SAILING THROUGH A FLOCK OF BLACK SWANS

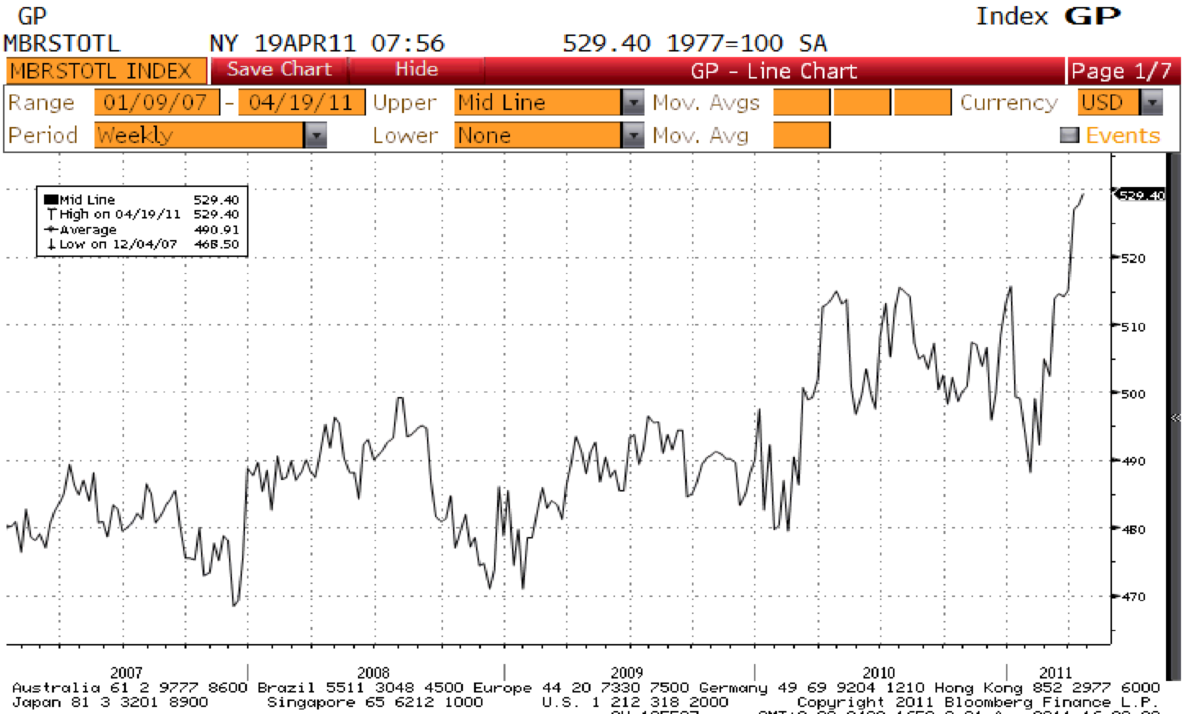
For equity investors, the world has become a terribly frightening and disorienting place. It seems as if every couple of months, some new event threatens to bring down the world.

In late 2009, the Dubai "default" threatened to derail the post financial crisis recovery. By 2Q, 2010, the sovereign debt crisis threatened to tear apart the Eurozone structure. This was followed rapidly by Ireland. All the while, world famous economists like Nouriel Roubini kept warning about a "Second Dip" in the US economy. Then in late 2010/early 2011, North Africa (Tunisia, Egypt and Libya) descended into revolutionary turmoil, followed by several other Arab countries like Yemen, Bahrain and Syria. This threatened to send oil prices (and inflation) spiralling out of control. Before the Green Revolution in the Islamic world could resolve itself, Japan was struck with earthquake-tsunami-nuclear meltdown. The Japan crisis not yet over, the Eurozone crisis erupted again driven by events in Portugal and Finland. The latest crisis is the near shutdown of the US government over budget disagreements and this saga has now morphed into the debt ceiling debate.

