Chief Economist's Comment

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The cycle is alive and well

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Germany is currently experiencing the snowiest winter in thirty years, and the mood in the financial markets also points more to an ice age than a global warming. How icy are the times actually, and with all the snow drifts and concerns about Greece, are the markets not perhaps overlooking the cyclical upward forces that are currently manifesting themselves?

Mood in the financial markets is frosty

Germany is currently experiencing the snowiest winter in thirty years, and the mood in the financial markets is also pointing more to an ice age than a global warming. The DAX has dropped significantly since the beginning of the year. The German bond market is serving as a safe haven, while the risk premium for Greek government bonds is reaching record levels. The fear over a possible breakup of the Euro zone is used as the chief argument for the weakness of the Euro in the last weeks.

Are the cyclical forces being overlooked?

How frosty are the times actually? Are the markets, buried beneath all the snow drifts and fearful about the fate of Greece, overlooking the cyclical upside forces that are currently manifesting themselves?

Strong growth in the US

A few days ago, GDP numbers for the US were reported. With an annualized growth rate of nearly 6%, one can no longer speak of anemic growth. The detailed numbers are even more encouraging than the already positive overall impression. The strong expansion at the end of the year resulted not only from inventory effects, as notorious pessimists had predicted. Rather, equipment spending is now emerging as an essential driver. In the last quarter, this kind of spending in the US recorded an annualized increase of 13%. Even private consumer spending, already presumed dead, contributed about 1.5 percentage points to growth. With that, the recovery is following the classical cyclical pattern and the outlook remains good.

Economic recovery not priced in

However, it is precisely this that does not yet seem to have been priced in by the markets. The majority opinion is that after the plunge into the deepest recession of the postwar period, the economic recovery will be slow. However, given the indicators and the current growth drivers, this seems very unlikely. After all, monetary policy in the leading industrial nations is extremely expansionary, and the fiscal measures will also exert their effects well into 2010.

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Skepticism exaggerated

The skepticism currently prevailing in the markets is therefore not appropriate. Instead, it could be seen as a contraindicator for the development of the stock market over the next few months. As long as the leading indicators continue to rise, we should expect to see a continuation of the cyclical upward move in the stock markets that has been going on since March 2009. Only when these leading indicators have topped out is more restraint called for. That should not be the case before the middle of the year.

Cyclical forces should not be ignored

The existing structural problems, just like the high budget deficits in nearly every national economy, should not obscure the perception of the cyclical forces. Just as an extremely cold winter can occur within an environment of what is called global warming, there can be a robust economic upswing in spite of a flattening out of the long-term growth trend. The existence of the cycle was denied also during the boom years, though in the opposite direction. The positive structural influence factors that existed at the time were supposed to lead to a new era with only moderate economic ups and downs.

No anemic upswing

And now the cycle is supposedly dead again. How else is one to parse the statement that the upswing is anemic? But it is once more wrong to join the chorus proclaiming the end of economic fluctuations.

Central banks must throw the switch at the right time

Against this backdrop, the central banks should likewise broaden their view again and take timely steps to counteract possible inflationary tendencies. The kind of expansionary monetary policy that is currently being pursued in the US and in the Euro zone is no longer appropriate during an upswing. Even if the central banks are still keeping their interest rates low at this time, the first voices can be heard, especially from the environment of the US central bank, that point to a trend toward tightening. I therefore expect that the US central bank will give up its zero interest rate policy by the middle of this year. For the ECB, the growing divergence in the Euro area poses a much greater challenge. However, in both currency regions a less expansionary monetary policy would not stifle the economy, but would keep inflation expectations in check.

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