Cuffelinks
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There's too much confidence in confidence surveys

Phil Ruthven

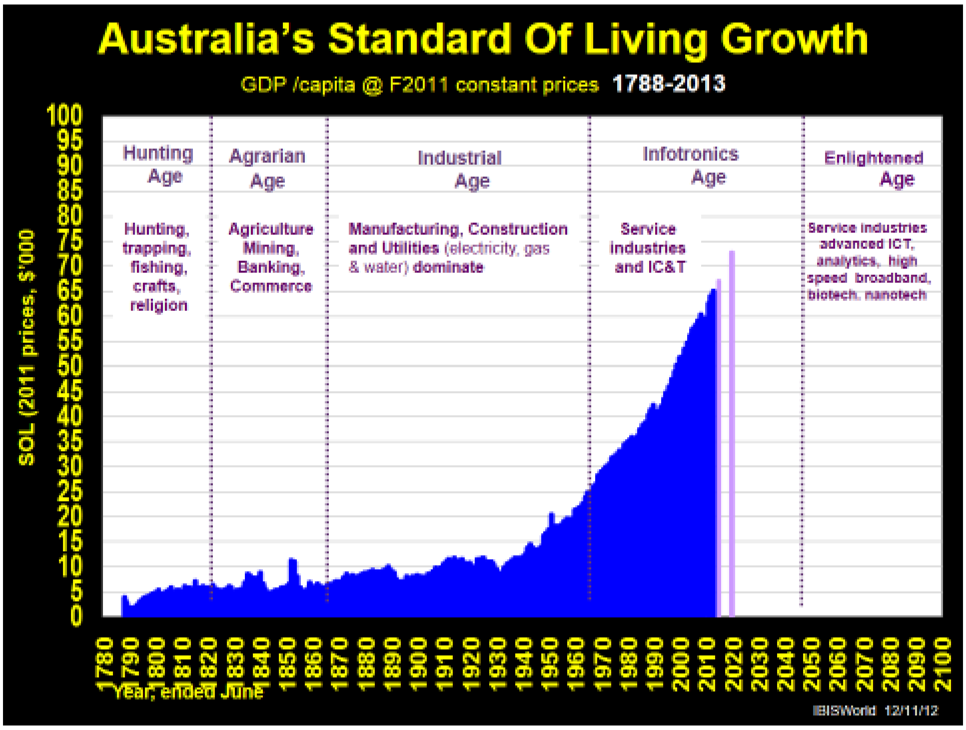
Some of us worry more than we should: what if this happens, what if that happens?

That said, truly awful events and disasters do make us at least wiser and cautionary. Bushfire losses, floods, typhoons, economic depressions, nasty car accidents, burglary, serious assault and other traumatic episodes in our lives or the lives of others can be traumatic.

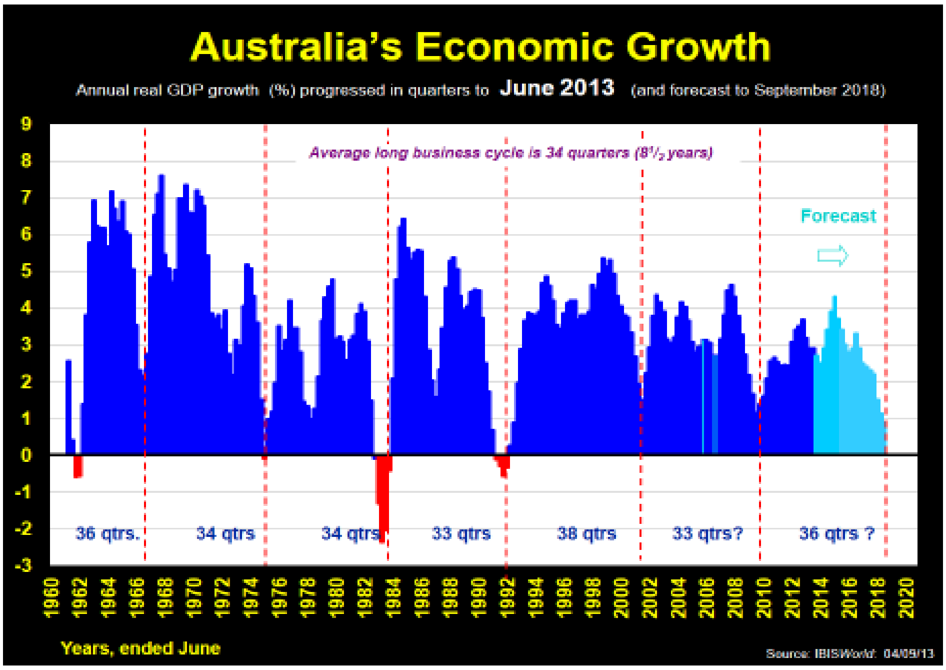
But there are usually more good things, progress and happiness in our lives than bad things.

