No alternative to growth

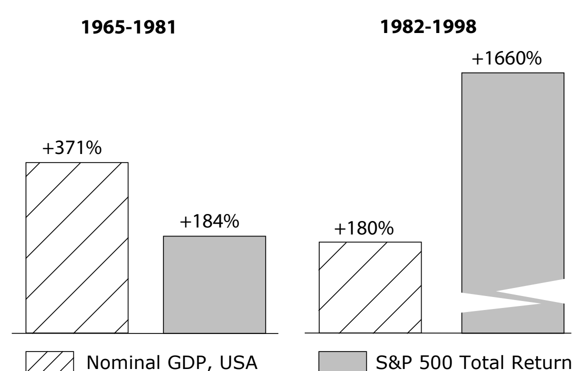
1. What equities have in common with apples and diamonds

Virtually every investment analysis begins with an overview of the economic situation. This is followed by a review of the current monetary conditions, including considerations on interest rates, and these can hardly be provided without dealing with currency relationships. After doubling back to economic growth and forwards to inflation or – depending on the prevailing mood – deflation expectations, one sooner or later arrives at the outlook for the stock markets – the matter of greatest interest to readers; understandably, in view of this investment sector's high potential for gains or losses. The sequence of these considerations suggests causality: high expectations of gains on the stock markets are justified with an attractive economic outlook, low or falling interest rates, fairly reasonable currency relationships and the absence of inflation or deflation.

If only it were that simple! A straightforward input-output model: economy, interest rates currencies, in; expected stock market returns out – simply and mechanically plannable. It would release not only the author of this investment commentary from future tiresome and laborious analyses. However, a glance at some data from the past reveals that there can be no such thing as simply modellable causality. The figure below depicts the growth of the US economy and the returns on the American stock exchanges for two different periods.

As we know, the 1970s and early 1980s were characterized by several periods of inflation, the 1973/74 and 1979/80 oil crises, the demoralizing effect of the Vietnam War and a series of fairly colourless and sometimes incompetent American presidents. The change came with Ronald Reagan at the beginning of the 1980s. The USA recovered its confidence and coherence. Astoundingly however, in this period the US economy grew significantly less than in the preceding decade. The reverse was true of the rise in stock market prices. 184 percent over 17 years produces an annualized return of just 6.2 percent. From 1982 onwards, by contrast, investors could look forward to 18.4 percent per annum.

High economic growth – low returns?



Source: Bureau of Economic Analysis, Bloomberg, own presentation

This is somewhat confusing. If it is true that share prices have something to do with the revenue situation of the companies whose equity the shares represent, and if it is so that the revenue situation has something to do with the economic situation in which the companies operate, then it must also be the case that equity prices are dependent on economic growth. Anything else would mean that equity prices were arrived at entirely unrelated to any actual economic circumstances, almost like in a casino. An accusation frequently made by fundamentalist anti-capitalists.

From an economic perspective, there is no simple causality between economic growth, company profits and share prices, nor is the accusation true that stock markets are simply playgrounds for wicked speculators. Share prices constitute the price of a part in the equity of companies, and as such do not differ significantly from the prices of apples or diamonds. From an economic point of view, there are no objective criteria for prices. Prices are arrived at because a number of individuals with highly individual perceptions exchange goods under conditions that seem to them appropri-

ate. That a morsel of pure carbon can be worth so much, despite the fact that one cannot eat or drink it, while a wonderful natural product – for which mankind was prepared to be driven out of Paradise, no less – is worth only a fraction of the price of a diamond, is simply a matter of the individual perception of economic benefit. And such perceptions can change significantly over time. Thus there was a time in Holland when whole fortunes were paid for tulip bulbs. And there was a time, at the beginning of the 1980s, in which investors obviously became more and more keen on American equities, regardless of objective criteria such as economic growth or company profits.

2. P/E ratio of 30 or 3?

There have, of course, been numerous attempts to get a grasp of these individual, and ultimately all-important components of the pricing of equities –investment decisions are, after all, based on such insights. The P/E ratio is a figure which appears to provide information about the attractiveness of equities. If a relatively high price is paid for a share in the future profits of a company, and thus for a share in the equity, the figure is relatively high – 20, 25 or even 30 and more. The readiness to pay a high price in relationship to the actual profits generated implies expectations of a significant improvement in the future. If these expectations are disappointed, investors' enthusiasm usually drops very sharply, and the P/E ratio falls to perhaps 15 or even 10 and less.

