America's Casey At The Bat

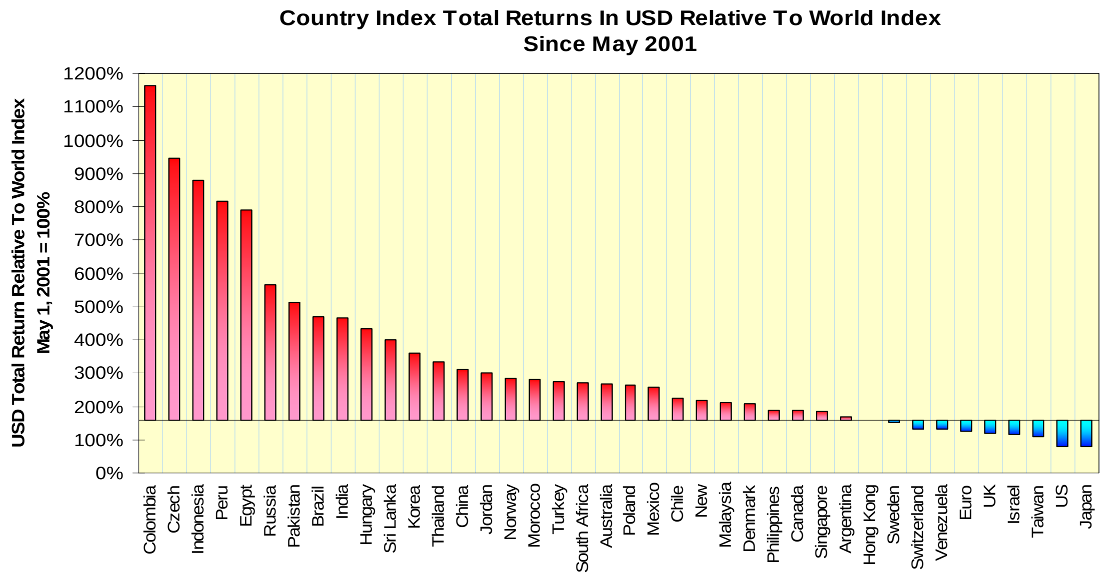
"Who had a better year, mortgage bonds or Barry Bonds? Discuss."

Those old enough to remember baseball's Washington Senators, perhaps now remembered best as the protagonists in *Damn Yankees*, are old enough to recall the twist on Henry Lee's eulogy to the first President, "First in war, first in peace, last in the American League." Who knew this could be twisted again in reference to the U.S. stock market's performance relative to the rest of the world for the past six and one-half years?

Morgan Stanley Capital International, truly a mean, lean index machine, has a set of total return indices for assorted national markets in both U.S. dollar and local currency terms. We will treat all nations using the euro as the single entity of the Eurozone. MSCI also has a world index – a World Series? – in USD terms going to May 2001, which establishes the starting date of our little study.

Say It Ain't So

The World Series has had a period total return of 160.0%, the horizontal line in the chart below. The various national indices' performance relative to the World Series are sorted in descending order. Only forever-moribund Japan, with a relative performance of 80.01% trails the U.S. relative performance of 80.04%. Other laggards include other "senior" markets of the Eurozone, the U.K. and Switzerland.



The list of outperformers includes the Fab Four BRICs of Brazil, Russia, India and China, a smattering of economies such as Egypt and Pakistan dependent on the repatriated earnings of their citizens abroad, and an assortment of truly emerging markets, led by Colombia.

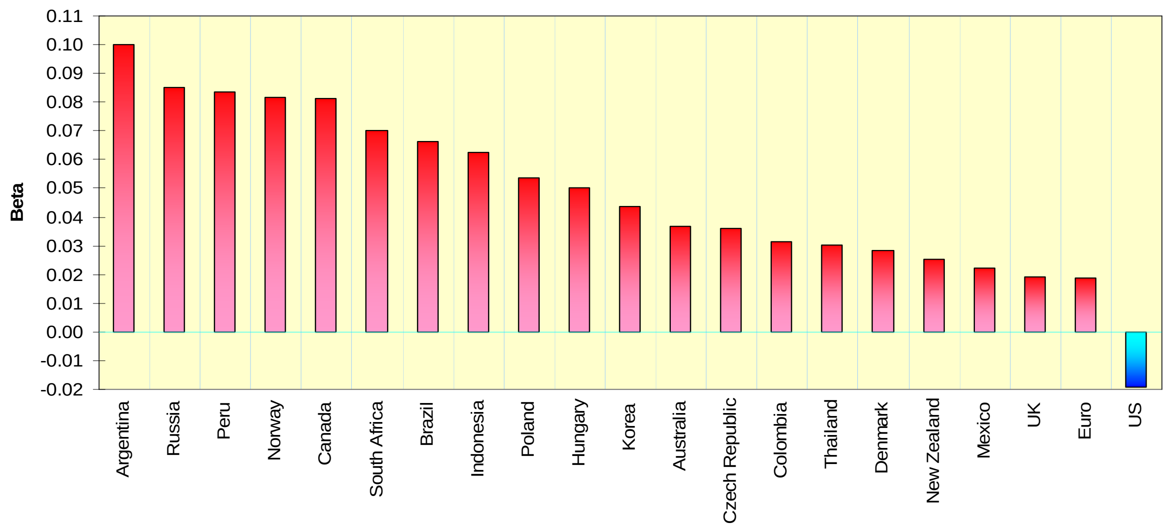
Factors Driving Performance

Well, you say, a lot has happened in the world since May 2001. We had yet to feel the effects of the Federal Reserve's first rate cuts in January of that year, the dollar was still ascendant against the euro and the entire global commodity boom was in the future (I wrote an October 2001 column on the negative macroeconomic signals from declining commodity prices).

