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THE REASON EQUITY MARKETS ARE STUCK IN THE ECONOMIC MIRE

As the market value of property has always been the backbone of any free economy, so it could be said, with a great deal of justification, that there is a close relationship between the market value of equities and capital spending.

Equities are an alternate source of funding for businesses, wanting to invest in capital goods, so that it stands to reason that capital spending demands a healthy and vibrant equity market.

But no self-respecting management, engaged in private enterprise, would commit to any large-scale capital expenditure without attendant profits, or the prospects of such profits, to justify the expenditure.

Therein lies the rub, as the bard would have stated.

The correlation between capital expenditure and equity markets goes without saying, but equity markets require, of themselves, the ability to give investors what they consider to be reasonable returns on investments.

Good equity returns require, for their part, robust profits; and, robust profits, of course, require capital expenditure in order to achieve dynamism.

After all, one cannot sell the family jewels, ad infinitum.

There is, as TARGET has just demonstrated, a circular relationship in the value of equities and the extent of capital spending by private enterprise, with one, reinforcing the other.

Since equity markets have demonstrated, only recently, that they are not, as yet, healthy, from the point of view of investors' purchases, a sustainable increase in capital spending by private enterprise is not likely to be on the cards.

Investors will only be enthusiastic in respect of purchases of equities, driving up prices, when they are reasonably certain that profits from industrial pursuits will rise.

But companies need to spend on capital goods before that can come to pass.

As such, it is likely that there will be negative, or negligible, capital investment for the remainder of the year.

Having said that, one must be as the chameleon, crawling over a tartan rug, changing colours as its moves over the hues and patterns.

It is likely that the weakness in most equity markets is due, in part if not in the whole, to uncertainties in capital spending.

One cannot say with any certainty which industry will commit to what.

In telecommunications, one cannot expect most established companies to lash out large-scale investments in capital goods because there is not the attendant suggestion of profits to be derived from the investments.

In the late 1990s, over-expenditure in capital goods resulted in excess capacity, which, in return, resulted in massive write-offs and/or write-downs in the carrying values of inventories.

Nortel Networks Incorporated, of Canada, for instance, is said to be lumbered, today, with mountains of telecommunication inventories that nobody wants, or is willing to purchase.

Nortel Networks watches as its aging inventories head toward obsolescence.

If anything, there is a disincentive for companies to invest in capital goods at this historical juncture.

If though, on a macroeconomic basis, things are improving, that in and of itself, is insufficient to turn the tide.

When times are difficult, it is simple for industry to tighten purse strings.

When times are improving, as is the case, today, industry has yet to loosen the purse strings, simply because it sees no reason so to do.

As with movements of indices of stock markets, prices of individual stocks and shares tend to rise, prior to the actual improvement in the financial prospects of companies – it is anticipatory of investors to invest ahead of change.

Equity markets lead; capital expenditure follows in their wake.

Equity Markets And Consumer Spending

Then, there is the correlation between equity markets and consumer spending.

The creation of wealth, definitely, can be correlated to consumer spending, with the creation, coming before the birth of spending.

Consumption, as Japan discovered in the past year or so, is not contingent on one factor, but on a number of factors, the complexity of which was not anticipated.

One of the factors that had been overlooked in Japan was that households, in general, cut back on spending on staples when times became difficult.

Of all the spending, one would have thought that such spending would not have been curtailed – because people have to eat.

Certainly, purveyors of staples were hard-pressed to explain the reason that Japanese households were cutting back on spending on traditional food items even when prices of such items had been substantially reduced from previous higher levels.

Japanese households, it seemed, were willing to cut back spending on many food items, but continued to purchase certain non-essential expendables to the immediate detriment of staples.

It would appear that the long recession in Japan had resulted in some strange and unexpected habits, coming to the fore.

Low interest rates, over the past 18 months, has not helped industry other than assisting in servicing debt, more easily.

And even in Japan with its very low interest rates, industry continued to stumble, with many thought-to-be unassailable companies, succumbing to economic pressures: Sogo Company; Daiei Corporation; Seibu Corporation and, etc.

Monetary policies in the US over the past few years have been very accommodating, to industry in general, to be sure, and this has assisted in keeping the cost of capital goods at very attractive levels, attractive, that is, relative to a few short years prior.

If the cost of capital goods should, in the near future, rise once again, such price inflationary pressures could well slow the growth of capital expenditures.

Should industries' profits and profitability falter, the clear scenario from price inflation of capital goods, then, the resultant sustainability of an economic recovery could be held to ransom.

Thus, industry will tread the economic waters with care.

There is little commitment by most companies to increase capital expenditure.

If it is held that capital spending accounts for only about 20 percent of an economy, and consumer spending accounts for that 80 percent, remaining, then, one must question the importance of capital spending, relative to consumer spending.

The conundrum, or seeming conundrum, is that industries' spending on capital goods is one of the most dynamic single forces of any economy, as TARGET has, already, pointed out by innuendo.

If there is a period of 3 consecutive quarters of sustained growth of profits, it is quite likely that industry will make a determined commitment in capital goods.

Once profits are growing, once again, management will take the plunge in order to scoop up more profits.

If the management of a company does not rise to the challenge, then, the company will stagnate and, most likely, it will be overtaken by a more dynamic challenger.

Conclusion: Equity markets appear to be unable to sustain any upward momentum and this situation is likely to continue for the remainder of the year unless there are changes of a material nature.

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