This may seem simple and trivial, but it is not. Why? For one thing, P/E ratios in the market typically fluctuate over time as if they were steered by an invisible hand. First apples are more popular, and then diamonds, and nobody can really explain why this happens or when the shift takes place. There seems to be an average value around which investors' enthusiasm waxes and wanes, and this is about 15. On this basis, pricing above this figure, such as we are currently again seeing in the USA (the P/E ratio for many stocks is now 25 and above) must be regarded as "high" or even "significantly overvalued". Such a valuation naturally implies that there are limits to the potential for future improvement.

This matter is also not trivial in that it raises the question of which "earnings", i.e. which measurement of company profits, are in fact relevant. We have said that pricing is based on an individual decision on benefit. If this is so, then the individual benefit must be costed, and then what matters is not the size of the "earnings" that leave the company, but the form in which they reach the individual investor, and what consequences they have for him. Is his profit simply taxed away? Or can it be simply reinvested? Does managing it require the employment of a whole army of consultants? The American economist Arthur Laffer, known for the curve named after him that represents the relationship between tax gathered and the rate of taxation, has recently introduced a new P/E ratio, that takes account of individual benefit. He argues that since the 1950s the individual tax burden on "earnings" has fallen continuously. Together with low interest rates, which – in terms of individual benefit – make the money or bond markets appear unattractive as investment alternatives, this results in a P/E ratio of somewhat over 3 for the S&P 500 stocks: in other words, the American stock market has never been so cheap. A clear signal to buy – refreshing in an environment teeming with pessimists of every variety. Though it does appear to us that, according to Laffer, such a signal would also have been given in the Spring of 2000. So whether it is entirely wise to rely on Laffer when making investment decisions remains an open question.

Look at it how you like, we can analyze ratios and their rates of change till the end of time, but this will not solve the problem of the relative attractiveness of apples and diamonds. And above all, it seems particularly difficult to forecast when opinions will change. According to Laffer, it is time that everyone finally acknowledged how cheap American stocks are. But according to other, no less prominent prophets, such as Warren Buffet, Robert Shiller and Andrew Smithers, valuations have already far exceeded the bounds of reason. According to Laffer, the American economy needs to grow only insignificantly to justify current stock prices. If the pessimists who perceive over-valuation are right, then the future cash flows of American companies would need to double, treble or quadruple within the near future – which seems questionable, given the once again comfortable profit situation and the generous margins. What are we to make of this divergence? The following interpretation may not be entirely erroneous. Both views are equally correct, but also equally questionable. Future developments are subject to probability, and thus cannot be determined. It *may* be that "America" is over-valued, if all that the pessimists fear comes to pass. But it *may* also

be that everything turns out differently, and better; that productivity and economic growth shoot up remarkably, or even that Mr Laffer is right with his very low need for growth. Neither of these extreme positions can take us much further.

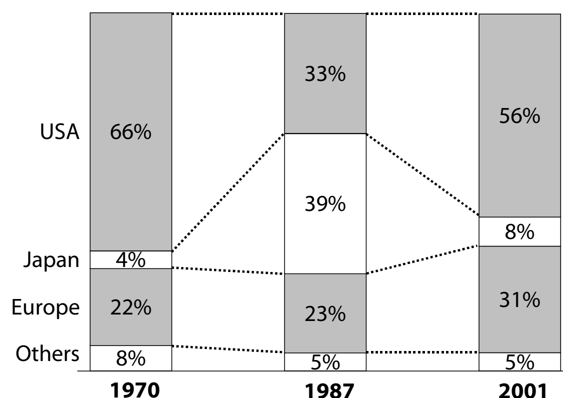
The stock markets send signals, by means of option prices, about the estimated probability of various – extreme or less extreme – development paths. The current extremely low volatilities indicate that the market currently expects a degree of normality in future developments. In this case the extreme positions of both Mr Laffer and the fundamental pessimists would seem to be inappropriate, and investors would be well advised to underweight their investments in the USA, so as to keep the current probability set within narrow boundaries.

