Why America's stockmarkets are ailing while others are hale

STOCKMARKETS around the world have had a ropey couple of weeks. First renewed fears about inflation, then the biggest bankruptcy yet of an American manufacturer (Delphi, a maker of car parts), pushed share prices down for a bit. But contrary to the old saying that when America sneezes, the rest of the world catches cold, the rest this time suffered less and recovered faster, thank you.

Shares have generally done less well in America this year than in Europe, Japan and emerging markets. Britain's FTSE 100 hit a four-year high this month. So did Japan's Nikkei, late in September. The Chicago Mercantile Exchange has just announced a new derivative contract on Asia's top shares, to capture their ebullience. American share prices, meanwhile, are moving sideways.

As the chart shows, the total return (including price appreciation and dividends) on equities in America has been slightly negative this year. In continental Europe, it has been a bit over 6%. Emerging markets, recent stars in the investing firmament, have returned even more, 21% to date. One of the brightest, Brazil, has produced 47%; others—in the Middle East, for example—even more. And this is after translation into dollars. In most instances, the difference in local currencies is even starker.

This is an odd state of affairs, on the face of it. America's economy has been the wonder of the western world, shaking off rising interest rates and sharply higher oil prices to persist in growth that is the envy of much of Europe. Its debt-ridden, gas-guzzling consumers have only recently begun to show signs of flagging. And most firms are defending their profit margins.

Explanations range from the technical through the fundamental to the psychological. Relative valuations head the list. American equities were more expensive than those elsewhere when the year began, and the gap,
though smaller now, remains. Stockmarket valuations are always a contentious business, but most measures show the same pattern.

Another negative factor is that interest rates are rising and the yield curve is flattening, both normally bad signs for business. While the Federal Reserve has hiked short rates by 275 basis points (hundredths of a percent), since June 2004, the difference in the yields on ten-year and two-year Treasury bonds has shrunk from 192 to 20 basis points. Against this, the euro zone's central bank has held rates steady for more than two years, and Britain recently cut them. And while long-term yields in America are lower than they were when the Fed started raising short-term rates, they are still higher than in almost any other rich country (Australia is an exception). Shares globally look cheap relative to bonds when yields on the two are compared, but in America they look less cheap than elsewhere.

Then there are "fundamentals", and each country has its saga. Germany's companies have restructured and cut costs, helped by cheap labour in central Europe. With a large manufacturing sector by the standards of developed countries, its export-oriented firms are riding the wave of global industrial expansion. Japan, for its part, is coming out of seven years of deflation with its companies modernised and profits shooting upwards—and maybe more economic reform ahead. Emerging markets have been re-rated, thanks to broadly more investor-friendly economic policies and booming commodity prices.

In America, by contrast, several worries are sapping optimism about economic prospects. One concern is inflation: though the evidence is mixed, it may be making a comeback. Another is the country's trade and budget deficits, which by some lights appeared to be improving until Hurricane Katrina boosted the government's projected outlays. A third has to do with the sustainability of corporate earnings: America's are among the farthest above their historical trend and thus may have farthest to fall.

Americans themselves prefer foreign shares these days, another reason why their own are lagging. The trend, though volatile, has been rising since March 2004. This June the net outflow was $11.8 billion and in July $8.9 billion, on Treasury figures. "This supports the view that American investors are not that pleased with the valuations on US equities and think that other markets are more geared to the pick-up in the world business cycle," says Richard Batty, global strategist at Standard Life Investments, part of a British insurer.

Mutual-fund flows confirm the Treasury trend and bring it up to date. Brad Durham, managing director of Emerging Portfolio Fund Research, which monitors mutual funds with $2.3 trillion in assets, says that net flows into American-domiciled American-equity funds are just positive for the year so far, but have deteriorated sharply. Net outflows in August were $6.9 billion, and a further $2.2 billion or so has walked since. Meanwhile, mutual funds based in America have poured $14.5 billion this year into emerging markets, another $14.5 billion into global and international funds and $5.5 billion into Japan. Europe suffered outflows earlier in the year, but is now attracting dollars.

Behavioural finance contributes a final piece to the puzzle. A new paper published by London's Centre for Economic Policy Research looks, unusually, at trust—confidence that financial data is reliable, that the overall system is fair—as a factor in stockmarket participation. The authors (Luigi Guiso and Luigi Zingales, of the University of Chicago, and Paola Sapienza, of Northwestern University) find that levels of trust, variously defined, are correlated with investors' propensity to buy shares. This supports the notion that scandals involving the likes of Enron and WorldCom may have turned off American investors. Indeed, Italy, whose once-tainted Parmalat returned to the stockmarket last week, is another underperformer.

Are America's shares now poised to close the gap? A couple of short-term indicators are less than bullish. For one thing, analysts have steadily raised the bar in their earnings forecasts, making it increasingly likely that companies will stop beating and start missing their targets. Investors often punish that. And for another, the number of companies suspending their dividends rose last month: to 11, from a monthly average of under
three, points out Mark Hulbert, a market commentator. Though only a few firms are involved, the trend may be significant: much academic literature suggests that when a company suspends its dividend, returns on its shares fall over the next 12 months.

The broader outlook is more encouraging, however. Most forecasters believe that America's growth will continue to outpace Europe's. Equity valuations are more in line than they were. And the bloom is slightly off various developing-country roses. The dependence of Asian countries on imported oil, a possible peak in commodity prices and some emerging political risk in Latin America are all things that investors are keeping an eye on. Nor does Japan fill everyone with confidence, for it is foreigners, not locals, who are pouring the money into shares there.

An intriguing twist in Credit Suisse First Boston's much-followed risk-appetite indicator seems to confirm this view. Last week, it shot into the "euphoria" zone for several days, which would normally be a signal to sell equities. But for the first time in ten years, enthusiasm for developed countries' shares did not accompany the spike, points out Andrew Garthwaite, a global equity strategist. It is bonds that investors are crazy about, plus shares in Japan and some emerging markets. Continental and American equities leave them cold, and British ones even colder. The indicator last shot up without support from shares in 1995, the beginning of a memorably snorting bull market in equities. Without implying anything half so dramatic now, the moral would appear to be to buy shares, and buy—curiously—British.

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