

Global Investment Strategy

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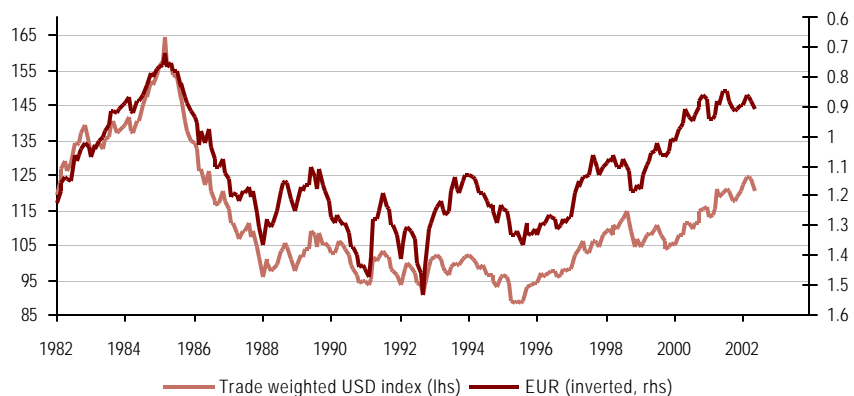
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A Weaker USD Structural, Not Just Cyclical

- We reiterate and extend our 22 August 2001 forecast for a weaker USD. We look for the EUR to trade at \$1.05 and the JPY to trade at 115 by the end of 2003. The trade weighted USD is expected to fall 10% over the next two years.
- Our view is based on a combination of cyclical and structural issues. The currency market remains focused on the financing of the US current account deficit and the relative strength of the different regions in the context of the “in sync” global recovery. This current account issue is not new. What is new is the cocktail of changes in international political economy and developing structural positives outside the US, particularly in Europe and Asia.
- We believe that the benefits engendered by the transparencies of a single currency in Europe will begin to be felt this year. We look for heightened competition among governments to attract investment via lower corporate tax rates, and that in our opinion will drive a higher return on investment. This trend contrasts with the US, where the capital spending boom of the last years outpaced sales by a significant margin. Europe, outside of the TMT sectors, did not experience such a boom and remains a more attractive capex prospect.
- East Asia is developing some independent growth potential partly in the capital spending arena but also because there is a structurally compelling Asian consumer story. Recovering economies mean banking sectors are willing to lend to households where balance sheets are still reasonable. Interest rates are likely to stay low. Current account surpluses give room for faster GDP growth versus domestic demand. And there is the prospect of real effective exchange rate appreciation. We note that Asia's recovery began before the end of 2001. Japan, moreover, has further capacity for cyclical upside surprises, e.g. from exports in the environment of an “in sync” global economic recovery, and this could help to keep the JPY firm notwithstanding continuing concerns about structural economic reforms.
- We don't expect central banks to fight a gradually weakening USD. A weaker USD is bullish for global growth, because it will help US companies, supporting the American consumer, even though the net impact on US growth of a continued gradual USD decline will be modest.

Chart 1: USD exchange rates



Source: Datastream

A new USD downwave

USD forecast to decline over the next 1-2 years

We reiterate and extend our earlier forecast for a weaker USD (see “Currency Shift,” 22 August 2001). We expect the USD to weaken further in the months ahead but more as a result of structural factors that we believe are causing better investment opportunities to exist outside of the US. While we share misgivings about timing, we are of the view that a USD downwave is at hand and we expect the USD to decline over the next 1-2 years. By the end of 2003, we expect the EUR to have risen to around \$1.05, having improved to 1:1 by the end of 2002. Against the JPY, we expect the USD to slip more modestly but nevertheless expect around 120 by the end of this year and 115 in 2003.

New challenges to US political economy supremacy

To some extent, structural change is evident in a number of challenges to the political economy status quo of the 1990s. First, the upsurge in sentiment against ‘globalisation’ and growing income inequalities within the First World and between it and the Third World have proven to be a rather unexpected challenge. Secondly, the traditional relationships between the US and Europe have begun to creak and moan. On the surface, these seem to be about what should be perfectly manageable matters of trade. However, there seems now to be a more vocal Europe and a more defensive and, in some areas, unilateralist US. Thirdly, the USD’s performance may now come to reflect some rebalancing of political alignments and maybe some changes in the performance characteristics of the European, Japanese, and even Asian economies relative to the US. The implications of these significant changes in political and economic relationships are explored further in a soon-to-be-released *Global Economic Perspectives Special* entitled “A new USD downwave—political and economic issues.” But rebalancing and realigning are also being accompanied by the tendency towards more balanced investment opportunities.

