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Volume, 10 No. 7

Last Commentary: March 16, 1999

## COMMENTARY

Market Opinions And Topics Of Interest  
March 19, 1999

### Understanding the Financial Markets in 1999 Part 2 – What Drives Nominal GDP?

*"[Last week] a few hundred members of the National Association for Business Economists piled into Washington for a conference, it wasn't hard to see the strain in their faces. After all, it's been a tough couple of years for these folks. U.S. growth hasn't stumbled as they'd expected. Unemployment slid lower, yet inflation fell. . . . Needless to say, many analysts are heading back to the drawing board to see which tenets of economic theory still are relevant in today's fast-changing global marketplace."* –Barrons, March 15, 1999

In Part 1 we detailed how nominal GDP is a better measure in gauging what is the appropriate level of interest rates than inflation or "inflation expectations." We also argued that with inflation muted, the driving force behind nominal GDP is "real growth." So, if "real growth" is driving nominal GDP, which in turn determines the appropriate level of interest rates, what is driving real growth?

Ask an economist and you will in part hear jobs, trade, inventories, technology (new paradigm), money supply, international economies, and the lack of government regulation. What few economists mention is the "wealth effect" or how the stock market is affecting the economy. We believe the "wealth effect" could be the most important factor driving the economy.

The following quotes summarize the position of the economic community regarding the "wealth effect":

*"The NABE [National Association of Business] panelists were asked that if the stock market were to decline greatly (for example, 30%), would they anticipate that a recession would be the likely consequence? Fifty-five percent did not think a market crash would, by itself, create a recession, while 37 percent thought that it would, and 8 percent was not sure."* – Survey taken in late **August 1998**.

*"With the major run-up in equity prices over the past several years, we wanted to gauge the panel's view on the impact of higher wealth on consumption. Only 5 percent of the panel believe that consumption is highly influenced by changes in equity values.*

*However, a very high 84 percent thinks that consumption is moderately influenced by changes in equity values. Eleven percent believes changes in equity values have no influence on consumption patterns."* -- Survey taken **April 1997**.

#### Economic Forecasting – What Are they Missing?

Since economists are largely not factoring the "wealth effect" into their forecasts, could this be the reason for their inaccurate forecasts? Consider the following:

#### Why Are Economists Are Always Too Low ?

| Quarter        | GDP -- First Release |             | Difference<br>(Act - Est) |
|----------------|----------------------|-------------|---------------------------|
|                | Actual               | Estimate    |                           |
| Q4 1998        | 5.60                 | 4.20        | 1.40                      |
| Q3 1998        | 3.30                 | 2.20        | 1.10                      |
| Q2 1998        | 1.40                 | 1.00        | 0.40                      |
| Q1 1998        | 4.20                 | 3.50        | 0.70                      |
| Q4 1997        | 4.30                 | 3.60        | 0.70                      |
| Q3 1997        | 3.50                 | 3.20        | 0.30                      |
| Q2 1997        | 2.20                 | 2.00        | 0.20                      |
| Q1 1997        | 5.60                 | 4.00        | 1.60                      |
| Q4 1996        | 4.70                 | 3.50        | 1.20                      |
| Q3 1996        | 2.20                 | 2.00        | 0.20                      |
| <b>Q2 1996</b> | <b>2.20</b>          | <b>2.30</b> | <b>-0.10</b>              |
| <b>Q1 1996</b> | <b>0.50</b>          | <b>0.90</b> | <b>-0.40</b>              |

MMS Survey taken the week before the release

Actual GDP has exceeded the consensus forecast  
for **ten consecutive quarters!**

Furthermore, actual GDP has been higher than any individual guess in four of those ten quarters! When forecasting errors are always in the same direction, it suggests that something has been overlooked.

Chart 1 presents a view similar to the above table. It shows the difference between actual GDP growth (first release) and the median estimate from the MMS International survey. This series starts in 1985 and is a four quarter average. This visually shows how the forecasts since 1995 are unique in that they are consistently too low.

The bottom panel shows a measure of the “wealth effect” – the two-year increase in stock market capitalization as a percentage of nominal GDP. During the period that the median estimate has been consistently too low, the stock market has been creating tremendous amounts of wealth. This strongly suggests that the “missing item” of forecasters has been the “wealth effect.” Despite the relationship between stock market wealth creation and the median estimate being consistently too low, the “wealth effect” rarely gets discussed.

