

Remarks on the outlook for the global economy and non-US capital markets

Before Asia Pacific Association of Fiduciary Studies, Saipan, 4 Nov 2005

- Although this is my first time to be in Saipan, it is a great pleasure to be here with you again in the relaxed atmosphere of the Pacific Investment Forum.

- I have been asked to make some comments on the outlook for non-US capital markets. As I will note that whilst the official base economic case is still quite benign, it must be hedged with more than the normal number of caveats. Stock markets themselves are usually much more volatile than the macroeconomic figures tend to warrant.

- A **first caveat** I should make is to quote that old philosopher Yogi Berra, the former manager of the New York Yankees, who warned us quote 'to be careful about making predictions, especially about the future!' He may have been talking about baseball, but it applies equally to economics and capital markets predictions - and no more so than today.

-The **second caveat** is that we can only talk about what happens in non US markets in the context of what happens in the US, since markets have become very highly correlated in this era of globalisation and relatively free capital movements. A lot has changed since the end of the Cold War, as India and China have modernised, and, by some reckoning the global labour force available internationally has doubled.

- We are meeting ahead of what could be a very challenging period in the global markets. The painful correction from the excesses of the dotcom boom, 911 and the Asian crisis of 1997-8 ended around the end of 2002. The markets have therefore been in a recovery period for three years and economic recovery in the US has been ongoing for slightly longer. In cyclical terms the upswing is getting long in the tooth and many imbalances have become embedded in the system, which pose dangers for the markets should something occur to make them unwind in a dramatic fashion.

Let me enumerate some of the uncertainties:

- **The present period has been characterised as one of unstable equilibrium;** a condition that an unexpected change could easily upset the apparent equilibrium with uncertain consequences. The timing of any change is uncertain since the present situation, whilst not ideal, works in the favour of the current players; Asia exports to the US and receives USD that it invests in the US Treasury market. It would probably take some external stimulus to change that calculus for one or more of the players, thereby upsetting the equilibrium.

- Chief amongst these imbalances is the US current account deficit, which has reached levels unprecedented historically. Today, it approaches 7 percent of the

US GDP. Every year the foreign debt of the US grows by about this amount and is now in excess of 30 percent of GDP and in 2-3 years time could be heading towards 50 percent of GDP.

- More than half of all US Treasuries are now owned by foreigners. Imbalances of this magnitude usually foretell trouble. The present level of foreign indebtedness is more than it took to send Argentina into default. Fortunately, Argentina is not America. The US since it borrows in its own currency can avoid formal default because it can always print more, as Mr. Bernanke has noted. However, it probably cannot avoid an adjustment at some point, which could occur through a depreciation of the currency or a recession. The question is how close we are to that point.

- The US current account deficit is, in turn, fed by the US budget deficit. Unfortunately, with the situation in Iraq, the fallout from Katrina and general disorganisation in the White House as a result of these matters as well as the recent indictment and ongoing investigation over the CIA leaks, we have a somewhat dysfunctional state unable or unwilling to address core economic issues.

- Coupled with these uncertainties we have **a new head of the Federal Reserve Board**, Ben Bernanke, taking up his position in February 2006. Whatever else his qualities, he has no experience of the financial markets. It seems highly probable that the markets will test his resolve soon after coming to office. They did this with Arthur Burns in 1972-74, William Miller in 1978, Paul Volcker in 1979 and Alan Greenspan in 1987. Miller failed miserably and had to be replaced within a year of taking the job. The markets have already started to move with longer-term interest rates increasing since Bernanke's appointment was announced.

- The markets also have a hidden threat – that of **a derivatives accident**. The recent expansion has been powered by an explosion of debt and a transfer of the credit risk from banks to other parties who may not be fully aware of all the risks they are assuming. Many of these derivatives are hidden away from the balance sheet in a most opaque manner. Fannie Mae is just one example of this. It will be a challenge for the authorities to make these risks more transparent and controllable in order to avoid a systemic explosion. The Fed will need a steady hand at the tiller if, as, and when any such events threaten.

- **Other risks that make any predictions more hazardous than usual are the outlook for interest rates, inflation and oil.**

- Short-term interest rates still have further to go on the upside, perhaps even more than the market is expecting. Indeed, the Fed recognises that it has an incipient inflation problem. It certainly will not want to revisit the situation of the 1970s under the last professional economist to head the Fed, Arthur Burns, who

allowed high inflation to become imbedded in the system. Will Bernanke be a hawk or a dove? The opinions vary and only time will tell. I suspect he will look at Burns experience and not want to replicate it. But at the same time, he is a political animal.

- Oil prices are a further unknowable. They have been driven higher by the global growth in demand especially from the emerging economies such as China and India where per capita consumption is still modest but expanding rapidly with industrialisation and the beginnings of a car culture. Speculation and the lack of new refining capacity in the US have also contributed to firmer prices. Prices may have topped out for the time being but that is not really something one can take to the bank. The International Institute for Economics in Washington still thinks they have the potential to reach \$100 a barrel.

- Inflation is wretchedly difficult to measure and the Government's present measures certainly fail miserably to provide a realistic picture of the situation faced by the average consumer. They get housing costs completely wrong, they fail to recognise the importance of services and they make heroic assumptions about why when we spend more on computers we are really spending less because all the bells and whistles we are being forced to buy, but do not know how to use, are making us more productive! Right!

- A more realistic adjustment for housing costs alone would add 3 or more points to inflation. Under these circumstances the interest rates set by the Fed are less than zero in real terms. It is this fact that encourages consumers to increase their indebtedness even if real wages are stagnant or declining.

- So we have a range of factors whose outcome is unknowable at this point. However, if we assume as a base case that interest rates, inflation and oil prices are reasonably well behaved, what is the global outlook?

