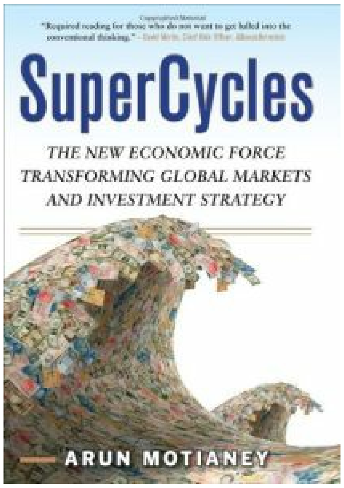

Book SuperCycles

The New Economic Force Transforming Global Markets and Investment Strategy

Arun Motianey
McGraw-Hill, 2010

Recommendation

In classic economic theory, market forces move the global economy toward a balance in the creation and consumption of products and services. In reality, markets rarely settle into a steady equilibrium that neatly matches supply and demand. Arun Motianey sets out a new paradigm to explain this mismatch – and much more. He says serial disequilibrium drives "SuperCycles," decades-long sequences of economic expansions, recessions and recoveries marked by a common pattern of changes in the prices of inputs and outputs. The "Classical SuperCycle," which ended with the Great Depression, lasted almost 60 years. The "Modern SuperCycle," which began in 1979, may die younger, largely because increased borrowing and other "financialization" forces are accelerating its advance. Instead of letting this unfold, regulators should set policies that sustain the Modern SuperCycle. Motianey criticizes classical macroeconomics' poor predictive power and proposes that the SuperCycle may provide a defined structure that could make it easier to foresee the economic future. *BooksInShort* recommends this lucid, if sometimes contrarian, book to readers intrigued by fiscal history and by new ways to understand long-term economic trends.

Take-Aways

- "SuperCycles" are multidecade series of expansions and contractions in the global economy.
- New monetary standards to promote price stability have heralded the start of two SuperCycles since the 1870s, the "Classical SuperCycle" and the "Modern SuperCycle."
- During a SuperCycle, deflation sequentially cheapens commodities, then manufactured goods and then services.
- The Classical SuperCycle lasted almost 60 years and ended with the Great Depression.
- The "Gold Standard" of fixed currency exchange rates controlled the forces of the Classical SuperCycle.
- The Modern SuperCycle, which began in 1979, may be ending. It has advanced faster than the Classical SuperCycle.
- Flexible exchange rates and increased borrowing have driven the Modern SuperCycle.
- Regulators are trying to limit this SuperCycle's ability to deflate prices.
- The US economy may be headed for a period of high inflation and stagnant growth.
- Diversified investment portfolios perform poorly during periods of high inflation.

Summary

An Overview of "SuperCycle" Theory

Classical macroeconomic theory lacks both scientific credibility and predictive power. Its practitioners have failed to forecast some of the biggest economic shocks in recent history, including the 1987 stock market crash, the 2000 collapse of the Internet investment frenzy and the 2008 worldwide financial panic. Consider the theoretical possibility that those economic shocks are part of a bigger unfolding trend, part of a single SuperCycle. The potential reward of this idea is better economic foresight because the current SuperCycle is following a pattern roughly parallel to the prior SuperCycle. This is why national policy makers and central bankers should consider the theory of SuperCycles as a practical alternative to modern macroeconomic theory.

> "The door is wide open to some new, alternative interpretations of events that lie outside the dominant models of macroeconomic behavior."

Imagine the economy as a pipeline representing progressive steps in the market-based allocation of resources. Raw commodity suppliers are at the front end of the pipeline, manufacturers and service providers are in the middle, and consumers (households and businesses) are at the back. This conceptual view is helpful in seeing cycles of economic expansion and contraction as part of a bigger trend, or SuperCycle.

Price Misalignment and SuperCycle Momentum

Excessive production of goods or services due to a misalignment of "relative prices" – or of the prices of outputs and inputs in relation to each other – drives a SuperCycle. For example, if commodities fall in price and finished goods' prices appreciate, this price misalignment will encourage excess production and lead to surplus inventories. The surplus will cause finished goods' prices to increase more slowly than before (disinflation) or perhaps to decrease (deflation).

> "The theories of modern macroeconomics have no built-in mechanism that signals that the theory is wrong."

