In Search of Equilibrium

08 Aug 08

By Wilson Aw

Another Watershed

"It is different this time."

What to make of it. Oil price is close to US $150 per barrel, gold is teetering on US $1000, and inflation is a multiple of the targeted 1-2%. And the crumbling stock markets. We must be living dangerously in what economists' term as 'stagflation', where growth is anemic or even negative (recession) and inflation is sky high – the worst combination for policymakers and all of us.

In the last article I wrote in Jan 2008 "Market Forecasting: A Fresh Perspective", the main prediction was that the major indices will close down this year and go into a bear phase if the markets tumble more than 20% from their respective market peaks. However, take heart that since 1926, the average bear market in the US has lasted just 1.3 years and stock prices come down about 30%. 2 of the last 15 bear markets have ended in less than 6 months. More than half the bear markets have ended in less than a year. So, we could well be in the midst of this correction phase and before we realise, the market could be turning for the better again.

In Search of Equilibrium

The Equilibrium concept can help to explain every phenomenon that we are experiencing in the financial markets.

It is the Nature in search of equilibrium, that everything in its path, is first tossed into a disequilibrium state, and through the interplay of surrounding forces, is morphed into the next equilibrium, only to be forced into disequilibrium again shortly after, when the existing or new forces dislocate it.

Just Another Equilibrium

While for every generation since the Industrial Revolution there is a common feeling among mankind – that the world is fast changing – it is a way of consoling ourselves that we are not alone in this 'suffering', it is true that the changes have indeed accelerated in the last quarter century. By many yardsticks such as the rate of technological and medical advances, amount of wealth created, the rate of urbanization, the amount of food consumed and the amount of information encountered.

In this changing picture, the equilibrium or balance of power is also shifting. The rising of new economic powers China and India due to the sheer size of their combined population of about a third of the world population, is sure to shift the centre of gravity to Asia. As with every shift of equilibrium, there is an innate resistance. Observe this. The US and Europe still exert a disproportionate influence on the world economy as they truly represent a big chunk of the world GDP. However, slowly and gradually over time as this proportionate influence reduces, the effect on other parts of the world will lessen for each cycle that these current economic and political powers undergo their booms and busts.
This will have impact on new wealth distribution, job opportunities, metropolitan cities, military powers, education centres. It is a whole new era that is dawning upon

us. What it used to take a few decades or even close to a century to evolve, this shifting of powers equilibrium may now accelerate at a pace that is afforded by globalisation and technology.

Black Gold

Think about it. Oil price has surged from about US $30 a few years ago to almost $150 a barrel recently. An ounce of gold has gone from US $260 to almost US $1000 in the same span of time. This represents about a factor of 4-5 times increase. Commodity prices have similarly surged.

If the prices of these economic goods are the 'symptoms', then the underlying cause is the changing equilibrium of world power centres. It started gradually, with a quiet stir. We witnessed the use of terminologies BRIC 'Brazil Russia India China'; we heard that gold prices were beginning to move up due to rising prosperity in India particularly; China hosting Beijing Olympics which symbolizes its coming onto the world stage, the construction booms which caused shortage of construction materials and resources. The US had capitalized on this new wealth creation in Asia to indulge on their own – easy credit – consumption. Financial engineering into exotic realms such as CDOs was the straw that broke the camel's back.

Whenever a fundamental shift occurs, it lends itself to be observed in a manner that distracts the observers to focus only on the symptoms. We are concerned about the speculation that plays a part in the recent increase and volatility of prices – again the symptoms. In fact, it is well documented that there is enough oil on earth that can last for another 50 years at least. What we are observing is temporary disruption. The demand and supply factors, the pillars of economic theory, are as valid today as during the tulip mania in Europe several hundred years ago.

Coping with Stagflation

A poser. How should we live in the present age - managing high inflation cost, low deposit rates, uncertainties in the global equity and bond market coupled with high crude oil prices?

It is true that inflation impacts the less well-off much more. Transportation and food make up a much larger proportion of disposable income. However, inflation could be looked at a bit deeper. A refrigerator or TV still cost about the same dollar value compared to 20 years ago. Perhaps they are less durable now, but the functionality is much superior; and because the functionality improves so fast, why do you need them to be durable? The same loaf of bread is much less today as a percentage of our total disposable income. Demand and supply factors coupled with continual advances in manufacturing and production technology have ensured that human kind continue to live at increasingly higher standard of living.

A new equilibrium will quickly emerge. Petrol price surge has led to people cutting down on the usage of cars, car manufacturers pushing out smaller and fuel-efficient cars, economies slowing down that eventually will consume less oil. On the supply side, new oil fields turn viable as production costs that used to be too high are now economical. Alternative energy sources will be pursued. Before we know it, new equilibrium emerges and oil prices start to correct by itself.

Equilibrium within Equilibriums

There is opportunity in crisis. Have we ever wondered or considered how lucky we have been for keeping money in the bank earning 0.5% instead of putting the same amount into the stock market and lost 30%? We tend to focus on the common voice that at this rate, the deposit cannot keep pace with inflation at all. In fact, it is a ridiculous -6% interest that the deposits are earning.

While $100,000 in the fixed deposit accumulates to only $101,000 after a year, always consider assets in terms of what they can transform into. For instance, this can buy into some blue chip stocks at a 30-40% discount compared to a year ago. It can even be paid as a down payment for a choice condominium unit at a discount that could be worth more than the down payment itself compared to a year ago.

This is what we can term ‘equilibrium within equilibriums’. Cash is so valuable that equilibrium demands that it can only earn a negative effective interest rate (compared to inflation), i.e. a negative risk premium, as it is highly probable that its alternative uses will be so much more valuable when the other asset classes tumble in value.

Too Fast Too Furious

Global financial markets have become integrated as one, and markets will remain volatile and uncertain beyond what we had experienced just a decade ago. It is not just the hedge funds, the speculators; it is actually the world financial markets trying to establish equilibrium at an increasingly shorter time window. How often have you read or heard of analysts calling for the market to open higher for the day or to close higher for the week, but the opposite occurs. This is because markets in the short term are ignoring fundamentals or even technicals; the forces at play are so confused and diverse they will rapidly form equilibrium at random momentarily only to search for the next.

However, if we set our sights further, the fundamental concept of value and prices remain the same. The explosion of wealth worldwide, the increasingly disproportionate concentration of wealth, the rise of new powers and new economies in the world, the preservation of wealth in the form of real estate and precious metals, the emergence of new metropolitan cities as human kind continue to congregate disproportionately on high density living, the inevitable emergence of alternative green energy. These are some value centres that will shape the next equilibriums in the years to come.

Stay invested. Be diversified. Ignore the noises. Be contrarian. Find your equilibrium.

“It is different this time.”

Is it?

The writer is a First Vice President and strategist at a Singapore bank. A Chartered Financial Analyst (CFA) charter-holder; certified Financial Risk Manager (FRM) and chartered marketer (Chartered Institute of Marketing), with experiences in developing strategies and insights for retail banking, e-business and private banking. The article is contributed in his personal capacity.