



Adviser Soapbox

Beware The Gordon Gecko Flashback Market

Drobny Global Advisors 06.04.07, 5:30 PM ET

Last month, *The New York Times* reported that a sequel to the 1987 film *Wall Street* entitled *Money Never Sleeps* is in preproduction. Michael Douglas will apparently star again in his role as Gordon Gecko.

Spoke Gordon Gecko in *Wall Street* (1987): "The point is, ladies and gentleman, that 'greed'--for lack of a better word--is good. Greed is right. Greed works."

Well, greed is back and the producers of the *Wall Street* remake are probably comforted that they will release the sequel during a mergers and acquisition boom akin to what was last seen in the mid-1980s. Huge private equity deals, leveraged buyouts, landmark merger battles. Barclays and Royal Bank of Scotland battle for ABN Amro. Also, accounts of vast amounts of "global liquidity" paint today's headlines.

This October will mark the 20-year anniversary of the market crash of 1987, which occurred in the face of seemingly robust market conditions. Will the current boom be derailed by a similar sequence of events as those that preceded the 1987 crash?

Of course, no two periods in history are ever exactly alike, but an examination of macroeconomic conditions in the two years leading up to "Black Monday" reveals a confluence of factors that bear an uncanny resemblance to the current period. These include:

- Economic slowdown in the U.S.;
- Expectations of benign interest rates;
- Pronounced weakness in the U.S. dollar;
- Flurry of corporate buybacks and M&A activity;
- Rising protectionist sentiment;
- Tariffs on an important Asian trading partner;
- Iran as a major focus of U.S. foreign policy concerns; and
- A banking crisis (think subprime).

U.S. economic growth picked up dramatically following the 1985-1986 midcycle slowdown. Stock prices accelerated to the upside, and bond yields rose significantly in response to a stronger economy, dollar weakness, an M&A-fueled increase in the supply of bonds. Protectionist policies aimed against Japan added to the combustible mix.

It was the combination of sharply higher equity prices and interest rates that made a correction all but inevitable, despite the fact that--to many market observers at the time--economic strength and robust earnings growth appeared to be supportive of higher stock prices.

With many investors today wondering whether the slowdown seen in the U.S. economy in recent months might be a precursor to recession, the 1987 template is an important reminder that the biggest risk to stocks may come from the opposite direction.

If the economy shows unexpected strength in the coming quarters, and if the dollar continues to break down and the supply of bonds continues to increase (as a function of surging M&A and private equity activity), if trade tensions between China and the U.S. worsen--and if the bond market responds to all of these factors by pushing yields sharply higher--then a valuation problem similar to that seen immediately preceding the '87 crash could materialize quickly.

From the end of 1986 through Aug. 25, 1987, the S&P 500 and the MSCI EAFE Index (tracking 21 developed markets in Europe, Australasia, and the Far East) both soared nearly 40%. This impressive performance followed four years of big gains for global equities, with the MSCI EAFE rallying nearly 300% from the fall of 1982 to the start of 1987. Then, like now, stocks seemed all but unstoppable, shaking off every piece of bad news and defying the skeptics at every turn.

In fact, the strength in equities during the past four years could hardly be more similar to what was seen in the 1980s. Both bull markets were born in the ashes of brutal, multi-year bear markets (1980-1982 and 2000-2002), and both witnessed very strong gains in the first 12 months after bottoming (1983 and 2003), followed by nearly a year of "consolidation" (1984 and 2004) before the strong bull-market trend resumed (1985-1987 and 2005-2007).

The resemblance between the current period and 1982-1987 goes well beyond a comparison of stock market charts. The unrelenting strength of equities this year despite evidence of a weakening U.S. economy in the first quarter 2007, and the meltdown in the subprime lending sector, is very similar to what was seen in the mid-1980s. Consider these parallel headlines, from 2007 and 1985:

--"Earnings growth among the largest U.S. companies has slowed compared with the big gains of a year ago." *Barron's*, May 8, 2007.

--"Corporate profits in the first quarter ... generally appear to be disappointing." *The New York Times*, April 22, 1985.

