Where are stocks headed in 2013?

STOCK MARKET

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The US economy continues to improve gradually. Europe's fiscal crisis is turning another corner. China is likely to stage a growth comeback in 2013. In Korea, the United States, China and major European countries, there will be growing hopes for an economic turnaround in 2013 as new leadership comes into place.

That said, the stock market outlook remains challenging. The range-bound trading pattern of 2012 will likely be repeated through the first half of next year.

Europe, the biggest problem

The European Central Bank's unlimited government bond buying program known as OMT managed to put a stop to the region's debt crisis spiraling out of control, but it is not enough to resuscitate the banking sector. The outlook for Germany, the strongest economy in the eurozone, is rapidly deteriorating. Economic recovery hopes will not rise until the market's confidence in Europe's ability to get out of the crisis returns.

Debt-to-GDP and fiscal deficit-to-GDP ratios, which are the key elements of credit rating decisions, will not get better any time soon. Further credit rating downgrades are on the plate with Spain and Italy expected to be downgraded to junk status sometime in the first half of next year.

Another stumbling block hindering the KOSPI's rise in the first half of next year is the US fiscal cliff, which will affect stock market fundamentals in a complicated cycle of fear, crisis and recovery. If tax cuts are extended, the fiscal cliff impact on the real economy will be limited. Nevertheless, the psychological impact of economic downturn fears will be felt.

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China's economic recovery momentum will not likely materialize until the initial six months of next year. China's new leadership may inflate policy expectations, but signs of meaningful growth recovery are not in sight.

The KOSPI is expected to move in the 1,850-2,050 point range during the first half of 2013, trading at 12-month forward price-earning ratios between eight and nine, according to Thomson Reuters.

We should wait until the second half of next year to see the KOSPI's upturn. Such upward march could last for at least two years if the following conditions are met for long-term sustainable recovery.

First, solutions to the European fiscal crisis should be put on the table early next year. Paradoxically, Spain and Italy debt downgrades to junk could provide clues to the permanent resolution of Europe's debt problem. Credit risk facing the eurozone's third (Italy) and fourth (Spain) largest economies will force Germany to act to speed up the formation of the eurozone's banking union.

Second, US fiscal deficit worries could dissipate by the second half of 2013 amid growing expectations for improving economic fundamentals. The third-round quantitative easing (QE3) effects will be kicking in gradually. The stabilization of the US housing market evidenced in steady rises in house prices and home transactions will strengthen the case for the self-sustaining recovery of the US economy.

Third, China's fixed asset investment will gain momentum, beginning in the second half of 2013. Fixed asset investment growth will reach a critical level. China's financial system may run into an all-out crisis if economic growth continues slowing in 2013. To stay ahead of the crisis, China's economy must create new demand to absorb goods produced by companies. Investing in infrastructure is the easiest way to digest inventories, generate corporate profits and contain banks' bad debt problem. China's accelerating investment drive and a subsequent recovery in economic momentum will translate into a boost to upside expectations for Korean equities.

Fourth, Korea's slowing economy will regain momentum in the second half of next year. Both the leading economic indicator and GDP growth will take an upturn. Even if earnings per share (EPS) growth slows, led by the IT and auto sectors (Thomson Reuters' corporate EPS growth consensus is 35 percent for 2012 and 17 percent for 2013), strengthening economic momentum will add fuel to earnings improvement expectations.

The KOSPI could find upside toward the 1,900-2,250 range in the second half of 2013.

The benchmark index could climb higher, going into the year-end. A KOSPI of 2,250 implies a price earning ratio of 10. A KOSPI of 1,950 at end-2012 and a KOSPI of 2,250 at end-2013 each represent a 6.8 percent rise in 2012 and a 15.4 percent increase in 2013. In other words, the KOSPI outlook is better for 2013, compared with this year.

Market Focus

Persistent weakening of growth weighs on global economy

GLOBAL ECONOMY

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We can now see clearly that there will be an overall slowdown in global growth from 2012-13 that can be explained by many contributory factors — it is by no means only because of the eurozone crisis. While the International Monetary Fund until recently expected growth in global gross domestic product to come in at 3.9 percent in 2013 and 4.5 percent in 2014, global growth is in reality likely to remain between 2 and 2.5 percent for these two years. What factors can explain this prospect of weak global growth?