3. The world is less global than it looks

Even if we reject Laffer's P/E ratio as impractical, it seems important to us to seize on, and reflect on, a central element of the argument: as prices, share prices are the aggregated result of demand determined by individual benefit considerations, and thus cannot be separated from the objective und subjective appreciation of the individual. The P/E ratio as yardstick for whole economic regions must include the prevailing appreciations, unless we suppose that the whole world is made up of individuals with identical approaches to global investment.

This is, of course, not the case. Americans – in particular – invest in America, Germans in Germany, the French in France; only the Swiss, and with them a small community of traditionally globalized investors, venture out to any extent into the global investment arena. Worldwide, there is only very limited arbitrage between the regions. Capital flows can obviously only be redirected very slowly.

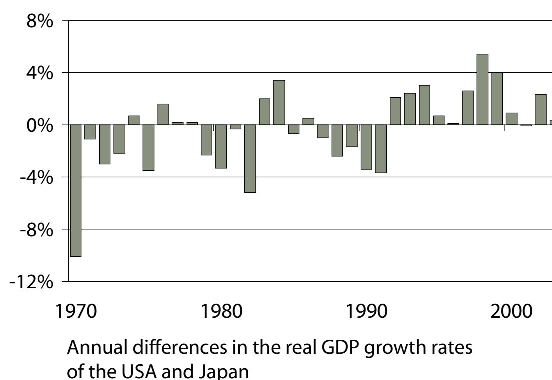
Regional shares of global stock market capitalization



Source: MSCI, own presentation

The figure above shows the development over time in the attractiveness of various regions, measured by the total capitalization of their stock markets. The differences over time can be very pronounced, as shown by the example of Japan, and some economic regions seem to be significantly underrepresented over time, as in the case of Europe for example, which contains such important national economies as Germany.

Differing GDP growth rates



Source: Datastream, own resentation

If one considers the differences in the real annual GDP growth rates of the USA und Japan over time, then here too, it becomes clear that any such relationship is dependable only to a very limited extent. Economic importance comes and goes; market capitalization comes and goes; everything is in a state of flux, and no-one seems to know why, when or to what extent. An attractive outlook for forecasters and investment advisers – one would like to be able, and one should be able, to di-

rect the funds to where one can next make a killing!

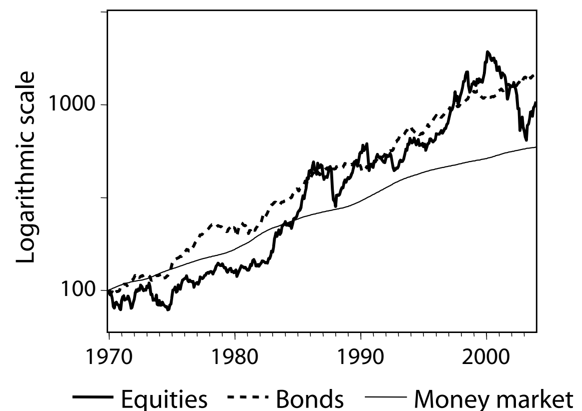
So little explanatory power is unsatisfactory, even for the author of this commentary, who is notorious for referring to our very limited understanding of complex interrelationships. Perhaps we should attempt to reverse the causality. So then, not high economic growth, therefore high company earnings, therefore higher equity prices, but rather a build-up of expectations due to investments on the stock markets, followed by enforced higher company profitability, resulting in the coercion of higher economic growth rates. This model can be tested on the German economy.

4. Enforced shareholding

Let us assume that technological advances have resulted in a sustained series of productivity improvements in the economy (which is undoubtedly true of recent years). Further, that the global political situation has, by means of outsourcing, enabled the restrictions of the domestic labour market to be circumvented with increasing success (which also appears to be a highly realistic assumption in our view). Lastly, that given the population structure, domestic demand will tend to weaken. If all these assumptions are correct then the logical result should be a markedly non-inflationary environment with sustained low interest rates.

Sustained low interest rates, little or no inflationary pressure: these are conditions that Germans have hardly ever been exposed to in the post-war period, either as individual investors or collectively. The fact that on the other side of the Rhine interest income is known as "Rente", or "pension" itself demonstrates the particular mindset in Germany – namely that income streams from invested funds will flow so regularly and to such an extent that they can be used to finance livelihoods in the same way as an old age pensioner's pension does. And this was indeed the case for decades. The figure below clearly shows that for Germans since 1970, the stock market has only very sporadically and to a very limited extent been superior to bonds and money market investments as a place to invest. For a very long time, it was simply not worthwhile accepting the additional risk of buying equities.

