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GLOBAL MARKET COMMENT: THREE KEY ISSUES FOR 2002 & BEYOND

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The Outlook for Global Markets: Three Key Issues for 2002 and Beyond

Three key issues will determine the prospects for the global economy, the likelihood of an impending recovery proving feeble or robust, and the outlook for sustainable longer-term growth.

The Effects of Macro Policy Initiatives

First, can conventional macroeconomic tools revive a global economy currently mired in a synchronous slowdown? During 2001, the major central banks slashed interest rates and flooded their economies with liquidity, and the universal character of the current slowdown underscores the importance of these attempts to boost domestic demand in each region, since it appears that no one economy is likely to serve as an engine of global growth as the United States did after the 1998 Asian market debacle. For conventional macro instruments to prevail over the domestic strains in each region, however, lower borrowing costs must be sufficient to ease balance sheet pressures and stimulate spending in both the business and household sectors. Toward the end of 2001, financial markets seemed to believe this was underway, as global markets rallied and bond yields backed up sharply. However, it seems premature to assume that the problems presented by excess leverage (United States, South America, and Japan), supply/demand imbalances (global), and structural problems (i.e., South America, Europe, Pacific ex Japan, Japan) have been fully addressed.

Drivers of Growth

Second, what will ultimately drive economic growth and equity returns, and will these factors be sustainable? If the eventual global recovery is primarily powered by the U.S. economy, the business cycle will remain vulnerable to the resilience of the U.S. consumer. On the other hand, a recovery firmly rooted in domestic demand in each region would develop stronger foundations that should support a longer-lasting recovery. In addition, the spectre of deflation, which is currently eroding the Japanese economy, could spread around the world if excess capacity is not liquidated and corporate pricing power—and profitability—revived.

Prospects for Structural Reform

Third, how will each country and region resolve its structural problems and imbalances? Japan comes first to mind for its litany of deeply rooted structural ailments, but there are concerns also about Europe and the United States. Some economists believe that Japan will not implement true reform unless beset by a crisis that compels the government to move from tinkering with reform to enacting painful but necessary measures, but any such urgency has thus far been conspicuously absent. In the European Union, some market pundits argue that a lasting recovery is unlikely unless labor, taxation, and regulatory regimes are overhauled—reforms that face stiff resistance from many quarters. In the United States, the overvaluation of the greenback hangs like Damocles' sword over the economy and capital markets, threatening to push up interest rates and sink stock prices if investors find more attractive returns elsewhere. How these imbalances are unwound—whether by gradual change, crisis, market forces, or not at all—will determine the long-term outlook for the economy and capital markets of each region and country.

More immediately, analysts are quite optimistic about the new year. According to Thomson Financial, the consensus expects earnings growth in companies in the FTSE World index to decline 16.8% in 2001, followed by an increase of 17.3% in 2002. Earnings of the FTSE World Information Technology index are expected to decline 75.0% in 2001, followed with growth of 84.5% in 2002.

Regional Issues

The United States

The bull's case for economic recovery and the next upturn for equity markets is primarily built on the Federal Reserve's aggressive reflationary policies. Over the course of 2001, the Fed lowered interest rates from 6.5% to 1.75%, and monetary growth has exploded in recent months. The bears argue that conventional monetary policies will be less effective in reflating the economy because the current cycle is quite different from other postwar slowdowns, since its cause is the collapse of an investment boom rather than the Fed's slamming on the monetary brakes to counteract inflationary pressures. Analysts, however, expect 2002 to be a strong year for equities. According to Thomson Financial, S&P 500 earnings are expected to decline 19.0% in 2001, followed by growth of 15.8% in 2002.

The United Kingdom

The factors that supported the U.K.'s economy in 2001—lower interest rates and robust consumer spending—are generally expected to continue in 2002. While GDP ground to a halt in the United States and Europe in 2001, the U.K. economy grew at a 2.2% annualized rate over the first three quarters. Lower interest and mortgage rates have helped sustain consumption, while the Bank of England has been willing to support domestic demand in the face of global slowdown. Relative to Europe, policymakers in the United Kingdom currently enjoy greater flexibility to ease monetary and fiscal policy, while its monetary transmission mechanism has been more effective, and its public finances are in better shape. However, if the global economy worsens, labor and housing markets would certainly weaken and undermine household spending.

