Macro economic overview
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Investment summary

- Compared to a couple of months ago, markets have now entered an era in which things may get tougher. From a valuation point of view there is still little that points to imminent danger. Earnings have been recovering for almost three years now, more often than not at a double-digit rate. It results in PE ratio's that are close to the lows of 2002. Interest rates have in the meantime hardly gone up, despite a long series of rate hikes by the Federal Reserve. Bond rates have come off their lowest levels but remain unusually low, from an historic point of view, in nominal as well as in real terms.
- Earnings growth over the next twelve months is expected to fall back to single digits, or the low double digits in the best of circumstances, but the combination of the current earnings levels and the current interest rates still leads to under valuations of about 20 to 30%.
- That is however where the good news largely ends. The difference with comparable valuations in 2002 is that at that moment most of the cyclical rebound still had to come and the potential for strong earnings growth was still fully present. That is a fairly big difference with the current situation. As a result of the forceful restoration of cash flows and earnings, company earnings have reached a percentage of GDP that has not been seen for several decades. It would be unreasonable therefore to believe that earnings growth can remain stronger than nominal GDP growth for any length of time yet. A more likely evolution is one in which earnings growth is more closely in line with GDP, which would mean a substantial slowdown compared with the past three years.
- Interest rates in the meantime have moved away substantially from the crisis levels the FED had brought them as a result of deflation fears. Few analysts doubt that the next FOMC-meeting at the start of November will result in rates going up to 4%. After that at least one other rate increase looks very likely, which would mean a fed funds rate of 4.25% by the end of this year. What happens after that is anybody's guess. The Federal Reserve has clearly indicated that inflation looks the bigger problem in the current circumstances. Unless oil prices fall back substantially, it looks like the rise in the energy prices will work its way through the system for some time to come yet, which could mean that the Federal Reserve keeps on tightening into 2006 as well.
- The "goldilocks" combination of low interest rates and strongly rising earnings seems therefore to gradually come to an end. Keeping up earnings growth at a pace above GDP growth will be hard in the face of rising costs and probably slower growth induced by higher interest rates. The fact that there is still a large gap between model values and market reality is comforting against this background, because it means that the less encouraging macro environment has, to a large extent, already been discounted in the current market prices. Inevitably it also means that the market's upward potential may be lower than it is suggested by model calculations.
- Several factors could nonetheless still have a profound impact on financial markets in the coming months. One of those is the evolution of the oil prices. For several months now the oil production has surpassed consumption by several million barrels per day. This is not just the result of increased oil production, but to a large extent also because of a slight fall in the world's oil consumption. World oil consumption in September was 0.12% below the level of a year earlier. Demand in the industrialized countries was down 0.6% from a year earlier and demand growth in the developing countries slowed to 0.6%. Apparently the 50-dollar per barrel level has led to widespread consumption cuts during the summer months.
- Over a longer term opinions remain sharply divided. Nobody ignores the fact that the drop in the oil prices in the eighties and nineties has led to insufficient investment in exploration and refining, causing bottlenecks and intermittent price hikes. Unless another supply shock occurs, oil prices may well have seen their highest level for this year, but at about 60 dollars per barrel they still have tripled from the level at the start of 2002. Analysts also see little improvement in sight next year. Estimates vary between 50 to 75 dollars a barrel and futures do not show any real easing in prices before 2007. That ties in with the expectations that by then new supplies will come to the market.
- In the meantime a lot depends on the evolution of demand. The sharp rise since 2002 was clearly tied to the expanding economies in China and the US. It led to the sharpest increase in demand in a quarter century in 2004 when oil use jumped 3.7%. The combination of slower growth and a late start of the winter, or temperatures at or above average during the winter months, may be sufficient to bring the oil prices back below 50 dollars. In that case growth and inflation forecasts will again improve from the current estimates. With supply and demand in such a tight balance, the possibility of a new spike in prices is however also relatively high. Inevitably this will influence inflation and growth forecasts.
- A second factor that may color markets in the coming year is the evolution of the dollar on the exchange markets. The dollar strength in 2004 was increasingly supported by central bank interventions. There clearly is a limit to this. The interventions were essentially aimed at stabilizing exchange rates against the dollar. That way export markets may have been safeguarded but the danger is that control on the internal money supply will be lost and with it control on the inflation rate.
- Keeping the exchange fixed at any cost is a concept which even the Chinese authorities have now left behind them, opening the way to more market oriented exchange rates and hence a lower volume of central bank interventions. Since the US may well see advantages in a more competitive dollar exchange rate, the probability of a new phase of dollar weakness increases as time goes by. European markets did relatively well over the past year, partly due to a stronger dollar. US markets went largely sideways or even lower. The reverse may well be the case in the coming period.

