DIFFERENT DRUMMERS

The Dow moves and the rest of the world reacts. Or does it?

By Matthew Rose

There’s a saying in the investment community that when the Dow sneezes, the rest of the world catches cold. The evidence for this bit of wisdom? Largely, the world’s reaction to big drops. After the Dow Jones Industrial Average plummeted 171.24 points, or 3.04%, on March 8, other indexes blithely followed suit. Similarly, when Wall Street crashed on Oct. 19, 1987, with the Dow falling 22.5%, traders watched aghast as markets around the world plunged as well: From Aug. 31 to Nov. 30—a period in which the Dow lost 31% of its value—the British market fell 26% and the German market 33%.

The Dow “cold,” however, is largely just a 24-hour bug. True, stock indexes around the world have a remarkably consistent reaction when Wall Street starts to panic. But over the long term, national stock markets follow national economic and political ups and downs, not the Dow industrials.

While the industrial average has roughly tripled since November 1987, for example, the Japanese Nikkei Index has fallen 12%, reflecting domestic economic problems. Meanwhile, emerging economies often have their own agendas: Both the Manila and Makati composite indexes in the Philippines were headed up in October 1987, having just recovered from a coup attempt against the Aquino government in August. Both bourses fell about 12% after the Wall Street crash, but recovered within days.

So, even though looser capital restrictions, floating foreign-exchange rates and increased international trade have speeded capital movements around the world, no one index—not even the venerable Dow—can influence the pack for long.

Local Hero?

The Dow’s power to influence foreign markets at all is a relatively recent development. Even as late as the Wall Street crash of 1929, the Dow’s effect overseas was quite limited. The 12.8% fall on Oct. 28, 1929, immediately ruined many investors in the U.S., but European markets took months to react. And even then, the downturn was less severe.

The Depression rendered the Dow even less influential in overseas markets. It left a legacy of high tariffs and other controls, making international trade much less important to national economies and virtually ending international stock investing. So, foreign investors had little reason to keep an eye on the industrial average.

Even during the economic boom of the early 1950s, markets were insular and behaved quite differently. As the Dow soared 262% from early 1950 to the end of 1961, the rebuilding German market powered ahead 1,233%.

Then, in the early 1970s, the rules of the game were dramatically altered. The Bretton Woods agreement, a series of formal accords that defined the post-World War II economic environment, collapsed under the weight of deficit spending by the U.S.

In the wake of this, exchange rates were allowed to float, albeit under the watchful eye of central bankers. Controls on capital movement across borders were abandoned in the U.K. and Japan in 1979, and in France and Italy in the late 1980s.

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International trade, under the auspices of the General Agreement on Tariffs and Trade, began to flourish. U.S. trade was particularly robust; the nation’s imports and exports jumped to a total of $1.79 trillion in 1994 from $125 billion in 1970.

At the same time, international investing was undergoing a revolution. Multinational companies, which had been the source of most international investment since the 1950s, were supplanted by fund managers. And, after the mid-1980s, managers were aided by a technological revolution that allowed everyone to know what everyone else was doing, and let traders zap orders around the world in an instant.

Increasing Stature

As a highly visible proxy for the U.S. market, the Dow’s stature in the world arena increased markedly with these developments. According to the Organization for Economic Cooperation and Development, the correlation between monthly stock-market returns in London and New York rose to 0.59 in the second half of the 1980s from 0.45 before 1973. That means, simply, that 59% of the movements in London stocks can be explained—via complex mathematics—by movements in New York.

In the same period, the correlation rose to 0.44 from 0.19 for Japan, to 0.45 from 0.39 for Germany, and to 0.44 from 0.28 for France.

But a closer look shows the real correlation is between nations’ economies, says Campbell Harvey, a professor at the Fuqua School of Business at Duke University in Durham, N.C. According to Prof. Harvey’s research, the correlation between market indexes has been strongest when economic cycles in different parts of the world move together—such as during the oil shocks of 1973 and 1979. During the early 1980s, when the U.S. went from recession to recovery and Europe just stagnated, the link weakened.
Moreover, the data are skewed by a huge anomaly: the 1987 crash. Leaving it out, the correlation between the Dow and Morgan Stanley Capital International's benchmark of stocks in Europe, Asia and the Far East has been stuck between 0.4 and 0.5 since 1984.

"Just because a market is more integrated with the world capital market, it does not mean that it is more correlated with other equity markets," says Prof. Harvey. "That is more fundamentally determined by the country's industrial portfolio."

Will Goetzman, associate professor of finance at Yale University's School of Management, concurs. Reactions to moves in the Dow "can fool the market for a few weeks," he says, "but not for much longer than that."

—Namju Cho in Seoul and Rexie Reyes in Manila contributed to this report.

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