INDEPENDENT
STRATEGY

GLOBAL MARKETS

A crude blow

- After a big sigh of relief post 9/11, equity markets have got far too optimistic about growth and profit recovery. We expect a significant correction from current levels. If profits are to recover as much as the market expects, labour income growth must slow sharply and consumption along with it. That will make the economic road ahead a twisty one!

- We expect the oil price to stay around $25-30/b. Misguided US policy on the Palestine-Israel conflict will be followed by intensified US-led action against Iraq. That's raising the political risk premium globally, particularly for oil and US financial assets.

- We have already diversified our global exposure away from the US, where equities are already richly valued. Now we are going underweight global equities by raising cash from US, European and emerging Asian equity markets. We are already underweight bonds.

12 April 2002

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INDEPENDENT STRATEGY

A crude blow

Vulnerable equity markets

• It would be risky to cut back on our equity overweighting if the markets were down in the pits and cheap. But since our super-bullish call on equities after 9/11, the equity markets we favoured then (US, Europe and emerging Asia) have soared. They don't look cheap any more. Investors are pricing markets rich and sure with prospective P/Es in the high 20s.

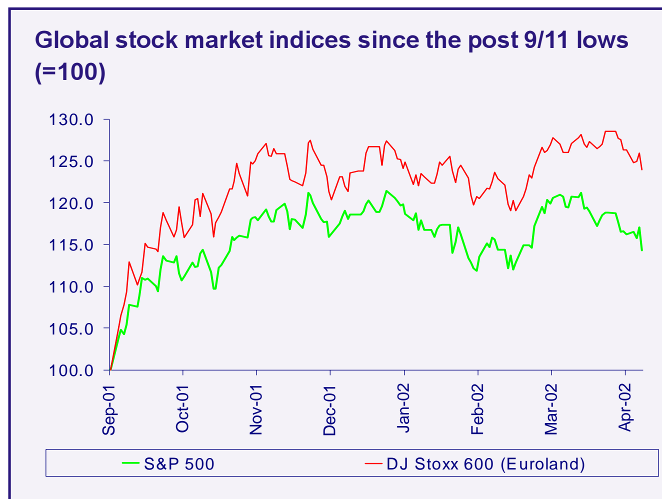

Figure 1. *Source: Datastream, Independent Strategy*

• And the US economy and its financial assets are a bellwether for the rest of global markets. There will be no decoupling. Indeed, there has been an increased correlation between US and European financial assets in the 1990s.

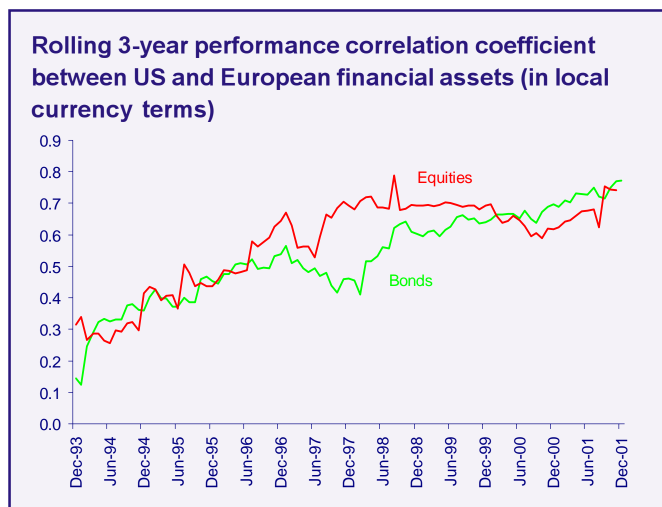

Figure 2. *Source: Datastream, Independent Strategy*

• The level of US households' exposure to high-risk assets (equities and bonds) remains historically high at around two-thirds of household wealth. They won't be encouraged to buy more risk, if risky assets get riskier.