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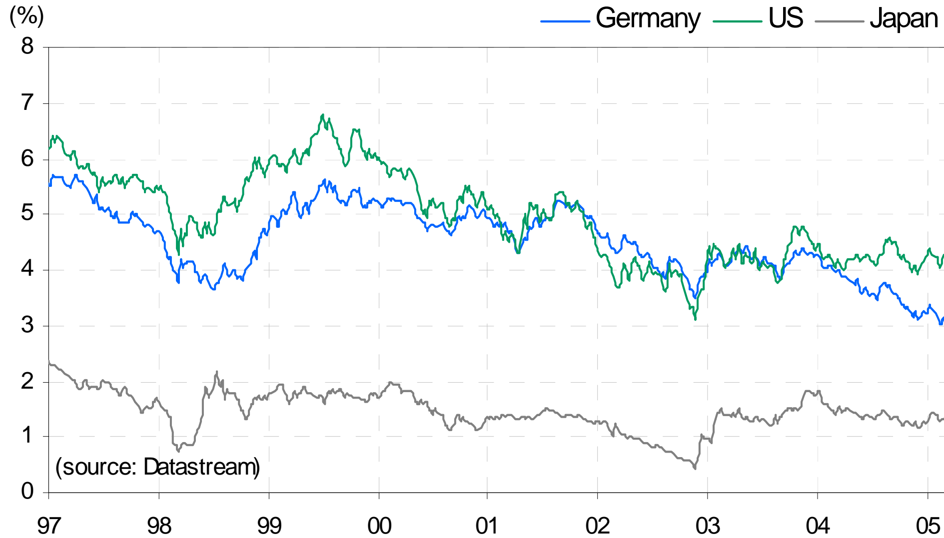
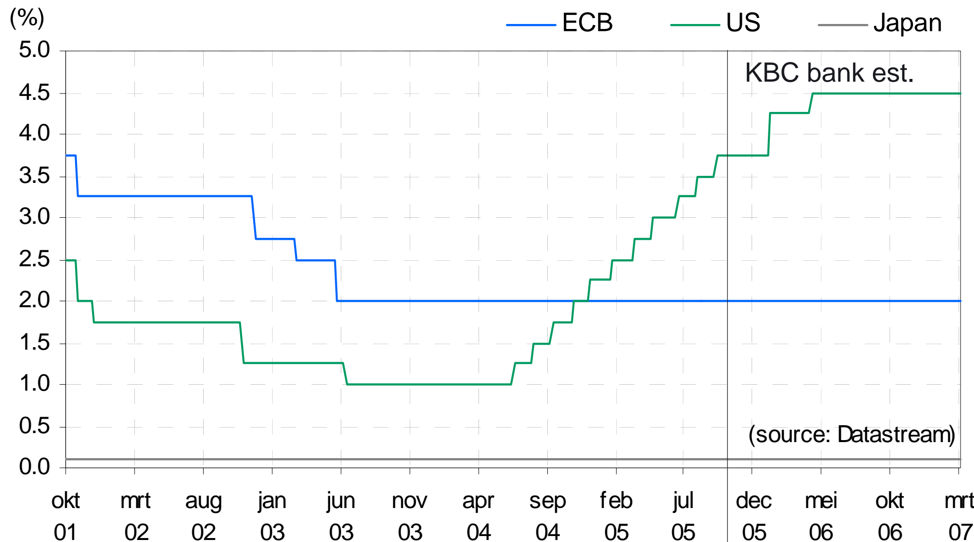
Interest rates

International interest rate evolution



Central Bank official rates



Overview

As expected the Federal Reserve has largely ignored the impact of hurricanes Katrina and Rita and has continued its policy of "measured" rate increases. Without saying it out loud the FED clearly feels that the inflation dangers are currently somewhat more important than the threats to growth. We believe this is a correct assessment. The immediate impact of events such as the damage caused by Katrina and Rita may well be reflected in lower growth, but as a rule this should be followed by stronger growth in the following period as reconstruction activities give an extra stimulus. Prices on the other hand are clearly rising at a rate that cannot easily be ignored. Producer prices in August were going higher at a 5.1% clip and consumer prices were 4.7% above the level of 12 months earlier in September. Since further price pressures can be expected to come from rising energy costs, logic demands that the central bank acts now rather than having to increase rates more sharply later on. The probability that the Fedfunds rate goes to 4.25 by the end of this year has increased considerably.

Conditions on the bond markets in the meantime remain benign and interest rates remain unusually low from an historical point of view. So far markets seem to be confident that the monetary authorities will keep inflation under control, while the imbalances in the world economy are not considered to be sufficiently threatening to require a risk premium on dollar bond rates. As the probability of slower economic growth ahead is increasing, chances are that bond rates can remain quite low for some time to come yet. The historically low interest rates clearly have other drivers than just the accommodative monetary policy of the Federal Reserve. The fall in the personal savings rate in the US and to a lesser extent in Europe, has apparently been compensated by a strong recovery of company earnings and cash flows and increased savings elsewhere. The allocation of savings towards fixed rate instruments in line with the changing demographic structure, is probably also a structural factor which is keeping rates lower than they otherwise would be. In the short run there seems to be little chance that the interest rate picture will change abruptly. In the longer run however the combination of higher energy prices and lower growth, can become worrisome if budget discipline does not remain tight.

Central bank rates

	Historical				*KBC estimates*		
	-1Y	*-6M*	*-3M*		*3M*	*6M*	*1Y*
US	1.75%	2.75%	3.50%	3.75%	4.25%	4.50%	4.50%
Japan	0.10%	0.10%	0.10%	0.01%	0.10%	0.10%	0.10%
Europe	2.00%	2.00%	2.00%	2.00%	2.00%	2.00%	2.00%