We live longer than any generation since the days of Methuselah. We have cures or preventions for all manner of ills and pains. We are safer at work, at leisure, in sport and on the roads. We live in dwellings with far greater comfort than mansions and castles of old.

Our standard of living is rising exponentially with only some setbacks from time to time as the first exhibit shows convincingly. We have had four depressions and 22 recessions over the past 225 years from 1788, but they are well and truly outweighed by growth years. Our standard of living today is 4½ times higher than 1913, and over 9 times that of 1813, 200 years ago.



Even if we take a much shorter time frame - the last half century - the news is still good, as the second exhibit reveals: only three recessions, and none in over 20 years since 1992.



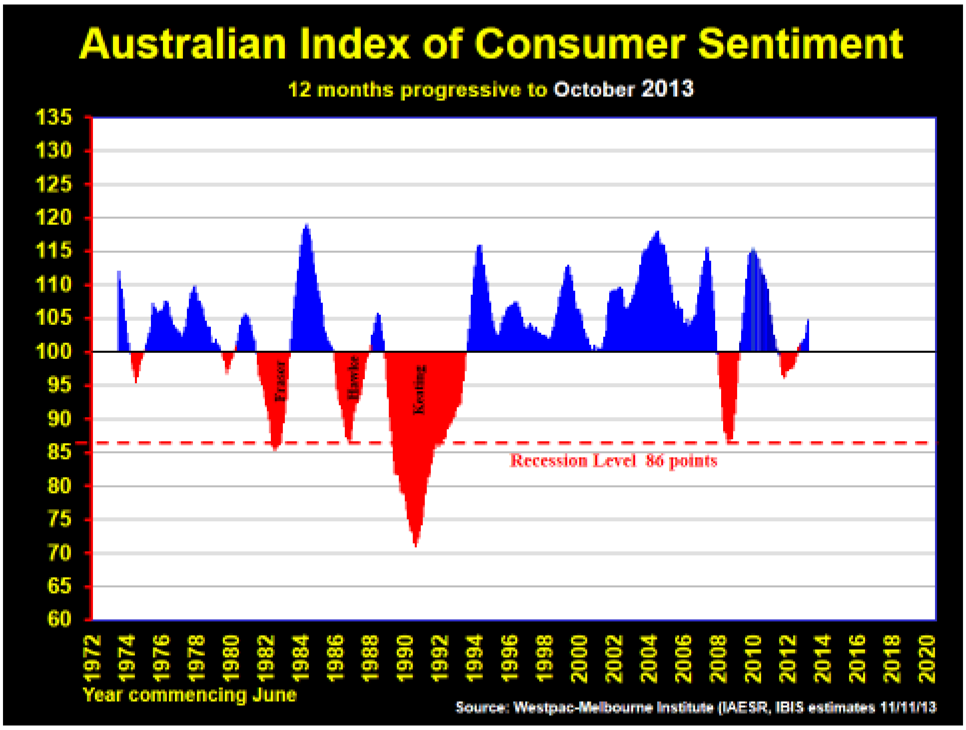
These days we measure confidence as well as talk about it. Before 1970, talk is all we could do as there was only opinion, anecdotal evidence and scuttlebutt.

The Consumer Sentiment Index (CSI), created monthly by the Westpac/Melbourne Institute tells us about the propensity to spend money at the household level. It's important given that household expenditure accounts for 54% of the economy directly, and over three-quarters of the economy indirectly via our taxes and housing capital expenditure. It shows quite volatile changes at times, as we will see shortly, but is a good bell-weather indicator of the economy for 3-6 months in advance.

But businesses need to be careful to avoid long term decisions based on consumer confidence, as they are based on short term perceptions by individuals. Most people do not think much further out than 9-12 months on most things except perhaps schooling, holidays and a change of residence. Business decisions, especially about strategy and capital expenditure, require time frames of 3-5 years and often longer. That is where business confidence indicators are more relevant.

So, where does consumer confidence fit in all of this? Firstly, it should be said that growth in consumption expenditure - over 70% of the economy - has never been negative in any year since the end of World War II. It may be taking a step too far to suggest we can thank female steadiness for this, unlike criticising males for the opposite with investment. Boards of directors are over 85% males and the volatility in capital expenditure range is enormous (+12% growth to 10% falls!) compared with consumption expenditure with a range of 1-5%, and all positive.

Of course, consumer sentiment can turn negative even if spending doesn't. The third chart shows the 12 month progressive average of the CSI over the past 40 years. At 100 points there is a 50:50 split between positive or negative opinions for the year ahead. Anything below 100 points could be a worry, except history shows that the index has to fall below 83 points for a recession to eventuate. That has occurred only twice over this period, in 1982-83 and 1991-92.



