Pl.

10 DOWNING STREET

Prime Minister

Brian drew my attention to this. See the charts on page 3, which suggest a monetary squeeze in the US. This can't I think be the whole story (if monetary policy has been tight, why has the $ been falling?) but it's interesting.

DRW
26/10

Midland Montagu Research

MONETARY BULLETIN

Editor : *Gordon Pepper*

23rd October 1987

Bulls in China Shops

The main purpose of this note is to explain why markets have been behaving as they have. Investors who understand the true reasons for the current behaviour of a market will have a competitive advantage over those who do not.

The sharp fall in the world's equity markets is the result of a financial bubble bursting. It did not start because the prospects for dividends, earnings and profits have deteriorated. Stock markets react to imbalances between buyers and sellers, and these can easily be the result of a financial disequilibrium rather than a change in the real outlook. This time financial factors were dominant.

The mechanics for the formation of the financial bubble in the UK were described in our September Monetary Bulletin. A parallel was drawn between the current situation and what occurred between 1972 and 1974, when Mr. Heath was Prime Minister. In 1972-4 there was an explosion in bank lending primarily to finance expenditure on goods and services. The additional bank deposits created by these loans were also spent mainly on goods and services. The result was a large rise in the price of goods and services, i.e. in conventional inflation.

This time the explosion in bank lending was primarily to finance the acquisition of assets. Until quite recently, the additional bank deposits were also being spent mainly on assets. The result was an increase in the price of those assets and the rise in the equity market was one of the main examples. This is quite a different form of inflation.

A financial bubble also existed in the US, for very similar reasons, following the record explosion in money and credit starting in 1982. The US bubble was more dangerous than that in the UK because the underlying economy is much less sound, particularly the

MIDLAND MONTAGU

Midland Montagu
10 Lower Thames Street
London EC3R 6AE
Telephone 01 260 9900
Telex 27783
Fax 01-220 7113

Midland Montagu Inc.
520 Madison Avenue
New York
NY 10022
Telephone 0101 212 715 5770
Telex 888401
Fax 0101 212 715 5975

Greenwell Montagu Gilt-Edged
Registered in England as an
Unlimited Company no 1915770
Registered address:
10 Lower Thames Street
London EC3R 6AE
Members of The Stock Exchange

budget and balance of trade deficits. The Japanese equity market was even more overvalued. The explanation was again financial; it was the result of a chronic surplus of savings rather than surplus money and credit. The Japanese markets had to become substantially overvalued compared with rest of the world in order to induce surplus savings to flow out of the country into international markets. Although the Japanese market was more overvalued than either New York or London, the financial cause was more enduring - chronic surplus savings are likely to persist longer than buoyant monetary growth.

So much for the background to the current situaiton. Why did the break come in the US and why did it occur now? The answer is that there has been a very substantial tightening of monetary policy in the US. The decline in the growth of the money supply in real terms, on all definitions, is illustrated in the charts. So far this tightening has received little publicity. It is nevertheless most important. **Given the dangerous financial bubble which existed, the Fed tightened monetary policy too suddenly and too sharply.** This turned a chronic situation into one which was acutely dangerous.

Other important factors were the large falls which had occurred in the German and Japanese bond markets. The German bond market, in particular, was scared of a replay of the events in the late 1970's and early 1980's, which followed the last massive intervention in currency markets by the Bundesbank to resist a rise in the DM. The 1977/78 intervention led to an explosion in German monetary growth. In due course inflation accelerated, in accordance with monetarists' predictions, to over 7%, which was horrifying by German standards. The same happened in Switzerland.

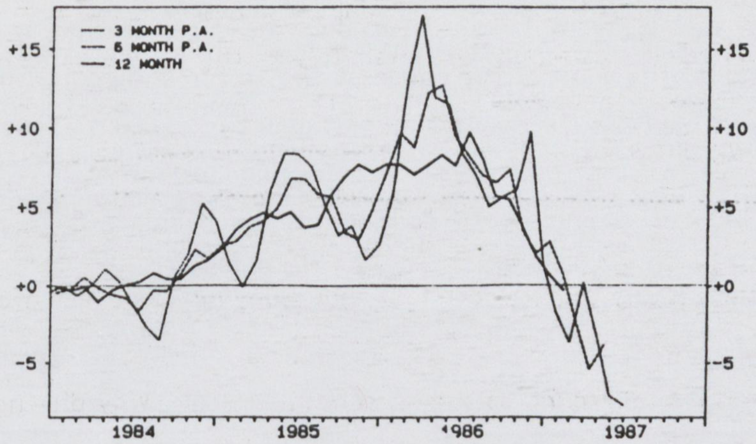
The foreign currency intervention by the Bundesbank this time was even greater. The result was, again, very buoyant monetary growth. Domestic inflation had not had time to respond, but global commodity prices started to rise more or less on cue. The result was a sharp rise in inflationary expectations and a fall in bond prices.

In effect, the German bond market was itself exerting financial discipline on its central bank and government. The message was for the Bundesbank to stop intervening because intervention was too inflationary; and so the the Bundesbank paid greater attention to the tangible message from its domestic financial markets than to the mere talk of US politicians, and German money rates started to rise.

