April 2000
ISSUE

Sterling's World Report

Cabin Crew— Please Take Your Seats

Frequent fliers are used to turbulence. When the skies get a bit choppy, the captain asks passengers to take their seats and fasten their seatbelts until he can find smoother air. Occasionally, when the ride gets very turbulent, the captain asks the cabin crew to take their seats as well — even if they are in the midst of serving dinner.

In the February *Perspective*, we wrote an article called "Keep Your Seatbelts Fastened," which suggested that we were likely to be entering a period of volatile and challenging markets. That article suggested that investors pay careful attention to their asset allocation and avoid being overexposed to single sectors, including the high-flying technology group. We adopted a cautious — not bearish — asset allocation of 55% equities and 45% fixed income.

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Sterling's Report

With technology-related stocks having pulled back sharply since mid-March, we have now clearly entered a period of extremely high volatility. With this kind of turbulence, if we were flying a jumbo jet, we would now ask the cabin crew to take their seats and fasten their seatbelts. We still expect a safe flight — but it could be an unpleasant one for a while.

Notably, the volatility we have seen lately has been nothing special when viewed from the perspective of broad stock market indexes like the widely followed Standard and Poor's 500 Index (S&P 500) (See Chart 1). Instead, the volatility has been most pronounced at the individual stock level and at the level of specialty indexes like the technology-heavy Nasdaq Composite Index.

As shown in Chart 2, the volatility of the Nasdaq index over recent 90-day periods has been among the highest posted in our database, which goes back to the early 1980s. Recent volatility even approaches that seen around the time of the 1987 stock market sell-off. Remember, however, that volatility comes in two flavours: upside and downside. Thankfully, until very recently, much of the volatility in recent months has been upside rather than downside volatility.

Understanding the recent declines in the Nasdaq requires some appreciation of the incredible outsized gains made by technology stocks since last October. Most investors know that technology stocks around the world have outperformed the broader market indexes. What is less well appreciated is how extreme this performance gap has been.

Nasdaq's Amazing Performance

As of the middle of March, the Nasdaq had outperformed the S&P 500 by an unprecedented 104% on a year-on-year basis (See Chart 3). Since the creation of the Nasdaq index in February 1971, we have never witnessed anything close to this type of performance gap. Statistically speaking, it is has been a seven-standard deviation event — which would normally be viewed as a one-in-a-trillion occurrence.