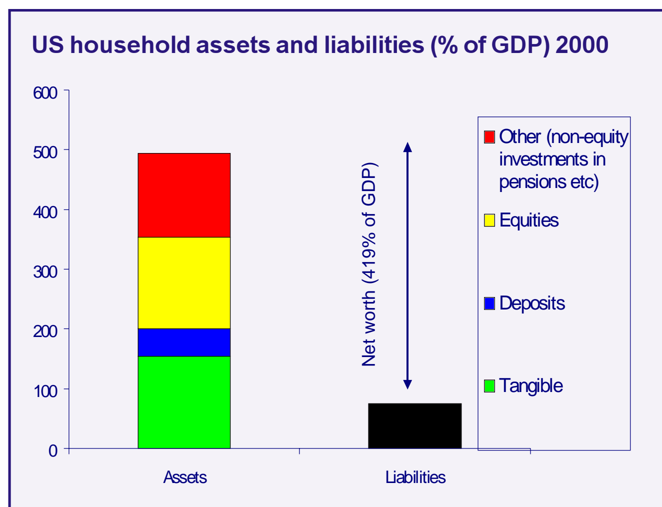

Figure 3. *Source: Federal Reserve, Independent Strategy*

Risk to corporate profit growth

• *There are reasons to expect a big pull back in global equities from here, even without a further hike in oil prices. US consumer demand must continue to grow rapidly, having already been strong throughout the phony recession. And labour earnings growth must slow dramatically. That would allow unit labour costs to shrink. Only in that way would pretax operating margins recover from current levels of 10.3% to around their average pre-collapse levels of 12-13%.*

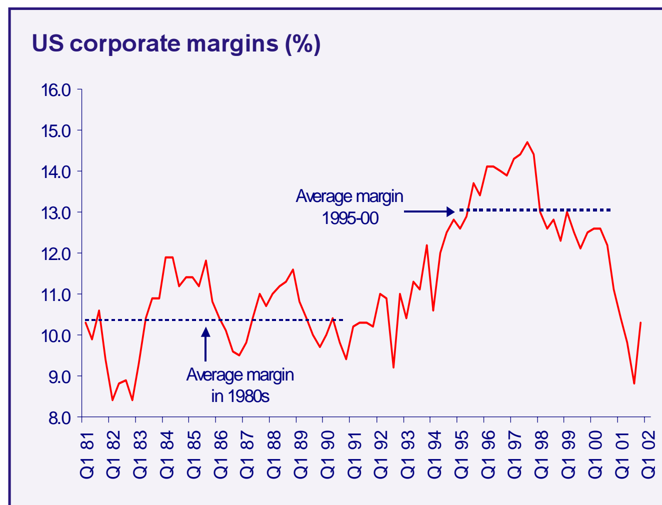

Figure 4. *Source: Datastream, Independent Strategy*

• *These sums are predicated upon the US productivity miracle of the New Economy being sustained. But we don't expect productivity growth to rise above the peak 5.2% rate at the end of last year in the downturn. That means that the footwork on re-establishing profit margins has to be done by slowing hourly wage cost increases. That's happening. But it will be at the expense of consumer purchasing power.*

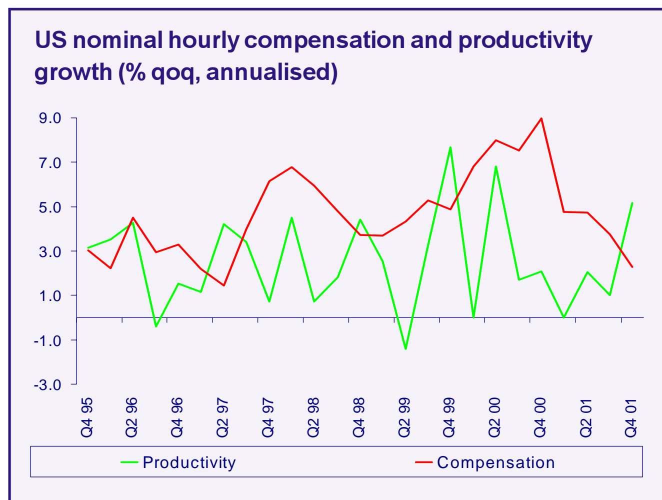

Figure 5. *Source: Datastream*

Oil and the global recovery

• *In our recent* Update *(2 April 2002) on events in the Middle East, we raised the risk that US policy and creeping oil embargoes would have a knock-on effect on equity and bond markets. That's because the crisis in the Middle East and the likelihood of intensified US action against Iraq come at a delicate time. The global recovery is fragile and based more on a bounce-back in global manufacturing output from depressed levels than confirmed recovery in final demand.*

