

The Equity Recovery: The “Dismal Science” of Economic Forecasting and the Pattern of Global Equity Returns



Martin Jansen
Senior Portfolio
Manager

As measured by the MSCI AC World Index, global markets have returned 29% so far this year and 70% since the global market trough on March 9. As markets tend to lead the real economy, typically by around six months, and we are now almost eight months from the market lows, it is an interesting exercise to compare the change in forecasts for major developed and emerging markets with the equity market returns in this timeframe.

For economists, forecasting economic growth on the basis of time-lagged data for complex systems is at the best of times a problematic exercise. Superimpose a global credit crisis of historic and vastly underestimated dimensions and it is understandable that the “dismal science” of economic forecasting is currently begging for an even less flattering description. Yet despite the formidable shortcomings, economic growth and currency forecasts, and how they impact industries and individual companies, remain vital ingredients for positioning global portfolios. Juxtaposing the economic forecasts of March with the current ones as well as simultaneous market returns could be revealing.

For the major developed economies, the current consensus economic growth for 2009 is, on balance, worse than it was forecasting in March, despite a recent spate of upgrades. The forecasts for the United States and Japan are marginally lower, but those for Europe and the United Kingdom are significantly lower. The post-trough market returns show Europe and the U.K. well ahead of the U.S., while Japan is the laggard by a large margin. This is the exact reverse order of the relative positioning in the melt-down in 2008 and early 2009. Currency movements have played a significant role: the appreciation of the British pound and the euro against the dollar substantially explains the excess dollar-based returns in their respective stock markets versus the S&P 500 index. Stocks tied to their respective local economies have performed strongly despite a continued problematic domestic growth profile. While the Japanese yen also rose against the dollar, Japan remains a notable laggard even allowing for currency effects.

In the developing world, the contrasts between the relative change in the expected growth outlook and stock market returns are even more striking.

Economically, the region that is emerging best from the crisis is developing Asia. The outlook for South Korea and Taiwan has improved markedly since early this year. China, after a small wobble late last year, is now expected to grow by more than 8% in 2009, while India has been a steady ship in the storm and is expected to see growth of 5.5% this year. The notable stock market laggard since early March is China, while Korea and Taiwan have recovered in tandem with an improving outlook and India has returned 119%. China, at least in the recent past, is acting like a low beta play in the Asian arena.

The economic outlook/market return contrasts in Latin America’s two major markets, Brazil and Mexico, are similarly striking. Brazil may actually post a marginally positive growth rate in 2009, a remarkable feat for an economy that has historically been highly geared to the economic trends in the developed world. A strong recovery of commodity prices, stable domestic consumption, and a fast appreciating currency have fueled a stunning 143% return since early March. Mexico paints a different picture; the economic contraction of more than 7% now expected for 2009 is vastly worse than foreseen in March. Yet its stock market has simultaneously more than doubled. The implication is that investors must be expecting a robust recovery in 2010. This is largely contingent on a strong recovery growth path in the U.S., given the structural linkages.

With the exception of Poland, the expected 2009 growth outlook in Eastern Europe is for a much worse contraction than envisaged early this year. As an extension of the pressured West-European industrial base, as well as the unwinding of an overextended financial sector going into the crisis, the region has been disproportionately impacted. Yet Hungary and Turkey, with the largest contractions, have seen their stock markets lead in the region.

The disconnect between the relative economic prospects and the global stock market recovery can arguably be attributed to the stampede into lower

quality and perceived recovery stocks as the fear of a global collapse receded after March. In the process, well-capitalized, "quality" stocks have lagged almost across the board. The focus has been on potential recovery rather than secular growth. China is looking much more attractive, India is a little rich against its emerging peers, while South Korea and Turkey look cheap. Mexico and Eastern Europe are leveraged to the U.S. and Europe.

So, while the dismal science had a poor handle on the relative stock returns this year, as the global stock market recovery matures a focus on relative growth rates and quality companies able to sustainably grow their franchises could prove more rewarding as we head into 2010. Expectations of continued outperformance by lower quality and capital impaired stocks may require a leap of faith that the global economic outlook in 2010 and beyond is substantially better than currently generally expected. ■

Divergent Economic Growth Expectations and Market Returns.

Country	GDP 2009 (e) 3/28/2009 % growth	GDP 2009(e) 10/31/2009 % growth	Current account to GDP (%) 2009 (e) 10/31/09	Local market in USD 03/09/09-11/05/09 % Return	Local Index
Developed					
U.S.	-2.2	-2.5	-3.0	60	S&P 500
Euro Zone	-2.4	-3.8	-1.0	82	DJ Euro
United Kingdom	-3.1	-4.4	-1.7	79	FTSE 100
Japan	-5.3	-5.7	2.8	37	Topix
Emerging/Developing Asia					
China	6.0	8.2	6.1	51	Shanghai Comp.
India	5.0	5.5	-0.3	119	Sensex
S. Korea	-5.9	-1.0	3.8	90	Kospi
Taiwan	-6.5	-3.6	9.6	76	TWSE
Latin America					
Brazil	-0.4	0.0	-0.8	143	Bovespa
Mexico	-2.6	-7.1	-1.1	105	Bolsa
E. Europe/Africa					
Czech Rep.	-2.0	-4.3	-2.1	134	Prague S.E.
Hungary	-3.0	-7.0	-2.8	170	Budapest S.E.
Poland	0.7	1.0	-0.8	115	WIG20
Turkey	-2.0	-5.7	-2.0	156	ISE Natl 100
South Africa	-0.8	-2.2	-5.4	102	JSE All Share

Source: GDP/Current Account: Economist, March 28 and October 31, 2009; Bloomberg

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