



The war for the truth: Are equity prices an accurate reflection of economic reality or merely a government sponsored showcase?

I believe August's interesting events are well summed up by the above title.

Politicians, whose currency is perception and not reality, would argue that the stock market is merely a showcase to show how financially strong the country is and a source of collateral upon which you can borrow.

Idealists argue that the markets reflect real prices for a conglomeration of assets and allow for funds to be channelled to the right places in the economy.

Central bankers would argue that the stock market collateral, alongside property, is an essential tool for giving the hoi polloi an illusion of wealth (even though the majority don't own either!)

There is general confusion. The stock market has been hijacked from the Wall Street robber barons and boiler rooms of yesteryear and given a veneer of sophistication and allure.

Our feeling is that to have functioning, liquid markets which provide realistic, accurate prices based on all available information, of which equity is just one, is a hallmark of a well-developed economy. These prices allow for relatively effective and efficient resource allocation. Not perfect – just more so than the rest. Publicly traded markets with integrity, price or otherwise, allude to the same on a wider scale.

But what happens when, expediently, prices get distorted, just for a weeny while, say 5 years, just to create some positive perception in a crisis? No problem. The politicians are happy to 'whistle past the graveyard' and argue at the end of it, the lie was justified and no-one got hurt.

The problem arises when this tactic works once, works twice and then becomes the go-to strategy in any market down more than 10%, whether or not it is justified.

When prices are wrong, they can be wrong for three reasons:

- 1) We didn't know the information which changed the price. It has just come to light.
- 2) It was known by a few but hidden.
- 3) It was known by many but those many suffered under a mass delusion and ignored the information.

So what was August mini-meltdown in equity prices?

Probably a bit of all three.

Firstly new information came to light. When China devalued the renminbi, it shattered the illusion of permanent and upwardly rising prosperity in China, an illusion which was shattered everywhere else in 2008.

Secondly, much of the information regarding the real state of the economy in China seems to be known but hidden and thirdly, mass delusion, remarkably similar in every financial bubble, was present in sectors of the Chinese stock market.

The Government response was to be expected – keep the illusion going and pray it is just a passing fad. However, the bureaucracy's heavy-handedness created even more uncertainty. If the fire is so small, why are there 100 fire engines here?

Paradise is only paradise if you can leave. Chinese equities became no paradise for most holders as trading halted in many stocks and selling has been banned for large equity stake holders within China. This is reminiscent of Hotel California where 'You can check-out any time you like / But you can never leave!'

But why is this turning the rest of the world upside down?

Well the emerging markets are a no-brainer. They did what a lot of noob start-up companies do to their ultimate chagrin; they relied too much on their biggest customer, i.e. China.

China used to consume around 50% of the majority of the world's basic commodities. In 2008, demand for the finished goods all but collapsed which eventually ran down the logistics and distribution chain and what we see now is a collapse in primary demand for commodities.

What about developed markets? They are still 'whistling past the graveyard' as well. We don't know if they will continue to decline or how far they will fall but the feeling is that the volatility is not over.

There is a view that extremely low interest rates and QE have kept the inherently expensive developed world's equity markets afloat in conjunction with the comfort of knowing that global GDP is fragile but secure mainly because the Chinese economy is robust.

None of these factors provide comfort anymore.

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