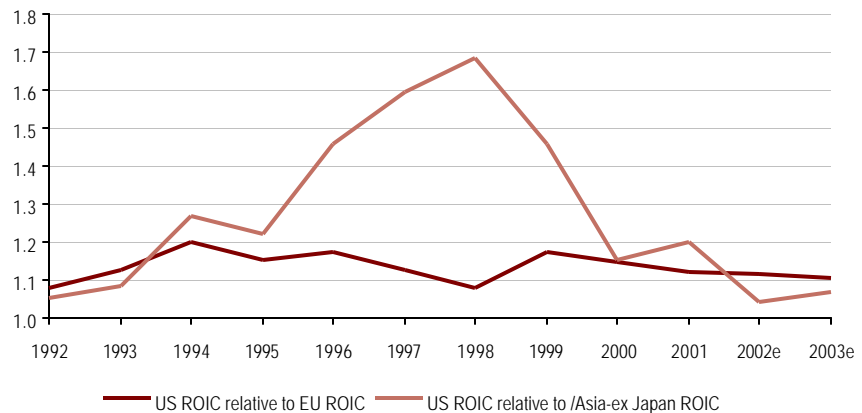
US returns constrained by past over-investments

Over the last decade the US has attracted a significant amount of capital as a result of deregulation, technology innovation, and demographic shifts. But over the past two years capital spending by the biggest companies in the US grew faster than their revenues, which stands in contrast to other regions, particularly Europe, where the opposite has occurred. Higher growth rates of productivity in the US over the past few years suggest that these heavy investments have, to some extent, paid off, though to the extent that this productivity growth has not necessarily translated into higher profitability, there is evidence to suggest some over-investment.

Other regions present greater opportunities

We believe that other regions of the world will prove to be more attractive for capital investment over the medium to longer term. Currency unification in Europe in tandem with heightened competition among European governments to attract investment via lower corporate tax rates will, in our view, drive a higher return on capital investment. Asia, meanwhile, is showing greater maturity and has clearly started recovering from the global slowdown in Q4 2001 several months before either the US or Europe. This is reflected in our bottom-up forecasts for ROIC for companies in the Dow Jones Global Index. Aggregating these forecasts for companies in the US, EU, and Asia-ex Japan, yields a decline in the US ROIC relative to the trend in Europe and Asia-ex Japan, evidenced in chart 2 below.

Chart 2: Global ROICs are converging



Source: UBSW

US investors have lately increased their purchases of foreign assets

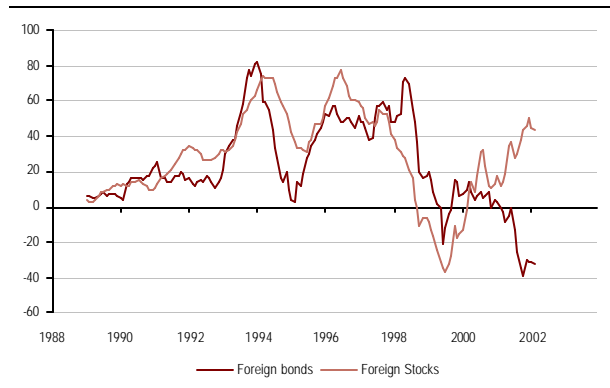
Capital account financing more troublesome for the USD

At the root of this USD downwave is the US current account deficit, which stood at \$98.8bn in the final quarter of last year, close to 4% of nominal GDP. The arithmetic of this position suggests that the US needs to attract at least a net \$1.5bn of capital per day or the USD will fall. If US investors are buying foreign assets, foreign investors will have to provide even more capital. And there is increasing evidence to suggest that US investors are indeed stepping up their purchases of foreign assets, which is one reason for the recent spate of USD weakness.

Purchases of European assets have been in high demand

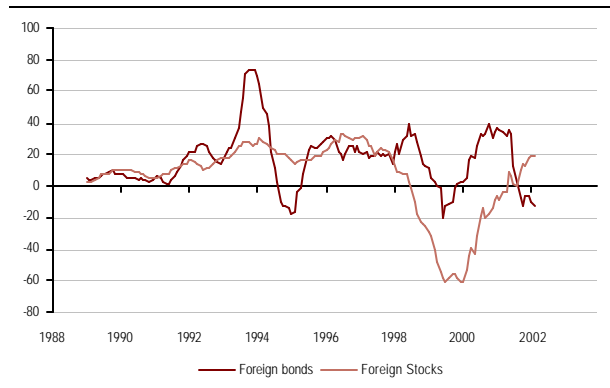
Charts 3 and 4 show the net overseas buying of foreign and European bonds and stocks by US investors. The charts, derived from US Treasury Department data, show a 12-month rolling picture of net foreign demand so that any point on the chart indicates the net foreign buying in the 12 months to that date. The charts suggest that the appetite of US investors for foreign equity has risen sharply over the last couple of years and that most of this has been due to an increase in buying European (including UK) assets.