--"Real gross domestic product... grew at a seasonally adjusted annual rate of 1.3% in the first three months of the year. That was down sharply from growth of 2.5% in the fourth quarter of 2006 and was the slowest rate of growth since the first quarter of 2003." *The Wall Street Journal*, April 28, 2007.

--"The U.S. economy, battered by foreign competition, grew at a sluggish 0.7% annual rate during the first three months of the year ... The gross national product, the broadest measure of the country's economic health, has not expanded at such a low rate since the end of the 1981-1982 recession." *Associated Press*, May 21, 1985.

--"At least 40 subprime lenders have halted operations, gone out of business or sought buyers in the past year amid rising borrower defaults." *The New York Times*, April 12, 2007.

--"Federal and state regulators closed two more insolvent banks today, bringing to 100 the number shut this year. It was the greatest number of bank failures since 1933." *The New York Times*, November 9, 1985.

Much like the period during the midcycle slowdown in 1985-1986, the market today anticipates a continued benign interest rate environment. Indeed, the Fed funds futures market prices in no Fed action for the remainder of the year and the possibility of a rate cut early next year.

Thanks in part to the persistence of low bond yields (which have translated into very low borrowing costs for companies and investors), the past few years have witnessed an unprecedented reduction in the overall supply of global equities. The volume of share buybacks, mergers and acquisitions, and private equity deals has swamped the amount of new stock being brought to the market via IPOs. This phenomenon has been described as "financial arbitrage."

Because the yield that even "risky" companies pay to raise money using junk bonds is some 2% lower than the equivalent yield produced by the cash flows of those firms, a private equity investor can acquire a company and easily cover the cost of financing the transaction without having to do anything to improve the cash flow or profitability of the company itself.

Not surprisingly, given the extent to which bond yields fell, a similar trend was seen in the mid-1980s. "Many bulls argue that there's a shortage of stocks, a reference to the elimination of over \$100 billion worth of equities over the past 18 months because of mergers, leveraged buyouts and corporate stock-repurchase programs," reported the *Chicago Sun-Times* on April 13, 1986.

And by the spring of 1987, more than \$235 billion in corporate equities had disappeared from the market since 1983--an amount equivalent to more than 10% of the entire market capitalization of the NYSE stock exchange at the time.

Over the past year and a half, the U.S. dollar has fallen significantly (continuing a longer downtrend that began in 2002), a move that echoes the huge decline seen

in the dollar from 1985 through 1987. Persistent dollar weakness is significant because it can put upward pressure on interest rates--foreign buyers of U.S. dollar-denominated bonds may demand higher yields to compensate for the risk of further currency depreciation.

Indeed, from 1985 to 1987, there was a series of efforts by global policy makers to stabilize the U.S. dollar, which they feared would suffer further declines due to rising rate expectations in countries outside the U.S.

Under considerable pressure to address the huge drop in the dollar, the U.S. was forced to increase rates in an effort to protect its currency.

A similar situation appears to be developing today, as interest rates in Europe and Asia continue to move higher. Yields on 10-year German bunds have jumped from 3.7% to 4.3% since last fall, and the Euribor futures market is pricing in two more rate hikes by the European Central Bank this year.

Expectations for higher European rates and flat-to-lower U.S. rates have fueled a massive rally in the euro vs. the dollar over the past several months. If the dollar decline were to continue, the burden could again fall on the U.S. to boost rates in an effort to stabilize the currency.

And there is another risk to interest rates in today's environment that was not present in the mid-1980s: rising commodity prices and elevated inflation readings. In 1985 and 1986, crude oil fell hard, but today we are seeing just the opposite. Following last year's sharp correction, oil has rebounded strongly in recent months and is now up 25% from its January lows.

Meanwhile, consumer price inflation in the U.S. and abroad has remained stubbornly above levels deemed acceptable by the world's central banks. The impact of higher oil is being seen at the gas pump, where prices are at record levels, and there is certainly the potential for higher oil and gasoline prices to increase inflationary expectations, thereby pushing bond yields higher.

In the context of the huge gains being seen in global stock prices, a significant rise in bond yields could quickly create a valuation problem very similar to the one that preceded the 1987 crash.

[Excerpted from the May 27 issue of Inside Global Markets, which includes expanded analysis and a trade recommendation. Click here for more information about Inside Global Markets and subscription details.](#)