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# GLOBAL MARKET COMMENT

# 2004: CAN THE MARKET STAY IN THE SWEET SPOT?

## December 2003

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## Can the Market Stay in the Sweet Spot?

Only a year ago, fears that the U.S. economy and capital markets were inescapably headed into a Japanese-style tailspin dominated the global financial zeitgeist. Federal Reserve Chairman Alan Greenspan had been furiously shoveling coal into the furnace for two years, making 12 policy interest rate cuts, but had very little to show for his efforts; the United States could not move itself, it seemed, let alone pull the rest of the world into recovery.

### Another Likely Victory for the Fed

The year 2003 demonstrated the remarkable power of low interest rates. To be sure, the maestro was aided by unprecedented domestic fiscal stimulus, as well as generous liquidity from central banks in the United Kingdom and East Asia. These coordinated efforts sparked a revival in industrial production, pushing global growth to 3.3%, its fastest pace since 2000. In the United States, yet another cylinder—corporate spending and private investment—has started to fire, which should provide a welcome relief to consumers who have provided the heavy lifting in recent years.

The fall in the US$ was a critical tool in the struggle for reflation, as U.S. authorities applauded the greenback's 16.8% fall against the euro, 10.1% against sterling, and 9.7% against the yen. While the lower US$ is boosting the bottom lines of many U.S. corporations, the appreciating euro and yen are creating strains elsewhere. The weak greenback also puts pressure on a global vendor finance dynamic, whereby non-U.S. investors used their domestic currencies to buy U.S. capital investments, which not only supports the value of the greenback, but also finances America's enormous current account deficit and allows U.S. consumers to purchase their products at still-inexpensive prices. Thus far, this arrangement has been virtuous, benefiting all parties, but it could morph into a vicious cycle if some part of the mechanism begins to break down.

After dropping for three years, U.S. corporate earnings, especially for many cyclical industries, finally bottomed during the end of the first quarter 2003. Powered by the boom at the macro level, as well as considerable balance sheet repair at the micro level, global earnings in 2003 surged. Earnings per share growth in MSCI World jumped about 35.2%, considerably higher than its post-1970 average growth of 6.9%, while its other areas are also expected to have enjoyed significant growth: MSCI Europe, 43.0%; the S&P 500, 19.2%; Japan, 17.7%; and Pacific ex Japan, 12.7%. Cyclical sectors in all developed countries outperformed the broader market for the year, though the margin of outperformance began to fade in the fourth quarter.

These patterns—global synchronous growth and sensitivity to interest rate movements—are expected to persist in 2004. This is not necessarily good news for equity investors, however, for left unchecked, the speeding global engine could overheat, pushing already-stretched equity valuations to even higher levels. What was the sweet spot for global equities in 2003 may become uncomfortably hot in 2004 and beyond.

**The Global Rally in 2003**

Global returns in 2003 depended, in large part, on making the right currency bet. The greenback's fall against most major currencies slashed returns for non-US$-denominated investors: measured in local currency, MSCI World returned 24.9%, compared to 33.1% when measured in US$. Currency also affected the market's drivers in performance contribution terms; in US$, financials was by far and away the dominant sector for MSCI World for the year, followed by information technology and consumer discretionary, while in local currency, information technology was the principal sector, followed by consumer discretionary and industrials.

Speculation was a relatively muted force in the global equity rally, particularly compared to the type of animal spirits that powered U.S. equities. In MSCI World, the stocks in the smallest quintile by market cap returned an average of 43.0%, not substantially more than the largest quintile's 34.3% return; by contrast the smallest quintile in the S&P 500 accounted for more than double the returns of the largest quintile. That said, there can be no denying that global liquidity has pumped up equity returns and encouraged investors to become more risk tolerant. If liquidity begins to dry up, equities will certainly get squeezed.

While MSCI World is moderately expensive, according to various valuation measures, the index is not as stretched compared to its U.S. and continental Europe subregions, while consensus earnings growth expectations do not strike us as particularly outlandish, forecast to decelerate to 15.2% in 2004. This does not suggest that investors rang in the new year with an unusual degree of sobriety; however, to a certain extent, analysts have been forced to show a degree of restraint as earnings growth *must* decelerate for several reasons. First, earnings growth in 2003 enjoyed an especially large bounce from depressed levels in 2002; and this mathematical fillip is unavailable in 2004.

