DAVID HALE GLOBAL ECONOMICS

Why the Stock Market Has Rallied

By David Hale

The US stock market has enjoyed one of the most dramatic rallies of the 20th century since March. It has modestly outperformed the rallies which followed the 1974-75 and 1981-82 recessions. It is far behind the 120% rally which followed Roosevelt's bank closure in 1933 and the 90% stock market decline of 1929-32. It is close to the rebound that followed the 1938 bear market. The US equity market was exceptionally depressed in March because of a sharp downturn in the real economy and investor uncertainty about the solvency of America's leading banks. Many investors feared that cascading bank failures could set the stage for another Great Depression.

There have been two major factors driving the rally. First, the financial crisis of autumn 2008 set the stage for dramatic changes in monetary and fiscal policy all over the world. Central banks slashed interest rates everywhere. The governments of the US, UK, Germany, and the Benelux countries took strong action to rescue their banks with capital injections. Many countries also introduced more stimulative fiscal policies through tax cuts, increased infrastructure investment, and other social spending. Most politicians and investors blame the financial crisis last year on the failure of the US government to rescue Lehman Brothers from bankruptcy. There is little doubt that the Lehman failure turned a slow motion crisis into a global panic, but it is possible that other events could have also produced a panic. The Lehman crisis had the advantage of forcing the US Congress to approve a $700 billion program to recapitalize the banks. As global banks have written off over $1.5 trillion of bad US real estate loans during the past eighteen months, it is doubtful that the banks could have coped with those losses if they had not received government

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help. The total equity capital of the US banking industry is only $1.3 trillion. The market was also relieved by stress tests which the Federal Reserve and Treasury applied to the banks during the second quarter. It projected another $600 billion of losses by year-end 2010, but asked the banks to raise only $75 billion of new capital because of expectations that bank profits would rise sharply and allow them to grow out of their capital adequacy problems. The banks were able to raise another $80 billion of capital in the weeks after the report came out.

The second factor driving the equity market has been the success of the US corporate sector in slashing costs to protect profits. The peak-to-trough profit decline of the non-financial corporate sector between the third quarter of 2008 and the first quarter of 2009 was only 8.5%. Profits actually grew at an 8% annual rate during the second quarter. The corporate sector increased productivity by 2.0% during the past year despite one of the sharpest output declines in the modern era. Firms bolstered productivity by slashing 7 million jobs. The job losses were one-third greater than predicted by econometric models on the basis of output decline. They confirm that American business has been ruthless about protecting profit margins. Other countries have fared very differently. In Germany, the government has protected employment by subsidizing 1.5 million part-time jobs. As a result, German productivity will fall by 6-7% this year. Japanese firms have laid off many part-time workers, but they are reluctant to fire permanent employees. The labor share of value-added in Japanese manufacturing has therefore risen from 57% to 78%. As a result of these divergent corporate responses to the downturn. American business is 10-15% more competitive compared to Germany and Japan than it was one year ago. US firms should be able to significantly boost exports as the global economy recovers. The US success at boosting productivity also suggests that profits could grow by 20-30% next year if output increases by only 2-3%.

The US stock market still faces major challenges. The household sector has entered a period of deleveraging which will dampen consumption for some time.

The Obama administration's policies are potentially hostile to economic growth. He wants to hike marginal income tax rates on ordinary income, dividends, and capital gains. Mr. Obama wants to raise the top marginal income tax rate on ordinary income back to 45% from 35%. He is running multi-trillion dollar fiscal deficits which could set the stage for large tax hikes in two or three years. The market is so relieved over the rescue of the banks and the resiliency of profits that it has overlooked these policy risks. But after the market rallies further in anticipation of economic recovery during 2010, it will have to confront the danger that the Obama administration's policies could dampen the economy's long-term growth potential. These dangers suggest that the US equity market could underperform many other markets during 2011 and 2012.