



Sluggish Economic Recovery and European Woes Curb Global M&A

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An encore of “*capital market seasonal-affect disorder*” may yet again be on the way in the summer of 2012.

Subdued business and consumer “animal spirits” preside in mid-2012. By some measures, the corporate sector looks more susceptible to doubts than are consumers. This rational anxiety springs from many roots.

Adverse seasonal headwinds temper optimism. Except for 2009, the third and early fourth quarters of 2007-2011 have been attended by what should be called “*capital market seasonal-affect disorder*.” This multi-century malady has an ancient ancestry.¹ In anticipation of this seasonality, performance gains up to mid-year may be ring-fenced by some organizations. Alternatively for laggards, defenses may be mounted against further financial disappointments before the submission of annual performance report cards.

An encore of “*capital market seasonal-affect disorder*” may yet again be on the way in the summer of 2012. Dominating market discourse for nearly three years, the European Contagion has not been corralled. While hardly a surprise, a possible disorderly “Grexit” may lead to some uncomfortable economic and knock-on effects. U.S. voters will choose between sharply divergent political and economic agendas in November. Global financial system overseers forage for additional untidy discoveries like Libor distortions and naturally seek new regulations to forestall reoccurrence.

Zooming out, this Great Recession and its still-unfolding aftermath already rank with the Great Depression of the 1930s in terms of longevity. For the structurally unemployed in locales like Greece, Spain, and the U.S., the Great Recession stands closer to the Great Depression than any other post-World War II downturn in terms of severity.

¹ The regular third-quarter/early fourth-quarter seasonal downward move in risky asset valuations can be attributed to the timing of major war inceptions, crop realizations, the final guidance confessions of some issuers to lower expectations for the rest of a year (following predictions of a year naturally looking up after that one-last restructuring/tough year), more credit ratings activity, congregation of usually gloomy global macroeconomic conferences appropriately concentrating on more risks than upsides, and propensity of modern institutions manned by career-minded individuals to become more defensive with the approach of their annual performance scorecard.

In our view, a revival of corporate confidence forms a vital missing piece to the economic normalization puzzle. Without vigorous, optimistic businesses, local economies will remain mired in low-altitude recovery.

Multiple catalysts instigated the Great Recession. Multiple remedies have been applied with limited success so far. In our view, these well-intentioned bromides, like an early dash of generic fiscal stimulus and a race to the easiest monetary policy in the modern central banking era as evidenced by negative short-term rates for high-quality European sovereigns, overly rely on macro trickle-down effects.

Policymakers have focused on stimulating economic growth while simultaneously marching on a knife edge toward sovereign fiscal rectitude, inspiring a transition to a more conservative global financial system to lessen the chance of another Great Recession, and offering rhetorical condolences rather than concrete actions to tame unemployment.

In our view, a revival of corporate confidence forms a vital missing piece to the economic normalization puzzle. Without vigorous, optimistic businesses, local economies will likely remain mired in low-altitude recovery.

Buffeted by mammoth uncertainties, the global corporate mindset currently inhabits a state of cautionary limbo. In July 2012, German investor confidence declined the most since 1998 (ZEW: -27.7 points to -16.9).² Japan Inc.'s outlook remains sedate. Japan's most important business sentiment indicator, the Tankan survey of large manufacturing enterprises business conditions, rebounded to -1 for the second quarter of 2012, up slightly from the first quarter's anemic -3. But this compares poorly with the 2004-2007 average of 18.8. U.S. business confidence also has become restrained. U.S. firms inventoried a whopping \$1.156 trillion of cash on their balance sheets at the end of first quarter of 2012 to guard against periods of non-capital market access as endured over 2007-2011.³ European firms held another \$800 billion of cash.⁴

² The ZEW investor confidence index is published monthly by the Mannheim-based Center for European Economic Research (Zentrum fuer Europaeische Wirtschaftsforschung- ZEW). Based on a survey of investor and analyst expectations, it is considered one of the most important leading sentiment indicators in Europe.

