It Is No Better Elsewhere

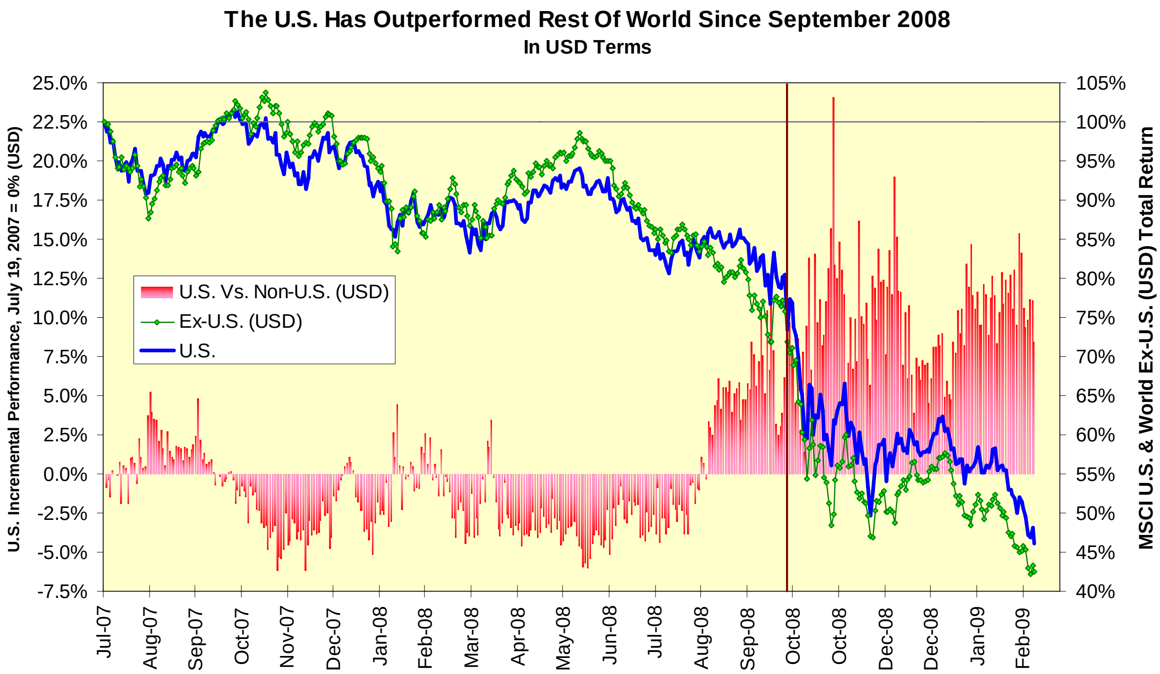
The late Erma Bombeck entitled a book *The Grass Is Always Greener Over The Septic Tank*. Whether this was an actual observation or a wry observation about our collective tendency to believe things have to be better elsewhere than wherever we are at present is unknown, but I will vote for the latter.

Surely our nomadic ancestors understood this, too. Genetic mapping studies indicate once early humans wandered out of the Horn of Africa they swept through the entirety of the Eurasian landmass and into the Americas in relatively short order searching for someplace, anyplace, better than what they left.

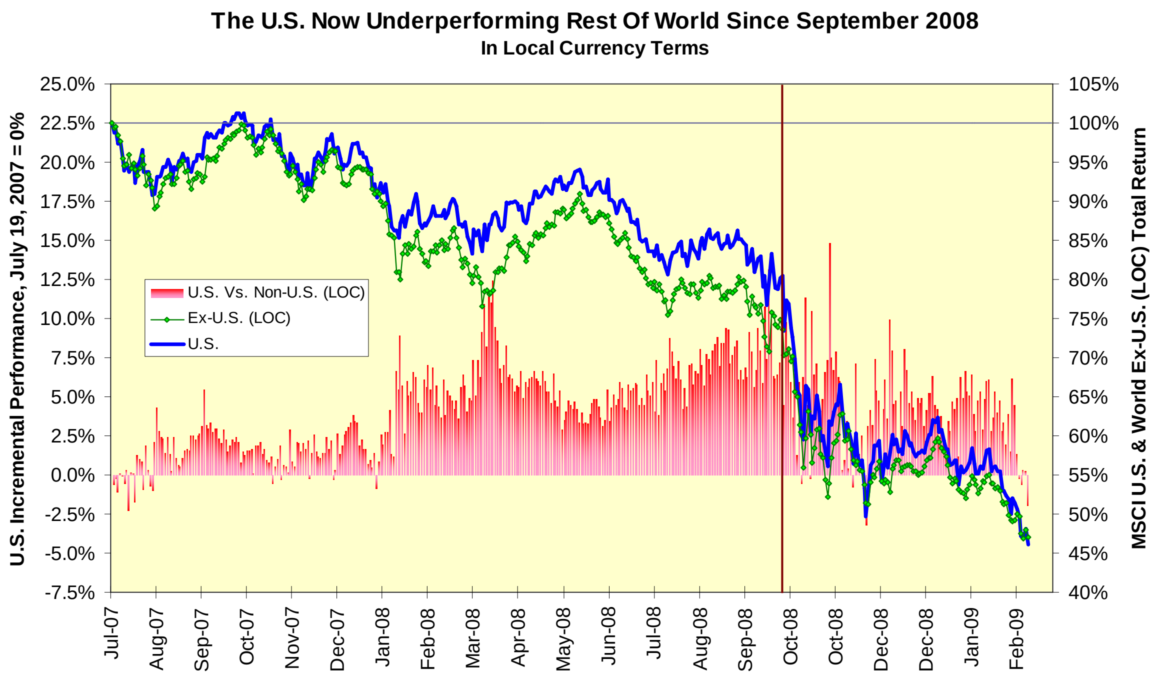
They did not find it. Even today I lie awake at night discomforted by the knowledge some distant progenitor of mine rode a camel around the wilderness for 40 years before finding the one place in the Middle East without any crude oil.