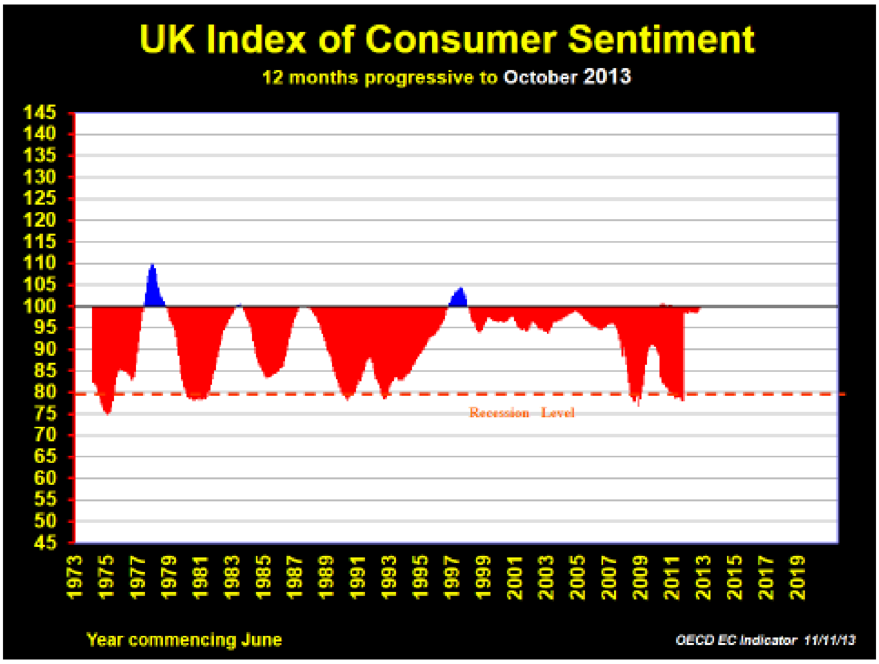
So there is a dichotomy between this volatility (± 15 or more points), and much narrower 1-5% spread (all positive) in actual consumption spending, as said before.

And should anyone still think we aren't all that confident, a look at the history of the CSI in the UK, the fourth chart below, should render them silent if not speechless at the near-perpetual misery in the Old Dart. How do you make a Pom happy for more than four or five years in a century?

The irony is that up until the GFC in late 2008, the UK economy had been growing at a somewhat similar rate of growth as Australia. Perceptions, national psyches and inherent cultures are often at odds with reality.

So confidence is important but can be misleading in terms of what is actually going on. Our emotions, which make us human, need to be balanced by facts from time to time to remind us that things are rarely as grim as they seem, are not grim for long, and we should celebrate the immense progress in longevity, health, living conditions, leisure and happiness.

Often.



Phil Ruthven is chairman of IBISWorld, Australia's best-known business information corporation, and he is also a director of other companies, advisory boards and charitable organisations.

In Boston, new ideas and evolving organisms

Jack Gray

Conferences, those somewhat theatrical groupings of friends and foes, competitors and co-operators, of those seeking new opportunities and those there for a ride, are ripe for a sociological study. As a speaker at the recent Global Absolute Return Conference in Boston, I was struck by the ritualistic nature of a cuddly get-together of hedge fund managers, private equity managers and institutional investors.

How should we judge the value of conferences? Are they worth the registration, travel and accommodation costs, and the opportunity costs? The benefits of access to new ideas and new people are easy to overstate. As a newly minted naïve academic, I expected each conference presentation and each new person I met to reveal ultimate truths. Now my expectations are profoundly pragmatic and reflect the difficulty of creating, articulating, extracting and using ideas.

A one hour presentation or panel discussion is time well-spent if I can extract *one* new (to me) idea, or *one* fresh insight into an existing idea, or *one* notion that challenges a belief or bias. In the same spirit, meeting one person with different patterns of thought makes that time well-spent. To identify let alone to absorb a single new notion demands both a prepared mind and constant unrelenting attention, especially as the most challenging notions often spring unexpectedly and sporadically from unprepared off-the-cuff remarks. Yet in our age of distraction those addicted to iGadgets, constantly fixated on their screen, will likely miss the rare gem of insight, as will those listening to people while simultaneously searching the room for someone 'better'. I asked an addict why he was glued to his iGadget through presentation after presentation. Paradoxically, his response, "because I might miss something", ensures that he almost certainly *will* miss something.

And what might that 'something' be? It's unlikely to be an implementable investment opportunity or something that will quickly make you smarter, richer or more attractive. More likely it will be singularly irritating, something that exposes your inadequacies and your lack of understanding. The 'something' may be no more than a vague hint of an unlikely possibility.

One such arose during a discussion on the supposed failure of diversification due to the convergence of correlations - a consequence of massive institutional herding. One panellist stepped away from the safety of prepared well-understood remarks and speculated (how refreshing is that?) that, as Irving Fisher might have put it, correlations are reaching "a permanently high plateau". Were that the case, we could reconsider the simplicity of a Capital Asset Pricing Model approach with but a single risky asset class ('the market') where an investor has a single decision - the weight in 'the market' and the (possibly negative) weight in cash. That's an irritating notion to play with ... and inchoate thinking *is* indistinguishable from playing.