Second, pockets of froth in equity markets are beginning to percolate, especially in technology and other cyclical sectors. The consensus expects earnings growth of the MSCI World Index to rise 35.2% in 2003 and 15.2% in 2004. Among sectors for these two years, earnings per share for technology are expected to expand 87.8% and 42.9%, for financials, 56.6% and 14.2%, and consumer discretionary, 54.1% and 22.3%. Clearly, these aggressive forecasts demonstrate high optimism for the performance of cyclical sectors, while the more defensive areas, such as consumer discretionary and health care, are forecast to grow relatively more slowly.

Third, the consensus generally expects the Federal Reserve to soon begin raising policy interest rates, which would brake the U.S. engine and slow corporate profit growth. At the moment, markets are confident the central bank will raise rates in the coming months, a consensus that seems at odds with the Fed's consistent promise to keep rates low until deflationary pressures are virtually eliminated and reflation is deeply entrenched, as well as Greenspan's reluctance to raise rates in an election year.[1] With capacity utilization low, the output gap wide, and inflation at decade lows, it would

Since 1988 (Greenspan became the Federal Reserve's Chairman in 1987), the Fed rose policy rates before November in two (out of four) presidential election years (50 bps in 1988 and 100 bps in 2000). Between Labor Day and Election Day, the Greenspan-led Fed *never* raised rates.

not surprise us if the central bank delays raising rates until the economy builds up steam—which increases the likelihood of an inflation scare and higher equity valuations this year. There is already some evidence of growing concern of simmering inflationary pressures, though consumer prices remain tame. Spreads between nominal bonds and inflation-linked bonds of comparable maturity have widened, while prices of industrial commodities have surged dramatically.

**Risks to This Outlook**

The consensus expectation of moderate global synchronous growth could be derailed by several risks. The first is interest rate risk. If the economy continues to grow as it did during the third-quarter 2003 (+8.2%), the Federal Reserve may move forward its policy-tightening program. However, for this scenario to materialize, the Fed will certainly signal its intention well ahead of time in order not to surprise the markets, and the preconditions—narrowing output gap and rising employment—for its tightening policy would have already been well apparent.

Conversely, the U.S. economy could weaken in 2004—either due to fading stimuli from mortgage refinancing or fiscal spending, or from a domestic financial shock. While this risk grows increasingly remote with each stronger-than-expected economic report, it should not be dismissed out of hand, primarily because its consequences would be so devastating. With the Fed funds rate currently standing at 1.0%, Greenspan is nearly out of coal to revive the economy, while the debt-laden private sector would exacerbate deflationary pressures.

Third, the slide in the US$ could intensify into a full-fledged dollar crisis. Given the enormous current account deficit, a collapse in the greenback could encourage non-U.S. investors to curtail their purchase of U.S. bonds, which could set in motion a vicious cycle whereby the Federal Reserve is forced to raise rates in order to attract overseas capital, triggering a sharper-than-expected economic slowdown. In last year's December Global Market Comment, we noted the risk of a US$ crash, "[w]hen everyone and their mother says that the dollar will decline in the next 12 months, we suspect the trade may be past its sell-by date." Clearly, with many investors now predicting a further drop in the greenback, the out-of-consensus calls for 2004 are either US$ strength or collapse.

Fourth, our analysis may understate the strength of domestic demand in non-U.S. economies. There can be no doubt that global trade has boosted domestic demand, particularly in emerging Asia. If this dynamic gains momentum, economies and capital markets may begin to be fired by their own internal engine, thereby decoupling to a certain extent from the United States. While this would be an entirely healthy and welcome process, it is still too fragile to cause us to abandon our view of the United States as a global engine of growth. With the exception of the United Kingdom, domestic demand in non-U.S. economies remains in its early stages and therefore vulnerable to export weakness. Were the U.S. economy to weaken, domestic demand could not power the global economy or capital markets.

## Global Survey

### Diversify

We continue to believe global equities are in the midst of a cyclical bull rally within a secular bear market. Secular bull markets do not develop when equity valuations are stretched; though, as stressed above, the U.S. administration's aggressive fiscal and monetary policies seem designed to forestall any serious relapse before next November's elections. Consequently, we continue to advise against underweighting equities, but recommend holding a broadly diversified portfolio and rebalancing assiduously. In addition, investors may want to explore low-beta ways to implement their equity allocations by investing in long/short equity hedge funds, underweighting aggressive growth, and allocating assets to equity managers who raise cash when they cannot find stocks that meet their investment criteria. We would also favor nontraditional assets, such as commodities and natural resources that are likely to benefit from central banks' reflationary policies.

