

CHAPTER 1

What Is Macro, and Why Should Investors Care?

History doesn't repeat itself, but it does rhyme.¹

—Mark Twain

People absorb information about macro-economic themes every day without realizing they are doing so. Newspapers and web sites—financial and non-financial alike—are filled with stories about the over-arching macro trends unfolding all over the world. If asked generally, most people would probably say that they know little about macro, but if questioned about the state of the housing market or the influence of China, most would likely come off as fairly well informed. The same goes for investors—the majority claim that they are stock pickers who focus solely on bottom-up company analysis. In reality, they often are choosing these stocks based on bigger-picture trends guiding the entire industry. The influence of macro extends far beyond what most people realize.

Question: If macro is so ubiquitous, then what exactly *is* it?

Answer: It is the force(s) that dictate how the world unfolds around us.

Macro permeates many aspects of day-to-day life. The cult of home ownership in the United States was rooted in political and monetary policies handed down from Washington, D.C. Ultimately,

this was embraced by the population at large and fueled the expansion and bursting of the housing bubble. Americans' adjustment to the new reality of less-available credit is reshaping spending patterns and lifestyles. This is just one of many unfolding macro trends that is important to markets. The aging of the enormous Baby Boomer generation is a force that will impact health care in this country for the next 30 years. The emergence of a new consumer class in China will change the balance of trade and economic power around the world. The technology revolution is giving a voice, and power, to people in far corners of the world that were until now largely silent. The accelerating pace of globalization is changing the face of trade, information flow, market movements, and even culture. The analogy of a butterfly flapping its wings felt halfway across the world is truer than ever for global markets.

Ten major macro themes developing today will significantly affect investors' portfolios, both directly and indirectly, in the years to come. These themes are:

1. Globalization
2. The internet and the technology revolution
3. The implications of the credit bubble
4. The rise of China and its emerging consumer class
5. A change in worldwide demographic trends
6. Americans' evolving relationships with credit and debt
7. Fiscal crises in the developed world
8. Troubles for the euro and/or the dollar
9. The Federal Reserve's dual mandate and its shortcomings
10. The changing face of "greed" on Wall Street

The investment implications of several of these market-moving trends are addressed directly in the book, but these forces do not exist in a vacuum. Each of them impacts the analysis in some way. In many cases, the implications of one theme lead directly into another, especially with respect to policy action taken. Take for example the sustained cycle of easy monetary policy following the bursting of the technology bubble in 2000. Federal Reserve Chairman Alan Greenspan lowered interest rates repeatedly as the markets corrected from the heights of the late 1990s. Following the technology meltdown were the 9/11 terrorist attacks and a series of corporate accounting scandals, such as Enron and Tyco,

that kept the markets on shaky ground. The solution in each case was lower interest rates. The chart in Figure 1.1 shows the lifecycle of several market themes of the past 20 years and their relationship to the U.S. monetary policy rate.

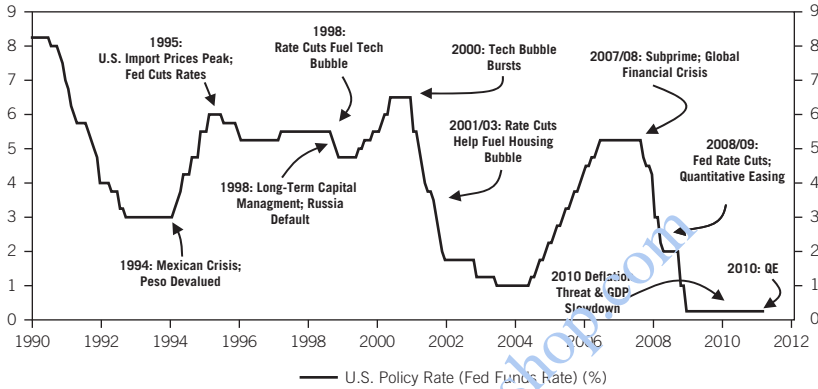


Figure 1.1 Federal Reserve Policy Fuels the Bubble Environment

Source: Wolfe Trahan & Co.