The World

- Globally, growth in 2005 has been the best in almost 30 years and using these assumptions, the IMF maintains a relatively benign outlook for the global economy with growth holding level at 4.3 percent, assuming an average oil price of \$61 in 2006 and US interest rates rising from 3.6 to 4.5 percent. I should also mention that they assume the trade-weighted value of the dollar is unchanged from its August 2005 level. That is also the sort of heroic assumption that economists are often forced to take. *The reality is that the dollar will probably be volatile and, if I may quote Paul Volcker, in the long run needs to correct , perhaps 20-30 percent.* But as John Maynard Keynes said at different times: ' in the long run we are all dead' and also ' the markets can stay irrational for longer than the average investor can stay solvent'.

The US

- Under these circumstances the IMF sees the US economy slowing down next year to about 3.2 percent from about 3.5 percent. (These figures were pre-Katrina, but I suspect that tragedy would not have a huge impact on US overall numbers next year, except to increase the deficit.) Since I am a believer in Murphy's Law, I believe the odds favour a sharper slowdown.

Europe

-The Eurozone will remain mired in stagnation with weak governments in the three main countries France, Germany and Italy. The IMF projects growth to improve marginally from 1.2 to 1.6 percent. I would, however, caution that they do this almost every year at this time and then have to downgrade again at mid year. There simply is no political will in Europe to change its economic model and stagnation at the core will remain unless there are significant political changes. However, as I will note later there is an interesting twist to this situation.

- Europe seems content to enjoy its genteel slide in relative economic power and relevance for the time being. The French even seem to be, at least rhetorically, willing to flirt with protectionism to maintain what they have and close the doors to globalisation and wreck to Doha trade round to save the 1 percent of their population that are still farmers. I hope and presume that cooler heads will eventually prevail.

-Spain and the Central European countries will continue to grow faster at 3-5 percent as they converge with core Europe.

Oil and commodity producers as a group are expected to continue to benefit from the recent strong prices.

- Russia, which is not in the EU, is expected to grow at over 5.5 percent powered by its oil and gas exports.

- Canada, another beneficiary of higher commodity prices is projected to grow at 3.2 percent, an improvement over 2005.

But I am sure you are more interested in the outlook for Japan and the rest of Asia.

- Japan is predicted to continue its recovery at a flat 2 percent growth rate whilst China is predicted slow somewhat from 9 to 8.2 percent. However, there is uncertainty here as elsewhere; CSFB, for instance, is looking for China's growth rate to accelerate to 10 percent. I would be very sceptical of that given the impact of high oil prices and energy shortages that still has to work its way through the economy and what appears to be a decline in domestic credit growth. However, regardless, the Chinese juggernaut moves inexorably forward. The world now

has two primary growth nodes, the US and China. These nodes are related, but even if the US growth rate were to sag, the Chinese rate would still be expected to move forward at a very healthy clip. Six percent growth is a Chinese recession!

- The story is similar with the other emerging economies continuing to show excellent performance. The Asian Development Bank estimates that:

- India should move forward at a healthy clip of 6.2 percent, albeit down somewhat from 2005's expected 7.2 percent rate as oil prices work their way through the economy.

- Korea, on the other hand, is expected to pick up from 3.6 to 4.8 percent and the core members of ASEAN are also to be buoyed by strong commodity prices with Indonesia increasing to a 5.3 percent rate, Malaysia to 5.3 percent, the Philippines to 4.7 percent, and Thailand to 5 percent and Vietnam to 7.6 percent.

- With this economic background in mind, what are the possible implications for the equity markets?

My first point would be that FTI are bottom-up investors looking at attractive companies and sectors. The macroeconomic picture I have painted is purely background since there are attractive opportunities in many places much of the time. The performance of the various markets is as influenced by factors such as liquidity and valuations more than economic growth rates.

At Templeton, we are heavily influenced by valuations and, in this regard, you may be surprised to learn that we are heavily overweight Europe. Given what I said previously about Europe growth prospects that may seem counter intuitive. However, probably nothing perhaps better exemplifies the disconnection between overall sluggish macro growth and opportunity than this. Europe has many global companies that have restructured themselves to perform in the global markets in areas such as finance (for example HSBC) and oil and gas (Shell and BP) and relatively speaking they are better value than their US comparators.

Opportunities seem higher these days in emerging markets generally since they have higher underlying growth rates, better demographics etc. Whilst some are beneficiaries of the improvements in commodity prices, others will suffer from increased oil prices. We are overweight Asia and dramatically underweight the US in the Templeton Global Equity Composite versus the MSCI All Country World Index.

These relative regional weightings can be seen on the attached chart alongside portfolio sector weightings.

On valuations, I note that Germany, Austria and Belgium sell for 6-8 times cash earnings compared with 15 x for the US.

Korea and Thailand sell for 6-7 x cash earnings and Thailand yields almost 4 percent. Both are fast growing economies. Korea now has a market cap of 35 percent GDP compared with well in excess of 100 percent at the time of the Seoul Olympics in 1988. The Korean market index has gone nowhere for 16 years whilst the economy has trebled in size. The US market performed this way from 1966 to 1982 and just look at what it did from 1982-2000. Korea could do the same!

Thailand is also a particular favourite of mine. It sells for about 17 percent of GDP. It sold for over 100 percent GDP in 1994. It also yields about 4 percent compared with 2 percent or less elsewhere.

International diversification therefore can provide:

- * exposure to faster growing economies and potentially higher returns
- * these economies are often in different parts of the growth cycle and can therefore reduced volatility of returns

I'd like to close here and look forward to your questions and comments.

Thank you.

William R. Thomson
Senior Adviser
Franklin Templeton International inc.
Hong Kong
4 November 2005