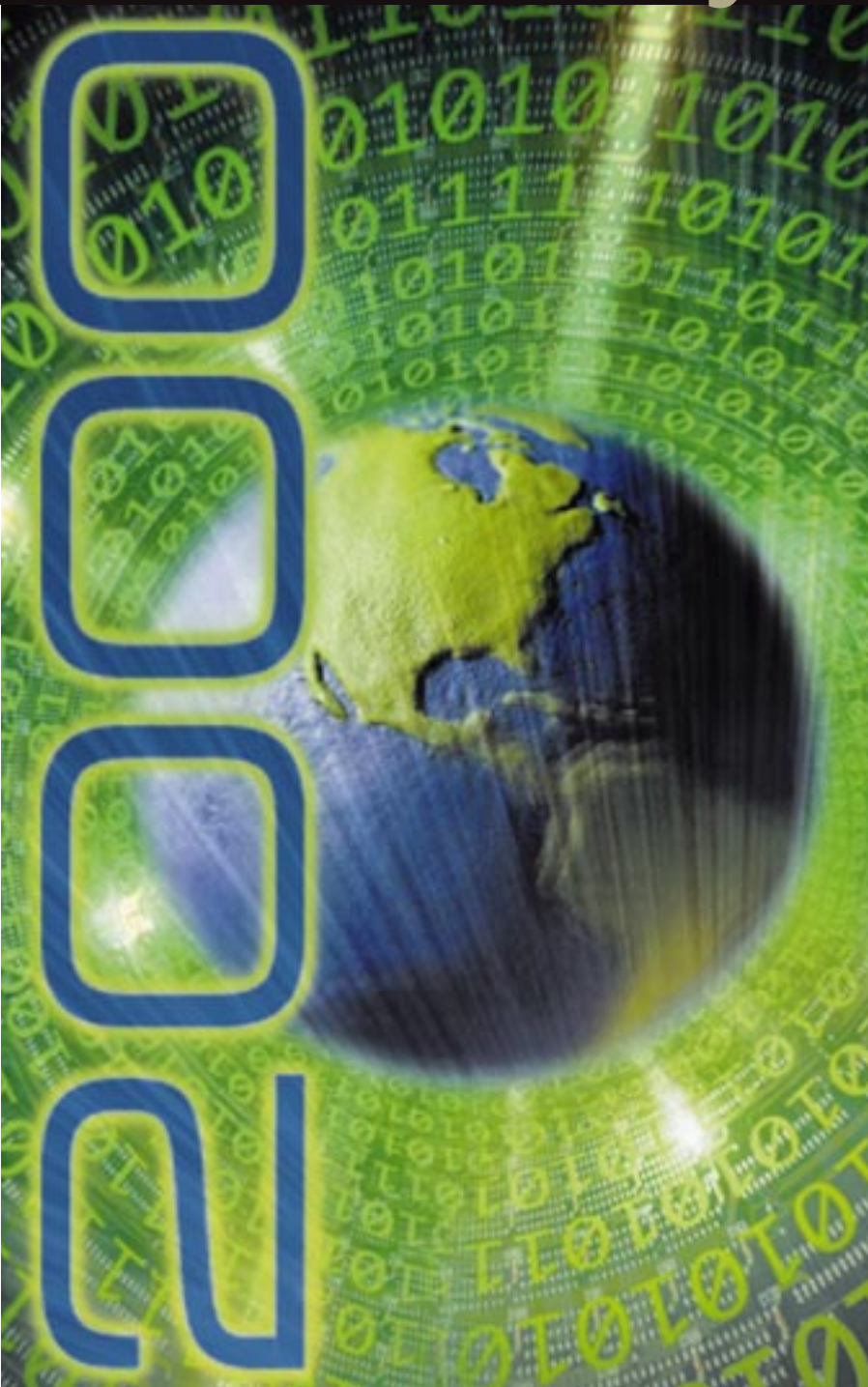


January Sterling Report



2000 Outlook: New Economy + Old Fed = Average Returns?

Pop Quiz

(a) The Dow Jones Industrial Average closed 1999 at 11,497. The index does not include reinvested dividends. If you redefine the Dow to include the reinvestment of all dividends since May 1896, when it started at a value of 40, what would its value have been at the end of 1999? Please write down your best guess.