³ Standard & Poor's, July 3, 2012.

⁴ *Ibid.*

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More striking and contradicting the clear impetus for “business refocus” in so many industries in this swift-moving “reconfiguration era,” global merger and acquisition (M&A) activity languishes as shown in Exhibit 1. On pace to an annualized plunge of 17% in 2012 as seen in Exhibit 1, many firms have concentrated more on the optimization of existing operations rather than acquisitions and divestitures. Capital spending growth also has stalled as manifest in Exhibits 3 and 4. Diminished bridge-financing from delevering financial institutions also crimped demand, especially from the leveraged buyout segment of the private equity sector.⁵

In addition to fostering organic growth, the stewards of large multinational firms must maximize their business portfolios through geographical, horizontal, and vertical integrations as well as periodic pruning of non-strategic assets. Although certain M&A transactions may not be workforce accretive in some circumstances, a vigorous volume of overall corporate recalibration forms a powerful reinforcement of aggregate corporate spending and hiring growth. Economic and equity gains usually follow in lock step.⁶

Like just about every statistic in economics and capital markets, the rhythms of M&A strongly correlate to business cycles. Recessions chill risk-taking; expansions unleash ebullience. On a microeconomic level, unique industry conditions also power M&A. As evidenced by the announced planned restructuring of News Corp. in June 2012 and, for example, the likely forthcoming strategic responses of financial institutions to the application of new regulatory requirements, an eventual quickening of M&A looks inevitable in our view.

With a dividend yield of 2.83% and a 12.4 forward P/E ratio of MSCI World Index on July 23, 2012, the global equity market ranks approximately in the middle of a fair value range as of mid-2012. This shift to a higher M&A tide also would be encouraged by discounted equity valuations at least as of mid-2012 in many local markets, all-time low debt-financing costs from very receptive investment-grade and high-yield corporate bond investors seeking portfolio yield, and an eventual elimination of uncertainties like the outcome of U.S. elections in November 2012, including the successful negotiation of the “fiscal cliff.” Policymakers and legislators also could play a constructive role by swiftly concluding their search for and settling on new rules for financial markets.

⁵ For example, in its second-quarter earnings call on July 19, 2012, the Blackstone Group, a prominent private equity firm, stated “challenging capital market conditions and ongoing subdued M&A activity limited our opportunity for exits.”

⁶ Contemporaneous correlation (1988 to 2012): Global M&A Volume (U.S. \$, % y/y) versus Global Nominal GDP (U.S. \$, % y/y): 0.23; Global M&A Volume (U.S. \$, % y/y) and MSCI World Index (U.S. \$ Hedged, % y/y): 0.63. Regression (1988 to 2011): $MSCI\ World\ Index\ (\% \ y/y)_{t+1} = 0.04 - 0.39 * MSCI\ World\ Index\ (\% \ y/y)_t + 0.30 * Global\ M\&A\ Volume\ (\% \ y/y)_t$, R-squared = 0.17, lagged Global M&A Volume is significant with 90% confidence. 2012 MSCI World Index (% y/y) annualized as of June 30 and 2012 Global M&A Volume (% y/y) annualized as of July 17.

On a long-term basis, global macroeconomic realignments, technological changes, and new vectors of product supply and demand naturally instigate commensurate corporate reconfigurations in pursuit of greater firm efficiency.

