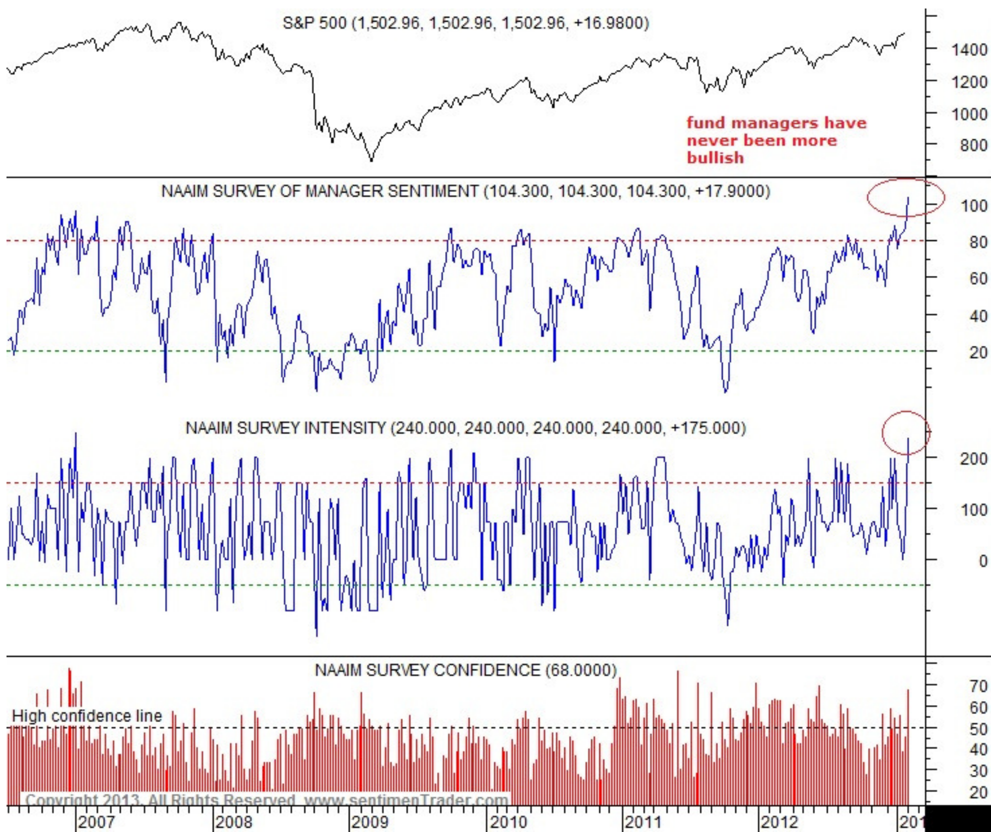
Stocks, Money Flows, And Inflation

By: Pater Tenebrarum - February 4, 2013

Sentiment Goes Nuts

Mish reports that this week's Barron's cover looks like a pretty strong warning sign for stocks (but not only the cover as he points out, but also what's inside). However, there may be an even more stunning capitulation datum out there, in this case a survey that we have frequently mentioned in the past, the NAAIM survey of fund managers. This survey has reached an all time high in net bullishness last week, with managers on average 104% long (this is to say, including the bears, the average response results in a leveraged net long position, a first).



A new record high in the net bullish percentage of the NAAIM survey of fund managers – click for better resolution.

However, that is not all. NAIIM asks fund managers to relate their positioning as a range bounded by “200% net short” to “200% net long”, in other words, even fully leveraged net long and net short positions are considered.
The survey keepers also relate where the most extreme replies are situated within this range. Naturally, the most bullish manager(s) have been between 180% and 200% long for some time. So that number is actually only of concern if it shrinks, which has in fact done (slightly) last week.

However, here is the stunner: the most “bearish” fund manager is now 60% net long! That has also never happened before – in effect, there not only are no bears left, there is also no-one left who's merely “neutral” on the market – the bullish consensus is now effectively 100% in the sense that not a single manager among those surveyed is left with an open net short position, not even a tiny one. Two weeks earlier, the most bearish respondent was still 200% short, and one week earlier 125%.