Currency movements will probably be a major theme in 2004, and investors should increase their allocations to assets denominated in other currencies, partly on the basis of relative valuations, but also to diversify their currency exposure and reap the benefits of further dollar depreciation. A lower US$ should provide a fillip for U.S. equities, while a higher euro would represent a headwind for euro-denominated equities, and a sharply rising yen could slow the momentum of Japanese equities. For those convinced the policies of the U.S. administration are systematically debasing the currency, gold is the preferred hedge against a US$ crash and the chaos that would ensue.

Will the bear market in fixed income assets finally begin in 2004? Clearly, this must be the largest global consensus bet—it has been for a while—and sovereign debt portfolios are well positioned for the yield curve to flatten, led by the short end. Although the corporate and high-yield sectors are quite overvalued, already tight credit spreads and an overall speculative appetite suggest investors will continue to move down the credit curve to pick up extra yield. After a stellar year for inflation-linked bonds in 2003, real yields are considerably low and break-even spreads quite wide; however, the desire for inflation protection may push this sector even further into the overvalued category in 2004.

### The United States

If the economy builds up steam, the Fed does not raise rates, and investors expect increasingly unattainable earnings growth, U.S. equities could grow considerably more overvalued. While current earnings expectations could be achieved if economic growth continues to surprise on the upside, the larger worry concerns the 12.2% longer-term growth forecast for S&P 500's reported earnings, more than double its 5.9% average trendline growth since 1947. In the fixed income market, as long as the Fed adheres to its promise to maintain low policy rates until reflation is firmly entrenched, the Treasury yield curve will remain quite steep. In the corporate sector, gains may be limited due to already tight spreads, a probable drop in issuance, as well as an increase in M&A activity, which typically bodes ill for bond holders. Yield-hungry investors could push high-yield returns even higher, though valuations are quite rich.

### The United Kingdom

While U.K. equities are roughly fairly valued, if global economies gain momentum, they will probably underperform on a relative basis in 2004 given their defensive bias. Furthermore, the United Kingdom faces one of the most severe interest rate tightening cycles in 2004; if the Bank of England raises policy rates, as the consensus seems to believe, this would not only disproportionately hurt financial stocks that make up 28.8% of the FTSE All-Share, but also ensure that the gilt yield curve undergo further bear flattening. Consensus earnings growth expectations of 17.3% for 2003 and 9.3% for 2004 seem plausible.

### Continental Europe

The strengthening euro represents the primary risk to Europe's economy and capital markets. Valuations for continental equities are stretched, and growth expectations appear rather aggressive, with earnings per share growth in the MSCI Europe ex U.K. Index expected to reach 22.4% in 2004, after rising 60.2% in 2003. However, the improving economy could help equities meet their expectations, particularly given their cyclical bias; and longer-term expectations are below their post-1987 average (9% compared with 12%).

### Japan

While the Japanese economy may be developing its own internal dynamic, it remains highly leveraged to the global economic cycle, and equity markets will probably take their cure from export strength. In the aggregate, Japanese equities still look inexpensive to fairly valued, despite their sharp rally in 2003. The consensus expects earnings to grow 10.9% in 2004 and 11.5% in 2005, according to I/B/E/S. Japanese equities will most assuredly enjoy the tailwinds of continued economic growth, assuming domestic demand is sustainable. Risks include policy complacency concerning structural reform, as well as the cooling down of China's economy, which would hurt Japanese exports and its overall economy.