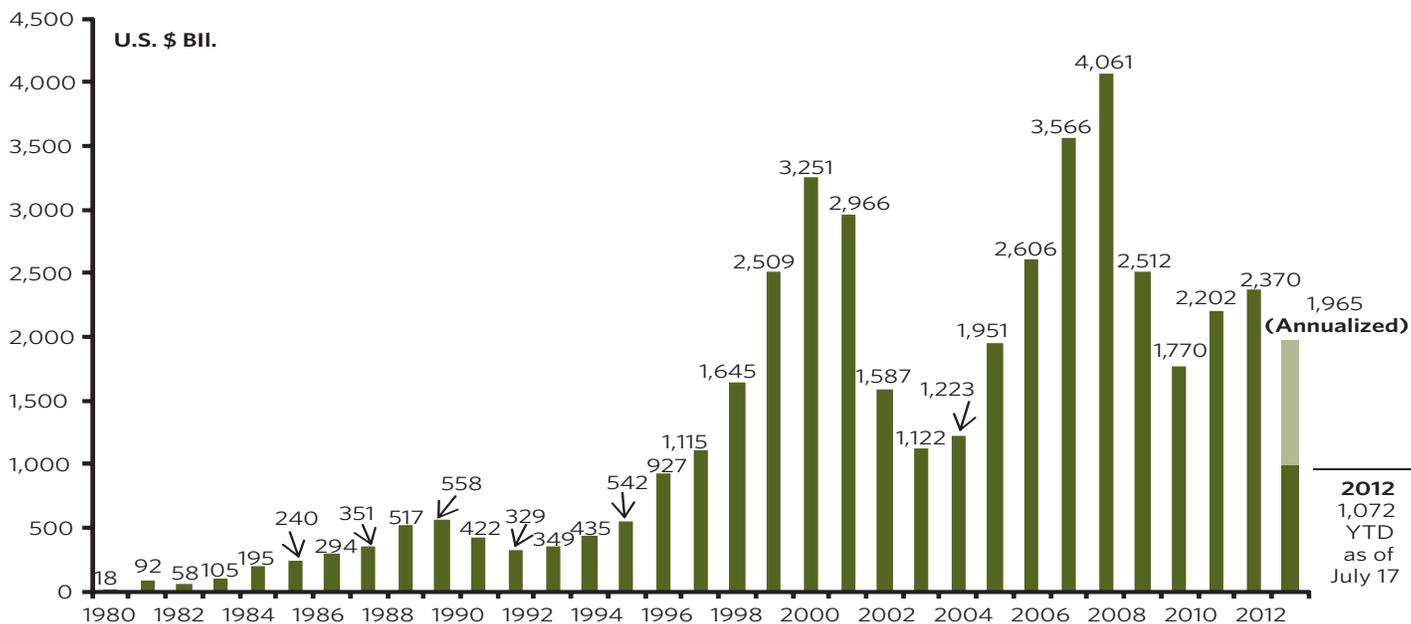
An abatement of international tax arbitrage also would prove helpful to firms with high corporate tax jurisdictions like the U.S., narrowing maximum statutory (40%) and effective corporate tax rates (25.4% for 2006-2009) at least to the global mean (22.6% per OECD) if not lower. By far, a resolution of European sovereign and bank woes would have the most salutary effect on prospective near-term M&A activity in our view.

Indeed, along with higher equity buybacks, dividend hikes, and solid but not spectacular earnings growth, a resumption of more prodigious M&A constituted one of the linchpins of our December forecast for a 10%-15% rise in global equity valuations in 2012. A rise in global M&A to the 32-year average of 5.1% of total capitalization in Exhibit 2 would imply incremental equity demand of \$1.46 trillion. The retaking of the 9.6% summit average enjoyed in 1998-2000 would generate \$2.24 trillion of additional equity purchasing power.⁷

On a long-term basis, global macroeconomic realignments, technological changes, and new vectors of product supply and demand naturally instigate commensurate corporate reconfigurations in pursuit of greater firm efficiency. With such vast recalibration of the global financial system underway, a proportionate vigorous global M&A rebound over the course of the rest of this decade approaches in our opinion. This will speed economic recovery and boost strategic equity valuations in our view. Policymakers can and should strive swiftly to promulgate policies that address *corporate outlook blues*. Otherwise, the likely perpetuation of this staccato on/off growth switch will almost certainly retard full global economic recovery and lead to another *capital market seasonal-affect "encore alert"* for mid-2013. This pattern must be broken to return to the sanguine days of the "old normal."