source: Datastream, KBC estimates

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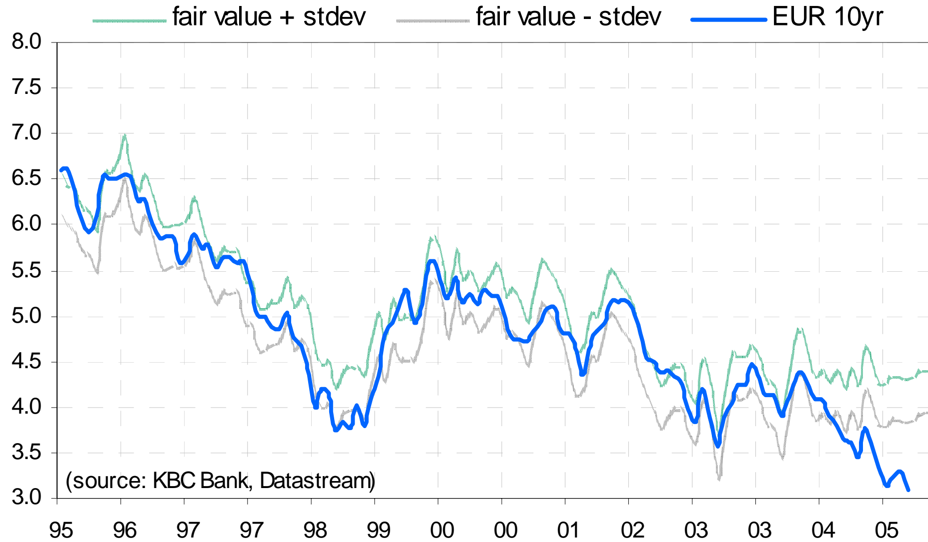
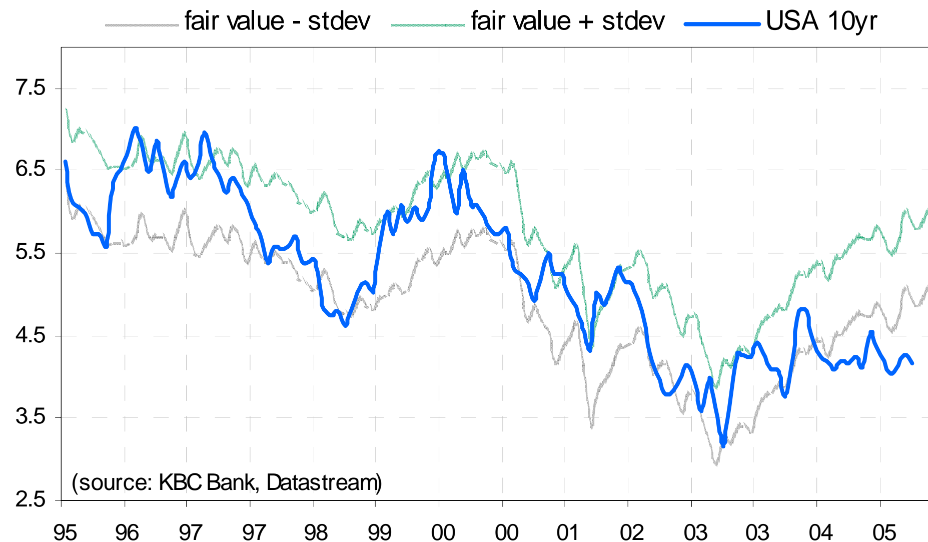
Interest rates

Fair value 10 year Euro (German government bond rate)



Fair value 10 year US rate (US government rate)



Fair value

Bond rates in the US and Europe should be substantially higher, if a number of macro economic fundamentals are taken into account. The so-called "fair value" rate has in fact been rising from its lows in 2003 for a couple of years now and even the lower end of the theoretical bond rate is now about 100 basis points above the current market level (the upper end is even slightly above 6 percent). Compared to the factors that largely determined US rates in the past, a break has apparently occurred. The message is not necessarily that bond rates will over the next couple of months have to rise substantially in order to make up for the divergence from the statistical expectations. It is however quite convincingly that bond rates have a higher probability of rising than falling in the coming period. Some of the factors that have driven the fair value higher during the past two years may on the other hand also start to lose some of their power. Inflation has been rising steadily as a strong hike in raw material and energy prices is slowly starting to work its way up through the system. Prices may however have peaked and, as the months go by the year-to-year comparison should slowly become more positive for price stability. Growth figures should also weaken somewhat, while the budget deficit has improved.
It looks therefore as if over the theoretical level of the 10-year bond rates in the US could gradually go slightly lower again. Market rates in the meantime will probably be pushed higher, even against the background of weaker growth, since chances are high the Federal Reserve will increase interest rates further to over 4 percent. Some of the extreme divergence we have seen over the past two years may therefore lose some of its edge. To go back into the fold however, some of the structural factors that have driven interest rates unusually low would also have to disappear, and this does not look very likely in the short run. A peculiar phenomenon is for instance the fact that bond rates fell further even in the face of worsening budget figures. Apparently the globalization and sharply increased mobility of capital has not brought the increase in financing rates that one should expect from capital moving into the new economies, but has on the contrary brought the reverse; savings coming to the "old" countries. Combined with central bank reserve build up it looks like something that will not go away overnight.

10 year bond yield

		KBC est.			*Consensus*	
		3M	*6M*	*1Y*	*3M*	*1Y*
US	4.49%	4.55%	4.65%	4.60%	4.49%	4.95%
Japan	1.56%	1.50%	1.65%	1.95%	1.51%	1.77%
Europe	3.28%	3.20%	3.30%	3.40%	3.37%	3.73%

