The market and the economy in 2010

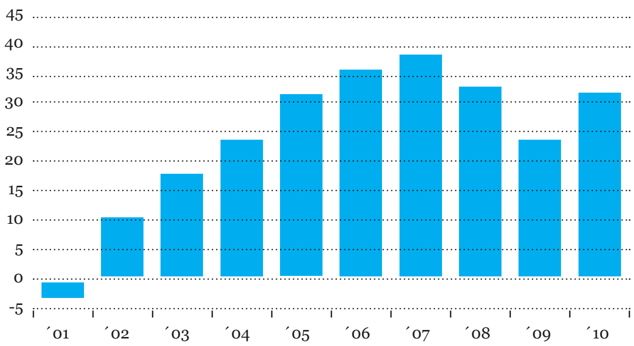
We often talk of being unable to see the wood for the trees, meaning of course that we are focusing so intently on individual details that we fail to see the bigger picture. The situation in 2010 was the reverse of this – many people were unable to see the trees for the wood. Those who were concerned only with the bigger picture, who focused on bad Western macro news (and there were a lot of them) overlooked the fact that, in reality, much of business and industry was in fact performing far better than had been feared.

Admittedly, the year began with a number of optimistic assessments and upbeat predictions. We started 2010 with clear hopes of an upturn in the wake of the most sweeping stimulus and rescue packages of all time. Stock markets, both home and abroad, rose sharply in the first quarter.

After that there was no end to the bad news. Ash from a volcanic outbreak in Iceland paralysed large parts of European civil aviation. The debt crisis escalated in Greece, Ireland, Portugal, Spain and Italy, with fears that it might spread even further afield. A raft of economists presented dire warnings of belt tightening measures within the OECD that would need to continue for years, to the accompaniment of intense protests and demonstrations against the cost-cutting. In the United States, there was talk of a possible double dip, in other words a new recession hard on the heels of the last recession, while China was increasingly seen as exposed to inflation and a growing housing bubble.

All this was topped off with a serious oil disaster in the Gulf of Mexico, followed by stringent restrictions which also affected Norwegian companies. At the time of writing, provisional figures published by the IMF reveal that the upturn in the developed economies has not after all been as significant as was thought. For most of these nations, including Norway, GDP has not yet climbed back to its 2008 level.

Buoyant growth in earnings

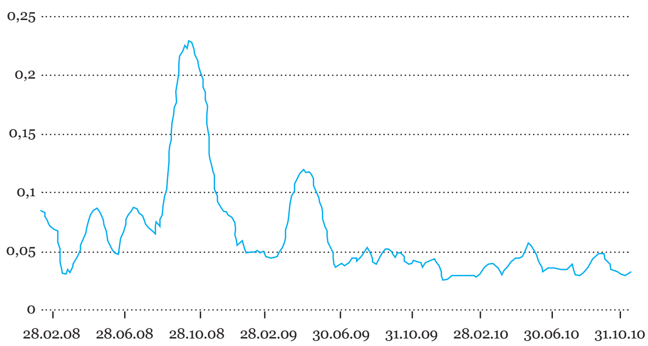


EPS (earnings per share) for OSEBX. (Source: FactSet)

In light of these developments, who would have predicted that the OSEBX would rise by 18 per cent last year? Or that the earnings of companies in the index would increase by no less than 31 per cent? Or that volatility (fluctuations) would be lower than for three years?

This was by no means apparent if developments in the market were analysed exclusively in terms of macro news and key figures. In other words, 2010 provided yet another example of the value of understanding companies, industries and long-term developments rather than timing peaks and troughs in the market.

An unusual year? Not in the stock market



OSEBX, 60 trading days standard deviation. (Source: Oslobors/Pareto)

Healthy trees in a sick forest

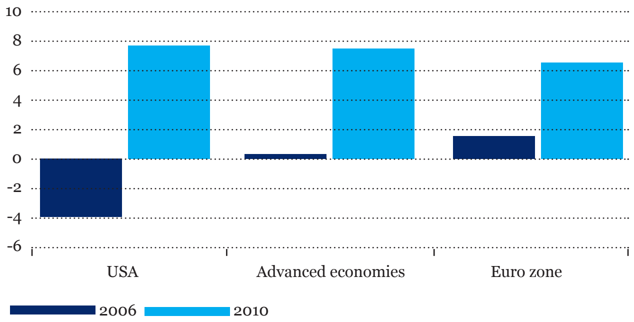
For anyone interested in stock markets, business and the economy, this diverging development also begged a very pertinent question: How could business and the stock market perform so well when the macro economy was so weak and apprehensive? The first part of the answer to this question must be that the massive accumulation of debt over the last two to three years primarily involves public sector debt. Over the course of just three years total world-wide public sector debt rose from 31 to almost 41.5 billion dollars, according to a continuously updated overview on The Economist website. If we also include municipalities and other public sector entities, the total may have exceeded 50 billion dollars.

