Global Markets Play Leap Frog

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There are two massive shaping forces operating in global markets today. One is the bust, bail, repeat dynamic earlier outlined on these pages. The other is the game of leap frog between declining stock and flow measures of wealth and economic activity. The stock measures I have in mind are values/prices of assets. The flow variables I have in mind are incomes, expenditures and measures of incomes and expenditures.

Over the last 13 months we have seen rapid and violent episodes of asset price decline ahead of falling measures of macroeconomic health. Deep into asset slides, bailouts and trading rallies occur. During these rallies markets surge ahead and negative economic news builds up unpriced. Eventually, asset prices get ahead of macroeconomic flow variables. In the next act, asset prices plummet until they have oversold the building economic weakness. It appears we are now well into an episode where oversold markets rise as macro data falls.

As we process Personal Income and Outlays September numbers from the Bureau of Economic Analysis (BEA) and the Advance Estimate of Third Quarter GDP it is important to remember these are backward looking advance estimates and are likely to be heavily revised-down. More importantly, GDP, income and outlays are flow numbers and all the big action has been in backward looking stock variables.

What do I mean? Flow variables look at how much income businesses, governments and individuals - foreign and domestic - earned and spent. This is about the changes in monies earned and spent. Stock variables measure total wealth and debt figures including the prices of assets- homes, bonds, stocks, securitized products. Wealth destruction - falling stock and home process - were the order of the day through September and October. Income, spending and GDP measure and report flow of income and expenditure across September 2008. We all know the big news was concentrated in the stock of wealth. This takes a while to appear in flow variables as missing wealth reduces incomes and employment with a lag.

Thus, our likely to be revised down flow variable reports are not designed to capture the actual economic damage until several months after it occurs. The reported measures are not designed in a way that captures recent events.

Across September and October trillions of dollars in wealth were destroyed in housing and asset prices. This will filter into the more closely watched flow variables in two ways over many months. The wealth effect looks at how falling wealth reduces people's consumption. Firms and households have seen trillions in losses on their homes, stocks, bonds, loans. They are poorer, fell poorer and are less positive about their futures. Thus, they reduce spending.

There is every indication that the staggering loss of wealth enveloping Americans will result in declining purchases, and this will translate into falling incomes for all who depend on this spending around the world. Indirectly, the losses of wealth and credit that defined the recent past mean millions of lost jobs, rattled confidence and reduced spending all around. This occurs as the vast income and spending generated by American wealth vanishes. This Friday's employment numbers will put a human face on falling consumer confidence, Supply Management Indexes and markets.

All over the world wealth - a stock variable - is being destroyed at dizzying speed. Over $8.5

trillion in global asset wealth has vanished this year. Credit constrictions have struck. Thus, asset wealth will produce much less income. Credit based purchasing power, borrowed now against assets and future income has also dried up fast. The carnage in reports on auto purchase signals the coming consumer swoon. Less wealth produces less income and reduces employment further reducing income over time. Less credit prevents firms and individuals from purchasing now and generating income. The global nature of these phenomenon means, less wealth, less purchasing power, lower exports/imports and credit opportunities. Carnage in stock measures becomes falling flows. This is how our market to macro cycle self perpetuates.

If things develop poorly - as they are likely to do over the coming months - we will get a self re-enforcing negative cycle. Falling stock variables will drag down flow variables. Depressed income flows will drag down stock variables, wealth. This will be the mirror image of the boom we just had. Growing wealth produced increasing credit provision and rising incomes. Rising credit and incomes flowed into assets like homes, emerging market stocks and massive consumption. This created euphoria and rising flows to the world stock of wealth.

This phenomenon of falling stocks of wealth, creating declining flows of income and spending, is creating the trend in world stock markets. Before September 2008, markets - stocks of wealth - were lagging global macroeconomic weakness - flows of income and spending. The two months between August and November 2008 saw global correlated wealth destruction proceed at a blistering pace. By the end of October, markets - stocks of wealth - had gotten in front of the declining flow, world GDP. Now, the destruction of income and spending is accelerating - the bad macro data from all four corners of the globe. Thus, we will see rising markets collide with worsening data on incomes and spending in the next leg down