Holding equities has hardly ever been worthwhile in Germany



Source: Globalfindata, Bloomberg, own presentation

Rising rates of tax on interest income and ever lower interest rates, both on the money market and for longer-term bonds, have drastically altered the benefit situation for individual Germans. It is simply no longer possible to live off interest income, and the word "Rente" has become obsolete. If the assumed conditions remain reasonably stable, Germans will *have* to take refuge with their savings on the stock markets. And not only has the individual benefit situation changed – the financing of the German economy will self-evidently also be forced to change drastically. When not even minimal returns can be had on savings accounts with banks, the whole credit-based financing of German companies becomes a thing of the past. The excessive influence of the banks will be drastically reduced. Equity-based finance will replace bank credits, which is indeed highly desirable, as German SMEs in particular tend to have low equity levels. This structural deficit is undoubtedly part of the reason for the currently miserable economic growth rate. Risk appetite, and particularly also the ability to undertake major investments are thus kept within narrow constraints. This debt orientation also results in a limited and local approach to takeovers. It is hardly surprising that there is a lack of readiness to invest, and thus of growth, under such conditions.

What will happen in the next few years is foreseeable. For the lack of alternatives, Germans will be forced to have greater recourse to the stock market. German private investors currently have 6 percent of their investments in equities, and institutional investors around 9 percent. So there is undoubtedly some leeway

here. It is also interesting that up until the First World War Germany was much keener on equities. A significantly greater number of companies than today were at the time organized as joint-stock companies. War, and the deliberate destruction or expulsion of the Jews (who were inclined to share-holding) brought about the currently prevailing corporate structure of the German economy. As mentioned, this will change, not because anyone particularly wants it to, but because individuals will be forced to change, and the system with them.

5. Popular capitalism against the reform logjam

Now, it might be objected that the situation in Germany is so hopelessly skewed, in terms of the inefficiency of the labour market, the high level of taxation, the generosity of social benefits and subsidies, the enthusiasm for regulation, and the envy of higher earners, that a shift towards equities would be bound to end in disaster. That it is utterly inconceivable, regardless of the pro-reform rhetoric of the ruling coalition and the pro-reform professions of the opposition, that German companies could ever manage their domestic personnel in the way that this can be done in the USA for example. That the right of consultation is as firmly embedded in the social market economy as the Zugspitze in the Bavarian Alps, and that any reduction in the claims to power of trades union functionaries is inconceivable. That subsidies now cover practically all parts and all levels of the population, so that any reductions would be politically impossible to achieve, indeed that no serious attempt could even be made. That the average German is anyway only concerned about protecting acquired rights and that a priori narrow boundaries would be set to the installation of growth-oriented incentive systems within the network of the social state.

To argue in this fashion is to think in political terms only, and to ignore the power of economic principles. We have set out above why, under the given conditions, capital would *have* to shift away from the interest-bearing area of money-market and bond investments and towards equities. Investments in equities are riskier than fixed-interest investments, and because they are, they have to provide higher returns. But they can only provide higher returns if companies achieve greater profitability, and this they will only do if they are forced to. For greater profitability is synonymous with different, more efficient structures, with lay-offs, with investments, with the employment of new personnel, with new wage systems, with longer working hours – all of these inconvenient, disagreeable, largely unattractive, high-risk actions that will certainly not be undertaken voluntarily. They are, however, necessary in order to satisfy the expectations concerning the return on capital invested in equities. Structural changes and investments result in higher productivity; higher productivity is the precondition for greater profitability, and a continuous striving for greater profitability is the necessary consequence demanded by the capital deployed.

The big question is, of course, whether capital will get its way. Given the numerous asymmetries between incentives and interests, no democracy is likely to be able to achieve a general reform, even when there is universal recognition that reforms are essential because zero growth will sooner or later starve the political system to death. Such a step is probably only possible if, through the sufficiently widespread dispersion of capitalist interests throughout the population, there is a high degree of accord between economic requirements and political calculation. In our view, things do not look bad, either for Germany or for other European countries, such as France Italy and the Benelux area. Interest rates are low throughout the Eurozone, so that the shift towards equities – where it has not already occurred – will become a general megatrend in Europe.