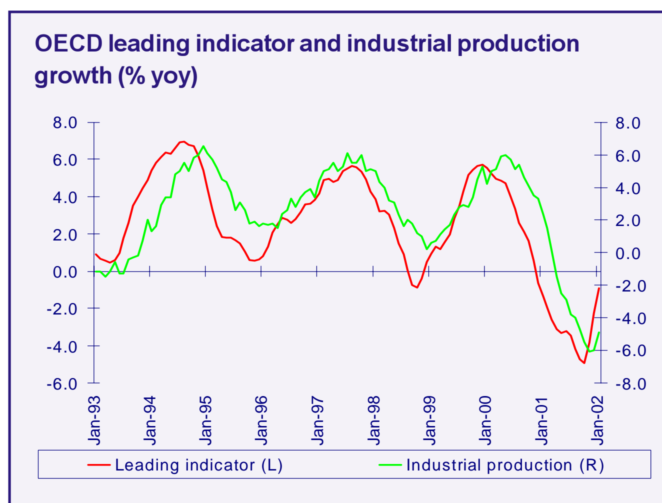

Figure 6. *Source: Datastream*

A crude blow

Oil and the global recovery

• *Iraq and the Middle East crisis could also force up oil prices even higher than the current $25/b. That will shift the balance of risk from global deflation towards inflation. Oil prices are like a sales tax. They travel straight down the wire to the consumer. That's because oil demand and supply is pretty price-inelastic, at least in the short term. We reckon an oil price moving to $30/b would add an extra 2% points to yoy CPI by year-end. By transferring purchasing power from consumers to oil producers who consume less, growth gets hit.*

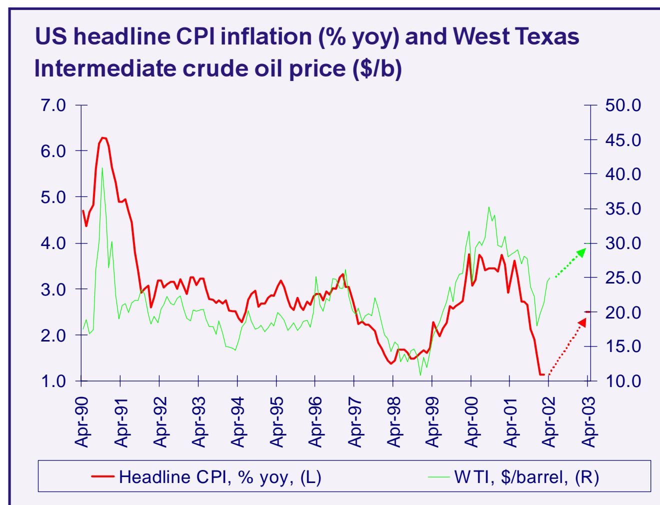

Figure 7. *Source: Datastream*

• *Will oil prices go over $30/b? Any intensification of the crisis in the Middle East and Iraq raises the possibility of an oil export boycott. Cutbacks by Iran and Iraq alone would eliminate most of the world's available spare capacity (1-7 mb/d, depending on whose estimates you believe). Mexico and Russia could provide some extra production. But we doubt that Saudi Arabia could step into the breach to help Uncle Sam without seriously weakening its position in the Arab world. And US action against Iraq will polarise relations with Islamic OPEC nations even more.*