Many finished goods actually are components of other products. For instance, hard drives are installed inside personal computers. If hard drives became cheap compared to PCs, this misalignment should encourage overproduction and discount pricing of personal computers, leading to excess production and disinflation by increasing labor productivity. Economist Robert Brenner of the Center for Social Theory and Comparative History at UCLA has researched the productivity enhancements made possible by information technology (IT) advances in the 1990s. In the second half of the 20th century, the IT industry became an unsustainably large contributor to US economic growth. It accounted for 33% of the growth in US gross domestic product, or total economic output, from 1995 to 2000, the year the powerful surge in IT spending ended.

> "Heightening the ferocity of the SuperCycle is our commitment to an exchange rate system that has lulled us into the belief that 'flexibility' is a virtue."

For a SuperCycle to advance, disinflation must move "forward" through the production pipeline, though not necessarily continuously. The SuperCycle is a progressive pattern of sequential disinflation that first hits commodity suppliers, then manufacturers and then service providers. In the end phase of a SuperCycle, disinflation slams households, largely due to the change in labor's value as wage growth slows or stops. The beginning of the Great Depression, the severe 1930s economic contraction, coincided with the end of a nearly 60-year SuperCycle. A new SuperCycle has emerged since then, but its lifespan could be shorter and its end even more calamitous.

The Importance of Monetary Standards

Certain "laws of motion" explain shifts in the momentum of a progressing SuperCycle. A SuperCycle begins when regulators establish some new monetary standard that makes people expect price stability. This new standard launches the sequential bouts of disinflation that push the SuperCycle forward. The adoption of new monetary standards defined the starting points of both the "Classical" and the "Modern" SuperCycles.

> "Macroeconomics fails the primary test of any modern science: It lacks predictive power."

The "Gold Standard," which sets currency values in terms of the precious metal, initiated the Classical SuperCycle from 1873 to 1930. The US adopted the gold standard in 1879, six years after Europe. The public generally expected the gold standard to limit inflation, and their expectation "became self-fulfilling." Following a period of high inflation from 1853 to 1873, "commodity prices went into steep decline" as the gold standard spread, constraining governments' ability to manipulate currencies. In 1873 and 1874, nearly 100 US banks failed when the mineral and agricultural assets they held as loan collateral lost their value. This pricing pressure on commodities revealed the first stage of the Classical SuperCycle.

> "The orthodoxy of modern macroeconomics is a hall of mirrors; yet it is still being applied inside central banks and policymaking institutions."

The Modern SuperCycle began in 1979 when Paul Volcker became chairman of the US Federal Reserve and helped to establish the "Enlightened Fiat Standard," as it was called. Under this monetary standard, flexible exchange rates determine currency values in terms of other currencies, not in terms of gold. Volcker led a monetary-policy clampdown that raised interest rates and defused inflationary expectations. He gained a reputation as a tough-minded inflation fighter as commodity prices dropped and the Modern SuperCycle revealed itself. From 1980 until the mid-1990s, commodity prices plunged more than 40% in relation to finished goods prices. Manufactured goods' prices fell in the 1990s after low commodity prices encouraged excessive output and aggressive discounting.

> Current policies "rationalize the industry's own feral behavior in herding investor capital into and out of these markets."

The SuperCycle essentially was dormant from 1930 to 1979, an intermission between the collapse of the gold standard and the establishment of the Enlightened Fiat Standard. During this period, the US dollar served as an international reserve currency with guaranteed convertibility to gold. The Enlightened Fiat Standard is based on confidence in currencies and the central banks that manage them, not on backing in gold or silver. Relatively stable prices for the inputs and outputs of production during the 1930-1979 intermission helped to keep the SuperCycle dormant. The prices of commodities and finished goods were well aligned in this period; the misalignment in relative prices that impels SuperCycles did not occur.

The "Financialization" of the Economy

Though their early stages were similar, the Modern and Classical SuperCycles have clearly distinct qualities. The role of finance is an important difference. Its increasing relevance in the economy since the middle of the 20th century has magnified the force of the Modern SuperCycle. The Classical SuperCycle was comparatively mild because the gold standard limited the financial flexibility of governments, businesses and households.

> "The stimulus behind the SuperCycle is the arrival of a monetary standard that promises price stability."

The financialization of the economy since the mid-1900s empowered the current SuperCycle but left the economy more fragile. For example, flexible exchange rates were major culprits in the disruptive, sudden devaluations of the Mexican peso and the Thai baht in the late 1990s. More recently, the misguided market for mortgage-backed securities soared after the start of the 21st century, ensuring broad access to home loans with easy terms, but then it collapsed in 2007 as mortgage defaults spiked and inventories of unsold homes ballooned.

"While history offers many possibilities, it is likely that we are entering a period of Japanese-style stagnation."