The reversal of causality is of the utmost relevance for two reasons. First, this is important in terms of social policy, since the general opinion is that it is necessary to first create the right conditions for capital to be “attracted”. A completely mercantilist approach! The reverse is true: capital will ensure the right conditions, so long as the population has no other option but to participate in this capital in some way. A great deal has been published in recent years on the transformation process in the former communist states. On the transformation process for ossified and encrusted democratic states of the Western European pattern, there is for the time being nothing comparable.

Secondly, the reversal of causality is relevant for investors. Europe, or, to be more specific, Germany, is relatively “cheap”, by the P/E ratio yardstick. If we assume that the Germans, and Europeans generally with them, are obliged to become shareholders on a large scale – on the basis of their individual benefit

considerations, in the face of a lack of practical investment alternatives – this will be a clear "buy" signal for the stocks concerned. If we further consider that this new, enforced shift to equity investments will both result in a fall in the tax burden, as in the USA, and also aid the popular capitalism thus developed to make all the other liberating reforms, then enthusiastic expectations would indeed be appropriate, completely in accordance with Laffer's theory

Sadly, however, we must mention that we have to do with probabilities here. It might be the case that the ossification and encrustation is so persistent that not even the pressure of popular capitalism will be enough to break the dam and open the way to reform; or conversely, that a series of flashes in the pan, such as we experienced in the unfortunate "Neuer Markt", will definitively block off any perspective on the advantages of an efficient capitalist system.

6. Reflections on capitalism

Traditionally, "capitalism" is associated with the unequal, if not indeed unjust, distribution of wealth. Unjust in the sense that labour only participates in an insignificant fashion in the added value generated, via wages. Capital, on the other hand, anonymously and without dirtying its hands, enjoys complete and exclusive possession of the fruits of value creation.

Such criticism of capitalism is generally countered with the argument that the risk is entirely with the provider of the capital, so that it is only fair when the provision of capital is "rewarded" with the profit of the company. Further, the ceaseless and unprejudiced search for returns results in the efficient allocation of capital in a society, with a quality that no other form of allocation can match – and certainly not the so-called "planned economy". It thus ensures the participation of society as a whole in the prosperity created.

The exclusive capture of added value by capital has long been opposed, in three ways. Firstly, through the attempt to create a monopoly position for labour, by using strikes or the threat of strikes to establish the power of trades unions. Secondly, through the redistribution mechanisms of the social state, financed via taxation. Thirdly, by the management of companies, a very special class of individuals, organized on "unionized" lines, trying (and still trying today, of course) to cream off company profits by means of asymmetric profit-sharing schemes, more or less hidden bonus payments, and fringe benefits.

All these anti-capital schemes function well enough as long as the interests involved are clearly defined; that is, concentrated on two or three sides: labour, and perhaps management, on one side, capital on the other. But when, on account of legal or economic conditions (such as low interest rates), capital is spread more widely, then the interests are no longer so clearly defined. Individual benefit considerations incline clearly towards shareholding, and the enthusiasm for reducing the return on equities in the interest of social equality diminishes. A new social and political balance develops between economic and social policy requirements.

The social policy component is one issue, the question of the valuation of equities the other. Laffer's P/E ratio, mentioned above, is thus significantly lower in societies with widespread shareholding, or may come to be lower under the impact of social and political processes, compared to societies that may be nominally oriented on the market economy, but that only permit capitalism in terms of a necessary evil. Accordingly, it is necessary to approach the very difficult question of global asset allocation in a highly differentiated fashion – by asking the question: Where, i.e. in which countries, in which regions, is capital so widely spread that the achievable returns can be captured largely without restriction? Where is this notoriously not the case, and in which countries or regions may conditions change, under pressure from an increasingly important shareholding class, in the next few years?

7. An inverted look at the currency issue

The American balance of trade is currently under vociferous attack. It can't go on like this – piling up billions of deficit day by day by importing too much must one day end in disaster. The Americans are an undisciplined bunch of consumer junkies, who get their kicks on tick. And the savings level is far too low. What are we to make of such arguments?

