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BuBa Boom

and America's Euro-industrials

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Two of the world's major central banks have eased monetary policy in the last 24 hours. First the Bank of Japan cut the ODR by 0.75% to 2.5%. Then, the Bundesbank cut its Lombard rate by 0.5% to 9.0% and its discount rate by 0.25% to 8.0%. And only about a week ago the U.K. cut its base lending rate by 1.0% to 6.0%. These events increase our confidence that global economic growth will strengthen late this year and into 1994. Japan and Germany have joined the U.S. and U.K. in pursuing easier monetary policies. Investors now have good reason to look beyond the trough year of 1993 and have confidence that 1994 will see economic recovery both in Europe and in Japan.

The Bundesbank's move, while long awaited, came as a surprise in its timing. The combination of interest rate cuts and reductions in bank reserve requirements shows a greater easing of monetary policy than we saw with the last interest rate cut in September 1992. BuBa has responded to a deteriorating real economy in Germany *despite* the fact that the preconditions previously laid out by BuBa have not yet been *completely* met -- although good progress on the inflation, wage and money supply growth fronts has already been made.

Further evidence of the speed of deceleration in the German economy came as BuBa was meeting. The release of industrial orders figures for Q4 1992 showed a 9.6% decline in orders for capital goods. These data, combined with the recent numbers showing industrial production declining at a 7.5% annual rate in the last three months, clearly prompted concerns about the damage being done by a very restrictive monetary policy.

Furthermore, BuBa may feel that it could justify a rate cut now because key wage negotiations (such as those with the engineering and steel workers and the public sector workers) have been completed in the 3 to 3.5% range that BuBa feels is acceptable. However, the questions about fiscal policy that remain crucial to the inflation outlook have still not been resolved. In this regard, BuBa President Schlesinger was at Wednesday's meeting that Chancellor Kohl had with the 16 state governors who must approve Kohl's draft "Solidarity Pact" plan. The meeting was adjourned without agreement on fiscal policy, and Kohl and the Governors will meet again on March 11 and 12. Thus BuBa's rate cut comes before agreement has been reached on revenue and spending plans to tackle the DM133 billion fiscal deficit in 1993 (4.5% of GDP).

Not all the elements are in place for BuBa to feel comfortable about the medium term inflationary pressure in the economy, which means that this rate cut may not be followed as swiftly by other cuts in the way past BuBa policies would suggest. Thursday's rate cut seems consistent with a gradual easing of monetary policy that began with last September's rate cut and continued two weeks ago with the 15 basis point reduction in repurchase agreement rates. These small moves are important first steps, but we are not expecting 50 basis points off the Lombard rate to *quickly* ignite European GDP growth.

Beyond the trough

However, assuming that Thursday's move is followed by further easing -- perhaps at the end of Q1 after agreement on a fiscal package -- we can begin to look beyond the trough of 1993 and into the recovery in 1994. While forecasters continue to finetune their figures for 1993 GDP growth, investors should be focusing more on 1994 numbers. As investors do so, the expectation that 1994 will be a year of recovery will lead to financial markets responding very favorably to the global easing of the last 24 hours. As evidence of this, in the U.K. the FTSE has risen to record highs in response to interest rate cuts of 400 basis points since September 1992, despite continued mixed signals on the real economy. In the U.S. the S&P 500 is at all-time highs despite a sluggish economy, as the Fed has maintained an easy monetary policy for two years. The S&P is up 37% since the Fed began cutting the discount rate in December 1990. Once again the key point is that these moves to new highs by both the FTSE and the S&P 500 come despite S&P 500 operating earnings that are 7% *below* 1989 levels, and despite expectations for U.K. economic growth in 1993 have been reduced by one-third since September.

For U.S. investors, the easing of interest rates by the world's central banks has several important consequences.

- First, the earnings of U.S. companies will benefit from the greater level of global economic activity that will ultimately result from the easing. As we have pointed out many times, many of America's largest companies are more of a play on the global economy than on the domestic U.S. economy: We estimate that 45% of S&P 500 profits now comes from overseas. U.S. companies benefit from foreign growth not just through exports (which account for about $300-400 billion per year) but through sales of U.S. foreign affiliates abroad (which run at about $1.6 trillion per year). And while Europe, Asia and Canada are equally important export markets for the U.S., each accounting for 20-25% of U.S. exports, Europe dominates the sales of U.S. foreign affiliates abroad, accounting for fully 60% of the sales of foreign subs.

- The world's most important central banks are in easing mode, which is also bullish for U.S. interest rates. The outlook for interest rates was already favorable given that inflation remains under excellent control and any fiscal stimulus is likely to be modest, with the new Clinton Administration apparently increasingly serious about reducing the budget deficit. Thus, the easing by Germany and Japan is just another factor pointing toward lower U.S. interest rates.