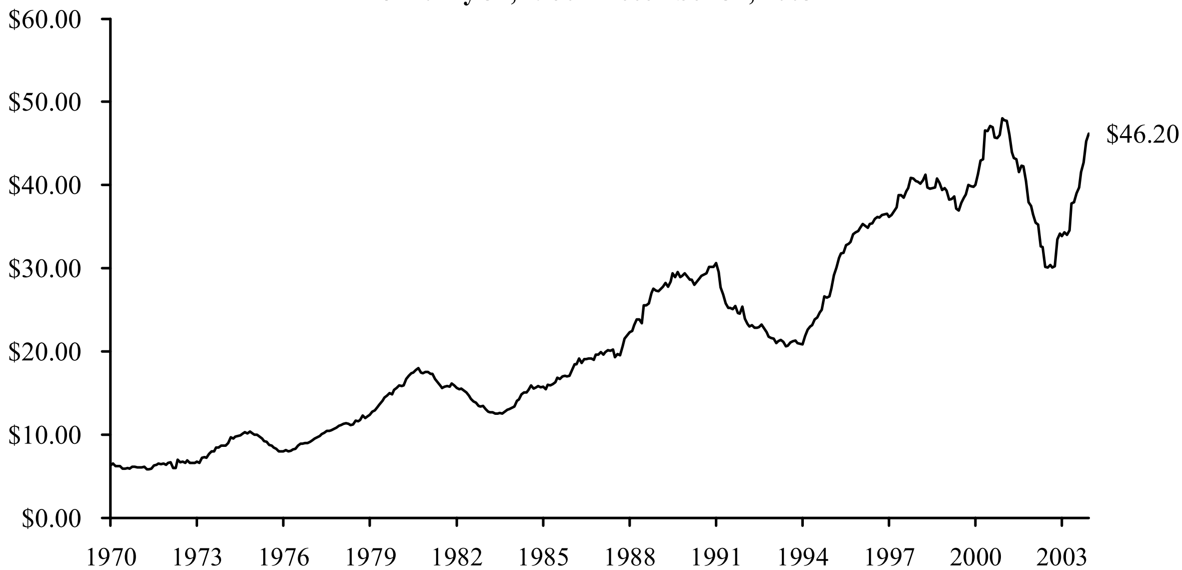
### Emerging Markets

Low interest rates and strong global growth should provide a fillip to emerging markets equities, particularly in Asia, which is closely tied to U.S. inventory cycle. For the overall sector, China's economic growth remains the dominant uncertainty, since interest rates may rise to cool down the overheating economy. Emerging markets equities are no longer cheap, but they still offer attractive value. MSCI EMF Index valuations are somewhat low relative to those of developed markets whose growth prospects are less alluring; earnings for MSCI EMF are expected to grow 24.7% in 2003 and 18.2% in 2004.