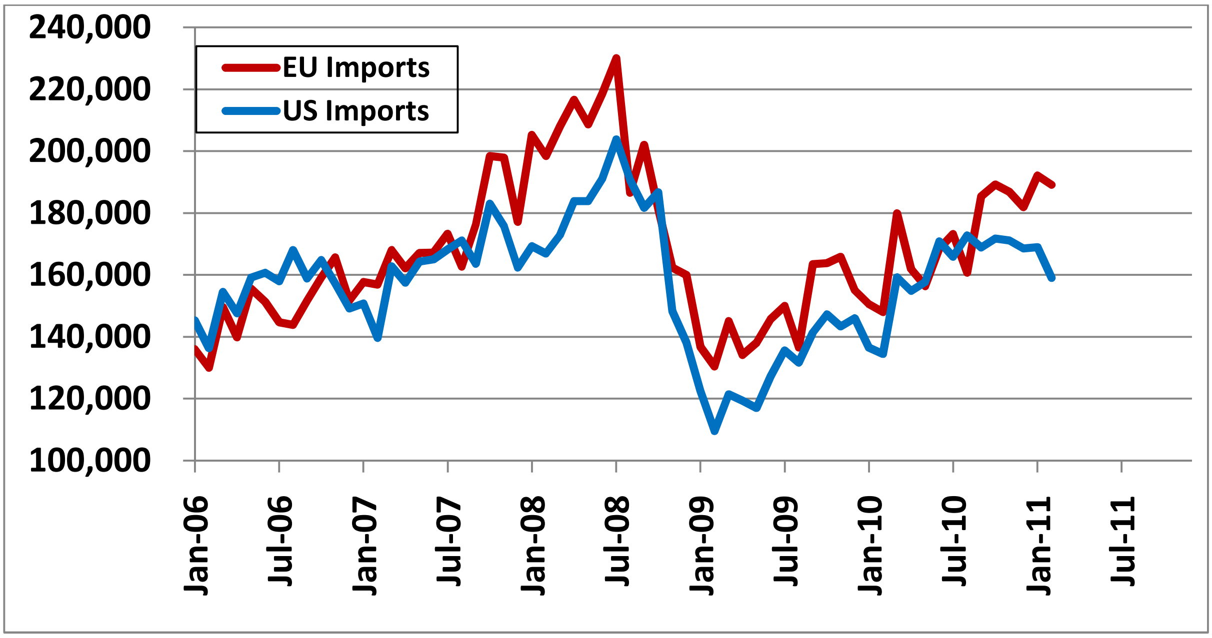
Too many newsworthy events have made people take their eyes off the most important factor underpinning financial markets – the overall health of the world economy.

Let's start with the US consumer, as consumption underpins 70% of the US economy. It is imperative that everyone be reminded that despite all the noise about China and India's emergence, **the US economy is still bigger than Japan, China and India combined!**

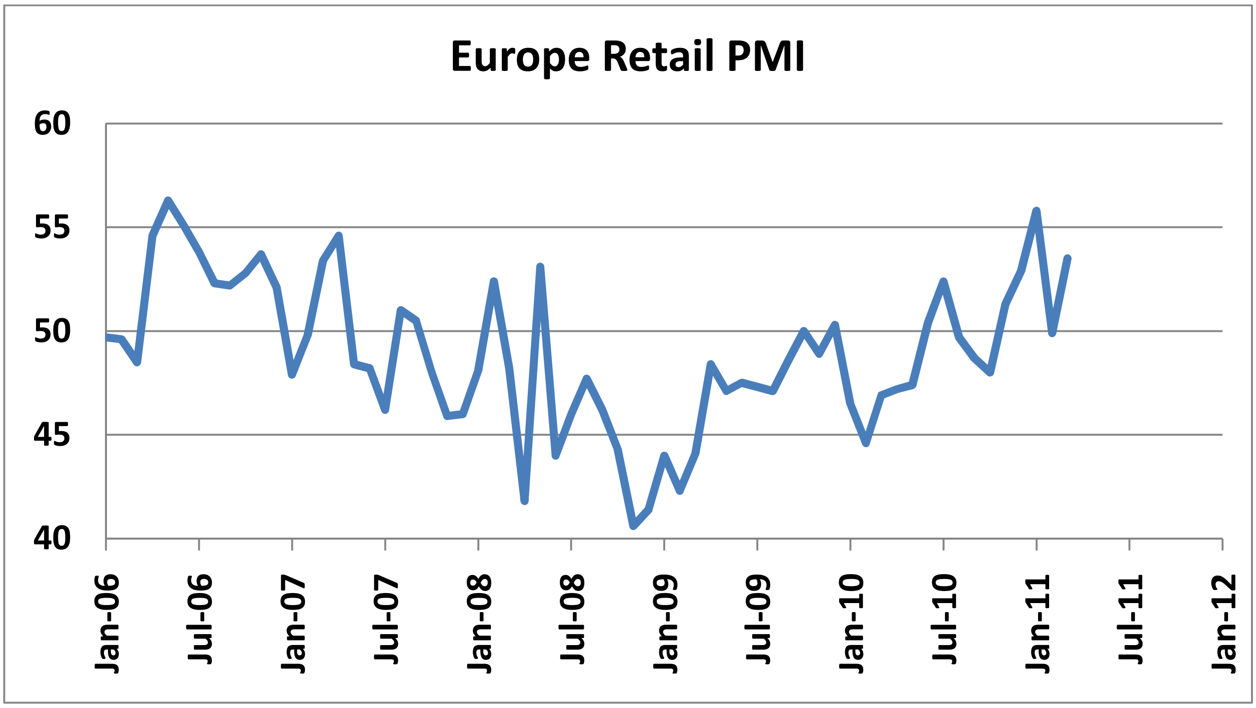
The following chart shows US chain store sales. One can clearly see that US consumption is nothing short of solid, having already exceeded the pre-crisis peak by over 6%. In fact, the trend in the last couple of months suggests some acceleration in consumer spending!