⁷ This estimate ignores the contemporaneous positive correlation between market value and M&A activity. M&A activity not limited to all cash transactions and may also include stock.

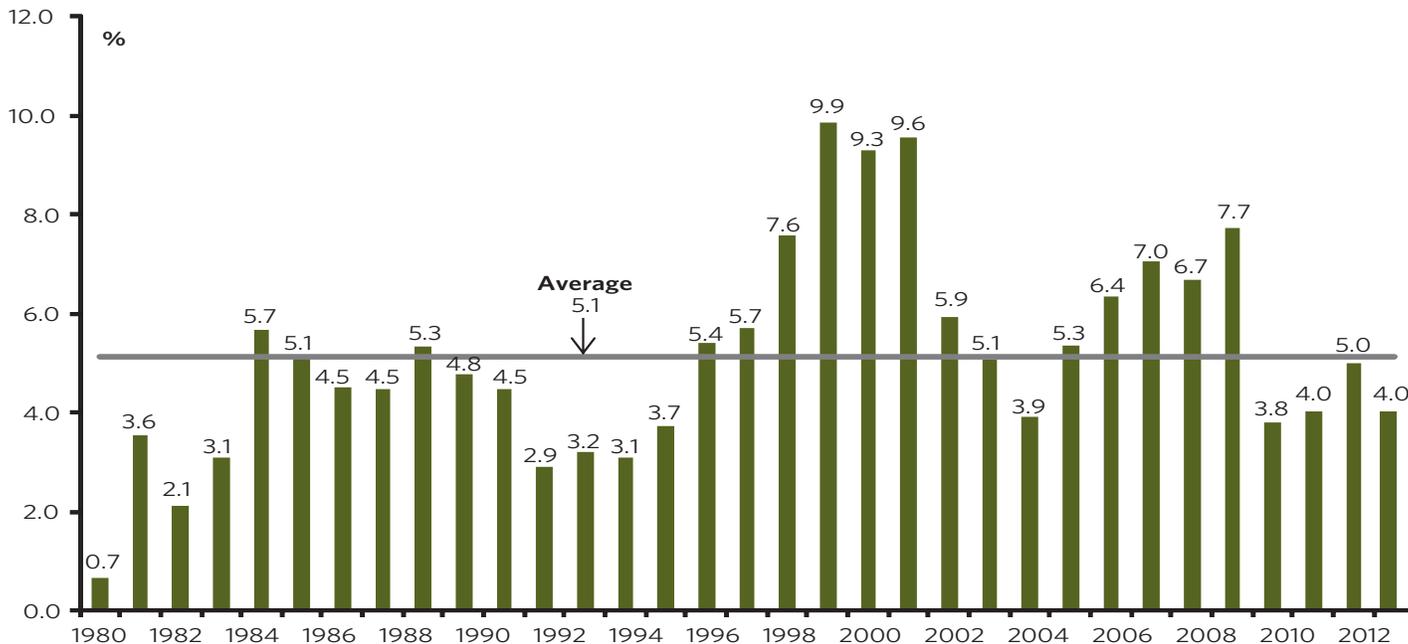
Exhibit 1 - Global M&A Activity*: 1980 to 2012 as of July 17



* M&A activity not limited to all cash transactions and may also include stock. 2012 Global M&A annualized as of July 17, 2012.

Source: Bloomberg; Thomson Reuters; BNY Mellon Asset Management.

Exhibit 2 - Global M&A Activity* (% of World Equity Market Capitalization): 1980 to 2012**



* M&A activity not limited to all cash transactions and may also include stock.

** 2012 Global Equity Market Capitalization as of June 30, 2012; 2012 Global M&A annualized as of July 17, 2012.

Source: Bloomberg; Thomson Reuters; Global Financial Data; BNY Mellon Asset Management.

