Breaking the government-stock market feedback loop

By Roger Martin | August 17, 2011

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The opinions expressed are his own.

The markets' jitters last week in the wake of Standard & Poor's downgrading of US government debt from AAA to AA+ reinforced the degree to which shifts in expectations about future events as opposed to changes in real events now dominate the economy. In this new world, governments need to both recognize the futility of attempting to reign in expectations and stop creating mechanisms that cause changes in expectations to ripple damagingly through the real economy.

Last week, the US stock markets experienced the greatest bout of volatility in history when in four consecutive trading days (Monday through Thursday) the Dow Jones Industrial Average moved more than 400 points – and amazingly rather than slide in one direction, it reversed course each of the four days.

What really changed with the S&P's downgrade after the close of markets Friday, August 5, 2011 that caused the massive volatility? The economist's classical answer is that the downgrading should have raised the cost of US government debt because a lower rating requires the provision of a higher yield to bond buyers. But oops, US government bond prices rose and yields declined in the wake of the downgrading. So if anything real happened, it was positive – stronger prices for US bonds.

What else really happened? After weeks of sabre-rattling, acrimony, fear-mongering and moral outrage, a budget agreement and debt ceiling deal was announced on Sunday evening, July 31, 2011. Rather than massive uncertainty about whether the US government was going to default and throw the global financial system into chaos, we had clarity – certainly not perfection but clarity.

So in the real aspects of our world, the period leading up to last week's volatility featured resolution of massive uncertainty (the debt ceiling deal) and a downgrading that had the opposite reaction (positive) than would have been predicted (negative) for the intended audience of the advice (US government bond buyers).

Thus far, there is no explanation of the stock market volatility – none. To understand the volatility, we have to appreciate what sets stock market prices and causes their movement. It is all about expectations and changes to expectations – not reality or changes to reality. Regardless of whether their expectations are based on good, indifferent or bad information, if investors expect the best, they can cause the Dow to hit an all-time record high of 14,165 as of October 9, 2007. If they expect the worst, as they did as of March 9, 2009, the Dow plummets to 6547. And if they think things are going to be pretty darn good despite the ‘crisis’ in Washington, they can cause the Dow to hit 12,724 – 90% of the record high of the Dow in its history – on July 21, 2011, a mere ten days before the budget deal and well into the chest-beating, finger-pointing, fear-mongering negotiations in Washington. This illustrates that expectations have no bounds, limits or rational patterns.

The S&P downgrade set expectations rocketing around like a pinball – this may be the end of life as we know it; but maybe not; but maybe so; no maybe not. Pundits immediately leapt in to declare the probability of a double-dip recession. The US Federal Reserve rode into town to make extreme interest rate announcements. Finance ministers got together to plot and plan. All of it is to deal with the ‘crisis’ generated by the downgrade.

But recall, the crisis involved slightly improving US government bond prices and, miraculously a Dow that closed Friday hours before the downgrade at 11,445 and after the orgy of volatility closed the following Friday at 11,269 – a miniscule 1.5% off.

Governments appear to have convinced themselves that it is their job to tame or control the expectations of stock market investors, as with the Federal Reserve leaping in with both feet last week to ‘restore confidence’. Worse still, governments have increasingly leashed the real market to the expectations market. For example, ‘mark to market’ accounting for banks, insurance companies and pension funds forces these institutions to take real actions when expectations markets shift – e.g. increase pension contributions or raise expensive equity capital – that are often damaging and can worsen expectations in a downward spiral as happened in the 2008-9 meltdown.

It doesn’t have to be this way. Asia’s richest man, Li Ka-shing provides a lovely illustration of the power of ignoring the expectations market. When Hong Kong’s Hang Seng Index dropped 23% over four days in October 1997 during the ‘Asian flu’, reporters asked Mr. Li how he felt to lose close to $10 billion in less than a week. Mr. Li calmly explained to the incredulous reporters that he hadn’t lost a single cent. He still held the same ownership stakes in the same set of companies because he hadn’t sold a single share; the only thing that changed was others’ expectations of what they were worth – not Mr. Li’s. And history proved that he was right, his portfolio recovered and grew to a far greater value than before the Flu.

But he is an exception in the modern world. A big difference between the modern and earlier worlds is that the expectations markets have become so central to our economies that they now drive the real world. The tail is now wagging the proverbial dog. It is dangerous because expectations vary greater than reality; so when expectations rule, the economy becomes more volatile.

Governments who have been entranced with the notion of managing stock market expectations need to recognize that they can’t. There is an equal probability that they will accentuate worries as ameliorate them. And they simply must stop leashing the real market to the expectations market – and then blaming the expectations market for economic problems.