Economic system complexity defies influence and control

Another 'something' was thrown out by the OECD's William White, an ex-governor of the Bank of Canada, who claimed that central bankers know not what they're doing, a frank admission made not in a pejorative sense but more as a recognition that the system they try to influence and control may be beyond their influence and control. Because our models derive from misguided attempts to make economics 'scientific', central bankers' implicit metaphor is an engineering control system like air conditioning, a stimulus and response system in which negative feedback mechanisms eventually result in stable dynamic equilibrium; a system where intelligent informed human turning-of-the-dials (think QE II) will eventually lead to desired outcomes.

But what if that metaphor fails because the system's complexity undermines and defies influence and control? White called for a quite different metaphor, one where the market is akin to an evolving, adapting imperfect biological organism, more like a forest or a coral reef or an English country garden where human involvement is a mixed blessing. One irritating question is whether that metaphor can be extended into a more explicit model, perhaps with practical insights? More irritating still: Is it true that complexity induces stability in ecological systems yet instability in financial systems?

At the conference there were hints of the tension recently exposed by the Nobel awards to Gene Fama, an economic positivist who showed the world to be flat and efficient, and Bob Shiller, a normative economist, who showed the world to be craggy and inefficient. No surprise that the positivists dominated a conference of hedge funds and their supporters. Nonetheless the belief that economics or finance is a value-free science driven by rational expectations was occasionally challenged. The Canadian banker made an explicit plea for economics to return to the principles of its founders - Smith, Bentham and Mill - as a humanist discipline. Barney Frank, the only left-wing, left-handed, gay, Jewish ex congressman, he of Dodd-Frank, was even more explicit in his call for more and better regulation and increased taxes. My similar appeal, part of a proposed solution to the underfunding of public sector pension plans, included the US adopting a simple tax-funded universal health care system, the effect of which would be to cut public pension liabilities by 45%. Later I was told a bunch of gentlemen were waiting to see me dressed in white sheets and carrying a noose and burning crosses.

Fees can't fall when we all believe we're uniquely gifted – like high fashion

Most revealing were the responses to "why is there (almost) no variation in hedge fund fee levels." Hedgies instantly justified 2&20 (2% per annum management fee plus 20% performance fee) on the usual grounds of paying for talent, an attribute they all claim to have in abundance, a justification that for painfully obvious reasons, was strongly supported by their clients. The real answer was left unsaid. In an open free market with no informational asymmetry, competition should force prices down towards the marginal cost of production, as happens with index funds. By comparison, the market for hedge funds suffers from massive informational asymmetry in which the buyer cannot determine quality (nor in truth can the vendor.) In such markets, pricing uniformity should be expected as any lowering of price will be interpreted as a signal of low quality, just as it is for women's *haute* fashion.

It's not only the hedge funds that have an abundance of rare talent. Pension fund executives solemnly declared that they too have a 'truly gifted and talented team' and a 'wonderful board'.

Why is it beyond us to openly discuss our inadequacies and failures? Especially in the *faux* science of economics and finance, we can learn most from revealed inadequacies and failures.

Dr Jack Gray is a Director at the Paul Woolley Centre for Capital Market Dysfunctionality, Faculty of Business, University of Technology, Sydney, and was recently voted one of the Top 10 most influential academics in the world for institutional investing.

In Macau, new Asian money and Australian property

Ashley Owen

I recently delivered an address at a Private Wealth Management summit in Macau for Asian family offices. Following are some trends I have observed in the three years I have spoken at the event.

Wealth management in Asia is very different from Australia. Australians have the highest median household wealth in the world but relatively few billionaires. Wealth in Australia has been relatively democratised since the 1850s gold rush, and especially since World War II and the financial reforms in the 1980s and 1990s. This has spawned huge wealth management and advisory industries that feed off it. In contrast, wealth in Asia is highly concentrated in the hands of relatively few and it is recent, so there is no large scale wealth management or advisory industry. Accountants count money and prepare tax returns, but they are not generally used for investment guidance.

Insights into attendees

The summit was attended by a hundred delegates from single family offices, multi family offices and private banks servicing wealthy families, mainly from Hong Kong, Singapore, India, China, Malaysia, Philippines, Thailand and Japan. A single family office is a team of people who look after one family's financial affairs, usually a billionaire. Many single family offices have half a dozen staff and cost $2 million or more per year to run, and were started by the second generation of the patriarch. Most multi family offices started out as single family offices, but now extend their services to other families as a profit-making family-owned business or to defray the costs of the original family office.

Most of the wealth in Asia is first generation or second generation money made after World War II and after the post-World War II independence wars. This is in marked contrast to the US and Europe, where wealthy families are often hundreds of years old. There is still much new wealth in the US, thanks to Silicon Valley, but there is virtually no new wealth in Europe.