This increase can in part be ascribed to expansive fiscal policy aimed at countering the financial crisis and the ensuing recession, in part to nothing less than the assumption of the debts of banks and other businesses under political decisions or guarantees. In this sense we are talking about a transfer of debt from the private to the public sector.

At the same time, that private sector has reduced its debt accumulation. Consumers in both the United States and Europe have increased their savings rates, admittedly from what were modest levels, while much of business and industry has significantly strengthened its balance sheets. For one thing, results have been surprisingly buoyant in the wake of the financial crisis and for another, payments in the form of dividends and investments have been modest.

It is no exaggeration to say that this consolidation in the private sector has been under-communicated when compared to the corresponding weakening of the public sector. One possible reason is that the figures are not readily available. On the other hand, they speak volumes. According to our calculations, the total financial surplus of the private sector in the United States (household savings and retained earnings in the corporate sector less investments) rose from minus 4.0 per cent of GDP in 2006 to plus 7.9 per cent in 2010. For the industrial nations as a group, the private sector increased the corresponding surplus from 0.1 per cent to 7.7 per cent of GDP in the course of the same four years.

Strengthened private sector



Private sector financial surplus (household savings plus retained corporate earnings less investments) as a percentage of GDP. (Source: Pareto/IMF)

This has not just resulted in a moderate level of business sector debt; we are in some instances talking about a substantial accumulation of cash holdings. The companies in the S&P 500 alone hold cash and liquid assets to an estimated value of 2.4 billion dollars, according to Bloomberg.

Thus, taken as a whole, the picture painted is of a massive transfer of debt from the private sector to the public sector. This helps to explain why the increase in debt and the widely publicised debt angst have failed to have a material impact on the stock market.

It is tempting to view the operation of a national treasury as a brilliant business scheme: You set your own prices (tax levels), payment is mandatory, and you even get to decide how many goods will be supplied in return for this payment – and of what quality. The problem is that maintaining this system is costly. Over time it may become necessary to purchase customer satisfaction and, in consequence, profits turn to losses.

At first glance, private companies appear to be faced with a tougher challenge: They must at all times strive to supply the best possible products at the lowest possible cost and the losers in this competition are eliminated continuously. Even so, this model has proved to be robust over the long term and a large number of listed companies are now in very good shape – notwithstanding macroeconomic uncertainty on an unfamiliar scale. In many ways this financial strength can be attributed to precisely this long-standing uncertainty, since it has forced companies to cut costs and to exercise prudence in their borrowings.

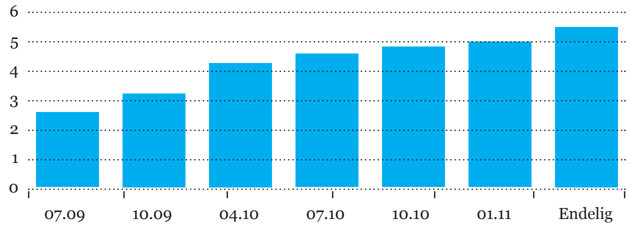
The overall effects of this can be seen in the significant growth in earnings and sound balance sheets of the private sector.

Profiting from Chinese growth

The next part of the answer is that private companies both at home and abroad have increasingly freed themselves from their former dependence on growth and fluctuations in their own home markets. Year by year international trade has increased relative to global GDP, interrupted only by a temporary set-back during the financial crisis, and measured as a proportion of market-oriented GDP (excluding the public sector) a significant portion of business and industry is now internationally oriented.

In other words, companies have become steadily more detached from the economic conditions in the countries in which they were based. As a consequence, it is far less of a problem that established industrial nations continue to report fairly anaemic growth rates with growth largely taking place in emerging markets. In 2010, Norway provided a good example of this, with provisional growth estimates of only 0.4 per cent. Final growth rate ended at 0.6 per cent.