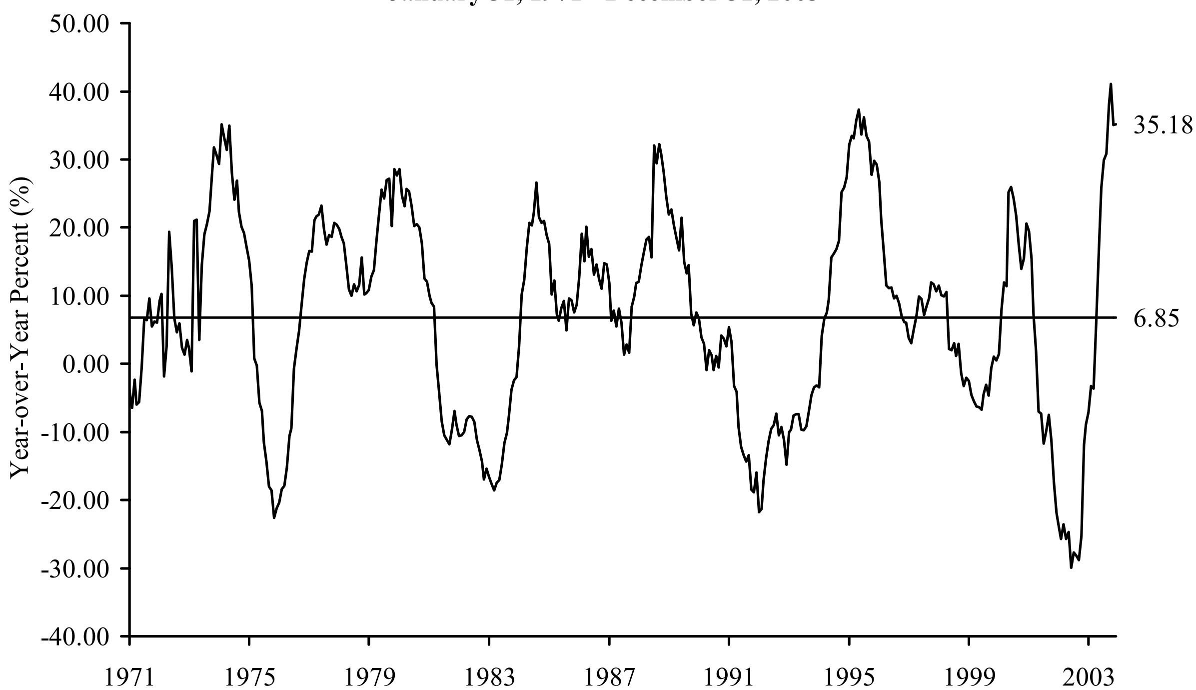
# Table A

## MSCI WORLD INDEX REPORTED EARNINGS

**Earnings Per Share**
**January 31, 1970 - December 31, 2003**




**Earnings Growth**
**January 31, 1971 - December 31, 2003**

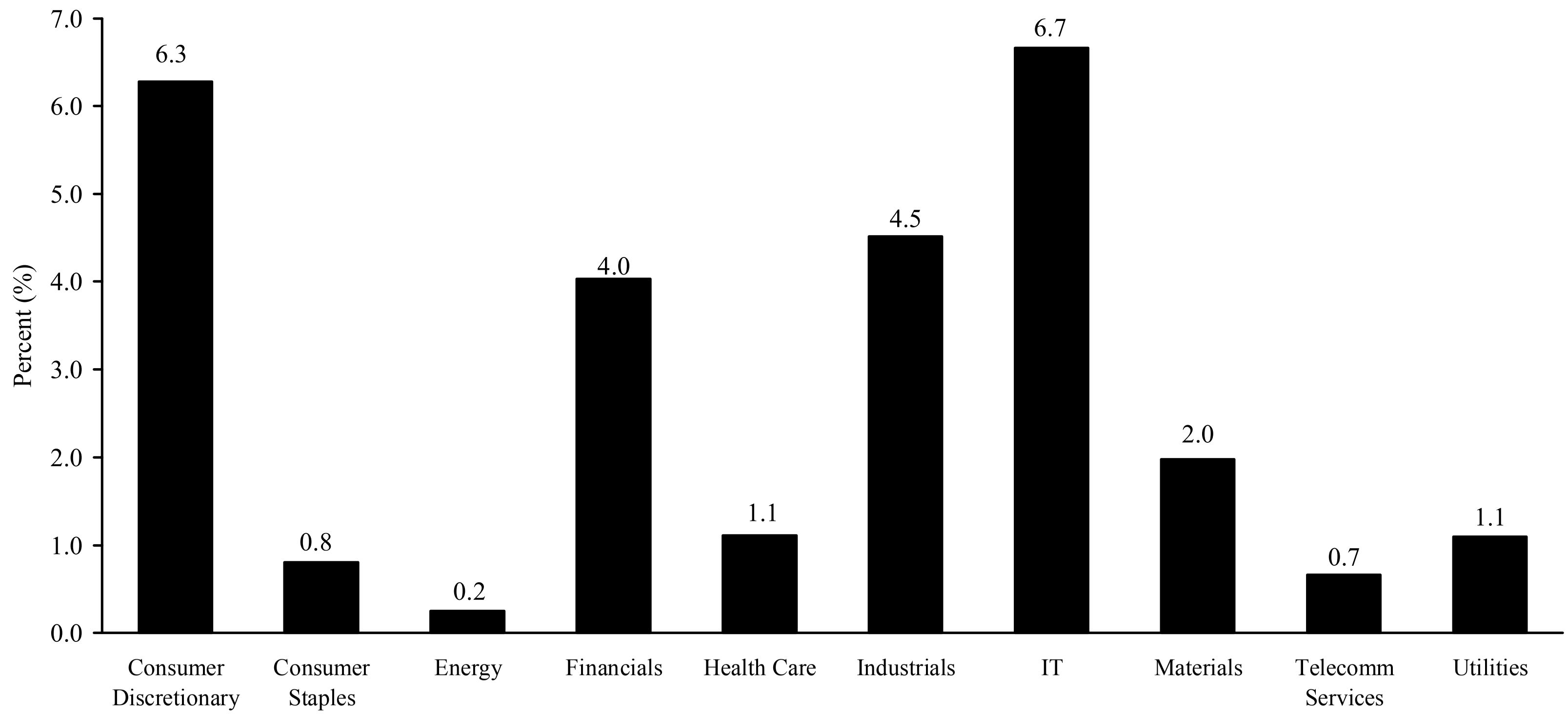



Source: Thomson Datastream. MSCI data are copyrighted by and proprietary to Morgan Stanley Capital International, Inc.

