

## Martin Barnes – How Safe is the Equity Market?

By Robert Huebscher

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When members of the Federal Reserve Board seek counsel on tough issues, one of the economists to whom they turn first is Martin Barnes. Speaking publicly last week, Barnes addressed two themes in the US economy and markets: the potential for a sustained bear market in equities and the likelihood of higher taxes. These two distinct questions are both critically important to investors.



To summarize, Barnes said the conditions were not in place for a bear market, but higher taxes await Americans, particularly wealthier ones.

Barnes is the managing editor of the *Bank Credit Analyst*, a highly-respected Canadian publication that goes to central banks and institutional investors. He spoke at the Strategic Investment Conference in San Diego, hosted by Altegris Investments and John Mauldin.

Barnes is Scottish and grew up accustomed to cloudy and rainy weather that, he said, may have predisposed him to a bearish outlook. He joked that bears typically appear more thoughtful and intelligent than bulls. But despite the genuine risks facing world markets, he said the economic recovery is sustainable – and he isn't worried about a double-dip recession.

Barnes reinforced what everyone knew – that the recovery was weak. That, however, shouldn't be taken as a sign of impending danger, according to Barnes. The recovery is weak *because of* risks such as the turmoil in the Middle East and the Eurozone debt crisis. If it hadn't been for those risks, he said, the recovery would be a lot stronger.

### The signs of a bear market

To anticipate the likely direction of the US equity market in the context of this economic recovery, Barnes studied a number of indicators to see if historically they were precursors to bear markets. He defined a bear market very specifically: a fall of at least 15% lasting at least three months. The last four of those began in October 2007, August 2000, July 1990 and August 1987.

One indicator is technical analysis. Although he is not a strong advocate of trend-following techniques, Barnes said bear markets rarely occur when there is upward price momentum, as observed when short-term moving averages are above long-term moving averages.

Another is liquidity, which he measured by the relationship between excess investible cash and GDP. Barnes found that a lack of liquidity signaled the onset of bear markets.



High real interest rates would logically signal a bear market, and Barnes said that indeed is so. There have been bear markets when real rates were very low, but never when real rates were negative, as is the case today.

The most reliable indicator Barnes found was the slope of the yield curve. In almost all of the cycles he studied, bear markets were preceded by inverted yield curves, where long-term rates were lower than short-term rates. This indicator, he noted, is also a proxy for liquidity. Inverted yield curves are indicative of tight credit and limited liquidity.

Today, the yield curve is at the other extreme – exceptionally steep.

Barnes also looked at leading economic indicators to see whether the likelihood of a coming recession has signaled a bear market. He cautioned that this line of analysis represents circular reasoning, since the stock market should lead the economy, so it's difficult to use the economy to forecast the market. He has found, however, that leading indicators generally turn negative around the time of a bear market. Currently, he said, they are very positive and “nothing tells me that there is a recession on the horizon.”

Valuations, such as the Shiller P/E ratio, predict returns well over 10-year horizons, Barnes said, but they have not been good indicators of bear markets. On this basis, Barnes said that the fact that the market is currently modestly overvalued is not a sign of an imminent bear market.

Lastly, Barnes showed that the third year of presidential cycles has coincided with excess future returns. Jeremy Grantham of GMO has written about similar results. The rationale, Barnes said, is that presidents tend to do the “nasty stuff” early in their term, and by year three they are preparing for the next election by enacting policies that are favorably received by the financial markets. Since we are currently in the third year of the cycle, a bear market is less likely.

Barnes said there is no common denominator – or Holy Grail – that is a fail-safe indicator of bear markets. That said, combining those indicators he studied – favorable technicals, the positive slope of the yield curve, negative real interest rates, economic recovery, reasonable valuations, and year three of the presidential cycle – gives him “some comfort that a bear market is not in sight.”

### **Whither taxes**

Barnes next turned to the subject of taxes, and he warned his audience, which consisted of advisors and high-net worth investors, that what he was about say could be “dangerous to my health and physical well-being.”

Barnes said taxes should be higher.



Higher taxes, of course, are anathema to most Republicans. Barnes noted that Mitch McConnell (R-KY), the senate minority leader, recently said that taxes were “off the table” because “we do not have a revenue problem; we have a spending problem.”

But Barnes said the country’s fiscal problems cannot be traced entirely to spending. He showed data representing government revenue and spending on a cyclically-adjusted basis. Federal spending rises during recessions (because of extra unemployment benefits, for example) while revenues (tax receipts) decline, and this measure adjusts for that. Federal spending has risen consistently over time, but revenues have not kept pace, and therein lies the problem.

On average, on a cyclically-adjusted basis, spending has been 22% of GDP, while revenue has been only 16%.

Moreover, Barnes said the US is not a highly taxed nation. Federal, state and local taxes as a percent of income are near the low end among developed economies. Our tax rate, relative to GDP, is about the same as Japan’s, and it less than that of the UK and western European countries.

Our effective personal tax rate is now 9%, the lowest it has been since 1980.

Although our 38% marginal tax rate for corporations is high, Barnes said American companies have done a “phenomenal job” of moving their income to low-tax countries. The effective corporate tax rate is now 25%; it was over 40% in 1980.

“Your revenues are low by your own historical standards, never mind those of other industrialized countries,” Barnes said.

Barnes said the tax code contains too much inefficiency. For example, he questioned why someone should get tax relief for a \$1 million mortgage. “Where is the economic theory that would say that is the smart thing to do?” he asked

America is the only industrialized country that does not have a national sales tax, Barnes said, and such a tax could address concerns that our economy is too consumption-oriented. The US gets 14.4% of its revenue from state and local sales taxes, about half of what the rest of the industrialized world gets, according to Barnes. Once such a tax is in place, he warned, there will be ongoing pressure to increase the rate – with the unappealing end-game of Europe, which has a 20% value-added tax.

Barnes acknowledged that the core of America’s problems can be found in its entitlement programs – specifically Medicare – but he said that addressing spending alone would be insufficient to resolve our fiscal difficulties. Addressing entitlements will not be easy, he said, because a majority of Americans are against cutting Medicare.



Fixing our fiscal problems is not “rocket science,” according to Barnes, who said the Budget Deficit Commission’s report contained many good ideas. Politically, he said, solutions will be hard to find and implement.

“I’m not an advocate of higher taxes,” he said. “That’s not the way I was taught, but I get annoyed when people say there is not a revenue problem at all.”

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