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Hedge Funds Play U.S. Multinationals Against Mexico

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One need only glance at the headlines of the past few weeks to see that cracks are beginning to appear in the foundation of the world's largest economy:

-- "U.S. Q3 GDP Growth Weakest In Over Three Years"

-- "U.S. Data Fluke Exaggerated Growth, Will Be Reversed"

-- "Biggest House-Price Drop In 35 Years"

-- "Housing Decline Sparks Slowdown In Construction"

-- "Wal-Mart Posts Weak October Same-Store Sales"

-- "Fewer U.S. Companies Plan to Hire, Boost Prices As Growth Slows"

-- "Manufacturing Expands At Slowest Pace Since 2003"

Toss in a still-vulnerable U.S. dollar and an inverted yield curve (i.e., long-term rates have fallen below short-term rates), and the small but increasingly vocal minority that has been predicting a recession would appear to have quite a bit of evidence on their side.

But the stock market, which tends to lead the economy, doesn't seem to be getting the message about the coming contraction. To the contrary, equities have been on a tear since mid-July.

Call it a sign of the times. If we had to pick just one word to describe the global market environment, it would be "conflicted."

Economies And Earnings ... How Strong?

There is no question that the recent economic data are problematic for those who have been forecasting a "Goldilocks" soft landing in the U.S., and astute market observers have questioned how Standard & Poor's 500 corporate earnings could appear to be so strong in the third quarter (on pace for a 17% year-over-year increase) when the third-quarter U.S. GDP data were so weak (a much lower than expected 1.6%, compared to 5.6% in Q1 and 2.6% in Q2).

Yet many of the fundamental drivers of the four-year-old bull market remain firmly in place. The Eurozone manufacturing purchasing managers' index climbed to a three-month high of 57 in October, suggesting that Europe's manufacturing recovery may be gaining fresh momentum. At the same time, the unemployment rate in Europe's largest economy--Germany--fell below 10% for the first time in four years.

Across the pond in Great Britain, the residential housing market is heating up again; the stocks of U.K. homebuilders have climbed since June, and quarterly GDP growth has held steady at 0.5% or higher for the past six quarters--despite the fact that the U.K. yield curve has been flat or inverted for much of the last two years. The outlook also remains bright for much of Asia, which should benefit greatly from the recent sharp decline in oil prices. JPMorgan recently increased its full-year 2006 GDP growth forecast for China to 10.6%, and it expects 8% GDP growth in India.

This is good news for large U.S. multinational companies, which have significantly underperformed the broad equity benchmarks in recent years but seem well positioned for relative outperformance in an environment of slowing U.S. economic growth yet still-healthy global consumer demand. A robust global economy has already supported double-digit gains in U.S. exports this year, and if the U.S. dollar continues to weaken as we expect, in part because of tighter monetary policy abroad, this could serve as a catalyst for S&P 500 companies with a significant amount of foreign exposure.

Buybacks, M&As & IPOs: A Supply And Demand Story

Conflicted economic data aside, we must also highlight one of the most important--yet often overlooked--upward forces being exerted on U.S. stocks today: the astonishing and little-appreciated reduction in the overall supply of equities.

According to Standard & Poor's, S&P 500 companies have spent over $630 billion on stock buybacks during the past seven quarters, putting buyback expenditures on track to match capital expenditures this year. The "equity reduction" trend has not been limited to buybacks. According to Thomson Financial, $2.5 trillion of merger and acquisition deals were announced through the first nine months of 2006, near the total for all of 2005, putting this year on track for breaking the $3 trillion barrier by year-end--a number more than 50% greater than 2004, and seven times the volume of 2003.

And despite rising stock prices, the pace of share buybacks and M&As has not slowed, thanks in large part to corporate balance sheets that are flush with cash. (*The New York Times* recently reported that publicly traded U.S. companies are sitting on so much cash that, as a group, they could pay off all of their debt and still have money left over.) Private equity firms such as the **Blackstone Group** are pushing the $20 billion mark in new buyout funds. When one considers that long-term interest rates (i.e., the cost of money) are well below 5%, it is hardly a stretch to forecast a continuation of the equity-reduction trend, regardless of gloomy economic news.

On the flip side of the equity supply picture, new share creation via initial public offerings has remained subdued, despite the seemingly welcoming bull-market environment. According to a PricewaterhouseCoopers report, IPOs on U.S. exchanges hit a three-year low in the third quarter. The three biggest IPOs in the third quarter of 2006--Warner Cilcott Limited, Qimonda and Security Capital Assurance--generated only $2 billion in proceeds.

All of this adds up to a favorable backdrop for equities: Shares are being taken out of the market at a much faster clip than new shares are being created. And in the near term, additional support underneath the market can be seen in record short interest on the New York Stock Exchange. As of October 2006, the biggest increases in short interest were in shares of McDonald's, with an increase of 47.5 million shares; Time Warner, with an increase of 17.1 million shares; and Campbell Soup, with increase of 13 million shares.

Despite this positive supply-and-demand picture, we cannot blithely ignore the recent spate of weak economic numbers, nor can we rule out the potential for a more serious slowdown than many expect as we prepare to enter the fifth year of the current bull market.

The conflict inherent in this analysis begs an obvious question: Is there a way to construct an equity trade that is positioned to benefit from the still-positive global environment for U.S. multinationals and the continuation of the M&A and buyback boom, while at the same time being positioned to perform in the event of a significant downturn in the U.S. economy? We think there is, by establishing a long position in U.S. stocks with significant exposure to overseas markets ... and shorting Mexican stocks against it.

Why Mexico, a country we have not mentioned in the preceding commentary? All is explained in the inaugural issue of Inside Global Markets.

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