Chart 3: Net purchases of overseas assets by US investors



Source: US Treasury/TIC data

Chart 4: Net purchases of European assets by US investors

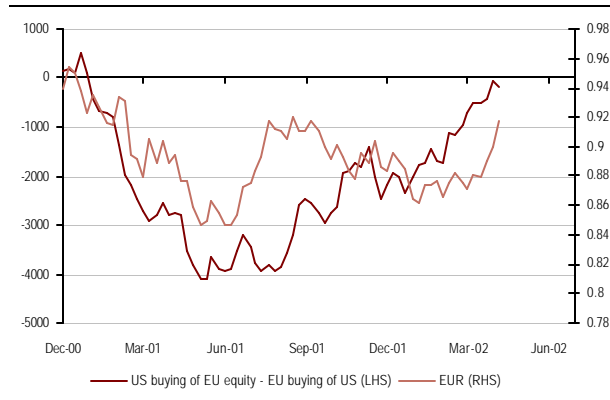


Source: US Treasury/TIC data

UBSW's flows suggest a similar pattern

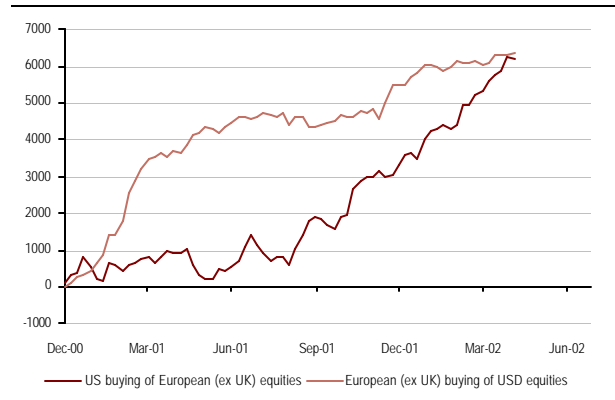
If we step away from the official data and look at the flows seen through UBS Warburg's books a similar pattern emerges. UBS Warburg monitors daily global equity market flows. The benefit that this has over the official US data is its timeliness and the fact that it incorporates derivative flows—expressed as cash equivalents. Charts 5 and 6 below show the cumulative picture (back to December 2000) and the difference between US flows into Europe and European flows into the US plotted against the value of the EUR. It goes without saying that the flows seem to have a high correlation with the value of the EUR.

Chart 5: The EUR and equity flow differentials



Source: UBSW

Chart 6: Cumulative purchases of US and European equities through UBSW



Source: UBSW

Shift in US demand for European equity can be broadly traced to Sep 2001

One further point emerges from these charts. There appears to have been a secular shift in US investor appetite for European equity that can be broadly traced to September 2001. This might reflect heightened risk aversion. US equity accounts—both retail and institutional—have until recently invested predominantly in domestic securities. The recent move to buy more non-USD stocks may reflect a process of diversification to reduce portfolio risk. But more fundamentally it might reflect a recent relative equalisation of investment opportunities, the result of excess capital investment in the United States in recent years relative to the rest of the world.

Equalisation of investment opportunities

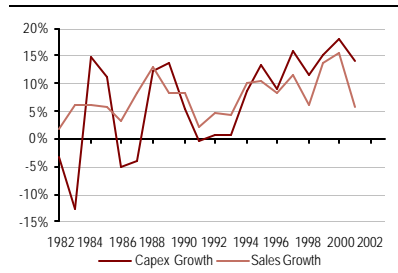
In the second half of the 1990s, the US economy benefited from an information technology-driven investment boom that raised the return on capital. Foreigners wanted to participate in this, so they bought US stocks and bonds and purchased US companies. This provided the capital required to sustain this investment boom, and insofar as domestic savings were not sufficiently large to finance the investment, helped to drive the current account deficit further into the red.

