

It's a Small World After All!

How quickly things change! Just a couple of months ago, the US equity market was focusing on the idea of rapidly rising inflation, driven by escalating energy and food costs and continued strong global growth. This quarter, concerns over slower US growth have been upstaged by increasing fears of slowing global growth. Energy prices, up almost 50% in the first half of the year and almost 100% in the 12 months ended June 30th, have fallen about 25% this quarter.

Despite the fact that growth in developed economies continues to deteriorate, the realization that growth is slowing in emerging markets has had a significant effect on recent relative performance in the global equity market. Even though the S & P 500 is currently down over 1% quarter to date, emerging markets have performed much worse. Overall, the developed markets have now done relatively better on a year-to-date basis, reversing a trend that has been in place for the last few years.

The theme of slowing global growth has been reflected in the sector performance within the S&P 500 Index. Energy and Materials, which had been stellar performers over the last few years, have been the worst performing sectors in the Index quarter-to-date, while Consumer Discretionary and Financials have been the best performing sectors. Despite the fact that fundamentals continue to be poor, these two sectors have benefited from their relatively higher exposure to the domestic economy.

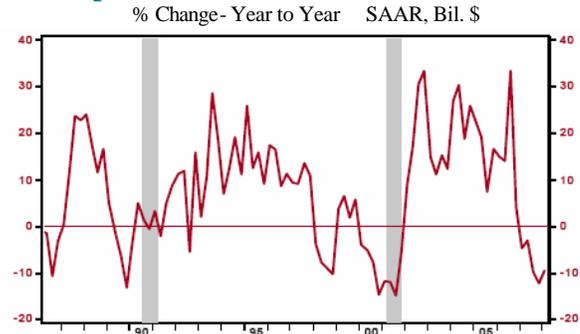
The shift in favor of domestic has also shown up in the relative outperformance of small caps, which derive a much lower percentage of their earnings from overseas than do large caps. Quarter-to-date, small caps, as represented by the Russell 2000 Index, are up about 6% while the large cap Russell 1000 is down about 2%. In every sector except Energy, small caps have performed better than their large cap counterparts. Historically, this has happened at the beginning of an economic upturn. However, this relative performance is occurring at a time when the macro environment is continuing to deteriorate.

In fact, domestic economic data has continued to be disappointing. Employment statistics have worsened, housing inventories have remained worryingly high, profit margins are getting squeezed and credit has continued to tighten. Elsewhere in the developed world, growth is also slowing. Europe and Japan are slowing further, as is Australia, where recent growth has been fueled by the commodities boom.

But it has really been the emerging markets that have fueled the surge in global growth over the last few years and pushed up commodity prices. They have been growing at rapid rates - much faster than the developed economies. Any slowdown in these markets would have major implications for global growth, and the possibility of a global slowdown is more relevant than ever to the US. It not only has implications for energy prices, but for US earnings growth. Our recent GDP growth has been helped significantly by strong export growth and a weak dollar. These same factors have been holding up corporate profits. Year-over-year, US corporate net income from foreign operations has been running up 34%, while net income from domestic sources has

fallen about 10% in the past year, as shown in the chart below. The proportion of S&P earnings from abroad has been rising over the last few years and reached an all-time high of 45% at the end of 2007. Obviously a slowdown in export growth will negatively impact GDP as well as corporate profits.

Corporate Profits: Domestic Industries



Shaded areas represent recession periods.
Source: Bureau of Economic Analysis, Merrill Lynch

Related to emerging markets' growth, a quick glance at the headlines does show signs of slowing in these markets. China's GDP growth, which has been expanding at a double-digit rate for the past five years, is slowing this year and may come in below 10%, primarily due to slowing exports. Manufacturing businesses in China are getting squeezed by rising oil prices, higher interest rates, a significantly appreciating currency, an inability to raise prices, and now weakening economies in the developed world.

India's growth slowed to 7.9% last quarter, the slowest pace since 2004, due to the highest inflation in a decade (12.4%), a steep falloff in manufacturing growth, and tightening credit. The Russian economy expanded at 7.6% in the second quarter versus 8.5% in the previous period, according to a Bloomberg survey. The slower growth is attributable to a higher cost of credit, a strong currency, and rising consumer prices. In Brazil, second quarter economic growth may have slowed to 5.6% from 5.8% in the first quarter, with inflation slowing slightly from a three-year high of 6.4%.

Although there may be further adjustments in world equity markets to reflect the slower growth, we would make several observations. The developing economies continue to grow at a much faster rate than the established economies. Global inflation is starting to abate, as food and energy prices come down. This should allow policymakers around the world to become more accommodative. In the US, macro conditions should continue to be poor for awhile, with earnings estimates likely to fall further. Thus the recent shift in the equity market to a domestic focus could be somewhat premature, as emerging markets should continue to provide a growing source of demand for US companies.

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