



Sterling's

World Report



Dealing with Divergences

For a number of years we have made the case for why equity markets outside the United States are likely to outperform the American market as the world comes to terms with huge global trade imbalances. Our simple argument has been that there are a limited number of ways to reduce the U.S. trade deficit:

1. The U.S. grows more slowly and reduces its demand for imports;
2. Foreign economies grow more rapidly and increase their demand of U.S. exports;
3. The value of the U.S. dollar declines, thus discouraging U.S. consumers from buying foreign goods, while encouraging foreign consumers to buy U.S. goods.

Presumably, some combination of all of the above fixes would work best, especially if spread out over a number of years to provide market participants time to adjust and to avoid what economists delicately call “discontinuities” – also known as market crashes, panics and severe recessions. To my knowledge, plague and pestilence currently are left out of the definition of discontinuities.

In taking the long view, it may be unlikely to have all three fixes always working simultaneously. In 2005, for example, the value of the U.S. dollar rose against many foreign currencies as the Federal Reserve hiked interest rates. Recall, however, that the foreign exchange value of the dollar had fallen for nearly three years by that time.

And while the case for long-term dollar weakness remains intact, it appears that items (1) and (2) above are currently dominating the outlook: prospects for slower growth in the U.S. and relatively faster growth overseas. This is related to diverging monetary conditions between the U.S. and major overseas economies, as we will discuss shortly.

We think that theme – the rebalancing of growth away from the U.S. – has been important and will remain enormously important in the years to come. From an equity market perspective, it suggests more positive earnings surprises are likely to come from overseas markets than the U.S. market. That, we believe, is likely to help foreign equity markets continue to outperform the U.S. market – so long as the dreaded “discontinuities” can be kept at bay.

“Fighting the Fed”

Before we go into more detail about the case for international markets, it may be useful to note the current lack of concern about the business cycle and the U.S. economy. Consider the data in Chart 1, for example, which compares the history of year-to-year changes in U.S. real GDP since 1995 with the consensus outlook for real GDP growth for every year through 2010. It shows that the consensus outlook of growth of 3.1% to 3.3% is right in line with the historical trend. There is certainly no “discontinuity” there – or even the hint of a normal business cycle.

That strikes us as rather curious against the backdrop of 15 quarter-point interest rate hikes since mid-2004 that have created a near-inversion of the yield curve. That kind of change in monetary conditions typically has been a reliable harbinger of much slower growth ahead. Unless we are missing something, the potential for disappointments in U.S. corporate earnings reports in coming quarters must be substantial.



We get the same impression when we look at five-year forecasts for U.S. corporate earnings, which still anticipate annual average earnings growth of nearly 11% per annum. That's down from the expectations of 19% per annum earnings growth that prevailed at the height of the dot-com boom in 2000. That said, current long-term forecasts strike us as rather ambitious against the backdrop of Fed tightening and the need for a rebalancing of global growth away from the U.S.

One final signal of market participants' high level of confidence in the future earnings outlook is simply the extraordinarily low level of U.S. stock market volatility. As we mentioned in our previous *World Report* ("The Iceman Cometh"), the volatility of the S&P 500 as measured by the VIX index is extremely low compared to its history. Based on calculations derived from options trades, the implied volatility of the S&P 500 is now running at only 11.1% annualized. That compares with a 10-year average of 21.5%, which included occasional gusts up to nearly 50% (in 1997, 1998, 2001 and 2002).

In short, economic forecasters and market participants alike appear to be "fighting the Fed" in the sense of not taking into account the implications of the significant change in monetary conditions that has now occurred. If history is any guide, the significant tightening of monetary policy is pointing to a meaningful slowdown in economic and earnings growth in coming quarters.

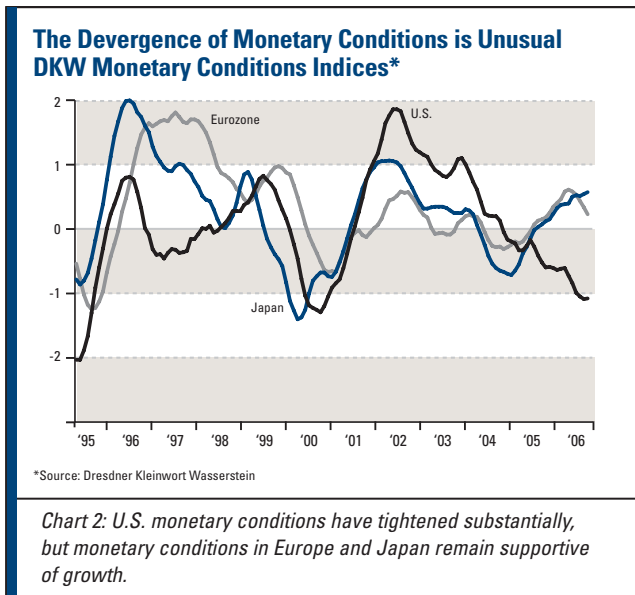
An Unusual Divergence

We think the case for better earnings prospects overseas can be supported by looking at the unusual divergence of monetary conditions in the U.S. from those in the Eurozone and Japan.