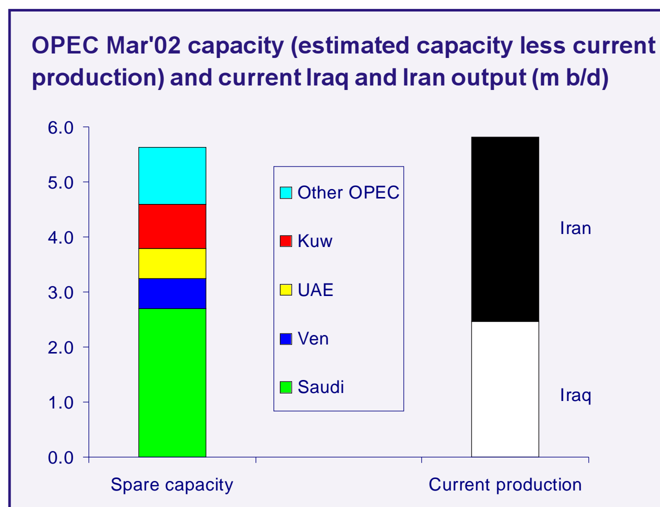

Figure 8. *Source: EIA, Independent Strategy*

• *Even if the oil price stays around $25/b, US real disposable income growth will slow to 2.5% yoy from its current rate of 3.5% by year-end. That's because factors that supported disposable income and consumption last year have started to wane (tax breaks and big wage gains). If the oil price were to rise from current levels to $30/b over the rest of this year, that would cut the growth in real take home pay to just 1%.*

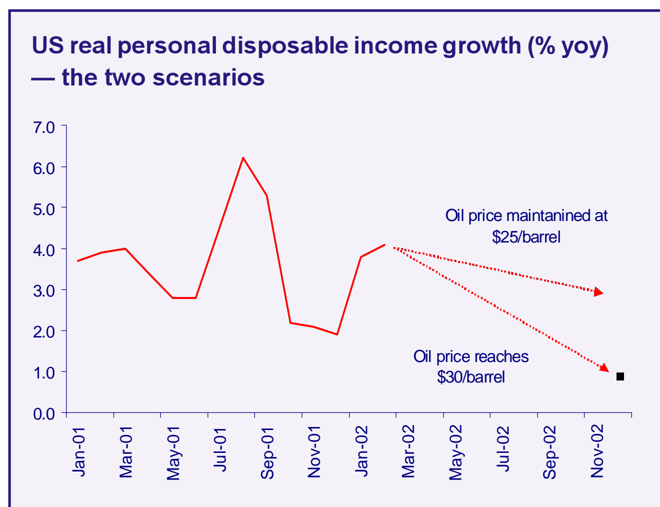

Figure 9. *Source: Datastream, Independent Strategy*

INDEPENDENT STRATEGY

A crude blow

Risk to the dollar

• *Normally when there is sharp hike in oil prices, the dollar strengthens against European currencies and the yen. But this time it could be different. The strong dollar is a product of huge capital inflows as foreigners buy US dollar assets. Now foreigners own nearly 40% of US treasuries. A growing political crisis in the Middle East may change the view of the dollar as a safe haven or as a desirable asset to hold by OPEC nations.*

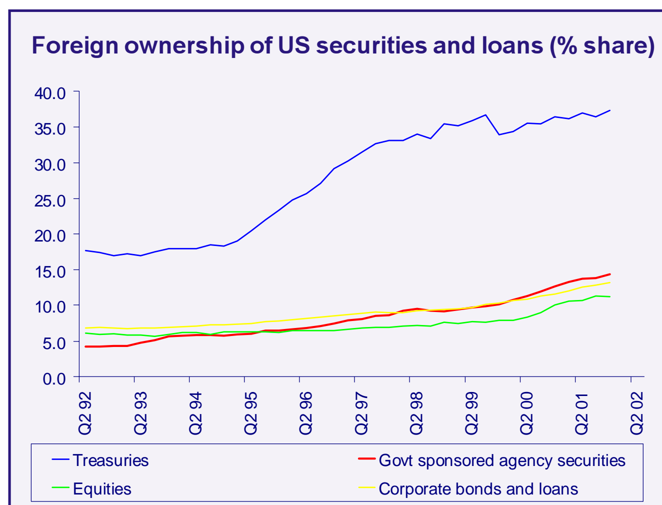

Figure 10. *Source: Federal Reserve, Independent Strategy*

Inflation and monetary policy

• *Many argue that the shift to higher interest rates will be delayed, because of concerns about economic recovery. But this makes little difference to the investor. That's because higher oil prices suck money out of financial markets into the "real" economy. Hence, provided central bankers don't ease to accommodate higher oil prices, which they won't, higher oil prices imply tighter monetary policy for financial markets.*