I met one US family office principal who was himself a 4th generation family office manager, looking after 7th generation family money. There are some rare exceptions to the rule that most Asian wealth is new money - for example, the people who look after the Kikkoman family money. Kikkoman (of soy sauce fame) is a 400-year-old family that consolidated into the current family business structure in 1917. Singapore is increasingly the preferred home of Asian family offices, now that Hong Kong is part of Communist Party-ruled China.

The family offices were the 'buy side' of the summit. On the 'sell side' there were a hundred or so attendees representing funds and products to the family offices.

Governance and ownership transition

Most Asian wealth is first generation, and the main issue is how to transition the ownership and management structure to the second generation after the patriarch or matriarch is no longer able to run the business. Often the main issue is just to get the next generation interested in the business. Many second and third generation family members are western-educated and their ideas and ambitions are often in conflict with Asian traditions where it is the strict duty of the son(s) to take over the family business.

Most Asian cultures follow the tradition of passing the business to the eldest male, who may or may not be the best leader and manager. Due the increasing longevity of the dominant patriarch, often the eldest son may now be 60 or 70 years old before he makes his first real decisions, and so lacks many of the 'street smarts' of the patriarch. The eldest male may be better at management and administration than leadership and creativity. Managing these types of conflicts between siblings, cousins, in-laws, and others like mistress and illegitimate offspring, is often the main priority for family offices.

The concept of a family office involving outsiders is foreign to most Asian cultures. Asian patriarchs tend to be dominant hands-on leaders, reluctant to outsource. The main trusted adviser tends to be the family and business accountant. Private banks or bankers are generally seen as conflicted product sellers. Investment banks are used mainly for deal flow and transactions.

Family offices also spend time on family 'concierge' services – keeping the mistresses apart, ensuring the kids and grand-kids are out of trouble, organising the staff in the various houses, firing up the boat or the jet, etc.

Asset protection, secrecy and tax

The second main issue for family offices involves hiding money from governments, creditors and predators. This extends to business succession planning, trust structures to enable effective sharing of wealth and power in running the business. There are often highly complex trust structures with nominee companies/trusts/directors in numerous tax havens. Often the structures are unnecessarily complex but are created to ensure longevity of the adviser relationships, rather than efficiency or cost-effectiveness. A second order priority is to minimise tax and manage control leakage to distant family members.

Getting money into safe haven countries often takes precedence over what to do with the money when it gets there. The most commonly mentioned countries were US, UK, Canada, Australia. The attractions of Australia include:

- rule of law, protection of property rights, away from autocratic or capricious regimes
- links due to education for their children
- close time zone
- weather, often compared favourably to Canada.

Philanthropy

There has been a shift in thinking from straight charitable giving (eg funding a hospital or university) toward 'impact investing' and 'venture philanthropy'. These involve a combination of philanthropy and investment, and require more hands-on involvement with the use of the money to achieve specific aims. This is more difficult than merely donating to existing charities.

There are plenty of well-intentioned causes and well-meaning people (everybody wants to relieve poverty, eradicate disease and provide better education for children), but it is hard to develop cost effective programs that deliver specific, measurable outcomes. They are discovering that this is often better left to existing charities rather than re-make the mistakes existing charities made years or decades ago.

Philanthropy is often seen as a good opportunity to involve family members in setting up and running ventures. Generally, the sons run the businesses and the daughters and wives run the charities. Most Asian cultures operate along strict gender lines, with notable exceptions.

Investments, fads and Australian property

Investment tends to be a third or fourth order issue for many Asian family offices. As most Asian wealth is first or second generation, the wealth is still in the family business, or related investments like commercial property (eg a shipping business owning warehouses).

Contrast this with US and European families, where there may be hundreds of family members with no one person owning more than a tiny fraction of the original business. The primary investment objective is usually to sustain the family legacy and to fund the lifestyles of those who live off the remnants of an empire or business long since passed out of family hands.

Some countries in Asia are run by capricious, corrupt regimes, and 'cave money' investments tend to be in hard assets like real estate, gold and cash in foreign safe havens.

Because there is little overt consideration given to portfolio construction and asset allocation, newer family offices are natural targets for fads and hot ideas. Two years ago the hot fad was Aussie small cap mining explorers. That market collapsed so they have not been seen at the summit since. At last year's summit, the main fads were gold and wine, but both markets have since collapsed so the peddlers of gold bars and wine were not back again this year.

This year the hot fad was Australian residential property. There were property spruikers peddling flats off the plan in Queensland (they are more resilient than cane toads!), Melbourne docklands (probably re-selling the same flats they sold to Aussies five years ago but at half the price this time), and even one spruiker selling apartments off the plan in Port Hedland and Newman.

At least half of the products and funds were from Australia, as in prior years. It is evidence that Australia is seen as both a safe haven and also an emerging market for opportunities. Next year, I will report on how the latest fad fared.