The rock-bottom interest rates that helped pull the economy out of the doldrums after the crises of the early 2000s laid the ground work for a massive expansion of credit. Easy access to credit helped fuel the housing boom of the 2000s, and the subsequent bubble that rocked the latter years of the decade. Although the federal funds rate was increased throughout 2004 and 2005, the damage was done and the economy is still sorting through the rubble. The extremely easy policy that Chairman Greenspan’s successor, Ben Bernanke, put in place in the years following the bursting of the credit bubble fueled the massive run-up in commodity prices. Only time will tell what the exact nature of the next bubble will be, but certainly it will come. Without a doubt, macro matters for investors!

Macro Explains More Than 70 Percent of Equity Returns

Ignoring macro is like ignoring the seasons when trying to predict the weather. Any December day in New York City is likely to be a cold one. The “macro” backdrop dictates wearing a coat instead of shorts. The “stock specific” issues determine whether that coat

should be a winter parka or a lighter jacket. It's possible to decide incorrectly on the choice of coat, but regardless one is usually better off wearing a coat than shorts in December in New York City.

Macro trends influence everything that happens in the markets, but the extent of its sway is probably a surprise to even those who embrace these trends. Investors who actively harness the powerful influence of macro and use it to their advantage can set themselves apart from the pack.

Investors often have a difficult time explaining the performance of their stock picks. This is largely because they underestimate the influence that macroeconomic forces have on individual stocks. They search for a connection between returns and earnings or management strength, but the truth is that an overwhelming majority of stock performance is explained by forces that go beyond the income and cash flow statements. In fact, the data show that historically 71 percent of equity returns are explained by macro trends.² This means that all of the time stock pickers spend poring over balance sheets and talking with company management accounts for less than one-third of a stock's performance. How many investment managers would willingly admit that they are investing blindly with respect to two-thirds of the factors driving their portfolio's return?

One of the prevailing trends over the past several years has been the heightened influence of top-down analysis and a renewed focus on macro. While some stock pickers may have been fortunate

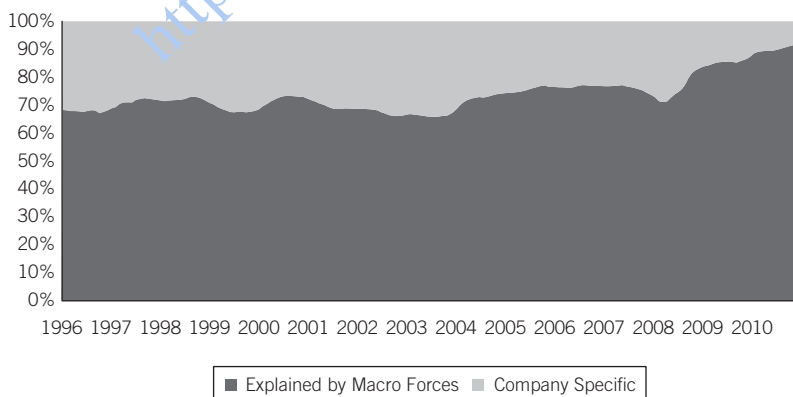


Figure 1.2 Macro Explaining a Record High Percentage of Equity Returns

Source: Wolfe Trahan & Co.

Wolfe Trahan Client Survey

How has the role of macro in your investment process changed in the past 10 years: Increased or Decreased?

Direction	Percentage
Role of Macro Increased	96.3
Role of Macro Decreased	3.7

Survey conducted March 25, 2011.
Total respondents to this question: 676

enough to pick winners that outperformed their benchmark indices, most stocks' relative performance trends were whipsawed by the macro-induced market peaks and troughs. Figure 1.2 shows that since late 2008, the percentage of equity returns explained by macro forces has risen steadily and reached a record high 90 percent by the end of 2010! Getting the "big picture" right has become a necessity for top performance results.

Macro's Role in Bubble-Mania

As shown earlier in Figure 1.1, policy moves meant to prop up the economy in the aftermath of the technology bubble actually laid the groundwork for the next bubble. This pattern is not unique, and in fact has repeated itself many times throughout financial market history. Certainly conditions must be ripe for a particular asset to develop into a bubble, but it takes much more than that. Usually it requires easy monetary policy for the bubble to form, and a policy-tightening cycle for the bubble to burst. The reason for this is that after a series of interest rate increases, the accommodative conditions that set the bubble in motion in the first place have dried up. As that bubble deflates, the central bank steps in again with more liquidity to temper the economic slowdown. This once again sets the stage for the beginning of another speculative mania.