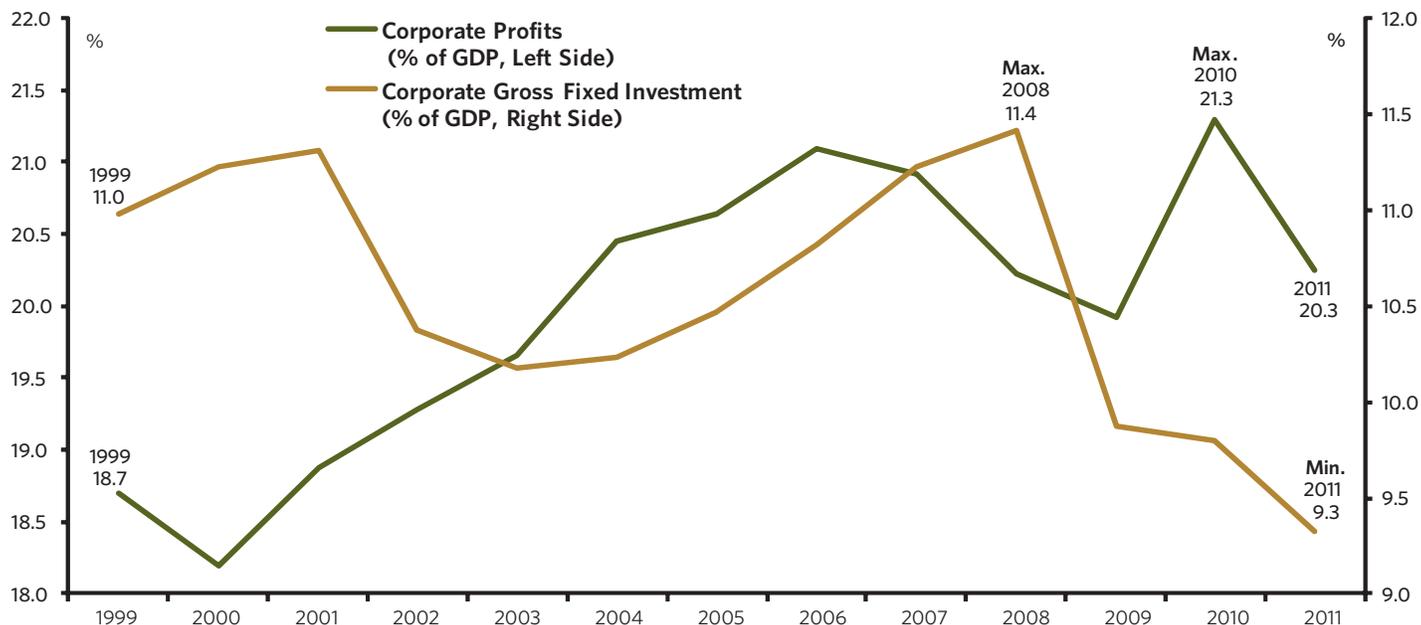
Exhibit 3 - Non-financial S&P 500 Companies: Total Cash and Short-Term Investments

Q4 2011: \$1,158,787.1 Mil.

Q1 2012: \$1,156,202.3 Mil.

Source: S&P Capital IQ; BNY Mellon Asset Management, as of July 17, 2012.

Exhibit 4 - G-4* Corporations: Profitability and Gross Fixed Investment*** (% of Nominal GDP): 1999 to 2011**



* G-4: Eurozone, Japan, U.K., U.S.; Japan: Data unavailable in 1999, 2000, and 2011.