Financial markets play a central role in many econometric models by helping to move the market forces of supply and demand into equilibrium. Classical macroeconomic model makers preach that the law of supply and demand pushes each in the general direction of the other, a natural tilt toward equilibrium. However, this theory assumes that everyone has "perfect knowledge" of the market, that all relevant data about any product or service's value is available and understood.

"Once wage deflation gets under way, a more generalized form of price deflation follows."

By the 1970s, US economists Jack Hirshleifer and Roy Radner rejected the debatable assumption of perfect knowledge when they refined the classical macroeconomic model. Their model of the economy posited that financial markets allay individual uncertainty, so people buy insurance policies to shift the risk of future losses to others, open savings accounts to push spending into the future and borrow money to move future purchasing power to the present. Economists call this the "intertemporal allocation of resources." In this way, financialization not only reshaped the economy, it became embedded in theories of how the economy works.

"Booms arise from a misalignment of relative prices; busts force a realignment of relative prices."

Financialization has made the Modern SuperCycle more volatile than its predecessor. But regulatory efforts to neutralize its intensity and stabilize business conditions are "only cumulating troubles for a much larger crisis" when this SuperCycle finally ends.

The Final Phase of the SuperCycle

Some analysts mistakenly conclude that the gold standard precipitated the Great Depression in the 1930s. The true cause of the Great Depression was the failure of the US government to loosen its monetary policy to offset the gold standard's financial limits. The US could have kept the Classical SuperCycle alive longer by stoking inflation, allowing debtors to repay nominal balances with increasingly cheap, inflation-adjusted dollars. Instead, policy makers diagnosed the primary economic problem as excessive supplies of products, not low public demand for them, and encouraged a massive liquidation of production capacity. This drastic liquidation boosted unemployment to historic peaks, drove rolling inflation that flattened the value of wages and killed wage growth, thus undercutting the primary consumers at the end of the economic pipeline.

"The US government is fighting the threat of deflation that the SuperCycle threatens to impose on the afflicted sectors."

Whether the Modern SuperCycle's end will resemble the Great Depression or something worse remains to be seen. It probably will increase inflation. Keeping today's SuperCycle alive is as important as forecasting how it will end. The Great Depression demonstrates that once a SuperCycle starts, extending it is better than letting it expire.

Options for Policy Makers

As they consider ways to elongate the SuperCycle, policy makers are likely to opt for higher inflation rates, moderated by slow economic growth, and to avoid action that could lead to a downward spiral of deflation. US government authorities reflexively favor policies that stimulate demand. This is the opposite of Depression-era policies that slashed production capacity, a futile attempt to align supply and demand that failed to restore economic vitality as expected.

"In immoderate conditions of deflation or high inflation, portfolio diversification does not seem to be the best approach."

Following the worldwide financial crisis in 2007, governments and central banks have tried to promote price stability. This may add years to the life of the Modern SuperCycle, though it is advancing faster than the last one, due in part to the heightened reliance on sovereign, commercial and household debt that followed the end of World War II. Greater borrowing also has magnified the risk that the death of the Modern SuperCycle will have cataclysmic consequences. In a more moderate, more likely future scenario, developed nations' economies will stumble into "stagflation," an extended period of stagnant business growth and elevated inflation, similar to economic conditions in the US in the 1970s and in Japan in the 1990s. This probable scenario would extend the life of the current SuperCycle and forestall its termination.

Options for Investors

Many investment advisers urge clients to keep their portfolios diversified. Owning a balanced mix of stocks, bonds and commodities can help investors hedge against the risk of losses on a particular type of investment. But research by Barclays Capital in 2008 shows that portfolio diversification is inadvisable during periods of high inflation or deflation. Given the likelihood of future stagflation, investors should consider assets that can appreciate amid a general rise in price levels. "Resource-based stocks" and "physical commodities" seem promising. Investment returns on stocks tend to exceed bond returns during inflation. While stock prices tend to fall temporarily in the face of higher inflation, bond prices tend to fall permanently until inflation subsides.

"We should take history as a guide, but only a rough one. The SuperCycle's future trajectory is truly unknown."

Gold, the basis of the global monetary standard from the 1870s to the 1930s, can serve as a hedge against modern inflation. Investing in gold involves greater risk and promises greater returns than any other approach to profiting from inflation. During the 1970s, the price of an ounce of gold rose from $35 to $600, but by the early 1980s, it was $300. Gold can play a useful role in investment portfolios, but given its potential price volatility, "the role should remain modest."

About the Author

Arun Motianey was managing director and head of macro research and strategy at Citigroup Global Wealth Management until March 2009, capping his 20-year career with Citigroup.