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Decoupling - America And The Rest Of The World

By: Jonathan Passmore

A major debate in the **investment** community today is the extent to which the U.S. and non-U.S. economies and markets are correlated.

The old adage, 'when the U.S. sneezes, the world catches a cold,' has been a foundation of market behaviours for several decades and there is no doubt that, in terms of asset allocation, getting this relationship right is a critical issue.

However, this era of globalization is prompting massive change, not just in the way that global business operates, but in how we, as **investors**, function in this shifting landscape. The question is whether in a period where the drivers of economic activity are shifting from the developed west to broader, more geographically diversified markets, can we start to consider a world where U.S. performance (economic or market) becomes an anecdote rather than a driver?

What are the changes taking place that might support the theory of decoupling? The components might include GDP and GDP growth, market returns, critical features of GDP such as exports and consumption, currencies, interest rates, and other issues such as government policy that might raise or lower the popularity of a given market.

Economics: GDP And Growth

That the U.S. was the world's richest economy throughout much of the 20th century is beyond doubt. But it is possible to foresee a time when the U.S. may lose its economic primacy. Already, powerful growth in the economies of China and India has propelled those countries far up the league tables, at the expense of some notable, old guard countries. The Economic Union (EU), has overtaken the U.S., albeit driven by the strength of the Euro.

Variations in growth can confirm the trend we see developing in the global picture.

Since the beginning of the 1990s, Europe (as defined by the EU) had been in economic decline as Germany grappled with the ramifications of reunification and France pursued its social programs. Similarly, Japan struggled with deflation and stagnation in the aftermath of the booming 1980s. At the same time, the U.S. rose to new peaks as the sole economic and military superpower in the post-Soviet era.

Move forward into this decade and the picture has changed quite dramatically. In 2007, GDP growth in the EU, Japan, the UK, and Canada is forecast to be higher than the U.S. Just as important, the growth rates for the EU, Japan, and the UK have been revised upwards in recent months, unlike the U.S. and Canada, which have seen their forecasts lowered.

What's going on? The stronger U.S. dollar environment has given way to a steady decline in the currency brought about by nascent recovery in Europe, rising rates around the world, and the dramatic development of China and India. Internally, rising deficits, both budget and current account, have added to the weakness.

The recovery in Europe's economy (and, to a lesser degree, Japan's) has not been wholly driven by a powerful U.S. economy as historical experience might expect. In fact, their recoveries are starting at a time when the U.S. is showing its weakest performance in several years.

The Pursuit Of Superior Returns

The only proof an investor needs that one market is better than another comes from performance and in this area there is compelling proof that the 'Rest of the World' and the U.S. decoupled a few years ago. For the period 1990 to 2002 (ending in the first year of the 'real' Euro and the final stages of the fierce, three year bear market), the S&P 500 outperformed MSCI EAFE with a 12.3 per cent annual return versus just 3.3 per cent (as measured in Canadian dollars). However, from 2003 to June 2007, we see a major reversal with the S&P gaining just 5.1 per cent annually versus a 13.7 per cent return for EAFE.

Of course, one of the most interesting facets of globalization is the widening distribution of corporate activity around the world. For bigger companies in particular, a stock headquartered in Paris or London may have little to do with the state of the market in France or the UK. It may be the activity they are generating in the developing markets, that will dictate the success of that business. American companies, as much as any others, have developed their commitment to overseas markets by setting up shop around the world. It is somewhat ironic that another piece of the decoupling puzzle should be driven by U.S. interests.

Consumption And Exports

One of the most powerful and carefully watched components of U.S. GDP is consumption, representing more than two-thirds of domestic product. Commentators believe that the U.S. economy lives and dies by the population's ability to consume, financed by healthy disposable incomes and substantial equity in their homes. Americans have been encouraged in their consumption habits by the influx of ever-cheaper goods, driven by aggressive retailing tacticians such as WalMart. It is logical to assume under the old model that the health of the global economy depended on the health of the American consumer. However, American consumption is no longer the only game in town. Consumption behaviours are accelerating in many regions of the world, providing alternative destinations for manufacturers of a wide range of products.

In the more mature markets of Europe and Japan, consumers are peeking over the parapet for the first time in many years. Driven by rising confidence and job security, the need for high levels of savings is giving way to a higher propensity to consume. In Europe, it is driven by falling unemployment and the election of centre/right governments more favourably disposed to capitalism and the workplace meritocracy. In Japan, where savings are quite simply massive, the end of deflation, modestly rising rates, and shifts in job demographics from part-time to full-time employment are all conspiring to encourage modest increases in consumption.

But it is the developing markets, especially in Asia, where behaviours are making economists and commentators sit up and take notice. The demographics are quite simply stunning. For example, 80 per cent of the world's population live in developing countries, with 37 per cent in China and India alone. Just a modest increase in consumption on the part of these groups has a massive effect on their local economies. While the vast majority of these people are still at a very low level of income, the shift from a pedal bike to a moped is profound indeed, in terms of economics, mobility, and standard of living.

In Asia, consumption already represents a healthy percentage of these rapidly growing economies. In 2006, consumption accounted for 50 per cent of China's GDP; 68 per cent of the GDP of India and Korea; and 80 per cent in the Philippines. Of course, exports are crucial too and we should in no way ignore the risk to all markets should global trade slow down. But consumption is on the rise and already ranks higher than exports in almost all countries, developed or developing, suggesting a growing reliance on local economic activity away from the historic dependence on overseas trade.

Rates, Currencies, And Governments

While GDP and GDP components provide fundamental issues for discussion, and market returns provide a scorecard for decisions made, there are other factors that can drive the impetus for investment at both the strategic and tactical level, either short- or long-term. Interest rates and currency forecasts can prompt major shifts of capital away from markets and into new areas of opportunity. The mobility of global capital makes market loyalty a thing of the past and the growing size and liquidity of markets outside of the U.S. promotes the consideration of true alternatives.

Currencies can also provide the reason for a shift in capital. Not only does the U.S. look vulnerable due to large budget deficits and a growing current account shortfall, but the currencies of the resource heavy countries are all backed by thriving commodity export revenues, highlighting the new investment paradox between resource consumers and resource suppliers.

So are the U.S. and the 'Rest of the World' still joined at the hip? A brief consideration of the above points would suggest a change in that long-standing relationship. The arguments concerning GDP and consumption, market returns and interest rates, currencies, and foreign policy make a powerful case in favour of decoupling, but there is still one intangible that has a powerful voice in this debate today – sentiment. While the signs of a change in American primacy might be clear, it will take a long time for the world's markets to consider themselves truly independent. The U.S. dollar is still the world's reserve currency (ask Japan and China) and the Federal Reserve still enjoys the image of the world's banker. Until such time as the Euro (or an Asian alternative) becomes a major reserve currency, the U.S. will retain much of its importance, despite any other fundamental failings. ■

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