It's hard to imagine in the immediate aftermath of a bubble meltdown that investors would get wrapped up in another would-be mania so soon, and history shows that bubbles do change investors'

behavior going forward. The lessons learned in the technology bubble that popped in 2000 still impact the way people invest today. The huge multiples paid by investors in the 1990s have led to a preference for companies with lower valuations. Equity market multiples in general have been in decline since the 2000 peak as the excesses work themselves out. Several years after the housing bubble peak, the residential real estate market is still sluggish. Most people are deleveraging their personal balance sheets and have altered their use of debt, choosing to use debit cards instead of credit cards. Lessons learned even as far back as the Asian currency crisis in the late 1990s are still being played out. Most of the Asian countries that stumbled from excessive debt during that period weathered the latest credit crisis better than most countries because they were less leveraged. The mistakes of the past can have a big impact on market trends going forward.

Yet, history also shows that there have been dozens of bubbles going back at least to the Dutch Tulip Mania in the 1600s. The study of human nature sheds some light on why investors fall for a new bubble each time around. One of the winners of the 2002 Nobel Prize for Economics, Vernon Smith, has attempted to address the study of why markets work the way they do through his research in experimental economics. Mr. Smith and his colleagues have produced significant work centered on laboratory-induced stock market bubbles. In the experiments, Mr. Smith and his team look for patterns that emerge from participants' trading activities and draw conclusions about investors' financial market behavior. During a series of 1988 experiments, his team of researchers made some interesting discoveries about how prior experience affects the severity of bubbles and crashes.³

Testing 22 simulated market environments, price bubbles formed and then subsequently crashed on 14 of those occasions. Participants' behavior did differ, however, based on their experience with trading. When inexperienced traders were involved, the price bubbles tended to be much more dramatic. Stock prices rose far above fundamental values, and then crashed back to fundamentals late in the stock's lifetime. As participant experience grew, the results changed. More seasoned traders did not avoid bubbles altogether, but the severity did decline. Mr. Smith and his team concluded that experience was the only way to avoid falling into the bubble trap. The laboratory results showed that by the third

go around, market participants recognized their past mistakes, and moved the market toward a more fundamentally grounded pricing structure. While this seems like encouraging news for the elimination of bubbles going forward, real life does not tend to play out exactly in this fashion. New participants are entering the financial markets all the time, introducing inexperienced traders who have not yet learned the lessons of bubbles. Also, the time lag between real-life bubbles weeds out the number of people who can gain enough experience to learn from their previous errors in judgment. Unfortunately, what qualifies as “experience” in the laboratory-created markets takes longer to acquire than the lifespan of the typical Wall Street career. The “good news” is that speculative manias tend to follow a predictable path, and it’s possible for astute investors to recognize the patterns. Distinguished and experienced investors such as Jeremy Grantham have built very successful careers on identifying and profiting from these macro patterns.

Bubbles are the natural outgrowth of extremely stimulative policies enacted in the wake of an economic slowdown, and these conditions usually hold regardless of whether the bubble forms in commodities, real estate, or equities; or during the 1600s or the 1900s. The rapid succession of recent bubbles—Asian currencies, technology, and credit and housing—is the byproduct of a series of recessions brought upon by the collapse of the previous speculative mania. Figure 1.3 highlights the short timeline from the creation

Technology Bubble

- **August 1998:** Long-Term Capital Management Failure & 75bp Fed Rate Cut
- **Y2K** Investments Further Fuel Money Supply
- **1999 - 2000:** Fed Raises Rates by 175bp
- **March 2000:** Nasdaq Peaks

U.S. Housing Bubble

- **2001: U.S. Recession Begins**
- **Jan 2001 - June 2003: Fed Cuts Rates 11 times from 6.5% to 1%**
- **2002:** Annual home price appreciation of 10% or more in CA, FL and many Northeast states
- **2004:** U.S. homeownership rate peaks at 69.2%
- **2004 - 2006: Fed Raises Rates from 1% to 5.5% in 24 Months**
- **Jan 2005:** S&P/Case-Shiller Home Price Index Peaks at 15.7% YoY
- **2005: U.S. Rent Inflation Begins To Accelerate**
- **2007 - 2009:** Fed Cuts Rates by 500 Basis Points & Creates Lending Facilities For Banks
- **Late 2008:** Global Economy In Recession, Widespread Policy Easing

Figure 1.3 Boom-Bust Timeline of the Previous Decade

Source: Wolfe Trahan & Co.

of the technology bubble through the bursting of the credit bubble less than a decade later. Given the increasing frequency of bubbles in the past several decades, it is more important than ever for investors to understand the macro forces at work.