First of all, criticism of any kind is to be treated with reserve. Saying "too much", "too high" or "too low" implies that one knows what is right. Such arguments often have something excessively didactic about them – a particularly widespread characteristic in Europe. Perhaps one should respond by asking what would have happened if the Americans had consumed less and built less in recent years. For then we would most probably now be in the midst of a depression on the scale of the 1930s. Rather

more profoundly, we must in particular ask why it is that the American capital transfer balance still remains on the level. There are obviously still enough entities and people in the world who are more than happy to accept payment in dollars for the goods they produce, and who are too keen on capital investments in dollars, for them to be ready to put an end to the game. They – the Japanese and Chinese, for example – tie their currencies by means of dollar purchases so that they can go on exporting happily.

The reason for this – and the core of our argument – is that this can only happen because the USA, as virtually the only region in the world, does have a capital market worthy of the name. Finding suitable investments and setting up appropriate financing is problematic all over the world, with the single exception of the USA. Shareholding in the USA is more widely spread than anywhere else in the world, and the variety of investment vehicles is virtually incalculable. This also quite clearly means that such a system can react far more flexibly to any serious threat to economic development resulting from a series of internal and external shocks, for, despite everything, the currency, and the investment vehicles on which it rests, will not lose their ultimate attractiveness. And this despite the fact that the whole nation is living on tick.

From this admittedly unusual, and literally inverted perspective, the complete headlong collapse of the American currency is not really possible. The relative attractiveness of the capital market in the United States would effectively prevent it. Conversely, the question naturally arises of an alternative to the dollar – of a long-term competitor. Despite the euro's current high altitude, we would venture to predict, on the basis of the above considerations, that it will only be seriously considered as a global reserve currency when the conditions for a capital market on the lines of that in the USA are in place. The euro would never, ever, survive a balance of trade deficit such as the current US one.

8. A more serious look at capital flows

There are thus two key messages. First: capital is frequently underestimated. Its allocation, that is, where it flows – to which part of the world, to which country, to which company, into which investment vehicle – is decisive for the future development of the recipient. Capital requires growth. Wherever capital can flow freely, and be freely distributed, growth will happen. Wherever these conditions continue to improve dramatically, as in many South-Eastern Asian countries, like India or China for example – or even perhaps, as suggested above, Germany, unfriendly as it now is to equity capital – the environment will also improve, under the pressure of capital's requirement for further or new growth.

Secondly: investors are faced with the problem of the distribution of their capital across those regions, countries, sectors, companies and vehicles best suited to their purposes. One possible strategy is to try to find out where an investment opportunity is available "cheaply". Our bank tries to do this, on a global basis and with some success so far, under the title of "Active Indexing" – which has recently become available in the form of an investment fund. Active Indexing identifies at regular intervals the three relatively most attractive country markets and the three relatively most attractive sectors. It is based on the calculation that capital flows are slower than our bank's reactions, and that it is also true in the longer term that "cheap" capital investments will always be found wherever capital can subsequently change something.

The reservation concerns the problem described above, of whether the inflowing capital can then be so distributed across society that those people or organizations that possess economic or political power (cartels, unions, managers, in emerging countries also criminal organizations) cannot just cream off the added value generated by the capital, regardless of the interests of others. For when this happens, the investment will sooner or later lose its attractiveness, and the capital will ultimately be destroyed. As they develop, investments of this kind become not so much "cheap" as "worthless". Active Indexing defuses this danger by means of a diversification strategy covering several countries and sectors.

To cover against such an – entirely conceivable – course of events, there is really only one form of "insurance". This is an established, free, efficient, broadly-based capital market, that evaluates, daily, hourly, and minute by minute, what is good and what is less good; that will unhesitatingly send a Parmalat to the wall, and will give Adecco a serious slapping without any regard for the people who stand behind it. No "corporate governance" body, no state supervisory authority could have done what the capital market accomplished within minutes on

the stock exchanges. These are extremely powerful indications of a highly functional system. It is called capitalism and we may have confidence in it.

There is thus no way round a mixed strategy – one that includes both established and up-and-coming parts of the capitalist economic system to a sufficient extent, in order to create enough room for the particular attractiveness of the markets that have not yet quite got so far. In one part of the world, growth is sufficiently and sustainably assured through the coercion that capital investment per se brings with it. In the other part, when capital flows in, growth will be forced to occur. The current global situation offers us the opportunity to take part in this fascinating mechanism.

KH, 19.1.2004