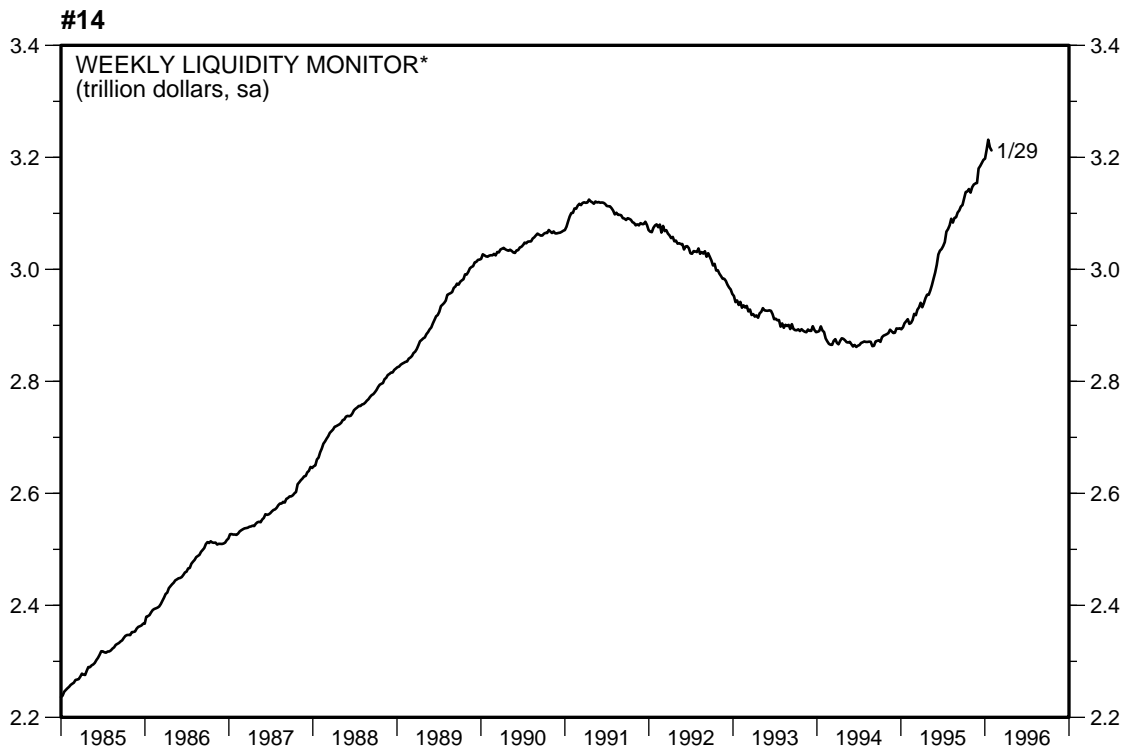


- Money Flows -



* Source: Investment Company Institute. Figures reflect sales less redemptions, plus the net result of fund switches, plus reinvested dividends.