Ideally, an investor would avoid buying into a market when prices and fundamentals are out of sync, but unfortunately, that is not always an option. Shunning the high-flying technology sector in the mid-1990s would have led an investor to drastically underperform the benchmark as the sector grew to more than 30 percent of the S&P 500 Index by market capitalization. Instead of fleeing a bubble, market participants must have a framework to understand how it developed, its typical life-cycle, and, most importantly, how it will eventually burst.

The pre-bubble environment typically is characterized by an easing of credit conditions and the general availability of easy money. Figure 1.4 shows how money supply typically builds and then begins to contract prior to the peak of an asset bubble. Flush with liquidity, this backdrop sets the stage for economic growth, and eventually speculative excesses.

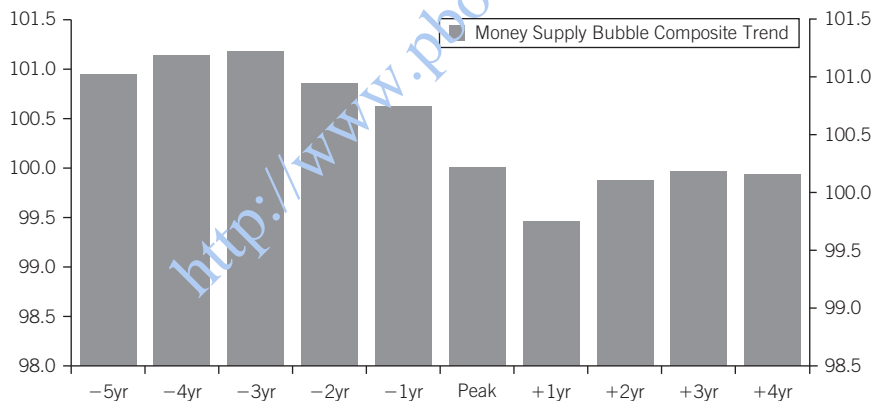


Figure 1.4 Easy Money Sets the Stage for an Asset Bubble

Note: Money Supply = 10 Year Compound Annual Growth Rate, Uses M1 & M2 in 1960s, MZM in 1999/2000

Source: Wolfe Trahan & Co.

At first, the asset-class-specific excesses are not apparent. A booming economy fueled by easy credit causes nearly all asset prices to rise as most of the population enjoys increasing wealth. The birth of the Tulip Mania in 1630s Netherlands was a typical example.

The Dutch Republic was experiencing a Golden Age of high incomes and commercial supremacy, and optimism led to an extremely consumer-oriented nation. At first, the tulip was just a way to brighten the landscape and decorate small gardens, but it quickly became a sought-after status symbol. Tulips had become a sign of wealth and luxury in the country.

The ability to consume and invest more eventually feeds on itself and leads to speculation, as “keeping up with the Jones” becomes a way of life. In the modern economy, house prices are a good proxy for this phenomenon. Homes are typically the largest investment people make, and as everyone now knows, are particularly vulnerable to asset-price inflation. The chart in Figure 1.5 shows how this measure of prosperity increases up until the peak of a bubble.

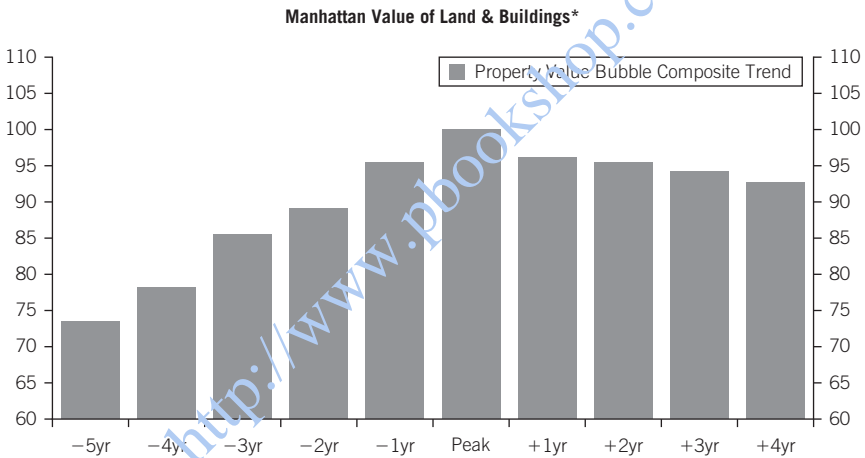


Figure 1.5 Increasing Prosperity Fuels the Bubble

Note: Composite = Value of Land and Buildings in Manhattan

Source: Wolfe Trahan & Co.

