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Stock markets adjusting to lower global growth

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MOST observers focus on the monetary policies of the major economic powers as the explanation for the latest turmoil in stock markets. A tightening of US monetary policy has been expected for some time and even if recent events in China cast doubts over when and how strong it will be, the consensus is that it won't take long. China itself is turning into a conundrum mainly because one of the biggest transformation and restructuring the world has ever seen is taking place in what is probably the largest economy in the world.

The quantitative easing put in place by the US, followed by the eurozone, Japan and now China, stimulated an unprecedented boom in asset prices. Going back seven to eight years, quantitative easing was seen as a shot in the arm helping the economy to recover. After a while prices in the goods and services market were expected to rise, alleviating the debt burden and thus serving as an appropriate policy step to launch the world on to a new and stable growth pattern. For a variety of reasons, it didn't turn out that way. The liquidity flowed into assets, boosting prices in this non-productive sector, distorting the economy and making a genuine recovery even more doubtful.

The missing link in the analysis of stock markets is the real economy. Quantitative easing can work for a while, but if it is out of step with the realities, something nasty is going to happen – and that is what we are witnessing now.

Bring in recent history and the picture becomes easier to understand.

After the dot.com bubble collapsed in year 2000, global stock market prices doubled from 2002 to 2007. The companion was an equally strong global growth, going up from 2.4 per cent in 2001 to 5 per cent in 2006 and 2007. Companies' earnings were in step with expectations, underpinned by economic growth.

From 2007-2008, the global financial crisis brought about a strong downwards reaction in stock market prices – half of their value was lost in three years. Investors in 2010 were at the same level as in 2002. Back to square one. Global growth tumbled under the impact of the calamities on the financial markets auguring lower earnings.

Now comes the surprise. Due to quantitative easing, stock market prices started to recoup the losses incurred from 2007 to 2010. In 2014, the global index was back at the level reached in 2007 and continued to go up, reaching an all-time high by spring-early summer of 2015.

That looked too good to be true and it was. Compared to the trajectory after the dot.com bubble, global growth shifted to a significantly lower trend growth. Not only that, year after year the forecasts proved to be too optimistic and had to be revised downwards. From a strong one-time effect in 2010 of 5 per cent after the global contraction in 2009, growth fell steadily – 3.9 per cent in 2011 and further down to 3.3-3.4 per cent annually from 2012 to 2014. In July 2015, the International Monetary Fund swallowed once again the bitter pill, revising downwards its earlier forecast for global growth, this time from 3.5 per cent to 3.3 per cent.

Stock markets continued their upward curve despite the fall in trend growth from 4.5-5 per cent to 3.3-3.4 per cent – a fall of some 30 per cent! Future earnings of companies became out of sync with stock market prices.

What we have seen over the last couple of weeks and will see in coming weeks, maybe months, are stock markets adjusting to the realities of future earnings steered by global growth. They decouple from liquidity partly because a tightening of monetary policy in the US is waiting. The result will lower global stock market prices. The correction taking place is in conformity with and engineered by economic realities rather than monetary policy in China.

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