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In Sydney, insights from Maxsted and Neilson

Graham Hand

On 8 November 2013, Morningstar held its first ever Individual Investor Conference, aimed at retail investors rather than advisers or super funds. It was fascinating to watch the crowd of about 450 during the day. Few were dressed in suits or ties, and the majority could have been watching a movie or attending a casual concert, but they were more attentive than a crowd of professionals. Many furiously took notes for hours, filling page after page, desperate to learn more.

To its credit, Morningstar did not dumb it down. It was a day rich with information across many asset classes and structures, and I have attended many fund manager and adviser days where I have learned less. And topping the bill were Lyndsay Maxsted, Chairman of Westpac, and Kerr Neilson, Managing Director and CEO, Platinum Asset Management.

Here are some of their more interesting observations (with my paraphrasing but with no editorial comment. I've tried to capture accurately what was said but without the length of word for word quoting).

Lyndsay Maxsted, Chairman, Westpac

Let me give some comfort on housing. First, there is no imbalance between supply and demand for housing in this country, and if there is, it's probably lack of supply. You can have micro exceptions, such as inner city apartments, holiday homes, Gold Coast, these are vulnerable in a downturn. We also look hard at 'one industry' towns. But they are micro exceptions.

Second, Australians take their home borrowing very seriously. They want to pay off their debt so they can keep on owing their own home. It's a really important attitude.

Third, because of the significance of housing for banks, the credit process we go through is just as intense as for business loans. There are dramatic differences between Australian housing lending and the US. In the US, a large part of lending is done by brokers, and the person who ends up holding the credit risk is not the originator. Here, the loan goes onto our books and we do the credit assessment. We heavily stress test our book.

If you look at the levers for Westpac's profitability, I don't think there's much more left in margins, and there's not much gas left in impairments, due to where we are in the bad debts cycle. And nobody thinks credit growth will go up to pre-GFC levels. That's a good thing, because it gives rise to a GFC at those high levels. Don't expect revenue to come from there.

But think about the role wealth plays for banks these days as opposed to credit, think about where you want to play in Asia, that's a growth story but whether it is profitable growth is debateable. The other piece is productivity and cost control. At Westpac, we lead with a cost to income ratio of 40 to 41%. Plus there's the whole technology piece.

And if you look at the Big Four banks, it's an amazing strength. Think of the customer strength, the distribution strength, the quality of the brand, all four banks are well-managed, there's no reason why that should be eroded.

On future regulations, in terms of what we know, we have gone a long way towards what the regulators want us to do. There's no leverage ratio in this country, and I hope it doesn't come in. Liquidity still has a bit to go, so all of us are building up our liquid assets, depending on how they finalise the liquidity commitment facility and address the lack of government securities in this country. On funding, we've all made giant strides in terms of switching away from short term wholesale into retail deposits. On that journey, we're 75-80% down the track.

Up until about 12 months ago, the biggest issue for the banks was Europe. In 2011 and 2012, the worry was whether something would happen overnight like a Lehman Brothers experience where one of the bigger banks defaulted. And how would that flow through global financial markets. Since Mario Draghi (of the European Central Bank) came out with the 'whatever it takes' statement, it has lessened the issue considerably going forward. I hasten to add it has not addressed the major issues. What has overtaken it is the whole QE piece. How is that distorting financial markets? We call it a 'wall of liquidity', but a lot of that liquidity is not going down into the underlying economy. It's floating around in financial markets, and the word 'bubbles' then comes to mind. Where are they? We don't think housing in Australia is a bubble, but we watch it like a hawk. But how do you come off this drug, and what happens? Nobody has been here before. What happens when the tapering starts? We saw what happened at the mere thought of tapering by maybe $10 billion of $85 billion a month.

I'm a big fan of superannuation. If we look back at what Paul Keating did, we have a lot to be grateful for. We need to make sure we don't go too far along the risk curve in the search for yield and growth, and remember what superannuation is for. There's been a lot of press on banking lending to SMSFs but it's not a big part of our business. It's very specialised and highly regulated.

We want a better, consistent environment in which to make our investment decisions. We have not had that through the minority Labor Government. That's not a political statement, as 'minority' is just as important as 'Labor' in that sentence. We want to know when we make a decision, the rules won't change.

The high Aussie dollar is holding back investment decisions. Is 75 to 80 cents the 'natural range'? I'm a great believer that no matter what the RBA does, this is 95% what the US Fed's doing, we're dependent on that whole QE piece. With those provisos, we need an environment which encourages investment and attacks the high cost and high regulatory environment.

I'm very bullish on China, that's got a long way to go (you'd expect that of a BHP director). The commodity boom is not over, although it's over in the context of iron ore at $185, and the commodity boom for the support industries around mining is over, as that push to open mines, build ports and rail, that's stopped. There's still plenty of money to be made in mining.