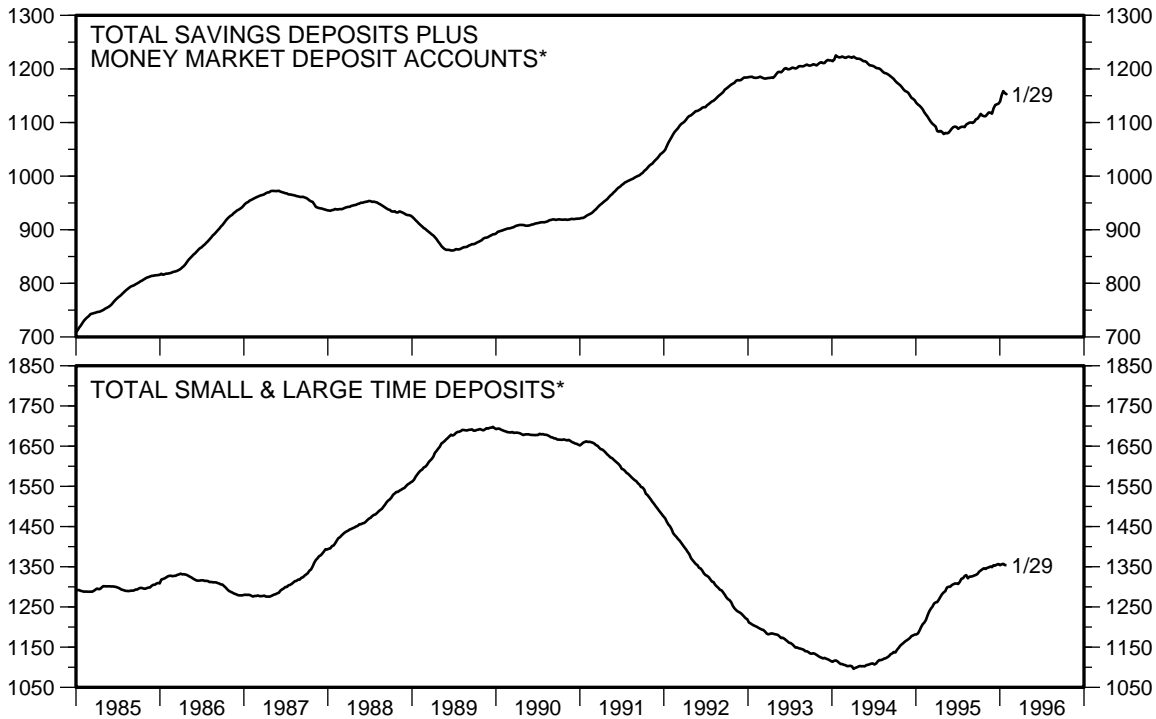
Huge inflows into equity mutual funds. Truly amazing given big inflow into liquid assets too.



* Sum of total savings deposits, money market deposit accounts, money market mutual funds, and small and large time deposits.

- Money Flows -

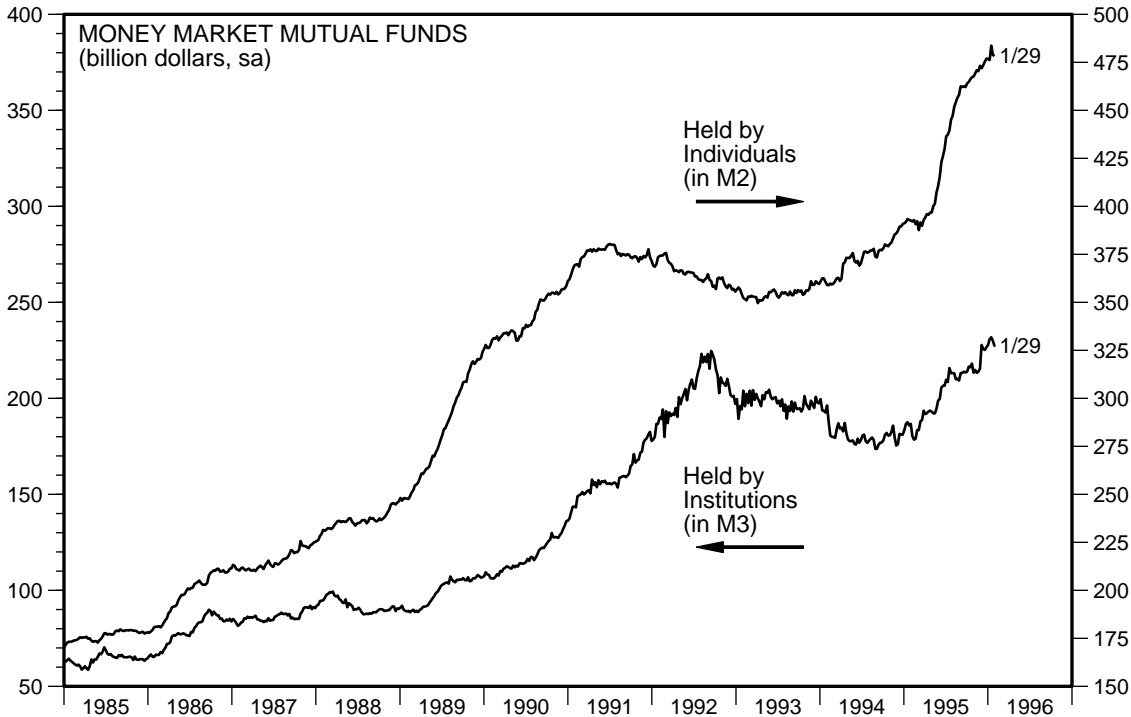
#15



* Billion dollars, sa.