source: Datastream, KBC estimates

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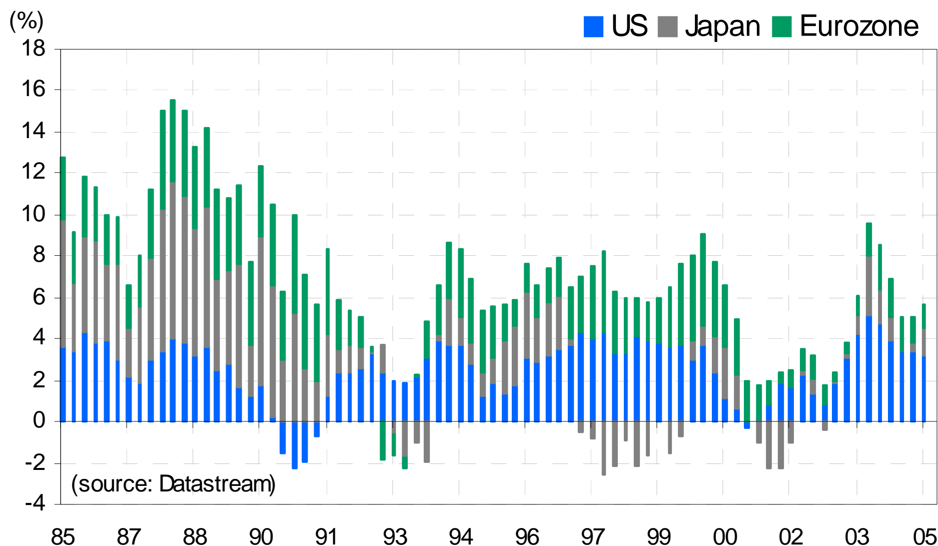
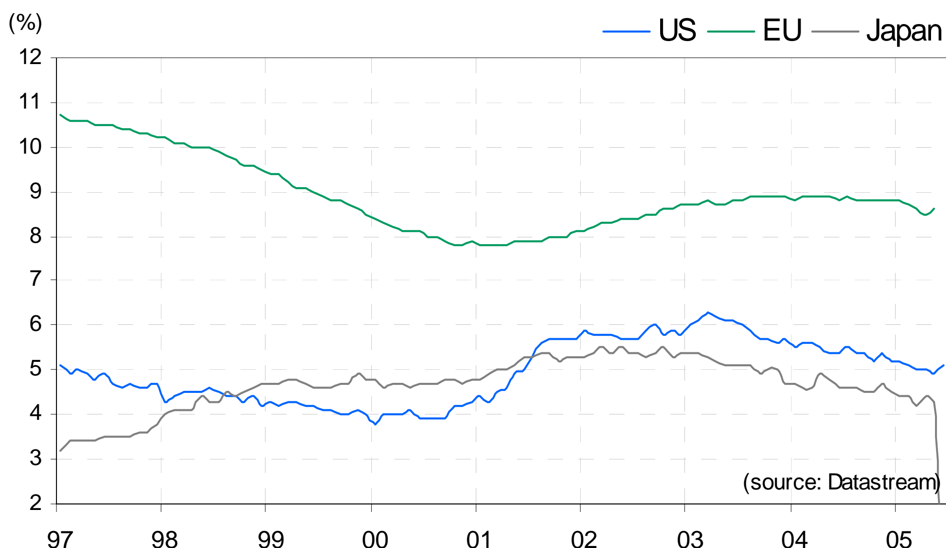
Growth scenario

International GDP growth since 1982



International unemployment rates (nominal)



Historical overview

While the visibility does not improve when the world's economic growth becomes dependent on new economies such as China and India, there is no doubt that the fact those countries seem bent now on a long period of strong growth, is changing the world fundamentally and permanently. The demographic make up of much of the industrialized countries seemed to doom the world economy to gradually slide into slower and diminishing growth. That interest rates in this environment could fall structurally to lower levels than those of the past 30 years looked quite possible, but the counterpart inevitably had to be also that returns on investment would structurally become lower.

The appearance of countries such as China and India, which combine almost half of the world's population and which have entered a faze of accelerated industrialization, changes all that. For one it changes the world's ratio of available labor to demand for manufactured products and chances that wage growth will outpace economic growth or be a the root of a wages/prices inflationary spiral have therefore diminished. It also changes the return on capital as it allows recycling some of the large accumulated savings in the industrialized world through countries in which the incremental capital output ratio is substantially higher than it is locally. The overall result of this should be that all parties gain. China and India lack the capital resources to support the grand scale development they envisage, but have the labor force and the will to grow as fast as possible. The industrialized world has the accumulated capital to finance this development but lacks the population growth to keep this capital stock invested in projects with a sufficiently attractive return. Combining both through the globalization process therefore has the look of win-win situation, even if it may be accompanied by less visibility and hence somewhat heightened risk premiums.

A new and somewhat surprising phenomenon in the meantime is that developing countries, for a number of reasons, have become the direct and indirect source of saving flows instead of having recourse to the industrialized world's savings pool. It has created the unusual situation that bond yields have fallen independently of monetary policy decisions in the major industrialized countries.

Projected unemployment rates (OECD estimates)

		OECD estimates		Consensus estimates	
	2004	2005	2006	2005	2006
Euro area	8.88%	9.04%	8.71%	9.04%	8.71%
VS	5.52%	5.14%	4.83%	5.10%	4.96%
Japan	4.72%	4.43%	4.11%	4.33%	4.05%