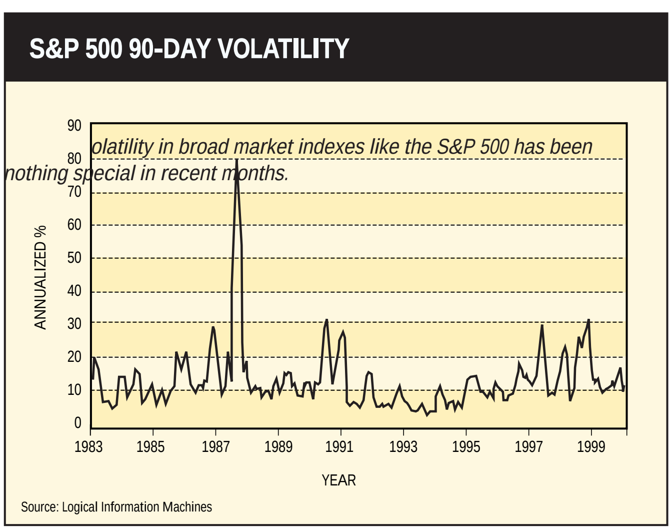

Chart 1: V

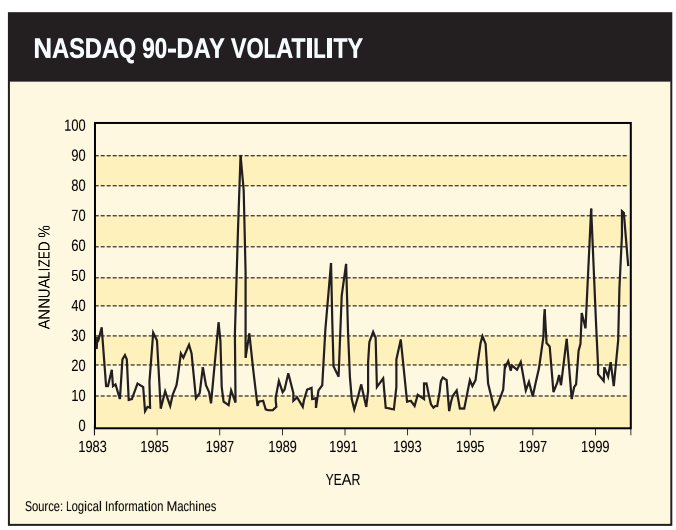

Chart 2: Nasdaq volatility has risen to levels not seen since 1987.

This amazing revaluation of technology stocks reflects some astonishing — indeed revolutionary — fundamental developments. These include an explosion of e-commerce, with announcements virtually every day of new business-to-business e-commerce exchanges and an outlook for over $7 trillion of e-commerce transactions by 2004. That should drive triple-digit rates of growth in many related Internet infrastructure industries.

As Peter Drucker observed last October, "e-commerce is to the information revolution what the railroad was to the Industrial Revolution — a totally new, totally unprecedented, totally unexpected development." Drucker noted further that within five years of the introduction of the railroad in 1829, the Western world was engulfed by the biggest boom history had ever seen — the railroad boom.

Related developments include the transformation of the world's communication and computing networks into an integrated broadband network. That transformation has accelerated dramatically over the past year, thanks to important advances in optical networking technology and wireless communication technology. In short, many of the world's major corporations, and virtually every premier technology firm, are engaged in what promises to be the biggest infrastructure development project in history.

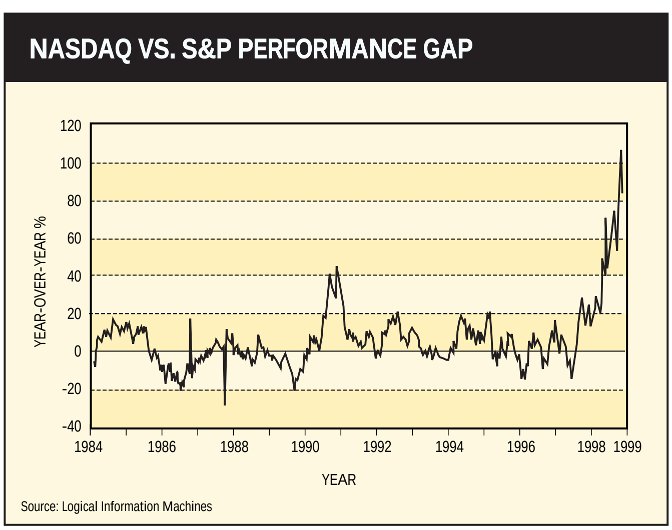

Chart 3: The relative performance of the tech-heavy Nasdaq vs the S&P 500 Index reached unprecedented proportions over the last year

In the meantime, another revolution is brewing in the area of biotechnology. The announcement early this year that the human genome project would effectively be completed this year has been a catalyst for a major revaluation of the intellectual property of biotechnology firms — which is a trend we have anticipated for some time.

The Real Y2K Problem

The only problem with all of this is captured in the old saw: success breeds excess. As we observed in February, the rise of day trading and momentum investing has resulted in average holding periods for some dot-com stocks of less than one week — or in one case, less than 72 hours. Margin debt grew by 60% last year and continued to rise rapidly in the first few months of the year. In addition, the U.S. economy has grown so rapidly in recent quarters that the Fed is determined to keep tightening monetary policy until it succeeds in dampening growth substantially.