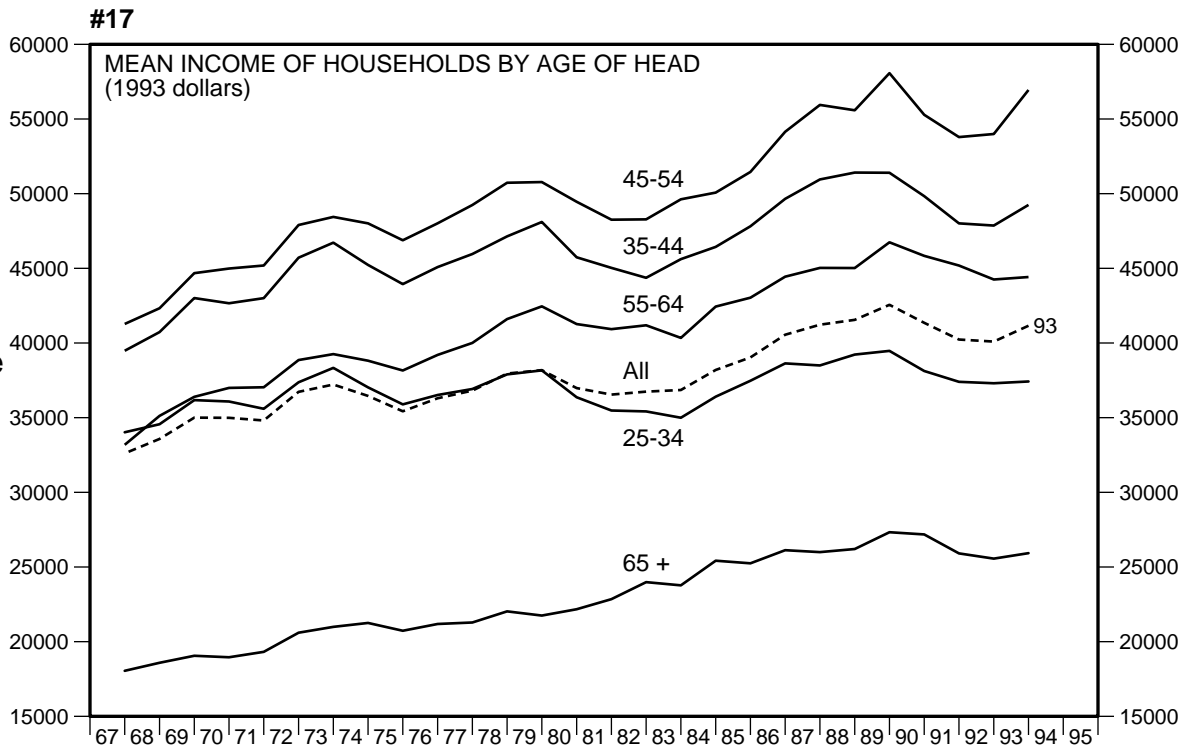
Stock market soared in 1995 even though money moved into (not out of) liquid assets. Money market accounts held by individuals up \$86 billion over past 52 weeks.