source: OECD, Datastream

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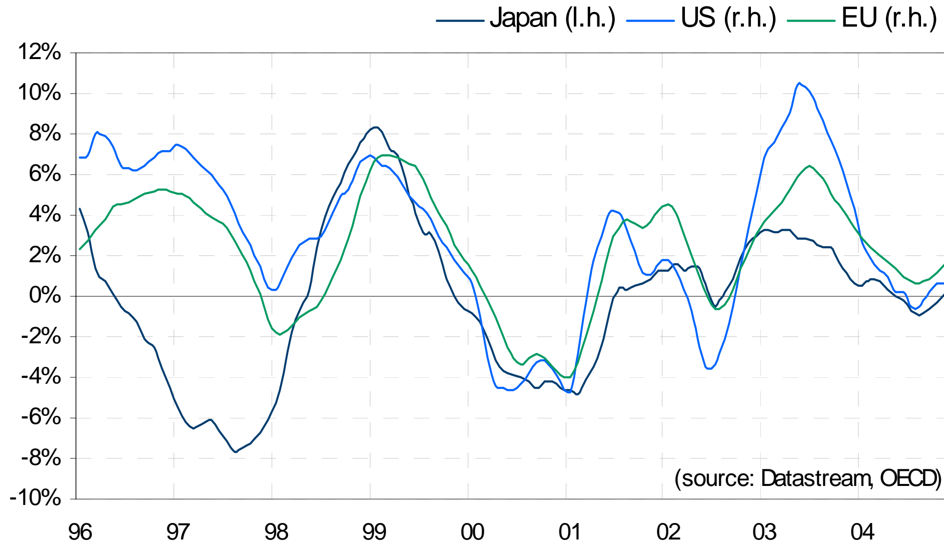
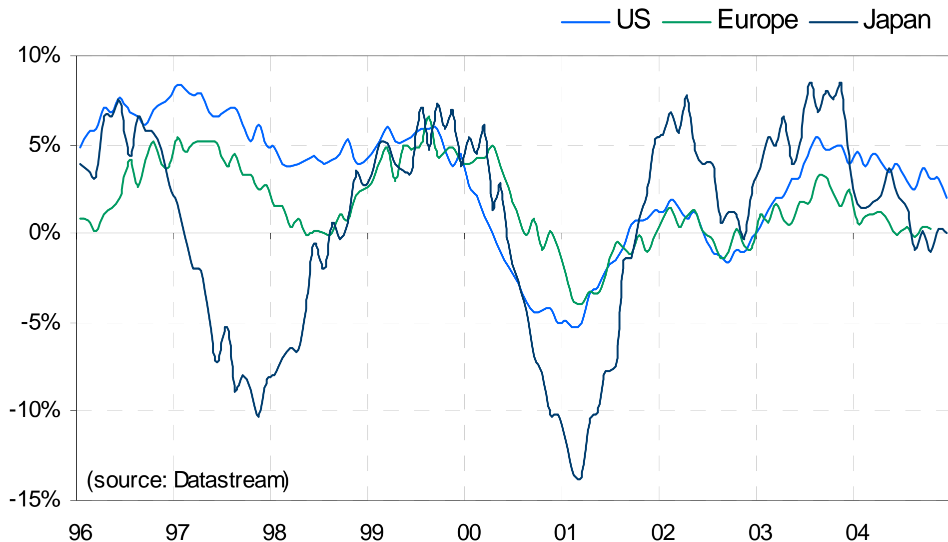
Growth scenario

Leading indicators (% chng YOY)



Industrial production (% chng YOY)



Projections

The autumn has brought the downward revisions to the growth scenario's that had been signaled for some time already by the evolution of the leading indicators in the main economic areas in the world. The year-to-year comparison seems in the meantime to have turned positive again, indicating a slowdown, but not an economy that is about to go under water. A lot depends obviously on the evolution of the energy prices. There is no doubt that the impact of oil rising another 50% on top of the price increase of last year, is making itself felt. The old thumb rule that a consistent 10-dollar increase in the oil prices means a reduction in economic growth of 0.6%, is probably no longer true as the mature economies in the industrial countries have become less oil independent. The sharp increase in the energy prices is on the other hand far from neutral and there will inevitably be a clear effect on growth. So far the downward revision of the expected growth rates has been relatively modest. If the energy prices fall back substantially from the current levels there is still a chance that the slowdown will be relatively small. If not, the fall in economic activity could be more substantial than it is currently assumed.

It is not just energy prices that are putting the brakes on the economic growth potential. There is sufficient evidence that it has mainly been the US that has been the driving force behind the recovery from the previous recession. It has come at a price. The US current account has not only gone too deep into the red to be comfortable over time, the room to fiscally stimulate the economy has also largely been used up. On top of that the monetary policy stimulus may go into reverse in the foreseeable future. Since mortgage refinancing and freeing equity out of the home market has been an important source of income over the past couple of years, a clear effect on consumer spending power can be expected. As consumer spending makes up more than two thirds of GDP, a serious slowdown cannot easily be made up by a revival in investments. Inevitably there will be a slowdown. The size of it is clearly linked to the next episode in the energy prices.

Projected real GDP growth (%, year average)

		KBC est.		*OECD est.*		*Consensus*	
	2004	2005	2006	2005	2006	2005	2006
Euro area	1.8	1.2	1.5	1.2	2.0	1.9	2.6
US	4.4	3.5	2.9	3.6	3.3	3.5	3.3
Japan	2.6	2.4	2.3	1.5	1.7	2.0	1.8