#### **How To Measure The Wealth Effect?**

The big problem with the “wealth effect” is measuring it. It is not easy. Even those with considerably more resources than us, like Alan Greenspan and the Federal Reserve, are also struggling with measuring the “wealth effect.” The following is transcript of the Q&A from Greenspan's December 2, 1997 speech to the New York Economics Club. The Questioner is Henry Kaufman:

**Question:** *Mr. Chairman, could I ask you really to elaborate on part of the -- how do you and your associates within the Federal Reserve evaluate the impact of changes in the value of financial assets on consumer and business behavior? Has the Fed done any studies that would shed some light on this difficult question, particularly since the effects may not be symmetrical for increases or decreases in asset values with the changing structure of the financial markets?*

**Greenspan:** *“Yes, I think you made the point in the last speech that you sent me, which I thought was...”*

**Question:** *I'm glad you read it. Thank you.*

**Greenspan:** *“No, I think that that is the right question. I think it's the issue to follow on from the previous answer is that the old notion that monetary policy was simply a question of endeavoring to watch some monetary aggregates and adjust the system, create stable product prices and the rest of the system would equilibrate was something which we hoped would persist for a far longer period than it did.*

*And there are even those who said that the persistence, even when we thought it was working, was an illusion.*

*What we are increasingly becoming aware of is how significant the issue of balance sheet effects are as the population becomes increasingly more affluent and hence the interaction between consumption expenditures for example and asset accumulation of various types. It's far more complex than it was when only a very small proportion of people had the luxury of making a judgment of how they were going to allocate between consumption and investment.*

*The result is that the so called wealth effect, meaning the impact of changes in household wealth, usually is a consequence of stock price or residential real estate price change, how that affects consumer behavior.*

***And we spend a good deal of time on that. [our emphasis]***

*We've recently desegregate the structure of consumption income and balance sheets into various different income quintiles (ph) to see how various different groups are behaving in this period when there's such a dramatic change in the ratio of net household worth -- net worth of households to disposable income. And indeed as you might expect, we find that the level of so called personal savings, which are savings excluding capital gains has gone down materially in the upper income groups, and indeed accounts for not insignificant part of the overall decline in personal savings which we observed.*

***So, there is no economic evaluation system. There is no detailed econometric model structure which will successfully forecast the next six months to 18 months unless there are some very sensitive balancing variables in them. And I don't know how successful we have been to-date, but we know that that is a direction which we have to move in an increasingly important way so far as our research efforts are concerned.” [our emphasis]***

So, as Greenspan said, the “wealth effect” indeed exists, but measuring it is almost impossible. If we had to offer one possible way of quantifying the size of the “wealth effect”, we would use the forecasts of economists.

As chart 1 demonstrates, from 1985 to 1995 the median estimate vacillated from too high to too low. Over this period, the long run rate difference between the median estimate and the actual growth rate was zero. This is what we expect from a median estimate – getting the big picture correct but erring on the little peaks and valleys of the cycle in the middle. However, the median estimate has been

too low for over four years now – it has underestimated actual growth by an average of 0.6%

The bottom panel shows the two year increase in the stock market's capitalization as a percentage of GDP. Notice how the tremendous rise in the stock market's wealth creation coincides with the economy consistently beating the median estimate. Since the long rate median estimate has been 0.6% too low over the last four years, is this how much the stock market has added to real growth since 1995? After all, the long run median estimate was dead on between 1985 and 1995.

Since we are making the case for a 0.6% boost to real growth since 1995, what is it now? This boost was probably much lower in 1995 and 1996 (the stock market's capitalization to GDP was under 100% back then) than it was in 1997 and 1998. Since the median estimate was expecting 1.80% real growth at the beginning of the fourth quarter of 1998 and it came in at 6.10%, we believe the fourth quarter's real GDP growth rate becomes an important barometer of the "wealth effect." Does this large forecasting error tell us how much the stock market "pushed" the economy in the fourth quarter? We believe it does. If so, it illustrates why the bond market is perfectly justified for taking its lead from the stock market (the inverse movement between

stock and bond prices that has become commonplace in 1998/1999). The stock market is exerting a huge influence on the economy (nominal GDP), which in turn is pushing interest rates higher.