The NAAIM Number
104.25
Last Quarter Average
70.53

Download Excel file with data since inception »

Date	NAAIM Number Mean/Average	Bearish	Quart1	Quart2	Quart3	Bullish	Deviation
01/30/13	104.25	60	85.25	97.50	110.00	180	32.24
01/23/13	86.38	-125	66.00	95.00	100.00	190	53.95
01/16/13	84.67	-200	67.75	97.50	100.00	200	60.85
01/09/13	83.27	-100	65.00	90.00	100.00	150	43.59
01/02/13	75.98	-125	59.25	77.50	100.00	200	53.25
12/26/12	88.10	0	67.00	85.00	100.00	200	44.51
12/19/12	80.19	-100	62.50	81.50	100.00	200	49.81
12/12/12	82.91	0	51.50	80.00	100.00	200	40.87
12/05/12	75.71	-125	51.00	85.00	100.00	200	53.95
11/28/12	55.19	-125	20.00	70.00	100.00	150	58.26

The NAAIM response range. The red ellipses show the new all time high in net bullish positioning, as well as the stance taken by the most “bearish” manager in the survey, who's now 60% net long.

That should be good for at least a two to three percent correction one would think, probably intraday (i.e., to be fully recovered by the close).

“Money Flows”

The nonsense people will talk – people who really should know better - is sometimes truly breathtaking. Recently a number of strategists from large institutions, i.e., people who get paid big bucks for coming up with this stuff, have assured us that “equities are underowned”, that “money will flow from bonds to equities”, and that “money sitting on the sidelines” will be drawn into the market.

What are “underowned” equities, precisely? Are there any stocks that are not yet owned by someone, so to speak orphans, that are flying around in the Wall Street aether unsupervised? If so, give them to us please. Since apparently no-one owns them, they should presumably come for free.

And how exactly does money “flow from bonds to stocks”, pray tell? There may well be bondholders crazy enough to sell their bonds so they can buy into a stock market that's already 130% off the lows, but then someone else will have to buy their bonds, and someone will have to sell them his stocks. If that happens, someone will end up the patsy, but no money has “flowed” from one market to another. All that has happened is that the ownership of bonds, stocks and cash has changed. The same holds of course for so-called “money on the sidelines”.

Admittedly, the stock of money is indeed growing, courtesy of the Federal Reserve's virtual printing press. At the moment it increases at an 11.2% annual pace (broad money TMS-2) respectively a 9.3% annual pace (narrow money TMS-1), which is admittedly none too shabby and undoubtedly a major reason why stock prices have held firm. However, what that mainly tells us is that money is now worth less, because there is more of it. Which prices in the economy will rise when the money supply is increased is never certain, but it is certain that some prices will rise.

Other than that, all stocks, all bonds and all cash are always held by someone. The only orphaned cash that is truly “on the sidelines” are banknotes people have lost on the street. Probably not enough to push equities even higher, but you never know.

John Hussman has also written about this very topic again last week (Hussman is among the handful of people actually getting this right) and has raised a further interesting and logical point in this context. He explains why the weighting of bonds versus equities at pension funds and other institutional investors has been altered toward a larger percentage of bonds:

“Quite simply, the reason that pension funds and other investors hold more bonds relative to stocks than they have historically is that there are more bonds outstanding, relative to stocks, than there have been historically. What is viewed as “underinvestment” in stocks is actually a symptom of a rise in the gross indebtedness of the global economy, enabled and encouraged by quantitative easing of central banks, which have been successful in suppressing all apparent costs of that releveraging.”

(emphasis added)

There you have it – all it means at this juncture is that there is more debt extant than before. In fact, a lot more – as Hussman also remarks:

“[...] the volume of U.S. government debt foisted upon the public (even excluding what has been purchased by the Fed) has doubled since 2007, not to mention other sources of global debt issuance, while the market capitalization of stocks has merely recovered to its previously overvalued highs.”

(emphasis in the original)

The above facts have been pointed out over and over again, by Hussman and a few others (to our knowledge, Mish, Steven Saville and yours truly. If we forgot to mention anyone, then only because we haven't come across their writings yet). And yet, the fallacy keeps being repeated by people all over Wall Street.

Stocks and “Inflation”
As noted above, there is currently (and has been for the past 4 ½ years), plenty of inflation. The money supply is inflated at breakneck speed, after all, the 10% and higher annualized growth rates we have experienced are compounding. We keep hearing from various sources that stocks are expected to be acting as a “hedge” when the time comes when a decline in money's purchasing power becomes evident by dint of rising indexes of the “general price level”, such as CPI. For instance, Kyle Bass last week reminded us of the excellent performance of Zimbabwe's stock market during the hyperinflation period by noting:

“Zimbabwe's stock market was the best performer this decade – but your entire portfolio now buys you 3 eggs"

He's quite right, but it would actually be a mistake to compare the current market situation and the situation we will likely have the opportunity to observe should CPI actually ever rise again, with the Zimbabwe situation (at least initially).