#16



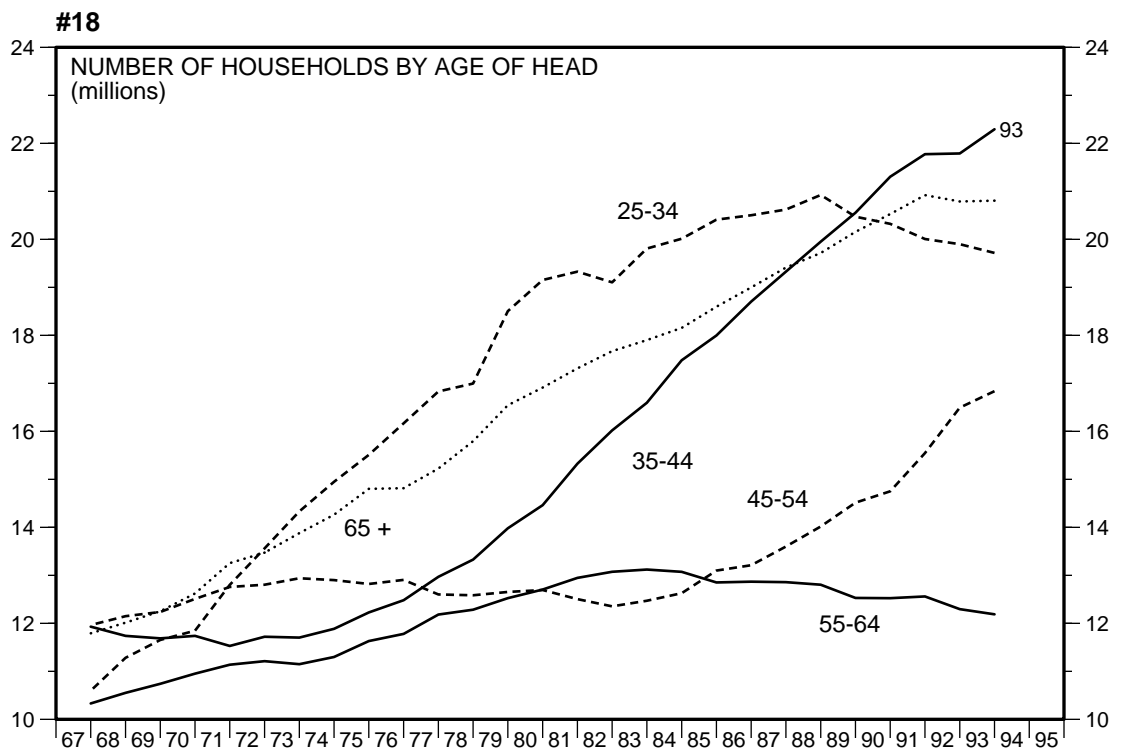
- Income By Age -

To calculate the total income of different age groups, we need to multiply the mean income of each age group by the number of households in each group. Notice that older workers tend to earn more than younger ones.



Source: Bureau of the Census, Income Statistics Branch, unpublished data.

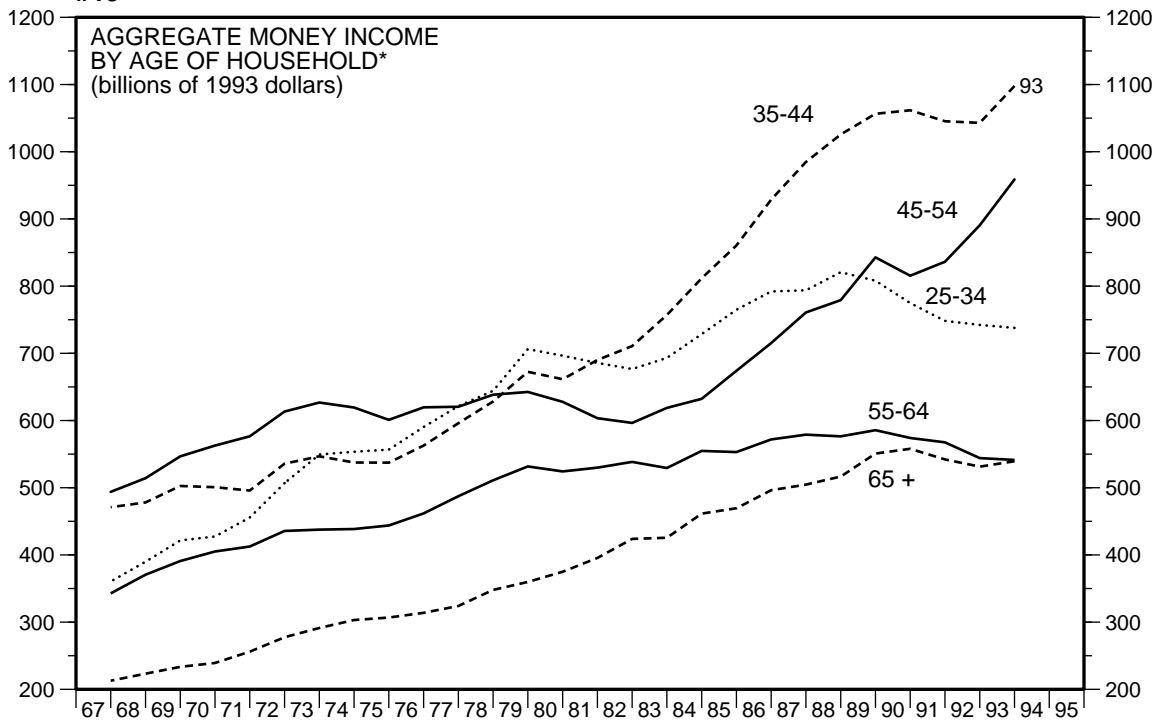
Over the next 5-10 years, as the Baby Boomers age, there will be more families and households headed by individuals who are 40- and 50-something.