• *In order to stop an increase in the price of oil becoming generalised, central banks must make sure there is not enough loose money around to finance increases in __all__ prices. Today's global monetary policy stance is far too loose to do this. It's still geared to preventing asset prices and economies collapsing post 9/11. The stance of monetary policy will have to shift.*

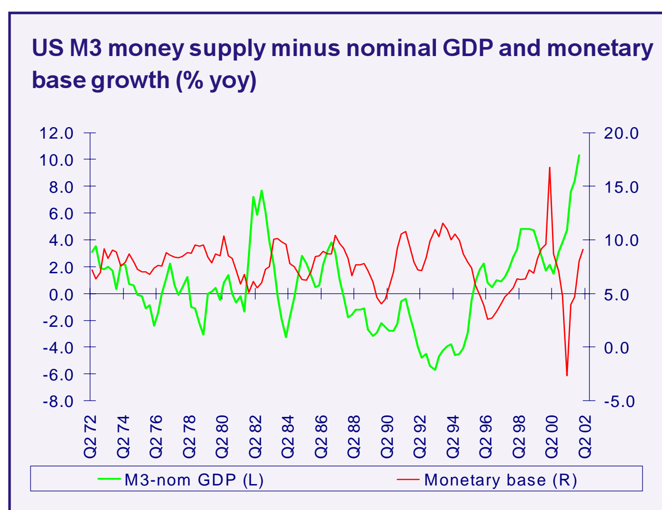

Figure 11. *Source: Datastream, Independent Strategy*

Inflation and monetary policy

- *Even if there is no further rise in oil prices from current levels, US equities look expensive. And if the oil price were to jump to over $30/b and drive up inflation above consensus forecasts, there would have to be a significant fall in equity prices to achieve fair value.*

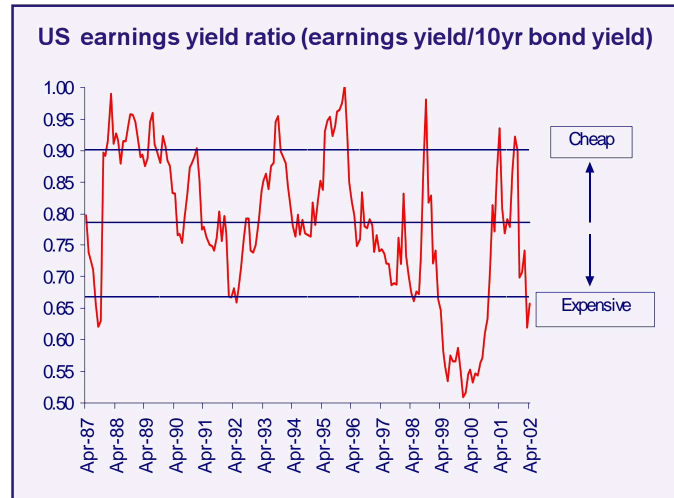

Figure 12. *Source: Datastream*

Investment strategy

- *We still have faith in the positive thrust of public policy to empower markets and in the New Economy productivity paradigm. That keeps us bullish about the world in the long term. But right now, the shining lure of the future has gotten a tinge of gray and the markets are not pricing in any such subtle hues about the future or profits. So we'd be out of sectors and markets dependent on fast US economic growth. That means consumer cyclicals and housing stocks in the US and North Asian equity markets in particular. We'd shift equity exposure to markets weighted towards energy sectors, as in Canada, Australia and Mexico.*

Investment strategy

Vulnerable sectors:	Beneficiaries:
US consumer stocks.	Few and far between among long-term financial assets.
Auto stocks worldwide — particularly EU and US.	Australian energy equities and the A$.
US housing stocks.	Canadian energy equities and the C$.
Asian airlines	Russian financial assets.
North Asian equity markets — Korea in particular.	Mexico: the peso and selected equities — but beware the impact of slower US recovery.
Emerging market dollar debt — particularly the Philippines, but watch out for Latin America too.	
Turkish debt — were selling our position.	
The yen.	
European banks: the yield curve will flatten.	

Figure 13. *Source: Independent Strategy*

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