source: Datastream, KBC estimates, OECD

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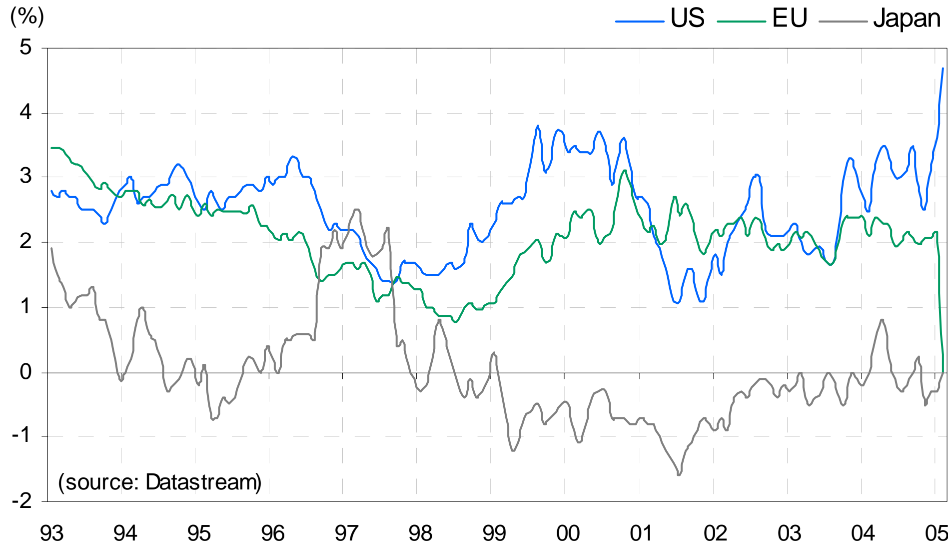
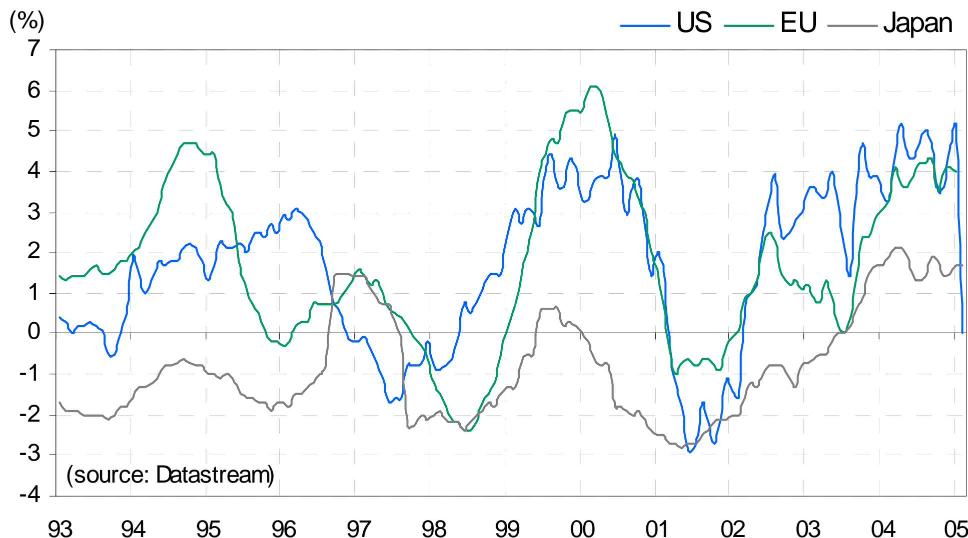
Consumer prices

Consumer prices (% chng YOY)



Producer prices (% chng YOY)



Overview & projections

For a longer period than initially thought the inflation news was better than expected. This period seems to have come to an end. Over the past couple of months the indications that price pressures are working their way through the system, have been multiplying. So far the impact has mainly been noticed in the producer prices with some traces nevertheless in the consumer prices as well. Even the so-called "core" inflation rates show a tendency to creep up. It has led to a series of declarations recently by Federal Reserve members in which they said unequivocally that inflation has now become the prime worry. The reasons for the increased upward pressure on prices are clear enough. Raw materials and energy prices have gone up substantially and as the output gap has largely disappeared in the US, the possibility for companies to raise prices has increased.

As a rule this does not necessarily have to lead to uncontrollable inflation, as long as wages do not take off and reinforce the wages/prices cycle. The pressure to increase wages however has been increasing lately. Partly as a response to rising costs for some items such as energy, partly as a reaction to a relatively long period in which wage income has relatively been limping behind GDP growth. Logic demands that the relative repartition within the GDP cannot continue indefinitely in the way it has gone over the last couple of years. Company earnings have indeed risen to a level that has not been seen for several decades. The fact that the globalization process has changed the labor/capital ratio and has thereby limited the potential for wage demands, has probably kept wage increases relatively in check so far. Mature economies however have a relatively limited manufacturing segment in which the competitive pressures are the hardest felt. Although service industries are far from entirely immune from the intense competition that the globalization has brought, the potential to raise prices in line with costs is clearly bigger than in industrial activities. In short, the inflation is still clearly containable, but, unless the energy prices drop substantially, it will take central bank action to keep it that way.

Projected consumer price evolution (%, year average)

		KBC est.		*Consensus*		*OECD*	
	2004	2005	2006	2005	2006	2005	2006
Euro area	2.1	2.1	1.8	2.1	1.8	2.0	1.9
US	2.7	3.3	2.8	3.2	2.8	2.4	2.3
Japan	0.0	-0.1	0.3	-0.2	0.2	-0.9	0.0