Let us explain: right now, the “inflation” backdrop is a kind of sweet spot for stocks. There is plenty of monetary inflation, but the officially reported decline in money's purchasing power is very small, which helps to keep bond yields at a low level. “Inflation expectations”, i.e., expectations regarding future CPI, have risen, but not by enough to disturb this happy state of affairs.

It should be clear that the chance to go from “almost no inflation” (let's call that state “A”) directly to “hyperinflation” (which we will call state “C”) is non-existent. Again, this is in the sense of rising consumer prices and disregarding the fact that the officially reported data are somewhat suspect. We are also disregarding the fact that the decline in money's purchasing power cannot be “measured” anyway.

So even to those who insist that stocks will protect one against the ravages of sharply rising prices of goods and services, it should be clear that things won't simply go from “A” to “C” in one go, but will first proceed to “B” (note, we are also leaving a deflationary contraction of the money supply aside here, which everyone agrees will result in falling stock prices. As long as there are Bernanke & co. at the helm, it isn't going to happen anyway).

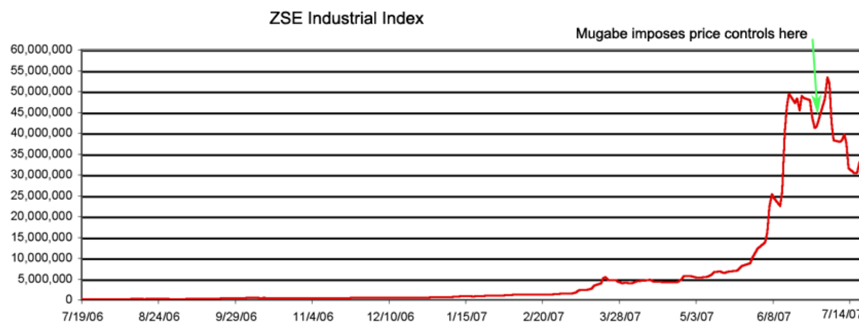
“B” is the state of affairs that pertained in the 1970s: high levels of CPI, close to and intermittently even exceeding double digits, but not hyperinflation. What would stocks likely do if we were visited by such a state “B” in spite of the valiant efforts to keep CPI as low as possible by means of an ever changing calculation method?

Both logic and experience tell us that their valuations will be compressed, this is to say, p/e ratios will decline, very likely into single digits. This is because high levels of CPI will raise bond yields considerably, and the future stream of earnings will have to be discounted by higher interest rates. Stock prices will also reflect the then presumably much higher inflation expectations. If nominal economic growth does not exceed the increase in CPI, then neither will earnings. The 1970s have in fact already shown what happens in such an environment: the stock market tends to decline.

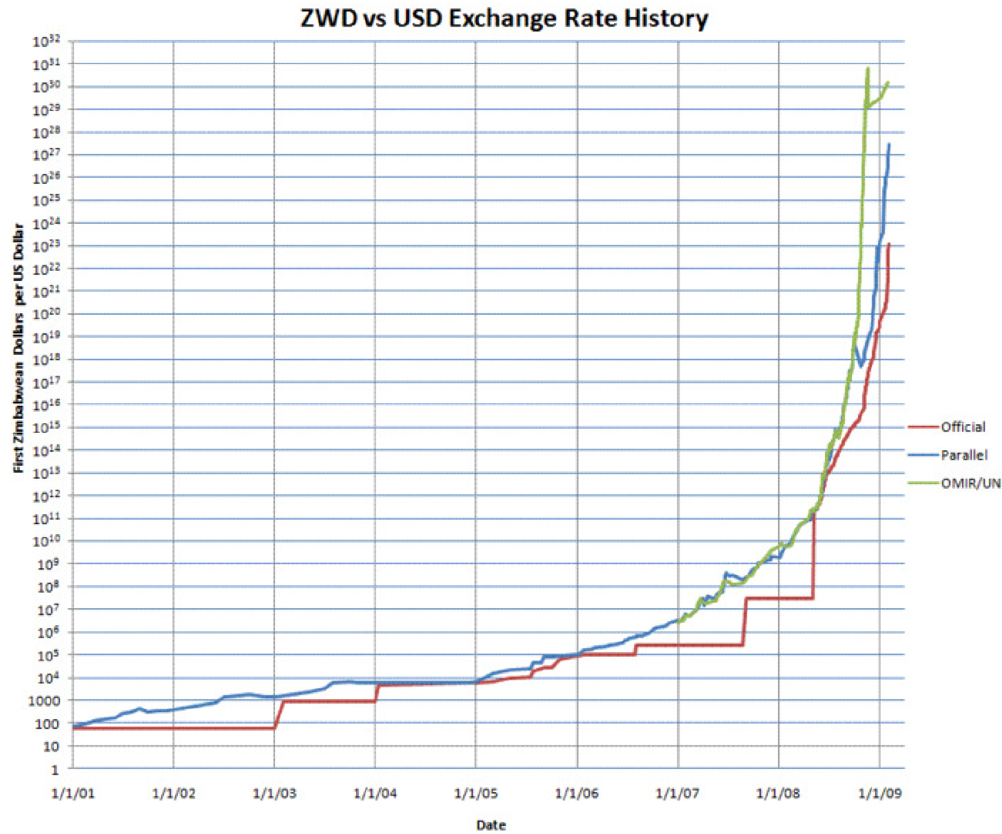
So what if hyperinflation were to break out one day? In Zimbabwe even the nominal prices of stocks of companies that were effectively put out of business because they could no longer pay for inputs (due to a lack of foreign exchange) soared.