The big issue for any mining company is commodity prices. Even BHP, the world's largest miner, has little control over prices. In terms of dividend and profit streams, the advantage that BHP has is that it ran hard on capital expenditure in 2010 and 2011, on the back of the mining boom, and there's no need to do that again. The good thing for investors is that money was not wasted. It was put into mines and ports.

Companies have to be careful not to change policies just because a group of shareholders want something at that point in time. What's more important is consistency.

I think about sustainable competitive advantage a lot. What's our UVP, our Unique Value Proposition? What makes customers come to us? And the flipside, what are the risks? Strategy is about where you are now, and where you want to be in the future.

Kerr Neilson, Managing Director and CEO, Platinum Asset Management.

We are interrupting the true behaviour of the markets by quantitative easing. We are removing the market mechanism for finding the correct cost of capital. We'll end up with some huge distortions in the value of different assets. We're seeing is already in property in places like London and Dublin, and it's washing through to equity markets.

The world will grow. I expect emerging markets to grow at about 5%, developed countries about 2.5%, the world at 3%. The world is being driven by emerging markets, with developed markets now less than half of economic activity across the globe. The world is fine. The US has got a lot going for it driven by cheap gas. There's a very aged car fleet and housing has improved. Banks are not lending as much as they could, and it must lift.

The two worst things we can engage in when investing is recency bias (over-emphasising near-term events), and extrapolation, assuming the recent trends will continue.

When investing, ask yourself, "What is your edge?". What do you know that others do not. If you do not know more, chances are it is fully priced. There's no point buying a good company that is fully priced, especially since many of us do not have the discipline to hold it through thick and thin. If you pay a full price, you have to sit with it.

We've been in business for 19 years, and in that time, a $1,000 invested with us would be worth $9,500. In the index, it would have gone to $2,500. But tragically, because of impatience and loss of faith, people have only earned with us on average about $3,500. Please think about your mentality.

I'd like to put to bed one terrible myth about Japan. The argument against Japan is that the population is aging. But the key is we live in a highly integrated global economic system. Many Japanese companies have one third to one half of their profits coming from abroad. The world is their market. That's the opportunity.

The Aussie dollar is not exactly the cheapest currency. France's minimum wage has been a concern to Europeans, it's nearly twice that of Germany. Yet our minimum wages are higher than France. We've got some problems in terms of adjustment, the Aussie dollar has lost some of its big drivers.

We think we're on the verge of a second great internet revolution. Most of you have not heard of the great companies involved. It indicates it's still early days. In the last boom, we had the hardware suppliers, this time it's the content suppliers and network groups. What is exciting about this is that your phone number is tantamount to a mobile internet address. Your phone is connected to 1.5 billion people. It is liberating emerging countries. In Africa since 2000, we have gone from 10 million connections to over 700 million. Think about the effect on things like payments and crop planning. This is happening everywhere.

The world is fine but it does not mean the stock markets are fine. When I look at the overall US market trading at 16 times, having rerated in anticipation of earnings that have barely come, that's not particularly interesting. But when I delve into that market, it's the composition and particular stocks that matter.

A day in the life of theory versus practice

Ashley Owen

Thursday 7 November 2013 was a good example of the often perverse relationship between economic growth, company earnings and share prices, and also an example of how markets react to unexpected news in unexpected ways.

In theory, improving prospects for economic growth and company earnings should be good for share prices, while deteriorating prospects should be bad for share prices. Nice theory, but not in the real world, whether daily, monthly, quarterly or even yearly time periods.

Expected versus unexpected

In the case of the relationship between news and share prices, expected news - like expected profits, dividends, economic numbers or interest rate changes, etc - is generally already factored into prices every day so it is unexpected news that causes prices to jump up or down sharply.

For example, if the market consensus is expecting a particular company to announce a 20% profit rise next Tuesday and it does in fact announce the 20% profit rise when expected, then the share price will not jump up on Tuesday. But if for some reason the company announces flat profits on Tuesday the share price will most likely fall significantly (all else being equal) even though profits have not fallen at all, because the flat profit result was an unexpected negative surprise.

Thursday 7 November 2013 was a good example of these factors at work in real life. There were two very significant pieces of unexpected news that affected global markets on that day.

European Central Bank rate cuts

The European Central Bank unexpectedly cut the refinance rate by 0.25% to 0.25%, and the emergency bank borrowing rate was cut by 0.25% to 0.75%. ECB President Mario Draghi also said that the ECB still maintained an easing bias, meaning more rate cuts were possible.

This was a big deal as it represented a change in policy stance and a change in the dynamics of the tussle between the hard line pro-austerity 'north' led by the Germans and the pro-growth, anti-austerity 'PIIGS' led by France and the International Monetary Fund.

Following the convincing win by Angela Merkel's Christian Democrats in the German Bundestag elections in September, the feeling in markets had been that the Germans would be highly likely to continue with their bias toward a moderately hard-line stance on austerity and fiscal rectitude, which is deflationary and stifles growth at least in the short term.