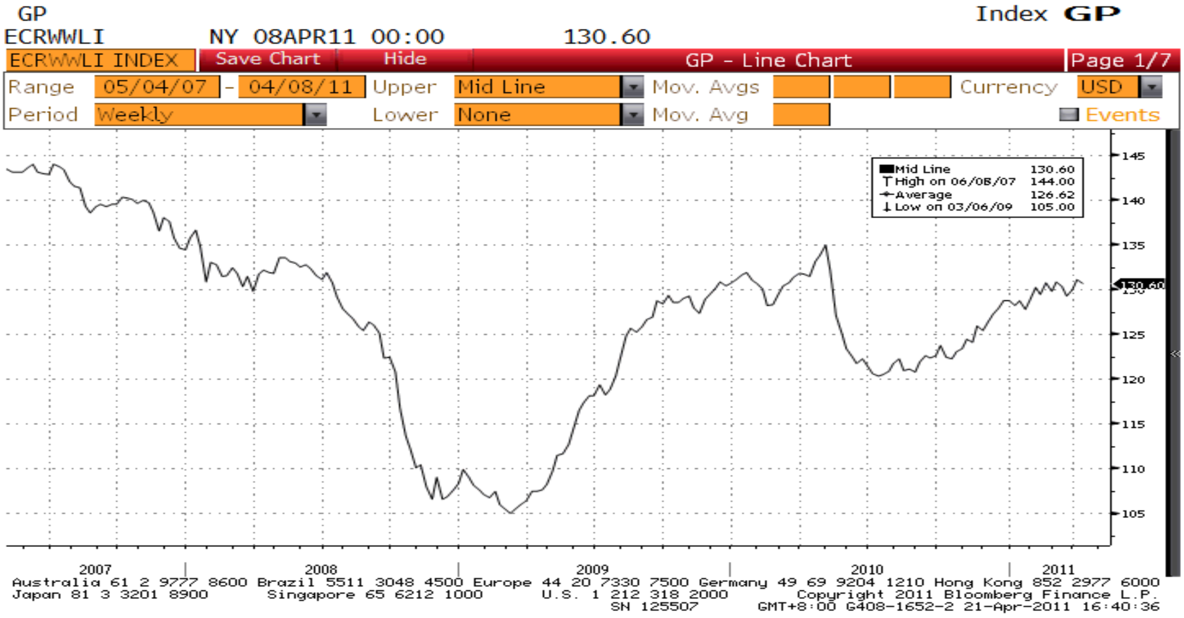
In order to consume, both the US and Europe have to import. Their monthly imports therefore give some indication of the health of their domestic economies. This is shown in the following chart, where one can see that in both regions, imports have been rising steadily since early 2009. Surprisingly, although perceived as an ailing region, EU import recovery is actually outpacing that of the US! Obviously, the EU economy is much stronger than its sovereign debt woes suggests, vindicating the ECB's more hawkish stance compared to the Fed and the BoJ.



Indeed, Europe's Retail PMI is in the pink of health, already back to pre-crisis levels. The ratio has been rising since bottoming out in late 2008 and since Nov 2010, has been above 50. A reading above 50 indicates that retail sales are growing sequentially.