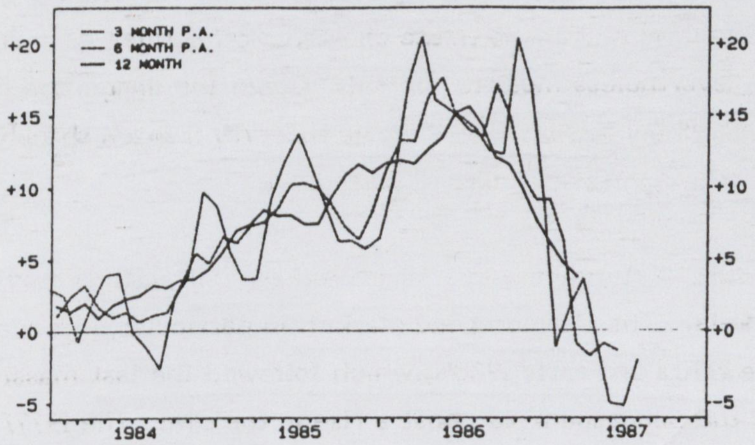
Why, if the US was also tightening?

All this had implications for the dollar; it was bound to fall. The US authorities can ignore a fall in the dollar if commodity prices are also falling, because the latter offsets the inflationary effect of the former. They cannot ignore the combination of a falling dollar and rising commodity prices; and the US bond market certainly won't.

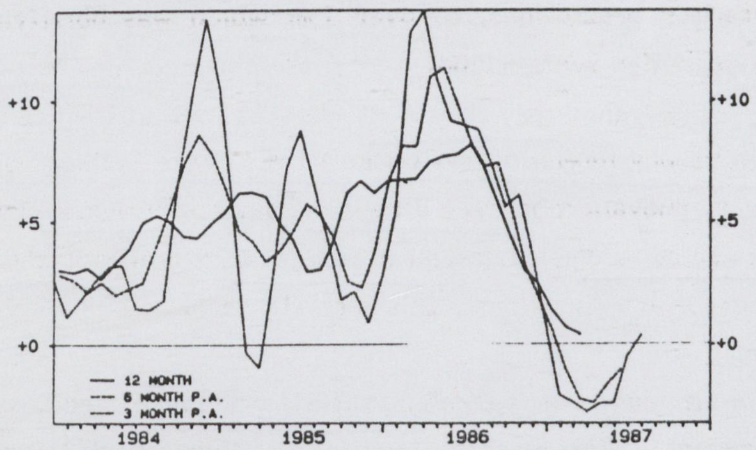
GROWTH RATES OF REAL U.S. NON-INTEREST BEARING M1 %



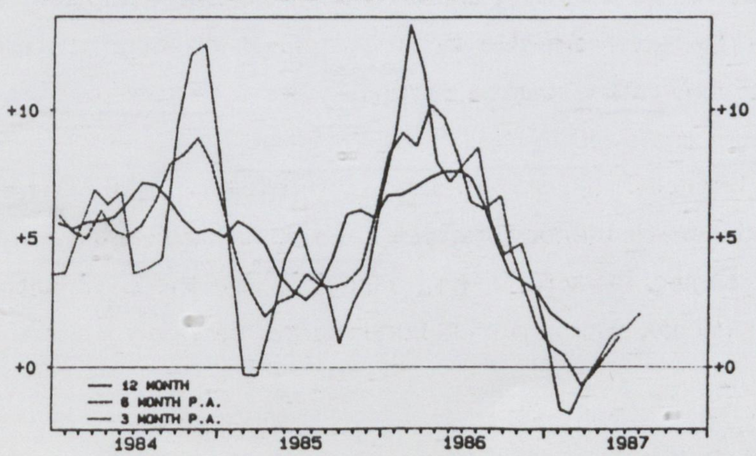
GROWTH RATES OF REAL U.S. M1 %



GROWTH RATES OF REAL U.S. M2 %



GROWTH RATES OF REAL U.S. M3 %



Where do we go from here? Although a deterioration in the outlook for dividends, earnings and profits was not the cause of the fall in the equity markets, the sharp fall in share prices will have a subsequent contractionary impact on economic activity and, therefore, the outlook for the real factors affecting ordinary share prices has now deteriorated. The danger facing world economies has changed from inflation back to recession. This is bad for ordinary shares and good for bonds.

The greatest danger is in the US. No less a person than Mr. Paul Volcker has drawn attention to the very worrying way in which the expansion of debt has far outpaced the growth of incomes in the US. One of the reasons why there have so far been few adverse consequences is that the ratio of wealth to debt was increasing as a result of the rise in asset values in general and equities in particular. With the fall in the equity market, the ratio of wealth to debt has now reduced. This suggests that the adverse consequences of the explosion of debt may now start to come through. Bankruptcies will be another factor depressing the US economy.

The monetary squeeze in real terms in the US will have to be reversed if economic activity is to be prevented from decelerating. Indeed, the Fed has already acted. The snag is that this will have dangerous consequences for the dollar.

It is difficult to envisage how the US trade deficit can be financed in the coming months. Japanese investors are likely to be shell-shocked as a result of the losses on their holdings of US securities. They are unlikely to increase their current rate of investment of new money in the US; indeed, they may reduce it. The reversal of the US monetary squeeze will also mean that net flows of banking money into the US are unlikely to increase. The conclusion must be that continuing massive intervention by central banks and reductions in interest rates in other countries will be absolutely necessary to prevent another sharp fall in the dollar.

Investors in ordinary shares throughout the world would be wise to monitor two other criteria. The first is German bond prices. Providing they remain strong the Bundesbank will be able to intervene to reduce the fall in the dollar and continue with the Louvre agreement. The same applies to Japan. The second criterion to watch is commodity prices. If they fall, a modest decline in the dollar will not cause a sharp rise in inflationary expectations and a fall in the US bond market.

If the outcomes to the factors identified above are not favourable, the outlook for equity markets is grim.