Firstly, are the restrictive fiscal policies that continue in Europe and will appear in the United States in 2013, involving government spending cuts. Also, in Japan there will be a VAT increase in 2014.

Secondly, amid the ongoing eurozone crisis, there is a need to improve the level of production sophistication in many economies, which is a lengthy process.

Lastly, there are long-term structural problems in the major emerging countries: China's loss of competitiveness due to a rapid rise in unit wage costs within its industry, which has brought them to 65 percent of their US level; stagnation in Indian industry because it is impossible to find sufficiently skilled new employees; and major weakness in the Brazilian economy as a result of the substantial overvaluation of the exchange rate.

Global trade is now stagnating, and this transmits slowdown to all open economies in Asia and Central Europe.

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First of all, and contrary to widespread belief, it is not at all certain that commodity prices, and in particular oil prices, will be very high in 2020.

Conventional wisdom has been that global demand for metals and oil would perpetually grow faster than production capacity, leading to surging prices.

But we can now see that metal consumption has increased by only 1 percent in a year in China, versus more than 10 percent on average, and oil consumption has increased by only 2 percent in the same time, versus 9 percent on average.

Eventually, there will be substantial unused production capacity for commodities, leading to a downward trend in prices. Oil prices are currently underpinned only by geopolitical risk.

The second challenge to conventional thinking is that Chinese growth is not going to remain strong and the Chinese market will not remain a buoyant market for European, U.S. or Asian companies.

If China's gross domestic product was measured according to international standards, we would see that its growth is in reality only 3 to 4 percent due to the loss of cost-competitiveness, the continuous rise in household savings, and the 7 percentage point decline in companies' capital expenditure in one year as profit margins were squeezed.

Lastly, in this environment, monetary policies will remain expansionary for a long time to boost economies, help finance fiscal deficits in the United States, Europe and Japan, and to try to drive down exchange rates in the United States, the United Kingdom, Switzerland, Japan and emerging countries. There is even talk of a currency war.

Therefore, it is time to change our conventional thinking in this environment of persistently weak global growth.

Serious woes on global growth

GLOBAL ECONOMY

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The global economy is not doing well. The International Monetary Fund (IMF) just lowered its forecast for this year to 3.3 percent and to 3.6 percent for 2013.

Experts reckon that even those rates may be optimistic. This is not good news. Growth is sorely needed in order to reduce unemployment and debt levels in developed countries and to continue shrinking poverty and expanding the middle class in emerging and developing economies. Europe remains a drag on the recovery

The twin problems of persistently high unemployment and massive government debt levels in Europe, Japan and the United States are perhaps the most urgent to tackle. After two years of austerity measures, the macroeconomic picture in Europe continues to deteriorate.

We have repeatedly called in the past for a shift in emphasis, as has the IMF. Surplus countries need to reactivate their economies to facilitate export-led growth in the heavily indebted peripheral countries.

A moderately higher rate of inflation driven by higher wages and spending in the surplus economies would not only give the southern economies an opportunity to grow but also reduce their debt burden in real terms gradually over time. If inflation were to gather speed, the European Central Bank has many tools at its disposal to bring it under control.

Price stability is not under threat but growth and employment are. Shifting policymaking to a growth agenda, as the IMF recommends, would also facilitate addressing the problems in the banking sector, saddled as it is with bad loans.

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In the United States all eyes and ears are focused on the outcome of the November election. The two competing candidates advocate starkly different ways to cut the deficit and reduce debt.

The rest of the world is watching and wondering which of the two strategies will yield faster results and make a greater contribution to global growth. In any event, the United States is no longer the global locomotive that it once was. In fact, it is an economy in dire need of rebalancing when it comes to its economic and financial relationships with the rest of the world. If anything, we should expect lower U.S. imports and higher exports in the medium run.

Given the limited positive growth impact that either Europe or the United States can have on the global economy, our best hopes lie with the emerging economies.

China's plan for a new, if modest, fiscal stimulus program is welcome news, especially for Japan, which benefits from Chinese domestic growth thanks to its exports of capital goods and high value-added components. But the jury is still out as to whether the world's second-largest economy will manage to reverse the downward trend in its rate of economic growth.

