



## Max Bublitz

# The great race...to the bottom

Predicting how long the downturn will last is a fool's game. Past cycles are no useful indicator because we are undergoing a more tectonic shift in the global economic landscape

One of the defining characteristics of the recent financial and economic upheaval has been the way that expectations about how things might unravel have continually fallen short of the way things actually did. Whether referring to the economy, jobs, writedowns, bailouts, defaults, earnings, or even the proper multiple to place on those earnings, one significant constant during this period has been that the breathtaking deterioration has continued to catch many by surprise. This tells us something important.

Markets, economies – and even social mood – tend to ebb and flow over time. These cyclical and secular rhythms are inevitable. Much has been written about how the current crisis is serving to unwind the excesses of this decade's credit cycle. I believe, however, that we are unwinding something more secular in nature, encapsulating multiple cycles going back perhaps as far as the early 1980s.

That expectations about the current state of financial and economic affairs have lagged the devastating reality suggest that many remain locked in a shorter-term cyclical mindset. This is not surprising as today's tectonic events are clearly outside most participants' personal experience.

Cyclical corrections do most of their cleansing via sharp contractions in price, and are characterised by distinct bottoms. Secular turning points, however, are drawn-out affairs and accomplish their cleansing in the more psychologically debilitating manner of time, where the drip-drip-drip of negativity simply wears everyone out. As a result, I've come to view the current gap between expectations and reality as a race to the secular bottom, with cyclical expectations still trailing the secular reality. And if history is any guide, we won't get there until negative expectations catch up with, and importantly, pass the economic and financial reality.

Another manifestation of the cyclical versus secular struggle can be found in the current debate surrounding whether or not the recent explosion in monetary stimulus from the Fed is necessarily

inflationary. Yes, money and inflation are linked if the normal transmission mechanisms are functioning. But in an environment where the economic output gap is wide and growing wider every month, where capacity utilisation is collapsing and where unemployment is skyrocketing, it would probably be more useful to replace the first two letters in inflation with "re" every time you read it over the next few months. Yes, there may be a time in the future when the economic transmission mechanisms actually do begin functioning in ways that raise concern about monetary stimulus generating inflation, although probably not in 2009. But in the meantime, let's just agree to refer to it as much-needed refutation.

### Philosophical fisticuffs

As for the stimulus efforts from the fiscal side, things are rapidly devolving into a theatre of the surreal with ideologues digging in on all sides. Keynesians are squaring off with combatants from the Austrian school, monetarists are going at it with supply-siders, and calls for a New Deal 2.0 are being met with chants for John Galt. These are the types of national debate we've encountered only a few times in the last 90 years. The sad spectacle of Alan Greenspan struggling with both his philosophical foundation as well as his tarnished legacy marks an unfortunate metaphor for the turning point we're going through. In many tangible ways, reading about history is more fun than living it.

So from my vantage point, it seems that we remain locked in a race to the bottom, if only because so many are spending so much time claiming *this* point or *that* stimulus plan will mark it. Perhaps we've already seen the bottom; we'll only really know in retrospect. But one thing we do know is that the race is largely about psychology, with the rot of failed expectations ultimately forming the nutrients for recovery as the cycle inexorably begins anew.

Max Bublitz is chief strategist at SCM Advisors in San Francisco