Let's take a look at some of the market factors such as individual commodities or currencies whose prices have changed considerably in recent years and see how and whether they have affected relative country performance. The test is fairly straightforward: The returns of each country-specific market relative to the world market were regressed against a set of sixteen different variables, only a few of which are presented below. Those regression betas statistically significant at the 90% confidence level were extracted. The higher or more negative the beta, the stronger or more inverse the relationship is.

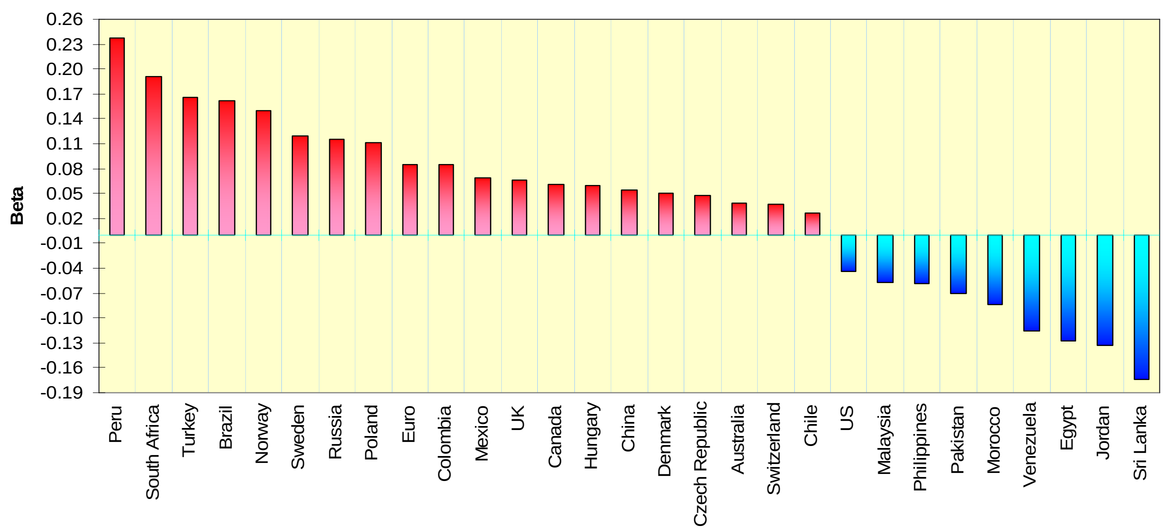
Crude oil, which dominates the world of commodities, had a much smaller impact than you might expect. It boosted the relative returns for petroleum producers such as Norway, Russia and Canada, but we also find importers such as Argentina, Peru, and a smattering of East European countries on the list. The presence of these importers reinforces the argument why higher crude oil prices have yet to derail the global economy: So long as buyers can add more economic value to a barrel of crude oil than it costs, they will continue to buy it. Only when this situation disappears will we see lower crude oil prices.

Relative Country Returns With Statistically Significant Beta To Crude Oil



We can see the same phenomenon with a twist in the case of copper. Large copper producers such as Australia, Canada and Chile have only weak positive betas. The list is dominated by large consumers of copper. Over time, the terms of trade favor those who buy commodities and process them into value-added goods, not those who produce commodities. Remember, the productivity of wheat has changed little over the past half-century, but the productivity of farm equipment and supplies has increased enormously.

