William Sterling Global Strategist

STERLING'S WORLD REPORT

The Perfect Storm – Is It Almost Over?

The imaginative Wall Street economist Ed Hyman cooked up a very scary scenario for the world economy just in time for traditional September and October Market jitters. His scenario is called "The Perfect Storm," and borrows the title of a popular book and movie about a frightening shipwreck. The Perfect Storm refers to a collision of unusual weather patterns in October 1991 that created a massive storm off the coast of New England.

Hyman's economic equivalent of The Perfect Storm is based on the collision of three powerful forces: higher interest rates, soaring oil prices, and a global slowdown in technology spending. Each force in and of itself might not be enough to trigger a global recession, but Hyman and others have raised the question of whether the combined impact of these forces will do the trick. He recently has put the odds of a recession next year at 40%. That view has undoubtedly influenced many investors since Ed has been rated as Wall Street's most influential economist for many years running.

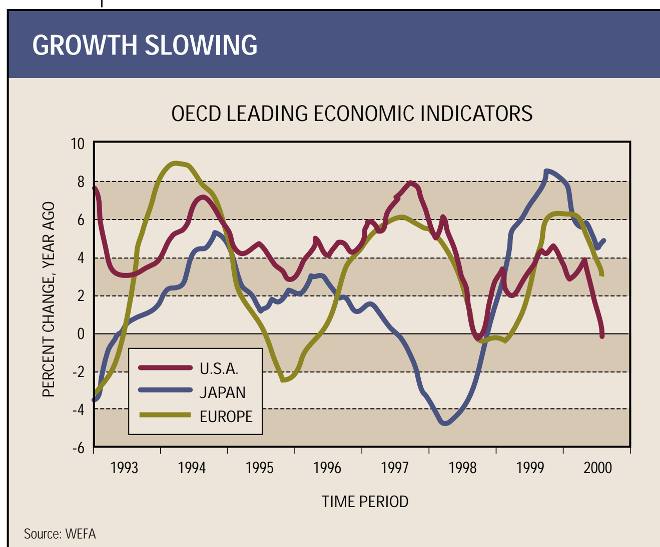

Chart 1. Leading indicators for the major industrial nations are pointing to slower growth over the next six to 12 months.

Far away from the emotional swings of Wall Street analysts are two academic business cycle analysts, James Stock and Mark Watson, who are associated with the National Bureau of Economic Research. They have spent years doing careful statistical research with literally hundreds and hundreds of economic data series in search of a scientifically grounded leading indicator of recessions. Their work, which represents the state of the art in economic forecasting, currently puts the odds of a recession in the U.S. at only 4%. (Their work is available online at http://ksghome.harvard.edu/~.JStock.Academic.Ksg/.)

Unfortunately, the state of the art in economic forecasting is roughly akin to that of weather forecasting. Even though economists are said to have predicted nine of the last four recessions, Stock and Watson's sophisticated leading indicators missed calling the 1990 recession. Even when the weatherman predicts the sun will come out, most of us are still likely to carry an umbrella when it is cloudy outside.

Storm Watching

So one of Wall Street's most influential intuitive forecasters says the odds of a recession are 40%, while the rocket scientists say 4%. What's the average citizen to do?

"Ignore it and turn to the sports pages," you might say. And that's actually a pretty good response. Some of the best long-term investors (those who

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know well how off-the-mark many forecasts turn out to be) often advise tuning out economic forecasts entirely when making investment decisions. It's fun – and in this industry even fashionable – to bash economic forecasts, just as it's fun to make light of weather forecasts. But there is still that nagging question of when you need to carry an umbrella. And for what it's worth, here are some of our views.

First: Keep carrying that umbrella! We may not have the perfect crystal ball, but we can tell when it's cloudy outside. The forces that Ed Hyman has outlined – tight money, oil prices and a looming tech slowdown – are all quite capable of delivering disappointing earnings over the next year even without a recession.

As we have pointed out earlier, the U.S. economy experienced remarkable strength in the fourth quarter of last year and the first quarter of this year. With the Federal Reserve having engineered a slowdown of the economy by hiking interest rates six times, the year-on-year comparisons for earnings in this current quarter and the next quarter are likely to be especially difficult.

Looking at history, periods of slowing earnings growth have tended to last seven quarters on average, and so far we have experienced just one (see Chart 1). And with earning expectations still quite high – especially with respect to long-run earnings forecasts – there is plenty of room for "negative guidance" by companies to keep things bumpy for a while longer.

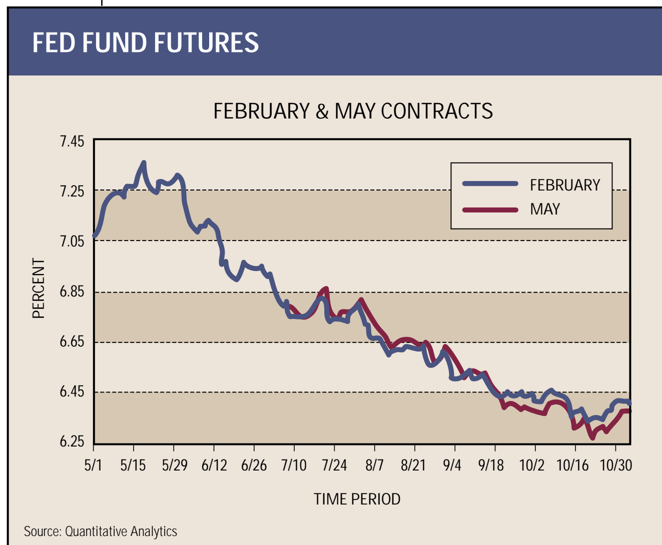

Chart 2. Financial futures markets are now anticipating a significant probability of Fed easing by next May.

