Chapter 12
Macroeconomic and Industry Analysis

Framework of Analysis

- Fundamental Analysis
- Approach to Fundamental Analysis
  - Domestic and global economic analysis
  - Industry analysis
  - Company analysis
- Why use the top-down approach

12.1 THE GLOBAL ECONOMY

Performance in countries and regions is highly variable
- Political risk
- Exchange rate risk
  - Sales
  - Profits
  - Stock returns

Table 12.1 Economic Performance, 2006

<table>
<thead>
<tr>
<th>Country</th>
<th>Stock Market Return (%)</th>
<th>Growth in GDP (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>In Local Currency</td>
<td>In U.S. Dollars</td>
<td>In Local Currency</td>
</tr>
<tr>
<td>Brazil</td>
<td>32.9</td>
<td>14.2</td>
</tr>
<tr>
<td>Britain</td>
<td>12.5</td>
<td>27.3</td>
</tr>
<tr>
<td>Canada</td>
<td>12.7</td>
<td>23.5</td>
</tr>
<tr>
<td>China</td>
<td>13.6</td>
<td>138.4</td>
</tr>
<tr>
<td>France</td>
<td>19.0</td>
<td>33.1</td>
</tr>
<tr>
<td>Germany</td>
<td>22.7</td>
<td>29.4</td>
</tr>
<tr>
<td>India</td>
<td>49.1</td>
<td>51.3</td>
</tr>
<tr>
<td>Japan</td>
<td>6.9</td>
<td>5.7</td>
</tr>
<tr>
<td>Mexico</td>
<td>49.5</td>
<td>67.8</td>
</tr>
<tr>
<td>Russia</td>
<td>56.3</td>
<td>70.7</td>
</tr>
<tr>
<td>Singapore</td>
<td>29.4</td>
<td>40.4</td>
</tr>
<tr>
<td>Southkorea</td>
<td>17.6</td>
<td>36.7</td>
</tr>
<tr>
<td>Thailand</td>
<td>20.9</td>
<td>22.5</td>
</tr>
<tr>
<td>U.S.</td>
<td>13.8</td>
<td>13.5</td>
</tr>
<tr>
<td>Venezuela</td>
<td>162.6</td>
<td>99.0</td>
</tr>
</tbody>
</table>


Figure 12.1 Change in Real Exchange Rate: Dollar Versus Major Currencies, 1999-2006

- U.S. -16.1%
- Euro -15.5%
- Japan -6.9%
- Canada -19.7%
- -20% -15% -10% -5% 0% 5% 10% 15% 20% 25%
12.2 THE DOMESTIC MACROECONOMY

Key Economic Variables
- Gross domestic product
- Employment
- Inflation
- Interest rates
- Budget Deficits
- Consumer sentiment

Figure 12.2 S&P 500 Versus EPS Estimate

12.3 INTEREST RATES

Factors Determining the Level of Interest Rates
- Supply of funds from savers
- Demand for funds from businesses
- Government's net supply and/or demand for funds
- Expected rate of inflation

Figure 12.3 Determination of the Equilibrium Real Rate of Interest
12.4 DEMAND AND SUPPLY SHOCKS

Demand Shocks
- Demand
  - An event that affects the demand for goods and services
    - Reduction in tax rates
    - Increases in the money supply
    - Increases in government spending
    - Increases in foreign export demand

Supply Shocks
- Supply
  - An event that influences production capacity and costs
    - Changes in the price of imported oil
    - Freezes
    - Floods
    - Droughts
    - Changes in the wage rates

12.5 FEDERAL GOVERNMENT POLICY

Fiscal Policy
- Government spending and taxing actions
  - Direct policy
  - Slowly implemented

Monetary Policy
- Manipulation of the money supply to influence economic activity
  - Initial & feedback effects
- Tools of monetary policy
  - Open market operations (federal funds rate)
  - Discount rate
  - Reserve requirements
Supply-Side Policies

- Supply-siders focus on incentives and marginal tax rates
- Lowering tax rates will
  - elicit more investment
  - improve incentives to work

12.6 BUSINESS CYCLES

The Business Cycle

- Recurring patterns of recession and recovery—business cycles
  - Peak
  - Trough
- Industry relationship to business cycles
  - Cyclical
  - Defensive

Economic Indicators

- Leading Indicators - tend to rise and fall in advance of the economy
  - Examples
    - Avg. weekly hours of production workers
    - Stock Prices
    - Initial claims for unemployment
    - Manufacturer's new orders

Economic Indicators (cont)

- Coincident Indicators - indicators that tend to change directly with the economy
  - Examples
    - Industrial production
    - Manufacturing and trade sales

Economic Indicators (cont)

- Lagging Indicators - indicators that tend to follow the lag economic performance
  - Examples
    - Ratio of trade inventories to sales
    - Ratio of consumer installment credit outstanding to personal income
12.7 INDUSTRY ANALYSIS

Industry Analysis

- Performance can vary widely across industries
- ROE can range from 10.6% for electronic equipment to 29.2% for the cigarette industry

Defining an Industry

- Where to draw the line between one industry and another
  - Money-center banks: Variation by
    - Size
    - Focus
    - Region
North American Industry Classification System or NAICS Codes

- Codes assigned to group firms for statistical analysis
- Industry classifications are never perfect

Sensitivity to Business Cycle

- Factors affecting sensitivity of earnings to business cycles
  - Sensitivity of sales of the firm’s product to the business cycles
  - Operating leverage
  - Financial leverage

Figure 12.10 Industry Cyclicality

Sector Rotation

- Selecting Industries in line with the stage of the business cycle
- Peak – natural resource firms
- Contraction – defensive firms
- Trough – equipment, transportation and construction firms
- Expanding – cyclical industries
Industry Life Cycles

<table>
<thead>
<tr>
<th>Stage</th>
<th>Sales Growth</th>
</tr>
</thead>
<tbody>
<tr>
<td>Start-up</td>
<td>Rapid &amp; Increasing</td>
</tr>
<tr>
<td>Consolidation</td>
<td>Stable</td>
</tr>
<tr>
<td>Maturity</td>
<td>Slowing</td>
</tr>
<tr>
<td>Relative Decline</td>
<td>Minimal or Negative</td>
</tr>
</tbody>
</table>

Figure 12.12 The Industry Life Cycle

Industry Structure and Performance

- Threat of Entry
- Rivalry between existing competitors
- Pressure from substitute products
- Bargaining power of buyers
- Bargaining power of suppliers