(b) In addition to your best guess, please write down a low guess and a high guess, so that you feel 90 percent confident that the true answer will lie between your low guess and your high guess.

Quiz Answer and Comment on page 6.

(continued on page 4)

Sterling's Report

2000 Outlook: (cont'd)

Happy New Year, Century, and Millennium! I am aware that some fans of *The X-Files* agree with Agent Scully that the new century and millennium do not begin until next year. But here I must side with Agent Mulder: "Nobody likes a math nerd, Scully." Speaking of math, you might like to try our little quiz before reading ahead. No peeking for the answers!

Congratulations also to all who survived the dreaded Y2K bug. I have to admit that after seeing in the early hours of the year that the lights were still on in Moscow, I was happy to have been among the technology optimists. As expected, there have been a few glitches that appear to have been fixed rapidly. But the most memorable Y2K glitch has to be the video store in Colonie, New York, that charged a customer \$91,000 for returning a video 100 years late!

Now it's back to the real world, and unfortunately, the same old commute. The financial markets appear to have had a little too much bubbly over the holidays and started the year with a bad hangover. Here, in question-and-answer format, are some of my thoughts about the investment climate.

Q. Let's start by looking back on 1999. Stock market returns turned out to be about double what you expected. What did you miss?

A. With hindsight, it is clear that I was too cautious about two factors. First, I underestimated the degree to which rate cuts in late 1998 and early 1999 would jump-start the entire world economy, especially Asia. Secondly, even as a bull on the technology sector, I underestimated the force of Internet-related technology investment.

Q. What are you looking for this year? After five great years in a row, it's hard to imagine that stocks will keep rising.

A. I remain positive on the outlook, although I think it's safe to assume that global market returns will be closer to the long-term average rate of 10-11% than has been the case in recent years. The key market issue in 2000, in my opinion, will be the intersection of the powerful dynamics of the technology and e-commerce revolution with

the conservative monetary management of the world's central banks.

The great thing about the technology revolution is that it appears to be delivering higher rates of growth with lower inflation than anyone dreamed possible just a few years ago. If anything, the sectors associated with the most rapid growth, such as computers, software, and telecommunications, are experiencing price deflation, not inflation. But rapid rates of unit volume growth are permitting profits to rise even without price pressures.

I would also caution investors against thinking that just because we have had five great years in a row, we are due for a bad year. That is a common misapplication of "reversion-to-the mean" thinking. If you flip heads five times in a row, what is your probability of flipping a tails on the next toss? If the coin is fair, it is one-half. No more, no less.

That said, after tossing heads five times in a row, psychologists have found most people feel strongly that they are "due to toss tails." That kind of bias seems hard-wired into human nature, even though it is often wrong. The correct application of reversion-to-the mean thinking, after a period of great market gains, is to expect gains to be closer to their historic average. That is very different from expecting below-average returns. (Sorry, Mulder, I forgot what you said about math nerds.)

Q. But what about those cautious central bankers? Aren't rate hikes likely to hit the markets hard?

A. If I thought that inflation was a major issue and that central banks would have to slam on the brakes, then I would be very concerned. But with inflation low almost everywhere, rate hikes are likely to be modest — on the order of 50 basis points in North America and Europe. That may slow growth a bit later this year and into 2001, but risks of a recession should remain low.

Overall, it looks like the world economy should grow by about 3% in 2000 while inflation remains subdued. That would represent a benign investment climate for bonds and stocks alike. The combination of new economy

productivity trends with old-fashioned central bank tightening is likely to give us substantial market volatility, because investors and policymakers are unsure where the speed limits to growth happen to be. So there may be periods when investors fear the worst, and central bankers fuel their fears with hawkish comments. But if it's a tug of war between positive profit trends and negative interest rate trends, we expect profits to win the day — just as was the case in 1999.