Analysts expect modest growth for equities in the new year. According to Thomson Financial, earnings of companies in the FTSE 100 are expected to grow 2.9% in 2001, and 5.7% in 2002. For MSCI

U.K., the consensus anticipates earnings to fall 0.5% for 2001 and grow 6.5% for 2002. Consensus expectations for certain sectors vary considerably: growth in the TMT sectors is expected to fall 28.7% in 2001, followed by growth of 36.8% in 2002; while growth in the market ex TMT is expected to be 3.0% and 3.9.%.

Europe

Europe's macroeconomic policy will exert a neutral to negative influence on the region's equities. Low inflation (currently 2.0%) may give the European Central Bank the flexibility to reduce interest rates, but although the bank's sole mandate is price stability, financial markets will no doubt continue to whine about its failure to lower rates enough to provide economic stimulus. In addition, the EU's Stability and Growth Pact sets a budget deficit ceiling of 3% of GDP, limiting the scope for fiscal stimulus, and governments remain committed to balanced budgets. In the absence of proactive help from macro policies, Europe's economy and equity markets will probably be driven by spending by corporations (which did not indulge in the same capital expenditures binge as did U.S. firms in the late 1990s), while sluggish labor conditions point to continuing weakness in domestic demand. Beyond this cyclical outlook, structural rigidities will pose difficulties for growth if global weakness persists. Economists generally agree that in order to foster a self-sustaining economic expansion, the Continent should reform its taxation, regulation, social security, and labor regimes—but the political clout wielded by opponents of such measures remains formidable.

Earnings of companies in the FTSE Europe ex U.K. index are expected to decline 22.1% in 2001, followed by growth of 18.5% in 2002, according to Thomson Financial. Expectations for Germany, with its larger manufacturing and industrial sectors, are more aggressive, with the bottom-up consensus anticipating that German corporate earnings growth will decline 22.8% in 2001, followed by 44.8% growth in 2002.

Japan

Nearly every measure of the Japanese economy's performance grew increasingly bleak during the course of 2001, and they continue to portray an economy sliding into crisis. The election of Mr. Koizumi as prime minister raised investors' hopes that the government would finally embark on structural reform, but his agenda has since stalled, increasing the likelihood that the government will try to muddle through without pursing serious change. The authorities seem to have exhausted all conventional policies to revive the economy: fiscal spending has been accelerated, but with public debt running at 130% of GDP, the budget will be hard pressed to allow for additional expenditures. Despite interest rates at zero and a surge in money supply, loan demand and household consumption remain in the doldrums. Many observers believe that the only viable option is to depreciate the yen, which should boost exports. Indeed, during 2001 the currency fell 12.9% against the dollar and 8.1% against the euro. However, since trade accounts for 10% to 15% of Japan's GDP, it is estimated that the currency must fall 50% to 80% in order to have a meaningful economic impact. This implies a yen in the 190-230 range against the dollar, which could well trigger a round of competitive devaluations throughout the region and send Asia into a deflationary spiral. To gauge the prospects for structural reform, investors should monitor the status of policies designed to dispose of nonperforming loans and revitalize the banking sector. In the private sector, signs indicating that the economy is not entirely moribund would include improvements in industrial production, the bank stock subindex, and mergers and acquisition activity.

The consensus expects extreme volatility in Japanese earnings: according to Thomson Financial, earnings in the I/B/E/S Japan universe are expected to decline 39.5% in 2001, followed by growth of 119.5% in 2002.

Emerging Markets

In 2001, the key to performing well in emerging markets was making the right country bets. The best-performing subregion was South Africa, while the worst was Europe and the Middle East, with especially sharp declines in Egypt and Poland. Russia was the top-performing submarket among all emerging markets equities, due to the rise in oil prices earlier in the year and increasingly positive macroeconomic news by the end of 2001.

At year-end, Argentina defaulted on some $166 billion of debt, prompting the government to abandon its currency board and devalue the peso by 30%. However, equities in Argentina and Brazil (-18.1% and -1.6%) were the only negative performers in the Latin American region, while Colombia, Mexico, and Peru posted strong returns.

In Asia, China was the worst-performing market, -24.7%, largely due to the government's attempt to eliminate market irregularities in the Shanghai and Shenzhen exchanges. In the Asia subregion, South Korea was the best-performing market, 54.4%, primarily due to optimism among non-Korean investors about the prospects for corporate restructuring.

Although it is increasingly perverse to lump "emerging markets" together as one entity, since entirely different dynamics drive, for example, South American and Asian developing economies; nevertheless we would stress that, considered in the aggregate, emerging markets equities are now selling at historically low valuations that discount rather pessimistic assumptions as to their prospects (in contrast to, for example, valuations in the U.S. equity market) and constitute an excellent way to place a leveraged bet on global economic recovery.