US investment boom at the root of the current account "problem"

Capex has been running ahead of revenues in the US in contrast to Japan and Europe

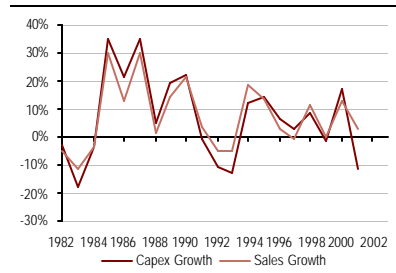
Our proprietary company-sector database suggests that capital spending by the US companies in the Dow Jones Universe peaked in 2000, but nonetheless still exceeded revenue growth by some margin in 2001, evidenced by chart 7 overleaf. In contrast to this, Europe's and—somewhat surprisingly—Japan's capital expenditure has been running fairly close to sales growth during the past few years.

Chart 7: US capex v sales growth



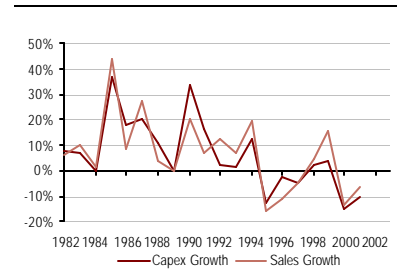
Source: UBSW

Chart 8: Europe's capex v sales growth



Source: UBSW

Chart 9: Japan's capex v sales growth



Source: UBSW

Suggests rates of return will converge, particularly between the US and Europe

This data suggests that the rate of return on capital is likely to have fallen in the United States relative to the returns that are potentially available in Europe and Japan. And to the extent that this excess investment in the US has lowered the marginal return on capital, lower interest rates are required to generate a marginal cost of capital that will boost domestic (capex) demand. Although corporate balance sheets in the US are on the mend they remain vulnerable to increases in interest rates. The maintenance of a loose US monetary policy is therefore likely to remain in force until past investment spending has been more fully absorbed or large-scale growth drivers—such as those relating to Technology and Telecoms spending during the 1990s—re-emerge.

Yields in the bond market tell a similar story

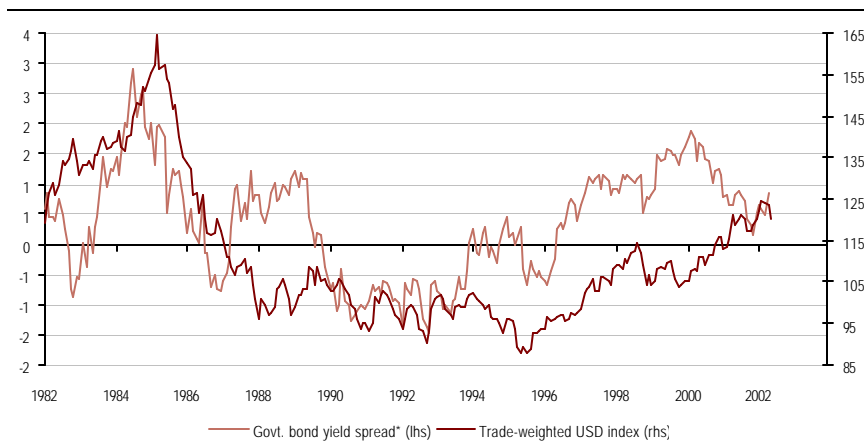
Chart 10 overleaf below shows the trade-weighted value of the USD plotted against the spread between long-term yields in the US versus an average of G7 (ex US) long-term yields. It illustrates that a close correlation has existed between relative yields in the government bond market and the relative value of the USD over the past twenty years. Yields on government bonds are a function of a host of macroeconomic factors, such as levels of short-term interest rates, inflation levels and a government's fiscal position. But in very broad terms they should reflect relative rates of return and thus provide an indication of the relative demand and supply of capital. That the relative yields on US government bonds were generally rising through the latter half of the 1990s is partly a reflection of the high level of capital investment activity that occurred in the US economy relative to other major economies, i.e., some "crowding out" of government bonds versus corporate needs. And the compression in spreads that occurred from the start of 2000 is a further indication of a relative excess of capital investment in the US versus the rest of the world.

For the USD to decline further we need to assume that higher relative returns on capital are available in other regions of the world in the period ahead. This in turn would imply that interest rate spreads between the US and the rest of the world will continue to converge.

More corporate friendly policies expected in Europe

Europe is expected to see a higher trend growth rate as tax and corporate governance laws harmonise, stimulating the restructuring of European industries. The transparency created by the introduction of the physical EUR this year in particular should lead European governments to compete with one another via fiscal policy to attract investment, suggesting continued downward pressure on corporate tax rates.