Q. What regions of the world look most promising?

A. With the exception of Europe, foreign markets mainly outperformed the broad U.S. market last year and we wouldn't be surprised to see that trend continue in 2000 (see Chart 1). Both Europe and Japan have ample slack economic capacity and are at earlier positions in their respective business cycles. As shown in Chart 2, valuation measures such as price-to-cash earnings or price-to-book value ratios show most foreign markets remain significantly cheaper than the U.S. market.

With economic growth improving in Europe and Japan, and with the U.S. continuing to run a large trade and current account deficit, the dollar seems likely to depreciate further against the euro and the yen. But we think risks of a dollar crisis are low, because the U.S. remains an attractive destination for foreign investment and because improving growth overseas should help boost U.S. exports and reduce the country's trade deficit.

Emerging markets experienced a significant recovery in 1999, and the outlook for 2000 remains positive. Asian

nations have generally rebounded from the crisis of 1998, and as long as monetary tightening in the U.S. and Europe remains modest, most Asian markets should continue to post decent gains. Japan's role in the region is likely to be positive, though that country's road to restructured banking and corporate systems is likely to remain slow and winding.

The outlook for Latin America has also improved, with Brazil and Argentina having clearly emerged from recession in 1999. A key issue for the region will be whether Mexico can avoid the type of financial crisis that has plagued its recent Presidential election years.

Q. Canada outperformed the U.S. last year even though the gains were highly concentrated in a few stocks. Will it be more of the same in 2000?

A. I would not be surprised to see another year of out-performance by the Canadian market. Prospects for robust global growth along with moderate inflation should provide a positive external backdrop. Also, the Canadian dollar still has room to appreciate significantly against the U.S. dollar based on most measures of currency valuation. Also, as evident from the chart on comparative market valuations, the Canadian market looks relatively cheap.

That said, I continue to believe that most Canadian investors need broad exposure to global markets in their equity portfolios for a simple reason: if they ignore foreign markets, they are ignoring 98 percent of the world's investment opportunities.

1999 EQUITY MARKET PERFORMANCE

(Canadian Dollar)

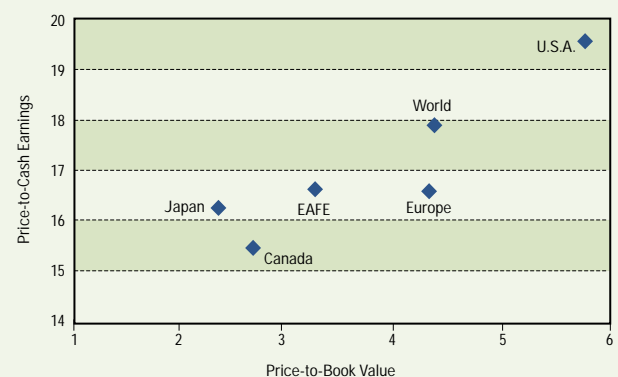
FINLAND	136.9%	DENMARK	4.7%
MALAYSIA	95.8%	UNITED KINGDOM	3.7%
SINGAPORE	86.2%	NEW ZEALAND	3.7%
SWEDEN	68.0%	NETHERLANDS	-0.6%
JAPAN	51.7%	SPAIN	-2.2%
HONG KONG	46.3%	ITALY	-6.9%
CANADA	43.4%	SWITZERLAND	-12.9%
NORWAY	22.4%	AUSTRIA	-15.4%
FRANCE	20.9%	PORTUGAL	-15.8%
U.S.A.	14.2%	IRELAND	-18.8%
GERMANY	12.2%	BELGIUM	-20.4%
AUSTRALIA	8.8%		

Source: MSCI

Chart 1: Global markets generally posted another strong year in 1999, with European markets lagging in response to a weak euro.