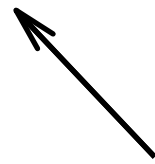
Source: Bureau of the Census, Income Statistics Branch, unpublished data.

- Income By Age -

#19

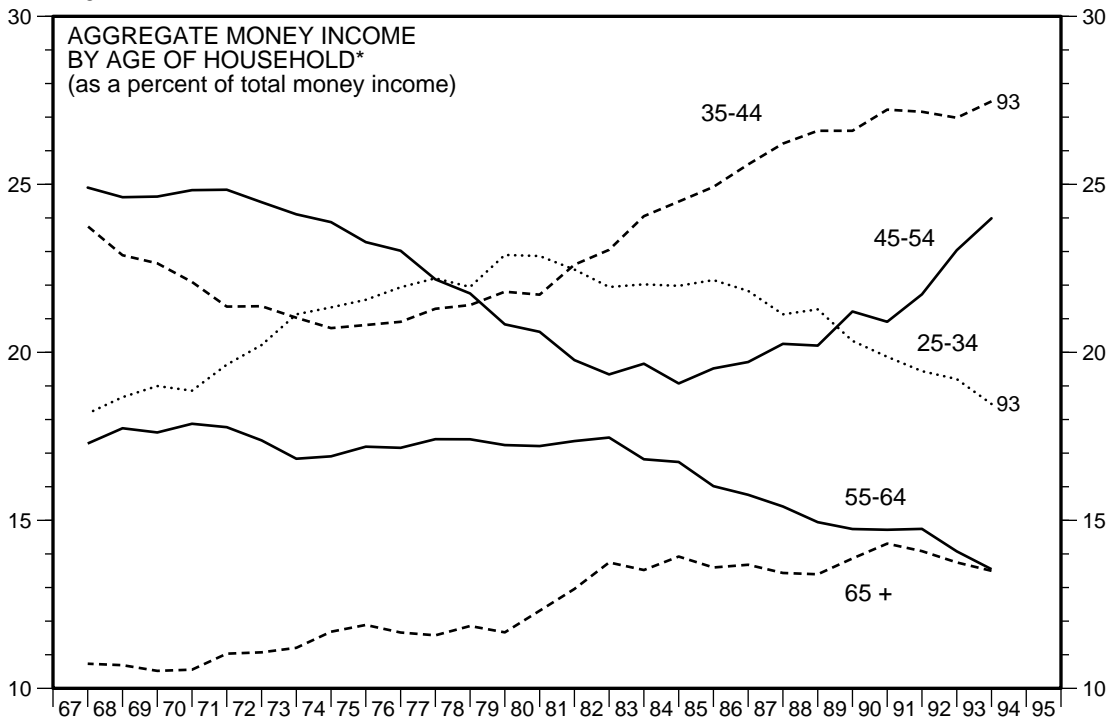


* Mean income times number of households.

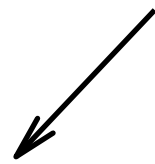


The largest share of total money income is earned by 35-44 year olds, but the 45-54 year olds are gaining share at the fastest pace. By the year 2000, there will be more households at the top end of the income distribution relative to the age of the household head than ever before!

#20



* Mean income in 1993 dollars times number of households.