Analysts at Dresdner Kleinwort Wasserstein (DKW), a European investment bank, have created "monetary conditions indices" (MCI's) for major economic regions. The purpose of these indicators is to look for turns in global economic momentum ahead of those that are registered by conventional leading economic indicators (such as the widely used OECD leading indicators).

Their approach is quite simple. First, they collect data on year-on-year changes in short-term rates, government bond yields, and trade-weighted currency indexes. Then, they statistically analyze those measures to determine how much weight to put on each item in order to have an overall index that best captures future changes in economic momentum. The reasoning is straightforward: When short-term or long-term rates go up, the economy typically slows down several quarters later. Likewise, when a nation's trade-weighted currency rises sharply, the export sector and manufacturing sector typically slow down several quarters later.

U.S. rates have risen more than most other nations' over the past 12 months and the U.S. dollar has strengthened significantly as well. Accordingly, the U.S. monetary conditions



index has deteriorated quite markedly and is pointing to slower growth ahead. In contrast, Europe and Japan have kept interest rates lower for longer and both have seen their currencies depreciate over the past year.

These observations can be summarized quite clearly in Chart 2, which shows the unusual degree of divergence in monetary conditions that now exists between the U.S. on the one hand and the Eurozone and Japan on the other. With Europe only recently having started to raise interest rates – and started with baby steps – and with Japan having not raised interest rates for years, monetary conditions are clearly far more favourable for growth in the Eurozone and Japan than they now are in the United States.

This alone suggests that economic momentum is likely to slow more significantly in the U.S. in coming quarters than in Europe and Japan.

Tracking Earnings Optimism

This may sound like simply another way of saying what we already know – that the Fed has tightened by more than other central banks. That said, the MCI indexes created by

Dresdner Kleinwort Wasserstein’s analysts also permit this insight to be tied clearly to future trends in economic growth and, more importantly to investors, to earnings growth as well.

In addition to tracking monetary conditions data, the DKW team also creates indexes for “EPS optimism,” which measure the percentage of analysts upgrading their corporate earnings per share (EPS) forecasts over rolling three-month periods. Clearly, EPS optimism is high when most analysts are upgrading their earnings forecasts.

Not surprisingly, monetary conditions tend to be a good leading indicator of not only overall GDP growth, but also of whether analysts are likely to be upgrading or downgrading their EPS forecasts. In countries where monetary conditions have deteriorated, as is currently the case in the U.S., earnings optimism can also be expected to deteriorate. In nations where monetary conditions remain accommodative, like Europe and Japan, earnings optimism is likely to persist.

Perhaps most importantly for global investors, a relative deterioration in U.S. monetary conditions signals a likely relative deterioration in EPS optimism, with a lead of about 18 months. This is shown in Chart 3, which plots the relative MCI for the U.S. versus the relative EPS optimism measures for the U.S. equity market versus non-U.S. equity markets. What the chart suggests is that the unusual relative deterioration of U.S. monetary conditions is likely to lead to an unusually large relative deterioration in earnings optimism as well.

Put simply, we suspect that there will be many more negative earnings surprises in the U.S. in coming quarters than in Europe and Japan. And since the U.S. market remains more expensive than foreign markets on numerous valuation measures, this suggests that foreign markets may be positioned to outperform the U.S. market based on both growth and value considerations.

Of course, perceptions can and undoubtedly will change. The U.S. may well decide to pause from monetary tightening by mid-year even as Japan and Europe proceed with tightening measures later this year and into 2007. Likewise, we can envision circumstances whereby the U.S. is actually cutting rates next year even as Japan and Europe raise rates. That said, since monetary policy works with long lags, the results on relative earnings optimism may not be evident for many quarters to come. And, of course, if the U.S. eases while Europe and Japan raise rates, it would likely trigger a resumption of U.S. dollar weakness. Presumably, the prospect of U.S. dollar weakness would also tend to reward investment in non-U.S. equity markets.

In short, we believe analysts and portfolio managers should remain wary about overly optimistic long-term earnings forecasts for many U.S. companies against a backdrop of strong cyclical and structural forces that seem likely to favour non-U.S. companies. This is especially true for companies that benefited the most from the ultra-low interest rates of a few years ago (banks, retailers, REITs, commodity cyclicals, small-cap stocks, value stocks) and

which now face a more challenging environment. Emerging market companies that have benefited from buoyant U.S. consumer demand and turbocharged commodity prices may likewise face a more challenging environment, especially if market volatility picks up and prompts investors to favour the more stable, developed nations' markets.

The good news is that, relative to bonds, equities continue to look attractively valued. And we also believe that policy-makers around the world are determined to avoid those nasty "discontinuities" that would make life difficult for investors – and everyone else.

William Sterling

William Sterling
Chief Investment Officer
Trilogy Global Advisors, LLC