The U.S. Has Outperformed?

This is why the chart below is so astonishing. We can compare the MSCI total return indices for the U.S. and the World Ex-U.S. If we go back to July 19, 2007, the date of a local high before things started to become unglued in August 2007, we can see how the U.S. has outperformed the rest of the world in dollar terms over the entire period.



The dark red vertical line at the end of September 2008 represents the point where Barack Obama pulled decisively and permanently ahead in the polls; more on that later. If you think the U.S. advantage above is due in part to the strength of the dollar over this period, you are correct. If we do the same comparison with the MSCI World Ex-U.S. index calculated in local currency terms, we see how the U.S. started to underperform the rest of the world at the end of February.



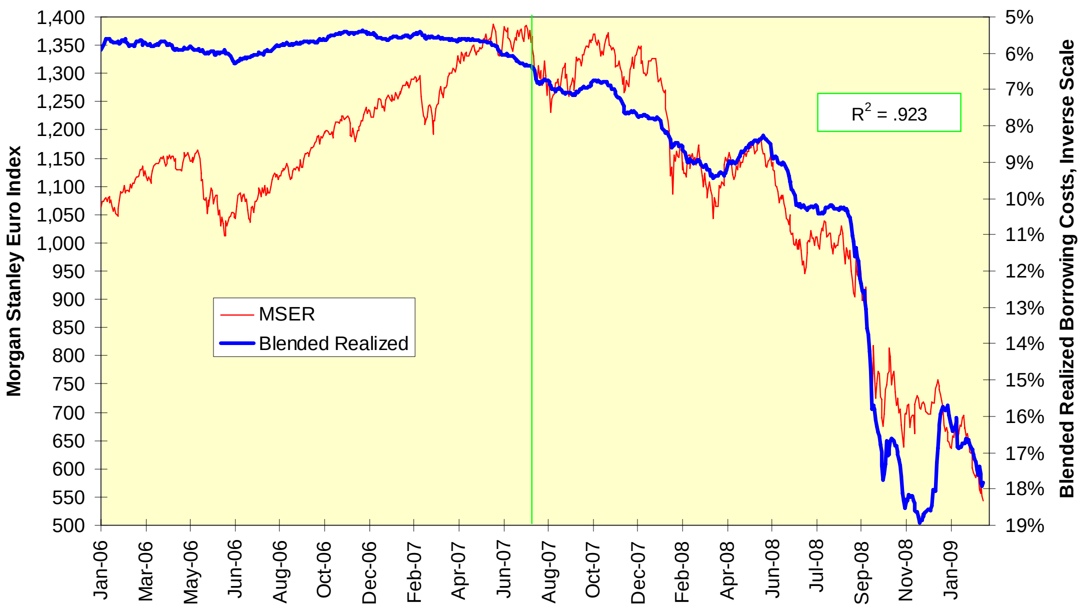
What is the purpose of the red line at the end of September? That is to run a statistical test to see whether the relative performance of the U.S. to the rest of the world changed when it became apparent Obama would be the next president. The answer is surprising to those who are referring to the "Obama bear market." We can be only 0.21% confident the pre- and post-September 2008 relative performance is different in dollar terms and 32.32% confident it is different in local currency terms. Unless we are willing to attribute the performance of the rest of the world to Obama, too, we should remain collectively quiet about the Obama bear market.

Oh, and before I get all sorts of vile e-mails, please remember I am a Libertarian and I vote that way. I disagree with his policies and approaches almost across the board.

