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Dow 11000 Is Only the Beginning

Companies go where the global growth is, and with leaner inventories and more efficient work forces, they can make profits even when national economies sputter.

By ZACHARY KARABELL

So we're almost there. The Dow is flirting with 11000 for the first time since October 2008—after falling to a low of 6500 in March last year. Now seems an appropriate time to ask whether the dramatic recovery of stocks is sustainable and to speculate about what comes next.

As always, bulls and bears have their argument, with bulls pointing to a recovery in confidence, stabilizing economic data in the U.S., surging corporate profits, modest valuations, and strong trends in the world at large. Bears fret about the threat of inflation eroding profits, banks with toxic loans still weighing down their balance sheets, high unemployment, easy money lulling the world into a false sense of complacency, and mounting debts on government ledgers.

Much of this argument may be irrelevant to the markets, which look primed to go up, not in a straight line, but up just the same.

Over the past decade, the fate of publicly traded companies, which tend to be larger and more global in scale, has detached from the fate of national economies. U.S. businesses rely on the domestic market for a shrinking portion of their revenue and profits, and many—including household names like Microsoft, Intel and Caterpillar—make far more overseas than they do at home.

These global companies, whether European or American, increasingly look to China for future income—the recent imbroglio over Google notwithstanding. And throughout the crisis most of them have been registering impressive gains in productivity and efficiency. How? The old fashioned way: by firing droves of workers and making better use of technology to trim inventories and utilize resources.

The dramatic sell-off in global equities between September 2008 and March 2009 was caused by panic; by the fact that as credit markets froze, equity markets were the only source of reliable liquidity. If you were faced with someone calling in your loan, for instance, you couldn't refinance but you could sell stocks at the click of a button and have your money in the morning.

The panic also stemmed from the cratering of financial companies' income, which made the entire market look suspect. Profits did plunge for several quarters throughout almost every industry and every country but began to recover far more rapidly than most expected.

Today, there is increasingly bullish sentiment among investors, or so surveys tell us. But even so, the Dow is only up 6% year to date, while global and emerging markets—where growth is humming—have done worse. U.S. mutual funds have seen inflows into bond funds and outflows from domestic equity; investors have withdrawn \$2.6 billion more than they put in, which means that the "average" investor isn't acting at all bullish. Money-market funds, which are yielding basically nothing, still have \$3 trillion, though outflows have been picking up.

What's more, U.S. corporate balance sheets are as flush with cash as they've ever been, in the neighborhood of

\$2 trillion. Conservative and cautious, companies haven't been quick to spend that stash. They haven't been buying back stock (which would be good for the market); they haven't been undertaking aggressive spending (good for other businesses); they haven't boosted dividends; and they haven't been hiring.

But those trillions will be spent, on mergers, acquisitions and capital spending. With trillions on the sidelines, there is fuel to move markets higher.

Then there is the global growth story, which is revolving around China but includes Brazil, Canada, Australia and many parts of East Asia. There is also strong positive momentum developing in India, and cash is once again piling up in the sovereign wealth funds of the oil states of the Middle East. That growth is generating cash, which is looking for return. The China Investment Corporation recently released a list of its holdings, which showed that it had begun to invest —albeit very quietly—in U.S. stocks ranging from Apple to Coca-Cola. That is a harbinger.

In short, much of our economic data doesn't matter to the prospects for the market. Corporate profits themselves bear more relation to an increasingly complex and interlinked global system than they do any national economy. Companies go where the growth is, and with leaner inventories than the world has ever known and sparser work forces, they can make profits even when national economies sputter.

There's a final reason to believe that the markets are headed higher. With interest rates so relatively low, even a modest increase in rates (which we've seen in recent days) isn't enough to make bonds an attractive investment for institutional and individual investors needing returns. Pension plans, 401(k) plans, mutual-fund managers and financial planners have all seen steep losses, and they all need outsized returns to meet expectations. Bonds simply don't offer that prospect. Only equities do.

None of the reasons why markets are likely to move up depend on a strong U.S. economy or robust growth in Europe. The jarring contrast between how companies and the overall economy are faring may yet produce a populist backlash, especially if unemployment lingers at 10%. But for now, there is little standing in the way of markets, and much to propel them forward.

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