Relative Country Returns With Statistically Significant Beta To Copper

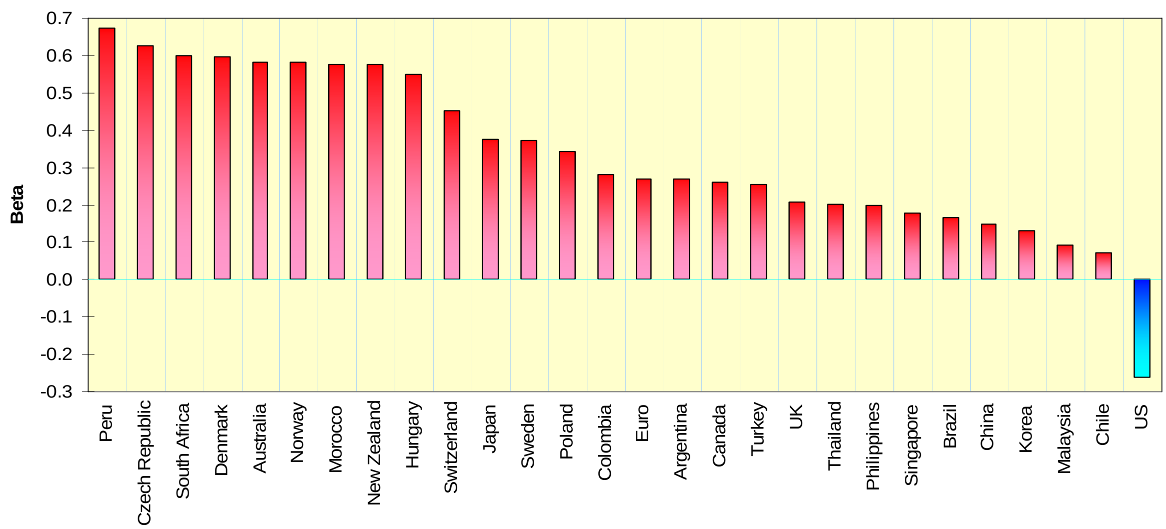


Currencies

The euro makes as many headlines as does crude oil, and its proponents are more sanctimonious in their public pronouncements. Who has benefited from its rise? The list is dominated by those countries on the periphery of the Eurozone, such as Turkey, various Eastern European countries and the Nordic countries and an odd mix including Brazil, Argentina and New Zealand. Brazil has been a success story, Argentina continues to be a basket case and New Zealand’s chief claim to fame in recent years has been as a receiver on the yen carry trade.

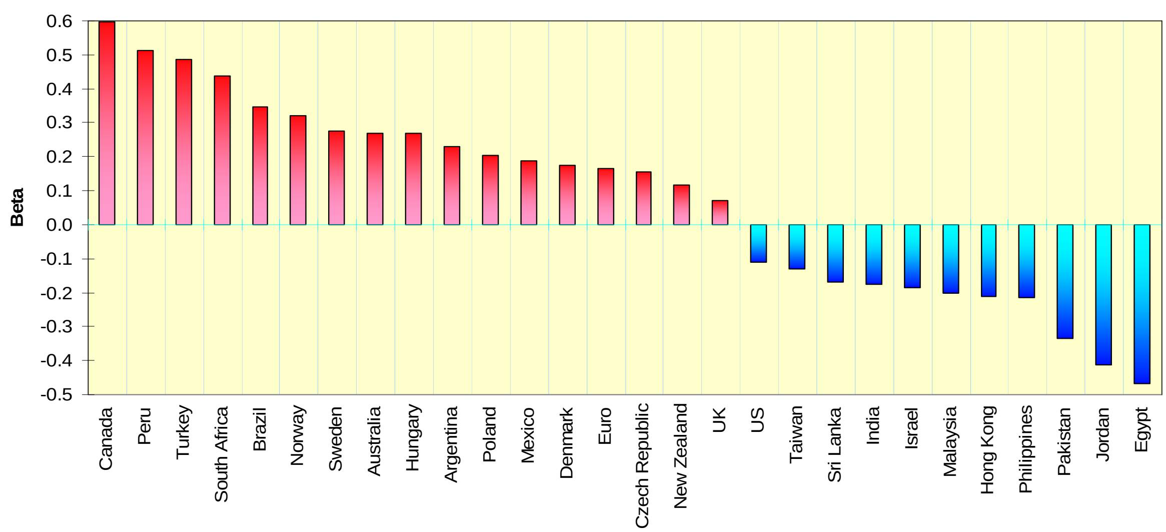
Significantly, the relative performance of the U.S. to the World Series has a negative beta to the euro.

Relative Country Returns With Statistically Significant Beta To The Euro



The contribution of the Canadian dollar to disparate index performance is equally mixed. Beneficiaries of a stronger Canadian dollar include commodity producers such as Australia, Norway, South Africa and Canada itself. Those whose national markets have negative relative performance betas to the World Series include major commodity importers in South and East Asia and the U.S.

Relative Country Returns With Statistically Significant Beta To Canadian Dollar



Policy Implications

Let's turn back to the first chart, the one depicting rankings across a wide range of countries. The Federal Reserve has been trying to reflate the economy with lower interest rates just as it did in 2001-2003 and later in 2004-2005 by keeping rates too low for too long. Comments last Friday by Federal Reserve Governor Randall Kroszner indicate this ploy may be ending, but we shall see how central banks react to the next financial crisis.

The net result of the Federal Reserve's last bout of monetary stimulus put Colombia on top of the global heap, followed by the Czech Republic, Indonesia, Peru and Egypt. Did you or anyone you know predict this in 2001? But that was the net result of monetary largesse: The Federal Reserve tried to stimulate the American consumer and instead stimulated emerging market producers and suppliers of expatriate labor, such as Egypt, Pakistan and the Philippines.

The big economies and markets finished last in this derby.

Let's go out on a limb right now and say if the major central banks stop throwing money on the floor to see who picks it up, the developed markets will outperform the emerging markets over the next five years. This would argue, once again, to lighten your exposure to recent strong gainers in emerging markets and in commodity producers.

It would be nice to hear the phrase, "damn Yankees," spoken out of jealousy of our stock market again.