- Finally, the dollar should strengthen in the near term as other currencies weaken somewhat to reflect the lower interest rate environment overseas.

America's Euro-industrials

Obviously, the degree to which U.S. companies will benefit from a global rebound, and the exact timing of any favorable impact, will differ on a company-by-company and an industry-by-industry basis. But the stock prices of those companies that have significant European exposure should begin to reflect, over the next few months, the likelihood of better earnings from European operations in 1994. Five companies that have significant exposure to European markets and that are currently being recommended by PaineWebber analysts are:

Allied-Signal The company has more than half of its auto sector sales outside of the U.S., so that a recovery in the European economies would be of significance. Allied is particularly sensitive to the British, French, Spanish and Italian economies.

Digital Equipment European sales account for about 50% of revenues. Computer companies typically make more money overseas than they do in the U.S. -- pricing pressures are not as intense because IBM is not as dominant, and many of the indigenous suppliers are in financial trouble.

Ford One-third of Ford's sales in 1991 was European, but the company lost $1bn on these operations. However, every 5% increase in European dollar sales is worth an estimated $0.40-0.50 for Ford. While the near-term economic impact of the German rate cut on the European auto market is probably negligible, it increases the likelihood that European economies will grow beginning in 1994. Moreover, the U.K., which is Ford's most important foreign market, has taken steps to boost its economy by cutting interest rates 400 basis points since September, 1992 and by eliminating the 5% sales tax on cars.

Goodyear Tire This is another beneficiary from a rebound in the European auto sector, which should see increased demand for truck and auto tires. In 1991, 21% of GT's sales were European, accounting for $123m in profits. Every 5% increase in European dollar sales is worth an estimated $0.30 for GT.

3M The company derives about 30% of its total revenue from Europe. 3M's European roots are deep; it has been doing business in all of the major countries for over 30 years. 3M's exposure is primarily to broad-based manufacturing companies, with just a small exposure to the auto sector. 85% of what the company sells in Europe it makes in Europe, with only about 9% of total revenue coming from exports.

Other companies that are well positioned to benefit from a European rebound but are not currently being recommended by PaineWebber analysts (but could be candidates for "upgrade" as European economic visibility improves) include chemical companies such as **Dow Chemical**, **PPG** and **Rohm & Haas** each of which derive about one-third of earnings from Europe.

DOW is the best play given that it has the largest exposure to European commodities markets; commodities account for about 40% of DOW's operations in Europe, a greater proportion than in the U.S. By contrast, PPG's European operations are oligopolistic in nature and so are more a play on a recovery in unit volume growth. The company has heavy exposure to the auto sector, particularly in France and Italy, where it is primarily involved in the sale of paints and glass to companies such as Peugeot and Renault. Rohm & Haas' businesses are economically sensitive in a broad fashion and will benefit from a pickup in the European housing and auto sectors.

Of the electrical equipment companies, **Emerson Electric** is the best play on a rebound in Europe. In 1991, approximately 27% of EMR's net sales to unaffiliated customers went to Europe, with France accounting for 8%, and Germany and the U.K. each representing about 6%. Emerson's primary business in France is electric motors, while in Germany and the U.K. the company sells a wide array of industrial products.

Another electrical equipment play on Europe is **Honeywell**. In 1991, European operations accounted for more than 20% of its sales and roughly 27% of its operating profits. Honeywell is not a significant exporter; most of its European sales come from its subsidiaries. HON's largest production centers are in Germany and the U.K., with approximately 5% of total sales coming from each of these countries. Honeywell's primary products are home and building controls, as well as industrial process controls and components used in chemical plants, oil refineries, etc.

Selected U.S. industrial and machinery companies would benefit from a turnaround in the European auto sector. **TRINOVA** has more than half of its auto sector sales outside of the U.S., so that a recovery in the European economies would be of significance. TRINOVA is particularly sensitive to Germany where it is a supplier for BMW, Opel and Mercedes.

Prices of companies mentioned as of 2/3/93:

This report was written with William Dinning and Michael Geraghty

Allied-Signal Inc ALD ($61 7/8)
Ford Motor[1] F ($47 3/4)
PPG Industries PPG ($64 1/4)
Digital Equipment[1] DEC ($43 3/4)
Goodyear Tire & Rubber GT ($71)
Rohm & Haas[1] ROH ($55 1/2)
Dow Chemical[1] DOW ($53 3/4)
Honeywell Inc HON ($33 1/8)
TRINOVA Corp TNV ($25 7/8)
Emerson Electric EMR ($55 1/4)
Minnesota Mng/Mfg MMM ($100 3/4)

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