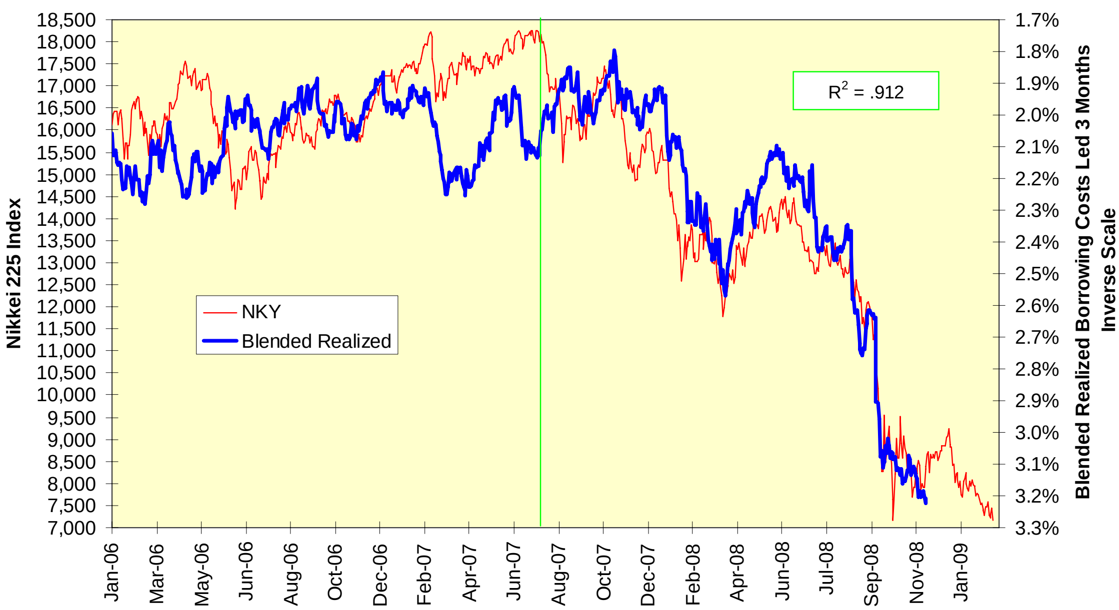
Europe And Japan Are Overvalued, Too

Let's extend the analysis done last week for U.S. equities to Japan as measured by the Nikkei 225 and Europe as measured by the Morgan Stanley Euro index. Both equity indices have tracked blended realized borrowing costs, a 60-40 mix of high-yield and investment-grade corporate bonds plus the underlying sovereign yield, very closely since July 2007. In fact, the respective r-squared, or percentage of variance explained, has been 0.923 for Europe on a contemporaneous basis and 0.912 for Japan on a three-month lagged basis. Japanese stocks, in a twist from patterns seen elsewhere, seem to anticipate events more than Japanese bonds.