### Conclusion

Remember that the economy is millions of households making billions of decisions. The only way to understand a system this complex is through the use of theories. Sometimes these theories are wrong. Sometimes our understanding of the economy changes (i.e., Keynesian, Monetarists, Phillips Curve, etc.). So, even though economists on Wall Street confidently talk about "the economy", they are doing so from the perspective of a theory of how the economy works.

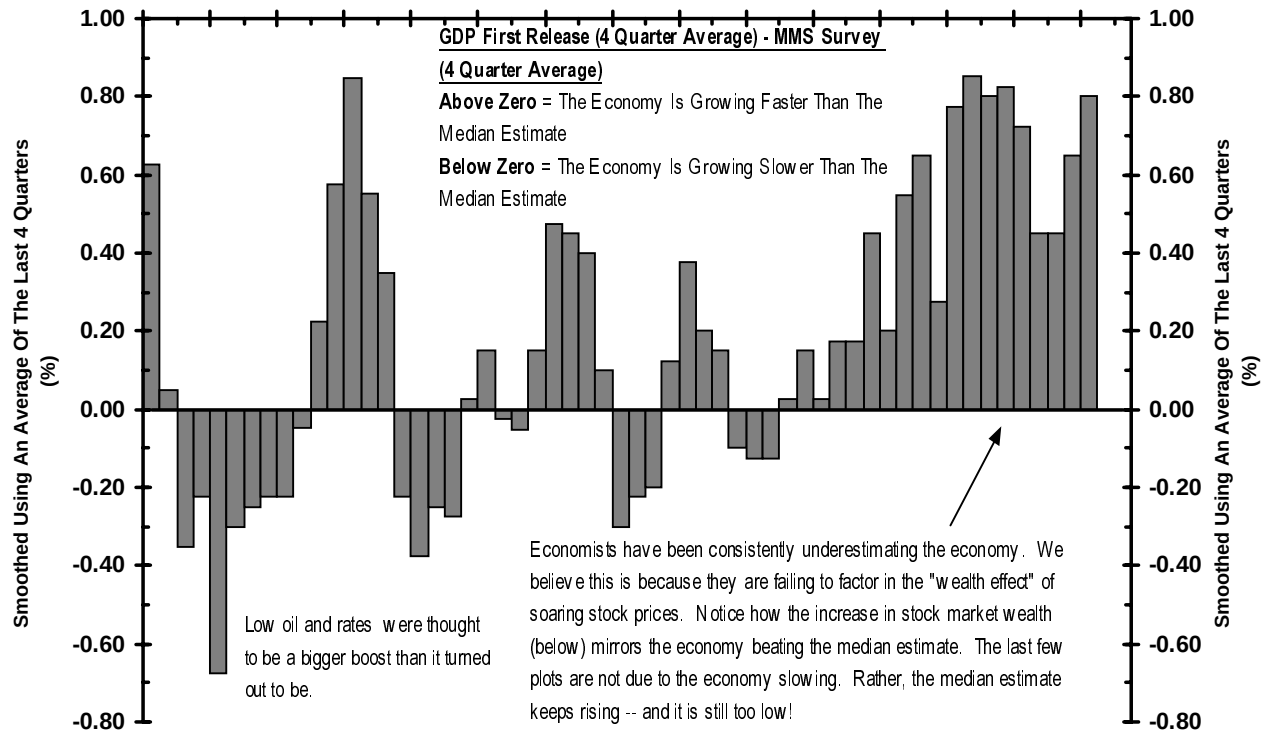
As the quote leading this article suggests, *many analysts are heading back to the drawing board to see which tenets of economic theory still are relevant in today's fast-changing global marketplace.* We believe this is exactly correct. The theories of what moves the economy today are flawed because all the forecasting errors are in the same direction. Economists need to go back to the drawing board and factor in the "missing item" – the "wealth effect."

In part 3, we will discuss the trading patterns between stocks and bonds.

Chart 1

**GDP Reality vs Perception: Actual GDP Minus MMS Median Estimate Survey**

Economists Continue to Underestimate the Economy

**2 Year Increase in the Stock Market's Capitalization as a % of Nominal GDP**

The Largest Creation of Wealth Ever