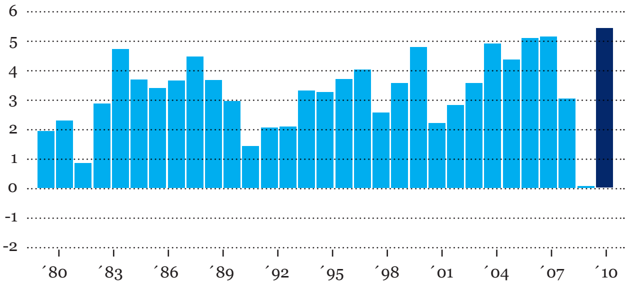
Getting better all the time...



Alobal GDP growth estimates for 2010 have continuously been revised upwards. (Source: IMF World Economic Outlook database)

In fact, for the world as a whole the year ended with one of the highest growth rates in over 30 years. Estimates have consistently been adjusted upwards from just 2.5 per cent in July 2009 to precisely twice that figure in the IMF's most recent update (as at January 2011).
The most pessimistic macroeconomists have been forced into repeated retreats.

The third best year since 1980



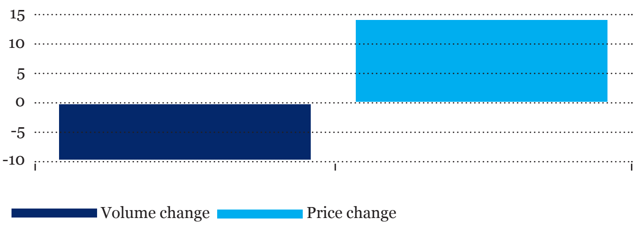
Per cent annual growth in global GDP. (Source: IMF)

And it is not necessarily Chinese companies that are most likely to benefit from this situation. After all, many Chinese companies export goods to the West, where customers have not exactly been spending freely over the last few years.
The reverse applies on Oslo Børs. We may not deliver that many goods directly to Chinese customers, but we sell tonnes of products that benefit from Chinese demand. Commodities and less processed goods, not least oil, are traded by the bucket load on the world market as a consequence of the Chinese hunger for goods. And the effects have been felt even on markets for more sophisticated products. German luxury cars, for example, are rolling on to the Chinese market at a dizzying rate.
China's current account surplus has in fact been halved over a period of three years, something that very few observers in the West seem to have noted. Last year alone Chinese imports grew by 39 per cent.

Company accounts in millions of barrels?

Finally, it should be noted that the constant focus on GDP growth can be misleading for anyone seeking to gain a true picture of developments in trade and industry. This is not solely because government accounts for a large proportion of GDP in modern welfare states like Norway, which means that cuts in government expenditure need to be removed in order to gain a true picture of developments in the rest of the economy.
Perhaps more importantly, GDP does not necessarily afford an accurate measure of the state of business and industry. The Norwegian economy in 2010 provided an excellent illustration of this: The low rate of growth of just 0.6 per cent can largely be attributed to the unusually low level of growth in the extraction of crude oil and natural gas, where value added (the sector's contribution to GDP) fell by no less than 4.9 per cent. This is a dramatic drop by any measure.
So why did energy-related shares on Oslo Børs not nose-dive last year? The answer is simple: This same sector, the extraction of crude oil and natural gas, recorded an average price increase of no less than 13.9 per cent. The national accounts measure only the volume of oil sold, whereas in corporate accounts, of course, the krone is what counts.

Two oil paintings



Extraction of crude oil and natural gas in Norway in 2010. (Source: Statistics Norway)

Moreover, a number of studies have demonstrated that there is little or no relationship between GDP growth and developments in prices on the stock market. Similarly, our own figures show zero correlation between stock market indices and GDP growth in the same year. This is true both of Norway and the United States. By contrast, the correlation between the stock market development one year and GDP growth in the following year is very high (no less than 0.6). Of itself this does not provide evidence of causality, but it does appear to fit the general perception that stock price movements are a leading indicator of business cycles.
From this perspective last year's upturn in the stock market should perhaps augur well for the future?

2010 in a nutshell

* OSEBX	+18.3%
* S&P 500 return	+15.06%
* MSCI World net	+11.8%
* 3-month NIBOR	From 2.19% to 2.60%
* 10 year Norwegian Treasury	From 4.15% to 3.68%
* Share turnover Oslo Børs (value)	+18.7%
* Brent Blend	from USD 78.70 to USD 94.70
* GDP growth global	5.4%
* GDP growth Norway	0.6%
* GDP growth Mainland Norway	1,8%

Sources: *Oslo Børs, Standard & Poor's, MSCI Barra, Norges Bank, FactSet, IMF, SSB, Pareto. GDP growth is updated with revised estimates after the respective Pareto annual reports were published.*