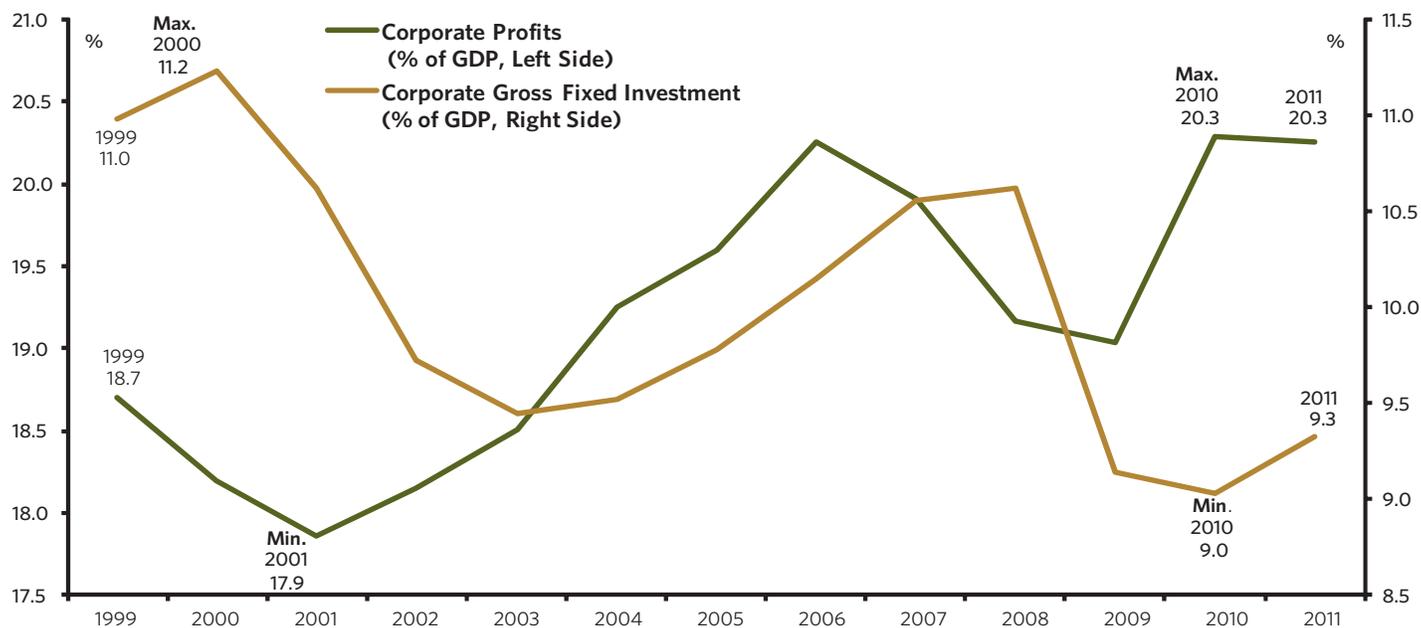
** Corporate Profitability: Gross operating surplus. Note: national income accounting standards differ from GAAP. Using GAAP, a similar but not exact profitability measure would be EBITDAR (earnings before interest, taxes, depreciation, amortization, and rent).

*** Corporate Gross Fixed Capital Investment: U.S. includes gross fixed investment of nonfinancial corporate and financial business as defined by Federal Reserve.

Corporate profits, corporate gross fixed investment, and GDP converted to U.S. \$ at year-end exchange rates.

Source: Cabinet Office, Government of Japan; Federal Reserve; Bureau of Economic Analysis; U.K. Office of National Statistics; European Central Bank; FactSet; BNY Mellon Asset Management, as of July 17, 2012.

Exhibit 5 - Eurozone, U.K., and U.S. Corporations: Profitability* and Gross Fixed Investment* (% of Nominal GDP): 1999 to 2011



* Corporate Profitability: Gross operating surplus. Note: national income accounting standards differ from GAAP. Using GAAP, a similar but not exact profitability measure would be EBITDAR (earnings before interest, taxes, depreciation, amortization, and rent).

* Corporate Gross Fixed Capital Investment: U.S. includes gross fixed investment of non-financial corporate and financial business as defined by Federal Reserve.

Corporate profits, corporate gross fixed investment, and GDP converted to U.S. \$ at year-end exchange rates.

Source: Federal Reserve; Bureau of Economic Analysis; U.K. Office of National Statistics; European Central Bank; FactSet; BNY Mellon Asset Management, as of July 17, 2012.

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