Inflation and growth numbers out of Europe over the past several weeks have being pointing to a slowing in the anemic European recovery. There was even talk about a rising risk of deflation, which is almost universally agreed to be even more devastating to economies and company earnings than than inflation.

European markets were trading flat in the morning until the announcement of the ECB rate cut. The moment the ECB announced that European growth was so sick the ECB has had to apply even more medicine to the ailing patent on life support, and that possible deflation was on the cards, investors all across Europe rejoiced and raced in to buy more shares at higher prices!

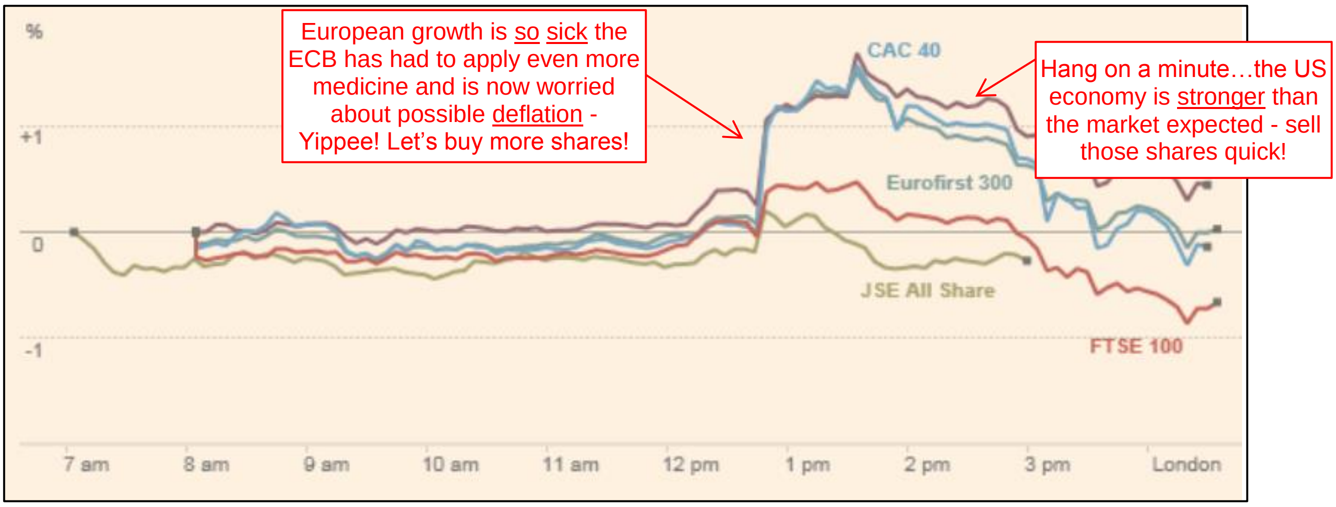
US economic growth

Then the second big piece of unexpected news hit the airwaves. The third quarter US economic growth number was better than expected and so perhaps the US would emerge from intensive care sooner than the market had previously expected.

Better than expected recovery for the US economy is good news for the prospects for company earnings and dividends and so should be good news for share prices - in theory.

But in practice such news was seen as bad news and investors across Europe, and in the US when markets opened there, dumped shares on the bad news that the economy and company earnings prospects were now improving!

The first chart from The Financial Times shows European markets during 7 November 2013. The second chart shows American markets after the ECB announcement, selling off across the board on the 'good news' of a stronger US recovery. Not even the successful Twitter listing was enough to lift markets.



Addiction to cheap money

The missing link in all of this is cheap money. Share prices are moved by the weight of investors' money and most investors have become addicted to rivers of cheap money for the past five years. They are motivated more by the prospect of more cheap debt flooding the world than by the reason for the need for all the cheap debt in the first place.

The US and European economies have been on life support in intensive care since the start of QE1 following the Lehman bankruptcy in September 2008. The very weak economic recoveries, the stock market recoveries that began in early March 2009, and property markets that have recovered over the past year, were all made possible, and supported, by an unprecedented flood of cheap money artificially created on a global scale by all of the major central banks of the world.

Markets work in mysterious ways, and not much of it has to do with text book theory.

That's just one day - what about longer periods?

The above story relates to how markets worked on a particular day. Similar perverse relationships operate on much longer timescales, including monthly, quarterly and even yearly. For a fuller explanation, see [this article on economic growth and market cycles].

For example, in 2012 global economic growth was *below* average, and earnings and dividends were flat or falling, but global stock market returns were *above* average. This followed 2011 when global economic growth was *above* average and earnings and dividends rose, but stock market returns were poor and well *below* average.

Going back further, in 2009 world economic growth contracted in the deepest global recession since the 1930s depression, but shares had a great year in 2009 and the world stock market index was up by 29%!

It pays to focus on what drives markets in the real world and not follow simplistic text book theories.

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