European Corporate Cost Of Capital Affected Stocks Once Crisis Began

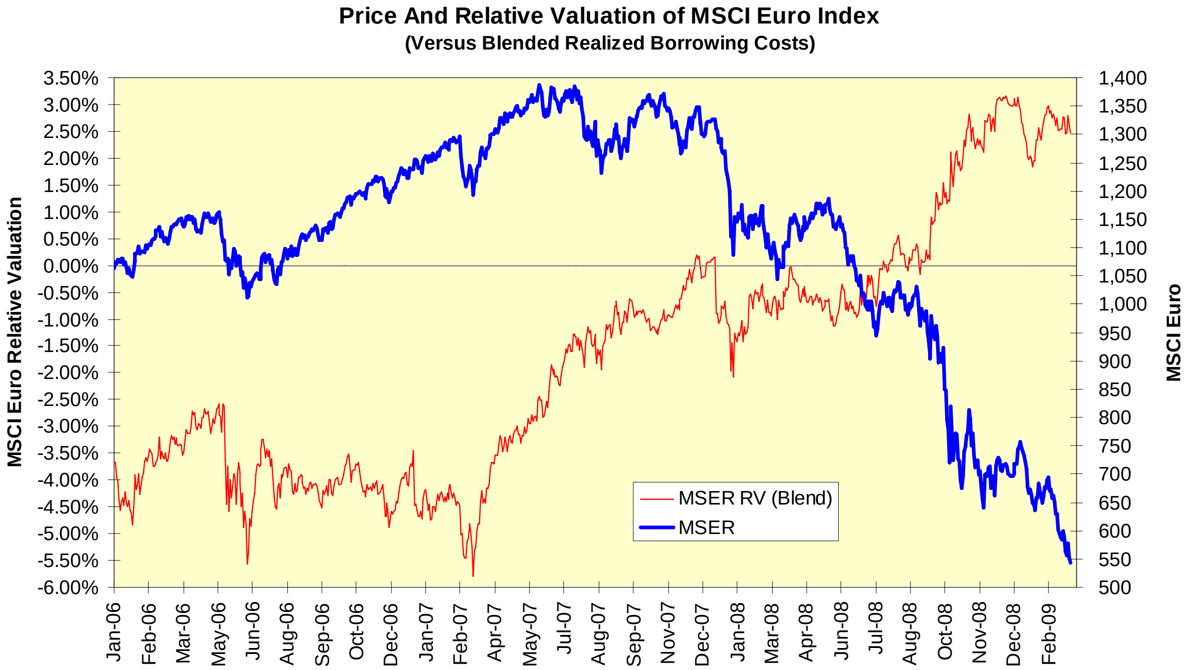


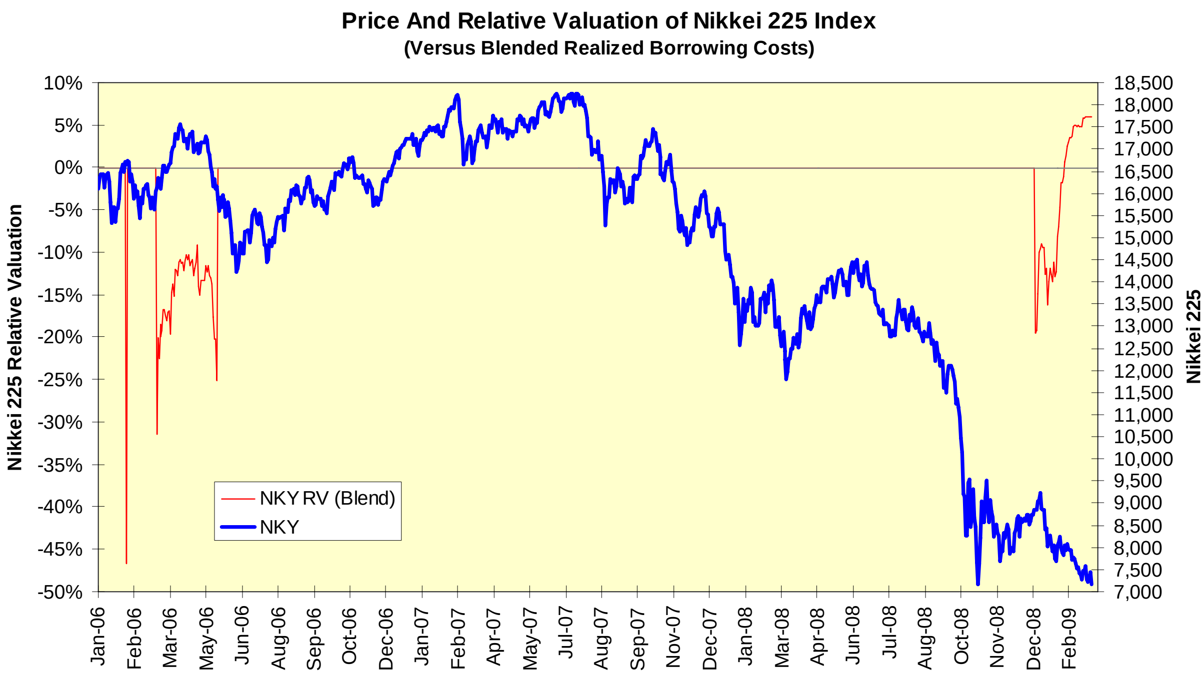
Japanese Stocks Affected Corporate Cost Of Capital Once Crisis Began



The implication for Europe is their stocks will not stop sliding until their cost of capital stops rising. The implication for Japan is the cost of capital will not stop rising until stocks stop sliding. How either situation can obtain when the global recession shows no sign of abating is unclear.

The net result of all this is stocks in both zones are overvalued relative to their blended realized cost of capital. This has been true in the Eurozone since August 2008, the positive values of the red line. In Japan, the measures were so distorted for most of the period as to be out-of-solution. They came back into solution this January and after one month of Japanese stocks being attractive, moved into an overvalued zone.





By the way, the forward-looking, top-down price-to-earnings ratio for the Nikkei 225 has been hovering around 140 over the past week. What does that mean, really, beyond the market believing Japanese firms will earn virtually no money over the coming year? And as much as people want to deny it, that was true in the U.S. for the fourth quarter of 2008. Earnings estimates around the world may be too high.

Until we stop making a bad macroeconomic crisis worse with bailouts that cannot be funded realistically with either taxes or foreign borrowing – what, China's going to lend us a trillion dollars or so after what they have seen? – we are going to crowd out capital for corporations and municipalities. That will contribute to slow growth and high levels of corporate stress. Effectively, we have tried to purchase a put option from ourselves against a depression and have financed it by selling a call option on future growth. The net result is grim, both here and elsewhere. The trick is staying over the septic tank.