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Plan B or no plan B? That is the question

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There's an old stock market saying, perhaps Shakespearean, that goes like this: 'Everything has a price." The proverb came into sharp focus this week during the Brexit brouhaha.

The theory goes that we're psychologically hardwired to place greater importance on current events than those of the past. Evolutionary biology apparently places a premium on survival rather than reflection.

So, whilst the parliamentary circus is unedifying and potentially economically damaging, commentators who tell us it's a calamity alongside historic world disasters are revealing their present-day bias as much as anything else.

The markets run to their own beat and don't necessarily follow collective opinion. Some say Brexit is just another dilemma that in time will be added to the lexicon that includes Norman Lamont singing 'Je ne regrette rien' in his bath over the ERM, Denis Healey at the IMF and David Cameron unleashing the 'dogs of civil war' when he paved the way for the 2016 Referendum.

Markets discount events. Interestingly and unexpectedly the pound strengthened as news of Mrs May's Commons defeat was announced. The market is already so short that any news is good news.

The same is true of the stock market which reacts swiftly to manias and panics but eventually keeps time with nominal GDP. This is the reason why it can pay investors to just ignore the noise.

Last Wednesday, the Office for National Statistics released the latest reading for UK CPI or UK inflation. It came in at 2% to the year ending 16th January 2019 (CPI Index level = 107.1). That's not much of course and just about target but the series has a base index level of 100 in 2015. In other words, a 2019 pound is worth 93.3p in 2015 money.

In January 2010, the CPI index was 88.8 making a 2019 pound worth 82.91p in 2010 terms. It's easy to see why Warren Buffett sees long dated bonds as a poor way to store and generate wealth.

Nominal GDP is a measure that uses current prices as opposed to constant volume or so called real prices. It's a calculation of real growth plus the inflation rate. Economists don't use it because it gives an exaggerated perspective of growth but stock prices and stock dividends are nominal prices that contain an inflation premium.

The progression of token GDP overlaid with the FTSE 100 gives an indication of how cheap or expensive stocks are relative to the underlying capital that drives them. Over time NGDP and the stock market move closely together. Since 1984 to the present day, the coefficient of correlation is about 0.88.

The overvaluation that led to the technology, media and telecom crash and indeed the credit crisis, is visible in the figures. What's interesting is that the recent downturn has already brought the market to trend. In this sense, the market has 'priced-in' Brexit.

In 2010 nominal GDP in Britain was a shade below £1.6 trillion. The government spends roughly 40% of GDP, making the budget for that year around £600 billion for health, welfare and the military.

In 2017, nominal GDP was over £2 trillion – raising the government share of spending to approximately £800 billion. 2018 GDP should be around £2.12 trillion.

This is the route which the stock market follows. In the short term it would be helpful if the politicians did the numbers and directed their energy towards growing the economy. A reduction in NGDP or self-induced recession is in no-one's interest.

In the long term however, investors should reflect on the corrosive impact of modest rates of inflation and realise that even unexceptional rates of GDP translate to large, compounded growth rates.