In Holland, the tulip mania was ripe for speculation since the colors of the flowers were not known until the tulip actually bloomed. Since any bulb could become a *Semper Augustus*, the most valuable strain, trading in these bulbs became highly profitable. As word spread around Europe and attracted more participants, the tulip mania was born.

The euphoria of success causes investors to increase their propensity for risk taking, much as a gambler winning at blackjack

Table 1.1 In 1637, You Could Have Purchased *One Semper Augustus Tulip Or...*

2 Dutch tons of herring	25 guilders
20 gallons of French brandy	30 guilders
2 hogsheads of wine	70 guilders
500 pounds of cheese	60 guilders
1 ton of butter	96 guilders
2 well-fed pigs	60 guilders
Annual earnings of a carpenter	250 guilders
Small town house	300 guilders
1 fat oxen	120 guilders
A ship	500 guilders
24 tons of rye	279 guilders
Typical salary of a middle-ranking merchant	1500 guilders
Typical salary of a well-off merchant	3000 guilders
Highest reliably attested price paid for a tulip bulb (1637)	6290 guilders

Source: Edward Chancellor, *Devil Take the Hindmost*, p. 18; Peter M. Garber, *Famous First Bubbles*, p. 82.; Mike Dash, *Tulipomania*, pg. 159

may up his bets with every hand. The media begins to chime in with talk of a “new paradigm,” and investing in the asset du jour becomes cocktail party fodder. In Holland, the popular frenzy launched a futures market for tulips. The average Dutch person who was unable to participate in the stock market of the day was able to wager on tulip bulbs, leading to an escalation of the mania. This social reinforcement builds a false sense of security and creates a feedback loop sending asset prices spiraling upward well beyond intrinsic value.

At this point pricing pressures accelerate, typically beginning with raw materials such as commodities. Several years into the tulip bubble, the value of some bulbs would nearly double in little more than a week. Capital rushed into the market and amateur “investors” ponied up all that they had. Volume reached all-time highs with bulbs changing hands up to 10 times per day.

In time, higher prices begin to filter through the greater economy as wage pressures accelerate and lead to higher overall inflation. This forces central bankers to intervene in order to maintain price stability. Eventually the removal of cheap capital squashes speculation.

The tulip mania ended with an internal “liquidity” crisis. Spring was fast approaching, and thus the impending delivery of the bulbs, so rumors began to spread that there were no more buyers. Tulips became unsellable and a spiral of defaults occurred.

The United States Federal Reserve’s attempt to control an overheating economy usually goes to extremes in the modern day as well. Not only do policy makers create enough economic drag to break the back of speculative excesses, but almost every Fed tightening cycle has concluded with an economic crisis. Figure 1.6 highlights how changes in the federal funds target rate often trigger the end of a bubble.

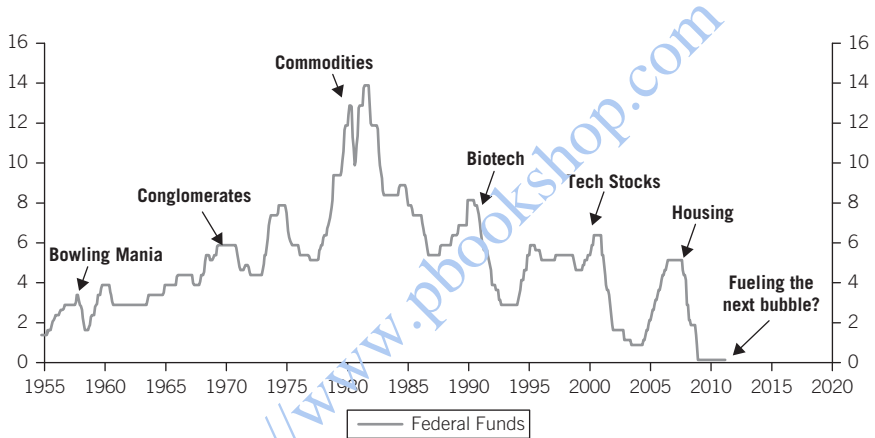


Figure 1.6 Tightening Monetary Policy Marks the Beginning of the End of an Asset Bubble

Source: Wolfe Trahan & Co.

