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## NO PLACE TO HIDE

Although the market averages that flash on the news screens have been telling a positive story over the past month and our cyclical work tells us this should continue through the first part of June, the underlying structure of the markets and the financial economy in general are telling us some unusual and disturbing things. Global equity markets are uniformly optimistic except in a few countries with particular circumstances like political or labor unrest. The Toronto Index traded at a new high this week and new highs are possible in some other markets blessed by oil or commodities. Risk-free interest rates are climbing everywhere and credit spreads are tightening too as the whole world is relieved that the financial structure looks sound once again. Considering the amount of liquidity that the Fed, the ECB, and the Bank of England have supplied to the market – we would guess over \$1 trillion by now – it would definitely have a major impact. If this money goes into the markets they will certainly go up, and that is what is happening as fear recedes. This outcome is exactly what the central banks have been aiming for, and with markets climbing there are no losers in the financial markets (except for a few short sellers).

It looks like these guys have hit a home run, but we are grouching just the same. We say it won't last. If these unusual injections of liquidity are driving the market higher, what will happen when they are absorbed over time, or when risk aversion returns? Obviously liquidity and risk are always powerful factors in the market, but usually they do not impact all the markets in such a uniform fashion. It would be more common for liquidity to expand in one place but

not in another and for enthusiasm to rise here but not there. Now, because of the artificial nature, and the size, of this liquidity injection, it is impacting every market everywhere at the same time. Last September 20, we wrote in a similar situation after the Fed had jump started the economy a la 1998 ("If Bonds Rally, Will Equities Follow?"), and we wrote and hoped that the markets would not all rally together and warned that these combinations of market movements warned of trouble ahead. Unfortunately equities rallied while interest rates climbed, one of the outcomes we feared, and the equity markets peaked within six weeks, declining into March. The same thing is happening today, except this time many of the global markets, like the US, are not as healthy as they were last fall and are only struggling higher. The peak should come within six weeks, risk aversion will rise quickly, and the next leg of the global economic crisis will begin. Interest rates will drop and the equity market will follow them down. More liquidity injections and bank rescues will be necessary over the summer.

Unfortunately, this will not be a V shaped recession, but an L shaped one, and most countries have not even started down the short but perpendicular decline that this implies. The reason that we are so sure that the major economies will not recover for several years is the fact that we are in a very major real estate decline in the US, Ireland, and Spain, and just beginning one in the UK, Eastern Europe, and in the other European countries. This assures serious bank problems for many years ahead and without credit economies shrink, that's the way it works. 

# CYCLICAL PERSPECTIVE

As the liquidity crisis appeared in the market last July, the major global markets became more aligned and this alignment has increased since that time. For quite a few years, global equity markets have been far more correlated than the underlying economies would warrant, and now the covariance among almost all of them is over 80%. Global interest rates have become more in line with the equity markets as well, and the relationship has been positive between rates and equity levels. That means as rates go up equities do as well. An interesting side note is that this is not the normal relationship between these two markets, but is the one that exists in recessionary and deflationary periods. During these darker times, higher interest rates mean that the economic situation is improving and that the monetary authorities are not pushing rates down to save the economy; therefore, higher rates equal more optimism.

The letters on the chart identify the major turning points in the liquidity saga, beginning with A, at the high in the week of 23 July, when the liquidity market first seized up. The yield in the US 10-year Notes topped here (remember, rates going down means fear). At C, the US equity market peaked, and three weeks later the Nasdaq (not shown) and AUD/JPY, representing currency carry trades, peaked as well. D and E show the two panic bottoms in the first quarter: the first one in January, the Soc Gen trading affair, and the second one in mid-March when Bear Stearns was folded up. The upmove from E has been the most highly correlated of them all, implying that the liquidity factor, the common variable behind these matching moves, has become more important than ever. The cycles call for a peak in mid-June followed by a major decline. 