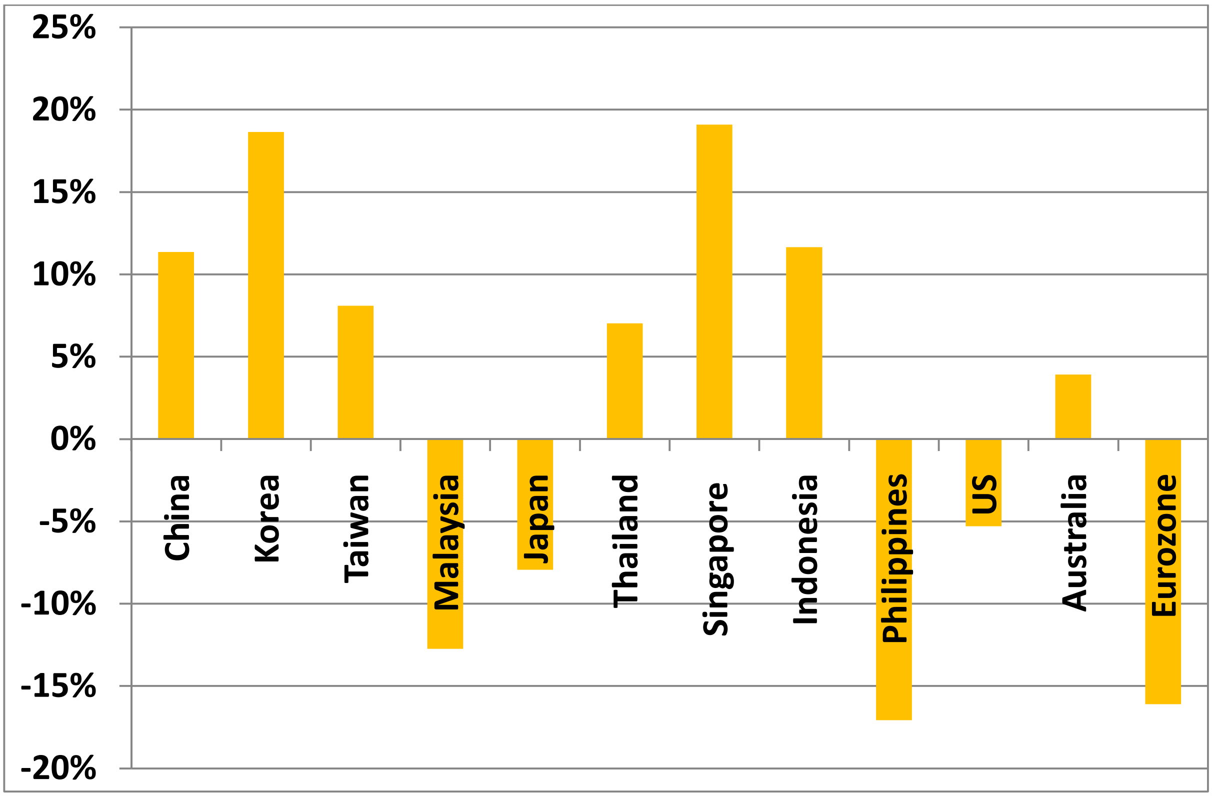
Back in the US, the ECRI weekly indicator is absolutely healthy. This is a composite leading indicator of economic activity. While it has not recovered to the full vigor of pre-crisis levels, the recovery is clearly on firm ground.



US and Europe consume and import, Asia produces. This is still the world order today although the process of rebalancing has started.

Over in Asia, new export orders for Taiwan as of Mar 2011 are perfectly healthy. In fact, the YoY growth rates are fairly similar to pre-crisis levels.

In terms of exports, most of the Asian export powerhouses have already exceeded their pre-crisis export peaks. The following chart shows a range of countries' most recently available export numbers relative to their pre-crisis peaks.



A few interesting features of the above chart.

- Malaysia and Philippines stand out as underperformers in terms of exports. Malaysia is particularly puzzling because of its wealth of natural resources – rubber, palm oil, natural gas, oil, etc. It is a very damning indictment of the country's industrial competitiveness.
- I've started tracking US exports because I believe that in the years ahead, the US will switch roles from being consumption driven to being manufacturing and export driven, facilitated by a very weak currency.
- The fact that exports from US, Eurozone and Japan are still so far away from their pre-crisis peaks suggests that the spare capacity in the industrial bases of these 3 regions are still very substantial, which in turn should put a cap on wage inflation in these regions.

In summary : To all equity investors, stop worrying. The world economy is moving along just fine.