One perspective on the remarkable market developments of recent months is that we are essentially dealing with a genuine Y2K problem, one that was created by the very generous liquidity conditions created by central banks in the fourth quarter of last year — back when they were worried about investors pulling money out of the financial system ahead of the millennial New Year. As shown in Chart 4, the Fed let its monetary base grow explosively toward the end of last year, and may therefore have let financial markets and the economy get ahead of themselves. Now its focus is on mopping up excess liquidity, resulting in increasingly illiquid markets.

All of these developments leave investors confused and nervous. That is contributing to major market volatility, with the Nasdaq index falling 18% from its closing high reached March 10 to the close on April 4. Such volatility should not be surprising in view of the remarkable gains posted by Nasdaq over the past year, and we would not be surprised to see high levels of volatility continue at least until the Fed has completed its tightening cycle. Our expectation is that the Fed will raise rates by one-quarter of a percentage point at each of the May and June meetings and then go on hold for the remainder of the year. That tightening of liquidity may deepen the correction in the equity market but is not, in our opinion, likely to trigger a recession or a prolonged bear market.

We continue to stand by the view we expressed in our February World Report: "Because of the risks noted above, we would not be surprised if the next 12 to 18 months turns out to be a volatile and challenging period for investors. Our best advice to investors on how to cope with current volatility is, unfortunately, rather boring: Just focus on the basic principles of diversification, balance, and long-term orientation. Those are enduring principles that have served investors well for decades, and there is no reason to abandon them now either in wild pursuit of the latest financial fad or in a pessimistic 'cash is king' strategy."

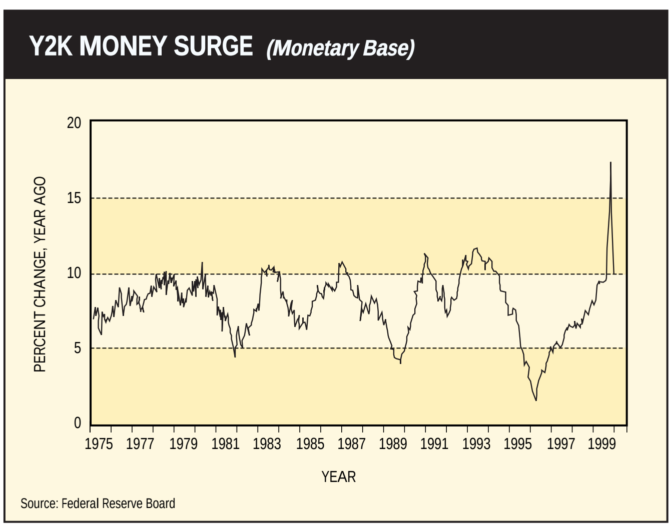

Chart 4: A surge in money growth around the end of last year was associated with rapid market gains.

We also noted in that report that we had established a more cautious asset allocation target (55% equities and 45% fixed income) in the C.I. International Balanced Fund and had substantially reduced our weights in the U.S. market and in technology stocks. We still maintain moderate overweight positions in technology and telecommunications stocks, focusing on the highest-quality companies. We also continue to maintain an above-average cash position in the C.I. Global Equity Fund to permit us to take advantage of exceptional buying opportunities that a high-volatility environment is likely to provide.

Our advice: Stay calm. Be prepared for more turbulence. And please keep your seatbelt fastened — just like we do up here in the cockpit.

William Sterling Global Strategist

Stephen Waite, Portfolio Adviser
C.I. Global Advisors LLP

MUTUAL FUNDS

HEAD OFFICE
151 Yonge Street, Seventh Floor
Toronto, Ontario M5C 2W7
Tel: 416-364-1145
Toll Free: 1-800-563-5181
BPI Funds: 1-800-937-5146

SALES OFFICES
Calgary – Tel: 403-205-4396 – Toll Free: 1-800-776-9027
Halifax – Tel: 902-422-2444 – Toll Free: 1-888-246-8887
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www.cifunds.com