## Table B

## PERFORMANCE ATTRIBUTION FOR MSCI WORLD SECTORS INDEX IN LOCAL CURRENCY

### As of December 31, 2003

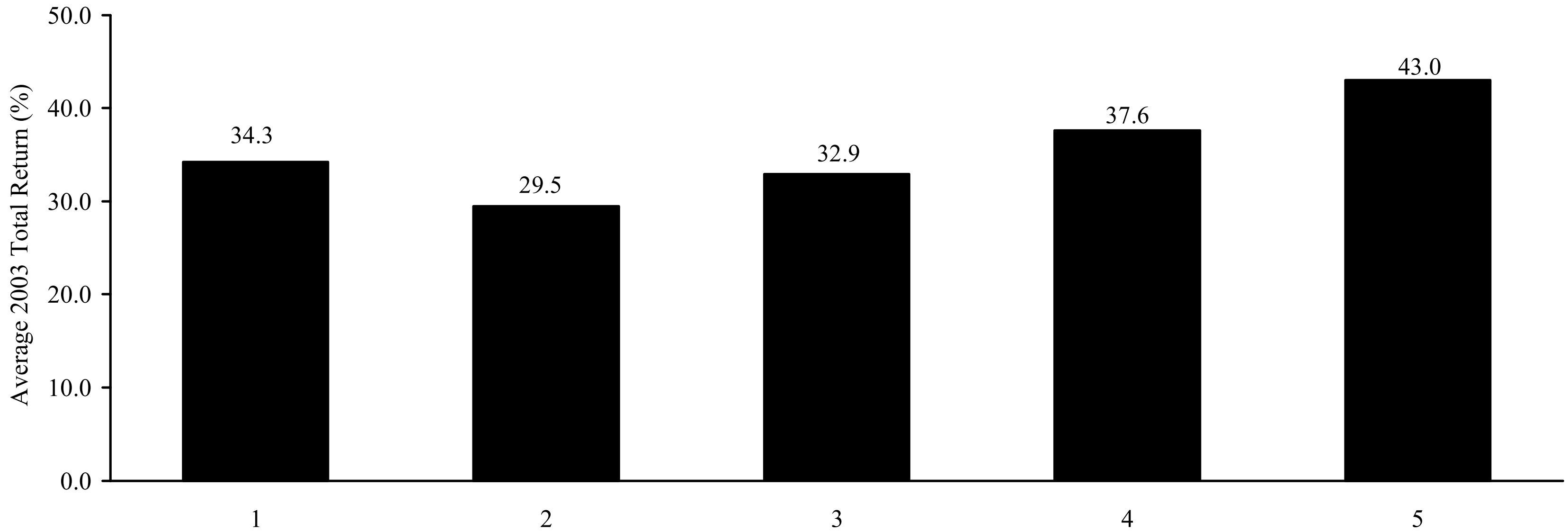



Sources: Factset and Thomson Datastream. MSCI data are copyrighted by and proprietary to Morgan Stanley Capital International, Inc.

Notes: MSCI World constituents are as of December 31, 2003. Sector returns are year-to-date through December 2003. Sector weights are as of December 31, 2002. Seventy-eight companies were excluded because data were not available. The annual return for the MSCI World Index in local currency was 24.9%.

## Table C

### THE MARKET CAPITALIZATION EFFECT: MSCI WORLD INDEX 2003 AVERAGE TOTAL RETURN FOR CAPITALIZATION QUINTILES




| | Largest Companies 1 | 2 | Quintile 3 | 4 | Smallest Companies 5 |
|---|---|---|---|---|---|
| Avg Market Cap (mil $) | 454,542.7 | 29,975.1 | 7,010.4 | 3,014.3 | 928.5 |
| Market Cap Range (mil $) | 7,485,329.8 - 74,331.6 | 73,766.3 - 10,525.5 | 10,489.1 - 4,553.4 | 4,549.3 - 1,768.1 | 1,754.5 - 131.8 |
| Weighting (%) | 91.7 | 6.0 | 1.4 | 0.6 | 0.2 |

Source: Factset. MSCI data are copyrighted by and proprietary to Morgan Stanley Capital International, Inc.

Notes: Nineteen companies were excluded because they did not have a 2003 total return. Sixty-six companies were excluded because they did not have market capitalization value. Market capitalizations are as of December 31, 2002. Annual total return for MSCI World for 2003 is 24.9%. All data are in local currency.