MARKET VALUATIONS

International Markets Offer Relative Value



Source: MSCI

Chart 2: The U.S. market continues to look expensive relative to other international markets, as has been the case for most of the decade.

Q. Can the technology rally continue this year after the huge run in 1999?

A. The market has been telling us that a very dramatic event is taking place. As Steve Waite and I argued in last month's *Perspective*, the most predictable trend for the year 2000 is that virtually all of the world's major corporations will put aggressive e-commerce strategies at the top of their agenda — especially in the business-to-business area. This trend is still in its early stage and is generating massive demand for computers, software, and telecommunications services. Although these sectors are vulnerable to profit-taking following big gains last year, the fundamental outlook remains extremely positive. In particular, Steve continues to emphasize wireless broadband equipment and service providers and optical networking equipment manufacturers.

Rapid technological advancement will not be limited to the Internet sector, in our opinion. In *Boomernomics*[®], Steve and I argued in 1998 that the next big thing after the Internet would be biotechnology. Recent developments continue to support that belief. By this summer, scientists will have a working map of the human genome, and that should set the stage for explosive growth in new drugs and therapies. For example, there are currently over 1,000 drugs in the biotechnology pipeline.

Q. What are your asset allocation guidelines currently?

A. In our relatively conservative international balanced fund, our target allocation is 60% equities, 40% fixed income. That allocation expresses our view that equities should continue to outperform fixed income this year, but not necessarily by a huge margin. Regional allocations in our global equity funds are currently 63% in North America, 22% in Europe, and 12% in the Pacific Rim. Our large weight in the U.S. is a reflection of our overweight sector positions in capital goods, telecommunications and information technology, rather than a call on the U.S. market as a whole. It remains our view that many of the key beneficiaries of the global e-commerce boom will be U.S. companies with a global presence.

Q. Any other comments?

A. I would simply like to thank our readers for helpful comments and support in 1999 and wish them the very best in the new year.

William Sterling

William Sterling
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IT WAS A VERY GOOD CENTURY

Total Return on S&P 500

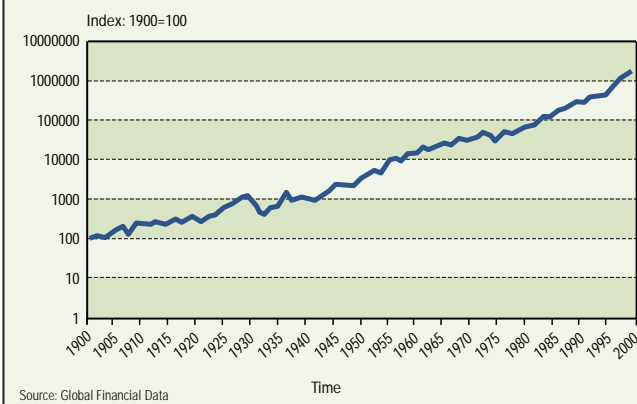


Chart 3: On a total return basis, investors in the U.S. market gained an average of 11.5% per year in the 1900-to-1999 period.

Quiz Answer and Comment

(a) Had the Dow been redefined to include reinvested dividends since May 1896, it would have reached 829,636 by the end of 1999! As you might recall, this was a period that included world wars, global depression, and a lot of other Bad Stuff.

(b) This quiz was adapted from *Beyond Fear and Greed: Understanding Behavioral Finance and the Psychology of Investing* (Harvard Business School Press, 1999) by finance professor Hersh Shefrin. The book summarizes the growing body of

research on how even the best investors let bias, overconfidence, and emotion cloud their judgment and affect their actions. In the quiz, if people were well calibrated, then 90 out of 100 would find that the correct answer lay between their low guess and their high guess. But Shefrin has found in his own surveys that virtually nobody finds that the true answer lies between their low guess and their high guess. For the most part, their high guesses are much too low. That reflects widespread overconfidence, even among "experts."