source: Datastream, KBC estimates, OECD

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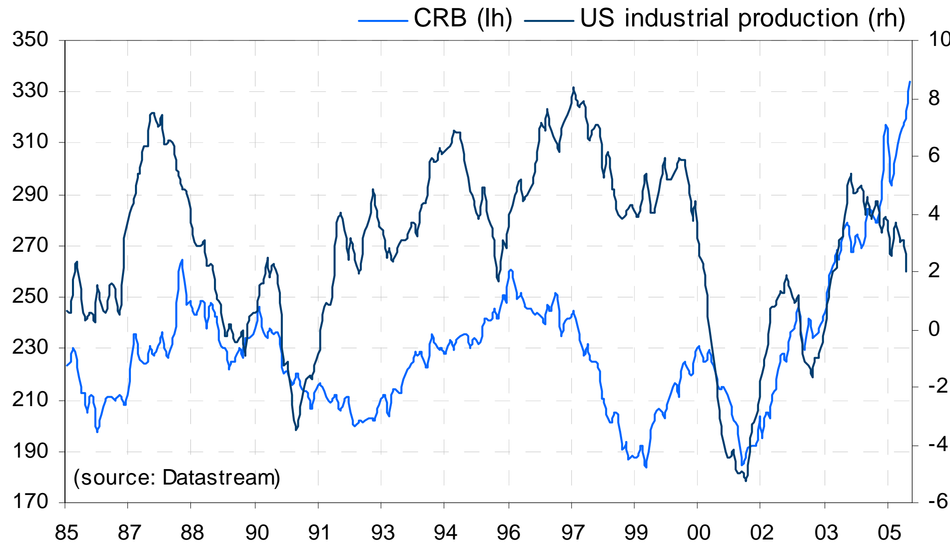
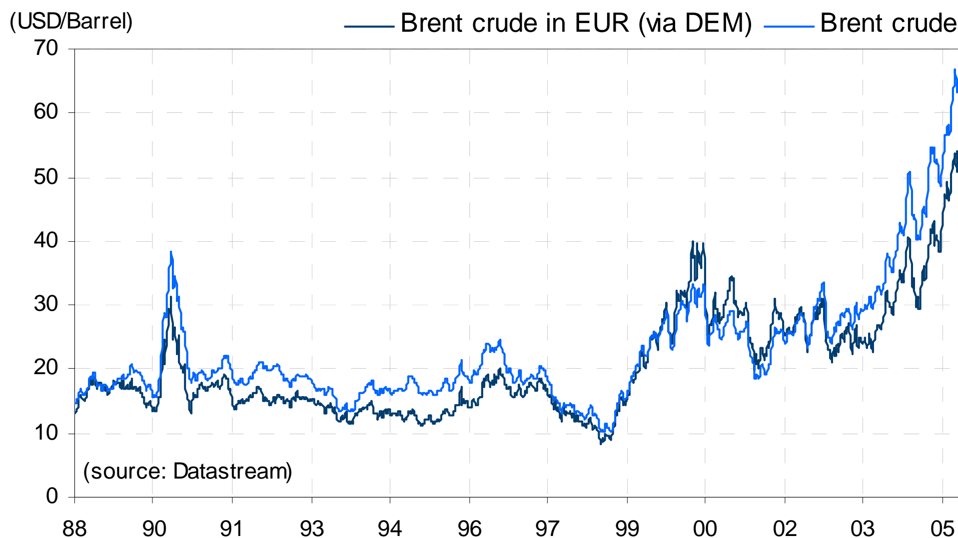
Commodities

CRB index



Oil price (Brent crude)



Oil price evolution

For several months now the oil production has been higher than demand. Partly this is the result of increased production, for a major part it is however also the result of slowing demand. According to the International Oil Daily the world oil consumption fell in September by 0.12% compared to a year ago. Demand in the industrialized countries fell by 0.6% while demand growth in the developing countries slowed to 0.6%.

For a longer time than expected it looked like the rising energy prices had little or no impact on consumption. Once the 50 dollars per barrel price had been breached however, demand seems to have slowed down relatively drastically and chances are that the September consumption levels may have to be revised further downwards.

Against the indications of lower demand the production level has been increased, be it that the tropical storms in the Gulf of Mexico have temporarily cut production as well as the refining capacity in the US. Current production levels surpass current consumption probably by several million barrels per day and the effect should made itself felt in the coming months, especially if the winter would be relatively slow in coming.

From a fundamental point of view chances are clearly higher that prices fall back quite substantially than that they should remain close to the recent highs. The main driver in this scenario is the expectation of more modest growth in the US, partly induced by the rising oil prices, partly as the result of a change in the monetary and fiscal policy as well. While Europe, and especially Japan may well do better than they did recently, the impact on the oil consumption growth will probably be limited.

The main question mark, for the overall economic scenario as well as for the oil prices is whether the developing countries, mainly in Asia and South America will be able to digest a slowdown in the US. Since most of these economies are export-oriented and, in the case of China, have a lagging development of the internal market, the ripple down effect from a slowdown in the US could be quite important. For the oil market and a series of other commodities, the overall effect could be quite substantial as well. While we believe that the industrialization in China and India will continue for a couple of decades, some caution is probably warranted about potential intermediate hiccups like the one we maybe are faced with right now. We think therefore that the coming year may be one in which the inexorable rise of a number of commodity prices will take a pause as the impact of a period of lower growth is digested.

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Commodities

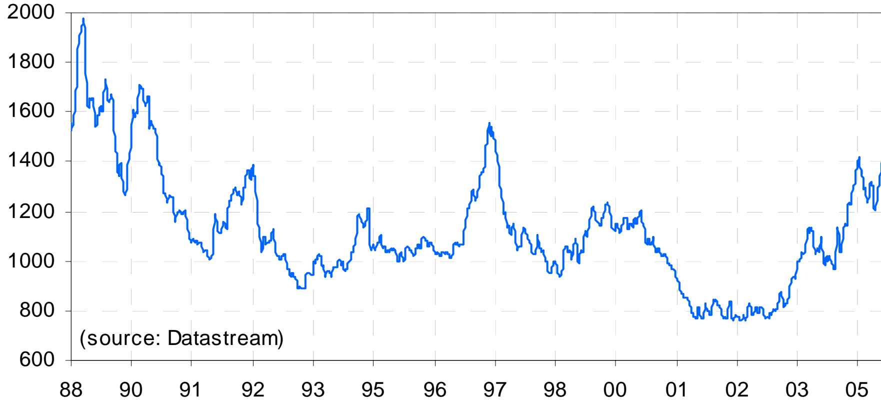
Gold price (Gold bullion $/Troy ounce)

Copper price (3mth forward US$/tonne)

