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## Growth in Asia propels US stocks

By Joergen Oerstroem Moeller

***Editor's note:*** *This article was written the day before Wall Street suffered its worst setback in more than four months on Monday, with the Dow Jones Industrial Average falling 158 points. Various factors contributed to the fall: weak retail-sales estimates spurred concerns about the holiday shopping season; the US dollar continued to decline for a fifth day; and crude-oil prices rose. But Monday's stock selloff ended a steady run-up in prices in recent weeks, and the argument presented in this article is by no means negated.*

It looks like something is wrong. Wall Street is not behaving in accordance with conventional economic theory. It goes up when it should go down.

All omens point to a sluggish US economy in 2007. The latest revised growth predictions forecast a fall from 3.6% in 2006 to 2.9% in 2007. The increase in labor force plus growth in productivity, the instrumental forces behind the high growth for a number of years, will be less favorable in the years to come and bring the economy down to a trend growth of around 2.5%. [1] Admittedly, such figures are full of uncertainties, but all indicators announce a lower trend growth in the coming years.

Stock markets should react to such predictions by falling or at least not moving very much, but contrary to conventional wisdom, Wall Street and Nasdaq are actually rising. Not even 16 consecutive increases by the Federal Reserve of the short-term interest rate, bringing it to 5.25%, has dampened the market.

When analyzing behavior out of tune with theory, the observer can say that the theory is correct and the stock market will realize that sooner or later, or that the stock markets know or react to factors most of us do not incorporate in our analysis.

Let us go straight to the second option. The stock market knows that we are living in a global world. Most of the companies listed on Wall Street get most of their profits from the domestic US market, but less so every year. Revenue from the US market is still very high, but growth in revenues and profits from Asia outshines US figures. Such companies as Microsoft, Oracle, General Electric and Dell switch more and more to the buoyant and unstoppable growth machines in Asia - China, India and the majority of Southeast Asian countries. They sell to these countries, they invest in them, and they move more and more of their research and development to them.

This has the following consequences for stock prices on Wall Street.

When investors look at buying stocks, they among other things focus on price/earnings (p/e) ratio. Basic arithmetic tells us that with 1.2 billion people in China and an annual economic growth rate of about 10% in the years to come, the increase in purchasing power will be of a magnitude not yet seen. Add to this 1 billion Indians and about 500 million people in Southeast Asia, and they far outweigh any increase in US purchasing power. This is in particular true as a rising middle class with strong purchasing power emerges.

A stock may show a traditional p/e of, let us say, 15, but if we add in the growth prospects from

Asia, a p/e much higher does not look out of tune. If p/e is above the average or normal level, the question is how long it takes for earnings to catch up - to produce earnings higher than estimated, thus bringing p/e back to normal. That depends on growth prospects and, as just outlined, the huge and fast-growing Asian markets will sharply reduce this length of time in the future.

A large part of the investors operating on Wall Street may still be American, particularly where pension funds are concerned. They want to buy a share of tomorrow's production to finance future payments, and to achieve such a performance, they look to companies getting an increasing share of profit on growth markets. This is where money is earned and production will take place. The pension claims from a growing number of people above 65 years of age dwarfs a fixed return from bonds, hence in reality eliminating bonds as a viable competitor to stocks, which explains why pension funds will gradually swing their portfolios from bonds to stocks and opt for overweight in companies having gained a firm foothold in Asia.

It is actually quite rational for stock markets to go up even in the shadow of a short-term economic slowdown and a growth trend falling to 2.5% for the US, because the market has concluded that this is not where growth is going to take place anyway.

As long as growth prospects for Asia remain bullish, there is no reason to expect falling stock prices on Wall Street for those companies acting as global players.

There are three key observations to learn from this analysis:

- To realize that an increasing number of American companies are only American by name and legal status but in reality global companies having chosen for historical and other reasons to maintain their headquarters in the US.
- To understand that pension funds are buying stocks expected to produce high earnings in the future, giving the pension funds the money they need to honor claims. Pension funds cannot live with a fixed income from bonds. They need to opt for a share of future production, and the answer is to buy growth stocks.
- To look at future stock prices not on the basis of an X-ray picture telling how the situation is right now but a flow - dynamic - analysis telling which markets will be decisive in the future.

***Note***

1. The Economist, October 26, 2006.

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