Political tensions between the two countries are not facilitating growth in the region.

Another source of uncertainty is India. Reforms have stalled and so has economic growth. While the Indian economy's impact on global growth is relatively modest, every bit of growth around the world counts. Brazil is perhaps the largest emerging economy that has taken the sharpest turn for the worst.

Growth has stalled and the global slowdown threatens commodity prices, which could bring down the country's stellar economic performance over the last decade and a half.

The global slowdown also creates unwanted problems on the trade front. Countries around the world are reluctant to stimulate their domestic economies and are thus intent on increasing their exports. Volatility in currency markets is high, and many experts expect currency friction, or even wars, to be the norm for the next decade or two.

The specter of protectionism looms larger and larger when growth rates slow down.

As we have argued in our book "Global Turning Points," the global economy is lacking leadership from the largest countries.

Coordinated action is required more than ever to lay the foundations for sustained growth.

Let us hope that the spirit of global consultation, collaboration and concerted action returns after the U.S. election and the leadership transition in China.

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Economics of spam emails and advertisements

GLOBAL ECONOMY

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Spam email is loosely defined as unsolicited commercial email. Some spam such as that from Nigeria is purely a fraud, while many others convey information. One major problem with spam may well be its sheer volume. Some stubbornly return even if I place them on the block list.

In the summer 2012 issue of the Journal of Economic Perspectives, Justin M. Rao of Microsoft Research and David H. Reiley of Google wrote an interesting article titled "The Economics of Spam." According to Rao and Reiley, the word spam came from "a popular Monty Python sketch set in a cafe that includes the canned meat product spam in almost every dish" that customers did not want. "Every day about 100 billion emails are sent to valid addresses around the world; in 2010 an estimated 88 percent of this worldwide traffic was spam." Rao and Reiley state that spam emails are so widely spread that the Hormel Company that makes the tasty meat product and holds its trademark "stopped objecting to the use of the term to refer to unsolicited email."

What is the difference between spam and advertising? Both are unsolicited and can be annoying. Both can contain valuable information but can also be misleading. Rao and Reiley state that one major difference between spam and advertising is that advertising generates "market-mediated benefit." For instance, Google, Yahoo!, Microsoft, Facebook and others that provide such valuable services as search, news, and e-mail are supported primarily by advertising revenue. We simply accept advertising as a price to pay to enjoy the services of these companies. Rao and Reiley claim that with spam, we do not have the opportunity to "opt out."

What is the difference between spam and advertising? Both are unsolicited and can be annoying. Both can contain valuable information but can also be misleading.

There is a continuing war between companies that send out sleazy spam and valuable companies that try to protect consumers from this. Rao and Reiley reviewed market share data for the top 50 largest consumer web-based email service providers for the period 2006 to 2012. They found that "webmail provision has become increasingly concentrated in the Big Three of Hotmail, Yahoo! Mail, and Gmail. The three-firm concentration ratio in this market has increased from 55 percent to nearly 85 percent over the last six years; we believe that spam is a significant contributor to this increase in concentration." My personal belief is that those of us who use email all the time are grossly underappreciating the protection that Microsoft, Yahoo, and Google provide us every day.

The first U.S. legislation directed at spam was the Controlling the Assault of Non-Solicited Pornography and Marketing Act of 2003, known popularly as "CAN-SPAM" Act. "The law requires unsolicited email to have a valid return address, to offer a simple opt-out option, and to identify itself as advertising in the subject line." However, Rao and Reiley warn that "the CAN-SPAM Act does not appear to have markedly affected the illegal advertising market." One of the reasons why the Act has not been effective in curbing sleazy spam is the involvement of many jurisdictions, which makes it virtually impossible to prosecute violators of the law. For instance, "A spammer may be based in Latvia, work for a merchant in Moscow, send spam to the United States from a botnet with zombie computers all over the world, and have the final goods shipped from India." A botnet is a collection of internet-connected computers whose security defenses have been breached and thus lost control to an unknown party. Each computer with breached security is known as a bot.

Even if we exclude all bad emails that are fraudulent or try to infect us with a virus, we have another problem in that a given email may be spam to you but provide useful information to me. I use Yahoo that allows me to automatically move undesirable email to a spam holder that deletes them after a certain number of days that I select.