Second: Don't fight the Fed. The next big change in the outlook is likely to come when the market sees the Fed beginning a new cycle of monetary easing. In view of the latest slowing of the economy, many market participants are beginning to bet that Fed easing could occur early next year (see Chart 2).

We wouldn't rule out an easing next year, but we suspect that the central bankers will drag their feet. Historically, the Fed has waited until some type of banking crisis forces it to shift to an easier monetary policy. Choppy markets notwithstanding, nothing seen to date is likely to trigger rate cuts anytime soon. Yes, the stock market has sold off, but Fed officials are not likely to be too surprised or too concerned about that. They are far more concerned that the low level of unemployment means that the economy can't keep growing without triggering wage inflation. That means they will be reluctant to cut rates until they see hard evidence that the labour market is softening.

Like many investors, Fed officials probably were anxious to see who gets elected president and, more importantly, find out what the new administration really intends to do about tax cuts, government spending, etc. If the Fed thinks that government policies could overheat the economy next year, they will be reluctant to cut rates. But they will not be able to get a good grip on what new policies will actually be until well into next year. Therefore, barring some kind of financial market crisis, don't expect them to turn on the liquidity pump anytime soon.

Third: Oil still matters. It has been fashionable in recent years for analysts to say that the New Economy is relatively immune to oil prices. There is a strong element of truth to this in the

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sense that the economy now uses far less oil per unit of output than it did 20 years ago. And it is probably fair to say that the tripling of oil prices we have experienced over the past year and a half does not on its own pack enough wallop to push the U.S. or global economy into recession. But Ed Hyman has a point: combined with tight money and with a potential slowdown in capital spending associated with the tech stock selloff, the effect of higher oil prices matters more.

Winter weather is the wild card. North America has had several years of exceptionally mild winters. But no one should be too surprised if this winter turns out to be fairly normal – i.e., cold. With oil inventories still tight, that could mean a sharp spike in oil prices that could rattle markets. (see Chart 3). And despite efforts by Saudi Arabia to try to moderate prices, there are still colorful characters in the oil world like Venezuela's Hugo Chavez or Iraq's Saddam Hussein who might have slightly less moderate views.

Most oil analysts seem to agree that once we get through winter, oil inventories are likely to rise to levels that could drive oil prices back into the mid-to-low $20s, or even lower. And that is probably a very reasonable scenario for mid 2001 and beyond.

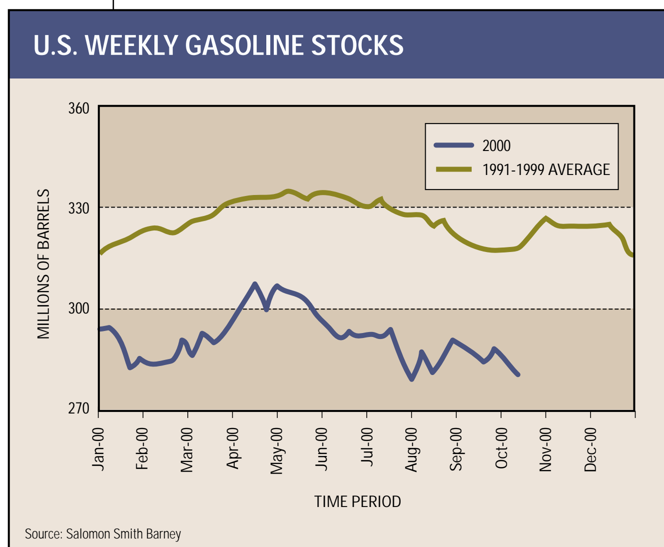

Chart 3. Oil inventories remain very low relative to levels seen over the past decade, suggesting the potential for more upward pressure on prices this winter.

But in the meantime, oil still matters. Despite the Fed's comfort with so-called "core inflation," which remains relatively tame, the overall inflation rate including the oil impact has approached 4% this year. So high oil prices are another reason for the Fed to hold off on cutting interest rates, despite signs of economic slowing. And in Europe, where higher oil prices are more apt to trigger catch-up wage demands by powerful labor unions, any further pressure on oil prices may trigger a further rate hike by the European Central Bank.

Apocalypse Not

Despite an apparent tendency in the recent years for global equity markets to stage major seasonal rallies following jittery Octobers, we are still cautious about the near-term outlook. But we do think that by mid-2001, the markets will have come to terms with slower earnings growth and may well have declining interest rates and falling oil prices to celebrate.

Accordingly, we think the odds of recession are actually fairly low, perhaps only on the order of 10 to 20%. The far more likely scenario, in our view, is that that next year the U.S. economy will enter the 11th year of an uninterrupted expansion, and that the rest of the global economy would continue to enjoy a healthy expansion as well. That also means that the longer-term positive forces we have described in Boomernomics – demographics, globalization and the technology revolution – should eventually dominate, creating an investment climate that permits investors to still enjoy healthy returns.

If we are right, you'll have to look for a Perfect Storm next year in video stores or book stores – not in the financial pages.

William Sterling
Global Strategist,
CI Global Advisors LLP