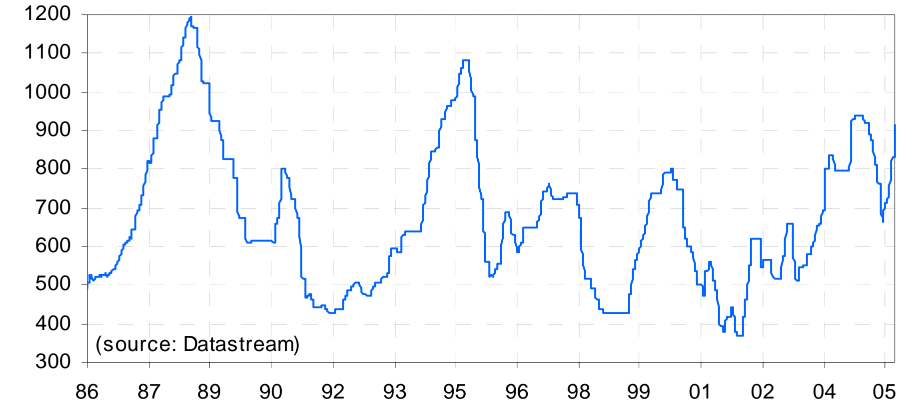
Goldman Sachs Commodity Index

Dow Jones AIG-Spot Commodity Index

Zinc price (3mth forward US$/tonne)



PVC price (spot price US$/tonne)



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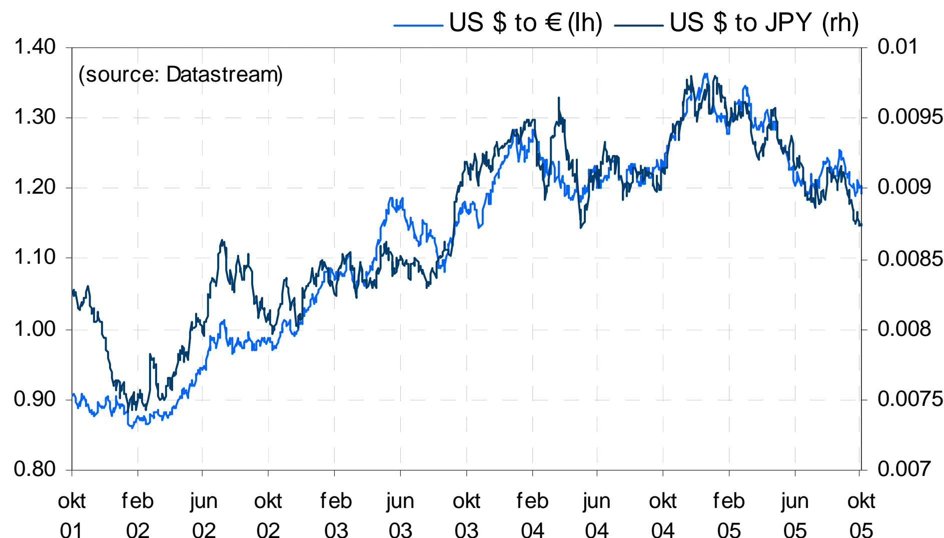
Exchange rates

USD/EUR



Forecasts KBC Bank

	Last	+3M	+6M	+1Y
USD/EUR	1.21	1.18	1.19	1.23
GBP/EUR	0.68	0.67	0.69	0.72
JPY/USD	114.00	113.00	112.00	106.00

source: Datastream, KBC estimates

Forward currency rates

	GBP/EUR	USD/EUR	YEN/EUR	YEN/USD	USD/GBP
+1W	0.684	1.207	137.710	114.046	1.766
+1M	0.685	1.209	137.518	113.615	1.766
+3M	0.687	1.213	137.018	112.810	1.765
+6M	0.691	1.220	136.262	111.585	1.765
+9M	0.694	1.226	135.484	110.471	1.766
+1Y	0.697	1.233	134.688	109.105	1.768
+2Y	0.710	1.257	131.662	104.760	1.771

Overview

The dollar's stronger "interregnum" may be coming to an end. While the growing current account deficit has been a threat for the dollar's stability since the late nineties, the difference in economic growth, the interest rate differential and the fact that the dollar is still the main reserve currency in the world, has given the US currency a firmer footing than could be expected. The driving forces behind the relative strength of the dollar have however been changing over time. In the late nineties the US attracted massive investment flows, which more than compensated the already substantial and growing shortfall on the current account. Over the past couple of years the investment flows have more and more been replaced by central bank intervention, mainly from Asian central banks. It is estimated that central banks financed almost 80% of the US current account deficit in 2003 and that this was still between 60 and 70% in 2004.

Recently the growing interest rate gap between the US and Europe has been supportive for the dollar, but there is an obvious limit to this. The ECB has kept its rates unchanged for an unusually long period, but has indicated recently that it may well act to counter budding inflationary trends in the near future. Unless US rates go up a lot more than it is currently expected, the interest rate gap is over time not sufficient to compensate for the huge current account gap.

Rising interest rates may in fact be about the only major factor supporting the dollar in the coming years, since consumer-led growth has reached its limits and the potential to stimulate the economy through fiscal measures has probably also been used to its fullest extent.

Fundamentally we therefore believe that the probability for the dollar to get weaker again is increasing. Some of the absolute resolve of the Asian central banks to keep their currencies unchanged against the dollar at whatever cost, seems to have lessened and China has made a first tentative step, which should eventually lead to a normal currency exchange market. In the US there has been growing pressure over the past year to push for currency realignment. It fits in a scenario in which lower growth and the reduced possibilities to stimulate the economy through fiscal measures leave few other choices.

If the market feels that there is little opposition to a weaker dollar, neither from the US authorities, nor from the Asian central bank, whose capacity to absorb dollar assets is not infinite, the readjustment of the US current account may well partly come about through the exchange markets. If this can happen in an orderly and incremental way, the whole episode may in the end be beneficial for the world economy. Even if the dollar is a special case because of its reserve currency status, it is hard to believe that massive current account deficits can be accumulated indefinitely. Although there is ample proof that currency markets are notoriously unpredictable and chaotic, we believe there are clearly more arguments pointing to a dollar between 1.30 and 1.40 within 12 months than arguments for a 1.10/1.20 margin

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