Easing? What kind of Easing?

Markets have started 2012 in a happy mood. The expectation of policy easing especially in growth driver countries like China and India have given investors reason to go into risk-on mode again. However, I think we are in danger of being jumping the gun.

Let's take a look at some recent history of the US.

Event	Start of Easing (Fed Funds Rate)	Bottom of S&P500	Months Lag
First Gulf War Recession	Jun 1989	Oct 1990	16
Asian/Russian Crisis	Sep 1998	Oct 1998	1
Dotcom Collapse	Dec 2000	Oct 2002	22
Global Financial Crisis	Sep 2007	Mar 2009	18

In every instance, there were many rallies following the start of easing but they all turned out to be head-fakes until much later.

The only exception is the Asian Financial Crisis. I would argue that the events occurring then were external to the US i.e. mainly Asia and Russia. The origin of that so-called crisis was not the bursting of a domestic bubble, which was the case with the other 3.

Furthermore, in none of these cases was there an overwhelming policy response on the fiscal side. In other words, the US government basically left it to the Federal Reserve Bank to cushion the downturn and revive the economy.

Let's now take a look at China.

Event	Start of Easing (Reserve Requirement Ratio or RRR)	Bottom of Shanghai Composite	Months Lag
Asian Crisis	Feb 1998	May 1999	15
Global Financial Crisis	Oct 2008	Nov 2008	1
Current Downturn	Dec 2011	???	???

Over the past 20 years, the PBOC (People's Bank of China) RRR has been in a downward phase only 3 times. And the circumstances were remarkably different.

During the Global Financial Crisis, China's faced a collapsing stock market bubble as well as a sudden evaporation of external demand. The policy response was not just rapid easing of monetary conditions but also one of massive fiscal intervention. This enabled the stock market to bottom very quickly.

The point I am trying to make is that if an economic crisis is purely the result of external shocks without any collapsing domestic bubbles or if there is massive fiscal stimulus measures, monetary easing would result in a bottoming of the stock market very rapidly after the first easing.

However, if there are large domestic bubbles bursting, absent any massive fiscal intervention, the cleansing process takes 12-24 months i.e. the stock market will only bottom after that process is completed.

In China's case, it is clear that there are large domestic bubbles bursting eg. real estate, shadow lending system, provincial government borrowing, etc. And China is not in a position to undertake massive fiscal intervention as those same levers have already been used just 2 years ago!

Therefore, I don't think one should respond to the easing of monetary policy in China or the prospect thereof with such enthusiasm for risk!