TOPICAL STUDIES

- #1 Dr. Edward Yardeni, *Exports Should Weaken U.S. Recovery*, March 22, 1983 *
- #2 Dr. Edward Yardeni, *The Ten Pillars Of Faith*, April 6, 1984 *
- #3 Deborah Johnson, *Behind The Corporate Borrowing Binge*, June 13, 1984 *
- #4 Dr. Edward Yardeni, *Why Has The Leading Index Of Inflation Failed So Badly?*, October 24, 1984 *
- #5 Dr. Edward Yardeni, *The Case For Lower Oil Prices*, December 12, 1984 *
- #6 Dr. Edward Yardeni, *The True Story Behind The Mighty Dollar*, January 9, 1985 *
- #7 Dr. Edward Yardeni, *Plenty Of Cash Around To Fuel Additional Stock And Bond Gains*, January 30, 1985 *
- #8 Dr. Edward Yardeni, *No Shortage Of Gluts*, July 10, 1985 *
- #9 Dr. Edward Yardeni, *The Protectionist Road To Depression*, September 9, 1985
- #10 Dr. Edward Yardeni, *The U.S. Becomes The World's Largest Debtor, So What?*, July 14, 1987
- #11 Dr. Edward Yardeni and Deborah Johnson, *The Restructuring Of Corporate America Is Bullish*, December 9, 1987
- #12 Dr. Edward Yardeni, *How The Baby Boomers Are Changing The Economy*, April 6, 1988
- #13 Dr. Edward Yardeni, *The Coming Shortage Of Bonds*, June 20, 1988
- #14 Dr. Edward Yardeni, *Could Real Estate Prices Fall? And What If They Do?*, August 24, 1988
- #15 Dr. Edward Yardeni and David Moss, *The New Wave Manifesto*, October 5, 1988
- #16 Dr. Edward Yardeni with Amalia Quintana, *The Baby Boom Chart Book*, January 25, 1989
- #17 Dr. Edward Yardeni, *The Triumph Of Capitalism*, August 1, 1989
- #18 Dr. Edward Yardeni and Deborah Johnson, *Dow 5000*, May 9, 1990
- #19 Dr. Edward Yardeni and David Moss, *The Triumph Of Adam Smith*, July 17, 1990
- #20 Dr. Edward Yardeni, *The Collapse Of Communism Is Bullish*, September 4, 1991
- #21 Dr. Edward Yardeni with Amalia Quintana, *The Baby Boom Chart Book 1991*, October 9, 1991
- #22 Dr. Edward Yardeni, *Apocalypse Now! (NOT!)*, May 8, 1992
- #23 Dr. Edward Yardeni, *The End Of The Cold War Is Bullish*, September 10, 1993
- #24 Dr. Edward Yardeni, *Hard Or Soft Landing?*, February 6, 1995
- #25 Dr. Edward Yardeni, *The High-Tech Revolution In The US of @*, March 20, 1995
- #26 Dr. Edward Yardeni, *The US Economy's Mega-Trends*, July 10, 1995
- #27 Dr. Edward Yardeni, *10,000 In 2000*, November 6, 1995

* Out of print.

Copyright (C) Deutsche Morgan Grenfell/C. J. Lawrence Inc. 1996. All rights reserved. The information contained herein has been obtained from sources believed to be reliable, but is not necessarily complete and its accuracy cannot be guaranteed. Any opinions expressed are subject to change without notice. Deutsche Morgan Grenfell/C. J. Lawrence Inc. and its affiliated companies and/or individuals may, from time to time, own, have positions in, or options on the securities discussed herein and may also perform financial advisory services, and/or have lending or other credit relationships with those companies. This material has been approved for distribution in the United Kingdom, to professional investors who fall within the exemptions contained within the UK Financial Services Act 1986 - Investment Advertisement Exemption Order 1988, by Deutsche Bank AG London, 6 Bishopsgate, London EC2P 2AT. Member of the LSE and SFA, Tel:(171)971-7900, Fax:(171)971-7988. Orders placed by UK persons directly with Deutsche Morgan Grenfell/C. J. Lawrence Inc. will not be governed by all Investor Protection provisions of UK Financial Services Act 1986. **Additional Information Available on Request.**