As borrowing costs increase, the economy slows and investors re-price risk. This generally leads to investors abandoning the inflated asset classes, causing prices to fall dramatically. The feedback loop that elevated prices to such lofty levels operates on the downside as well. In most cases, stock prices and earnings growth have already begun their declines by the time the recession officially begins. In fact, Figure 1.7 shows that stocks have peaked on average about nine months before the start of a major slowdown, earning their status as a leading indicator of the economy.

The post-bubble environment generally depends on how deeply the bubble has penetrated the economy. Thematic bubbles, which

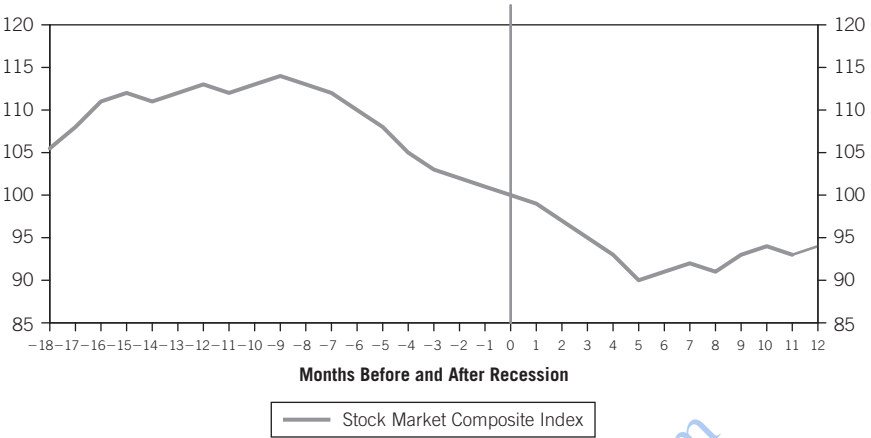


Figure 1.7 Stocks Usually Peak About Nine Months Before the Slowdown Hits the Rest of the Economy

Note: Stock Market Composite derived from railroad stock prices during speculative periods around 1857, 1873, 1884, 1893, 1907, and 1929, and the S&P 500 Index in the late 1960s/early 1970s and late 1990s/early 2000s periods.

Source: Wolfe Trahan & Co.

occur when a particular asset theme becomes popular and crowd mentality promotes ownership of the group, do not usually leave a massive mark on the economy. The thematic popularity of bowling stocks in the 1960s was just a blip. The “Tulip Mania” became “Tulip Phobia”, causing most of the common varieties to never recover their values, but no general economic crisis ensued. Life-changing bubbles, which are often based on new and transformative technologies or infrastructures that change the face of the business world like the internet or railroads, tend to be farther reaching, and have historically led to massive over investment and subsequent economic declines. In the aftermath, with the economy in the throes of recession and anemic growth, policy makers typically begin increasing liquidity to jump start credit creation. This reigniting of credit is typically the link that ties serial bubbles together.

Chapter Summary

- Data show that historically 71 percent of equity returns are explained by macro trends. This means that all of the time stock pickers spend poring over balance sheets and talking

with company management accounts for less than one-third of a stock's performance.

- Given the increasing frequency of bubbles in the past several decades, it is more than important than ever for investors to understand the macro forces at work.
- Speculative manias tend to follow a predictable path and it's possible for astute investors to recognize the patterns.
- The pre-bubble environment typically is characterized by an easing of credit conditions and the general availability of easy money. The ability to consume and invest more eventually leads to speculation. Pricing pressures accelerate, central bankers tighten policy to maintain price stability, and the bubble bursts.
- Policy moves meant to prop up the economy in the aftermath of a bubble usually lay the groundwork for the next bubble. Policy moves to end the bubble usually go to extremes, and almost every Fed tightening cycle has concluded with an economic crisis.
- Only time will tell what the exact nature of the next bubble will be, but certainly it will come. Without a doubt, macro matters for investors!

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