However, Kyle Bass is correct: the devaluation of money in the wider sense was even more pronounced than the increase in stock prices. Stocks did not protect anyone in the sense of fully preserving one's purchasing power. It was clearly better to hold stocks than cash or bonds in the hyperinflation period, but still your portfolio would 'only buy you three eggs' when all was said and done (while cash holdings bought absolutely nothing anymore in the end).

The only things that actually preserved purchasing power were gold, foreign exchange and assorted hard assets for which a liquid market exists. We have put gold in first place because it not only preserved purchasing power during the hyperinflation in Zimbabwe, it actually increased it. Stocks did no such thing.



The ZSE Industrial Index – impressive, right? Not so fast.....(via Random Thoughts) – click for better resolution.



The Zim$-USD exchange rate, official, parallel market, and the 'OMIR' rate (which is probably the most exact one: "...the Old Mutual Implied Rate (OMIR) was calculated by dividing the Zimbabwe Stock Exchange price of shares of the insurance company named "Old Mutual" by the London Stock Exchange Price for the same share." – click for better resolution.

Zimbabwe's estimated inflation rate (from a report by the CATO institute, pdf):

Zimbabwe's hyperinflation progression

TABLE 1
ZIMBABWE'S HYPERINFLATION

Date	Month-over-month inflation rate (%)	Year-over-year inflation rate (%)
March 2007	50.54	2,200.20
April 2007	100.70	3,713.90
May 2007	55.40	4,530.00
June 2007	86.20	7,251.10
July 2007	31.60	7,634.80
August 2007	11.80	6,592.80
September 2007	38.70	7,982.10
October 2007	135.62	14,840.65
November 2007	131.42	26,470.78
December 2007	240.06	66,212.30
January 2008	120.83	100,580.16
February 2008	125.86	164,900.29
March 2008	281.29	417,823.13
April 2008	212.54	650,599.00
May 2008	433.40	2,233,713.43
June 2008	839.30	11,268,758.90
July 2008	2,600.24	231,150,888.87
August 2008	3,190.00	9,690,000,000.00
September 2008	12,400.00	471,000,000,000.00
October 2008	690,000,000.00	3,840,000,000,000,000,000.00
14 November 2008	79,600,000,000.00	89,700,000,000,000,000,000,000.00

NOTES: The Reserve Bank of Zimbabwe reported inflation rates for March 2007–July 2008. The authors calculated rates for August 2008–14 November 2008.
SOURCES: Reserve Bank of Zimbabwe (2008a) and authors' calculations.

Hyperinflation episodes compared:

TABLE 2
HIGHEST MONTHLY INFLATION RATES IN HISTORY

Country	Month with highest inflation rate	Highest monthly inflation rate	Equivalent daily inflation rate	Time required for prices to double
Hungary	July 1946	4.19×10^{16}%	207%	15.0 hours
Zimbabwe	Mid-November 2008	79,600,000,000%	98.0%	24.7 hours
Yugoslavia	January 1994	313,000,000%	64.6%	1.4 days
Germany	October 1923	29,500%	20.9%	3.7 days
Greece	October 1944	13,800%	17.9%	4.3 days
China	May 1949	2,178%	11.0%	6.7 days

NOTES: The authors calculated "equivalent daily inflation rate" and "time required for prices to double."
SOURCES: Hungary (Nogaro 1948); Zimbabwe (authors' calculations); Yugoslavia (Petrović, Bogetić, and Vujošević 1999); Germany (Sargent 1986); Greece (Makinen 1986); China (Chou 1963).

The time it took for prices to double, several hyperinflation episodes compared. As can be seen, the rise in Zimbabwe's stock market was no match for the decline in money's purchasing power.