Chart 10: USD and government bond yield spread



Source: Datastream/UBSW. * Spread of US 10-yr govt. bond yield less average govt. long-term bond yield of Canada, France, Germany, UK and Japan.

Furthermore, there is a growing need for European governments to encourage more private sector funding of pensions. Corporate profits and dividends are a vital part of that funding. Further reform should yield more corporate friendly policies within the EU and the resulting increase in profitability should make European companies more attractive to all types of investors, encouraging, in turn, higher valuations and a structural increase in the value of the EUR.

Faster productivity growth expected in Asia

Elsewhere in the world, we believe that East Asian economies are also well placed to reap higher trend GDP growth in the period ahead. This is thanks largely to faster productivity growth in most of the region's economies, the result of their continued openness to trade and investment, as well as their relatively large manufacturing sectors (Hong Kong excepted). North-Asian economies and Singapore, in particular, are better placed to maintain and even expand the productivity gains seen since the Asian crisis since they benefit from high levels of IT investment and human capital.¹

UBS Warburg's Asian equity strategist Ian McLennan believes Asian equities are trading at a discount on a historical basis with our in-house forecasts suggesting that 2002 will be the first year since 1994 that Asia's return on equity could be superior to the world average. The previous times that Asia has enjoyed ROE comparable to world averages, the region's typical P/BV discount was between 5% and 25%. Today, the discount is 37%. This suggests to us that the region still looks relatively attractive despite its strong year-to-date performance.

¹ See 'Medium-term growth projections for East Asia. What sort of growth rates could East Asia see over the next five years?' Christa Janjic, 21 January 2002.

Immediate effects of FX market adjustments can be disruptive

But a weaker USD should be a medium-term positive for the global economy

A weaker USD should encourage structural reform in Europe and Japan and allow more balanced global growth

A weaker USD is positive for exports and the earnings of US companies' overseas affiliates

The impact of a weaker USD

The immediate effects of meaningful currency market changes on capital markets can be disruptive. Markets often take unkindly to the uncertainty of any move in terms of both magnitude and timing. There might be concerns about an overshoot of any initial adjustment and investors might discount—wrongly in our opinion—increases in both inflation and in official interest rates. In the same vein, the effects in markets where the currency is appreciating might be precisely the opposite—favourable on the inflation and policy fronts and supportive as regards the prospect of stronger capital inflows riding the exchange rate gain.

But however volatile and uncertain the initial effects might prove to be for capital markets, we believe that ultimately the global benefits of a weaker USD outweigh the costs and the short-run effects. In the first place, a stronger EUR and a stronger JPY would add weight and force to the need for structural reforms in Europe and (far less certain) Japan, further encouraging capital to flow to these destinations. By changing not just the short-run but also the structural configuration of both input and labour costs, competitiveness and capacity parameters, a stronger currency would encourage firms in the direction of greater M&A and more significant efforts to raise productivity growth. It's quite likely that such efforts would run into greater resistance than was the case in the US in the last 20 years but the outcome doesn't have to be a perfect match. Different versions with different roles for the state and regulatory agencies can be accommodated but the overall impact is likely to be of this nature.

The second major benefit of a weaker USD is again to force change, but this time at the macro policy level in Europe and (again, far less certain) Japan. By lowering imported inflation and thereby lifting real profit and income growth for domestic firms and individuals, policy settings can be and should be altered to allow a stronger bias to a domestic demand revival. In the case of Europe, the ECB, currently focused on a sticky headline inflation rate and expected to send out a warning interest rate signal in the next month or so, might welcome a stronger EUR in heading off inflationary pressures and significant rate increases. Japan's challenge would be quite different since a stronger JPY would amplify the country's existing deflation. But the background of a strong currency would give the Bank of Japan plenty of room in which to expand further liquidity stimulus and to move towards an explicit inflation target while also giving 'wobble room' to the fiscal authorities to reform the country's tax system with a view to long-run fiscal consolidation. We don't yet maintain, however, that the anticipated rise in the JPY is much more than a cyclical increase tied to an "in sync" global recovery in a weak USD environment.

The counterpart to more pro-active domestic demand policy management in the EU and Japan would be some breathing space in the US within which to allow exports to grow and assume a larger role in generating economic growth while, at the same time, raising the foreign earnings of US companies' affiliates. We would hope and imagine that greater reliance on the foreign sector would be a part of the adjustment process in which the domestic savings and investment gap would narrow.

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