



WILLIAM STERLING

GLOBAL STRATEGIST



STERLING'S WORLD REPORT

Is There Light at the End of the Tunnel...

... Or is that a locomotive coming at us? The dismal performance of global equity markets during the summer stood in odd contrast to a growing number of signs that the U.S. economy has bottomed and is positioned for recovery in coming quarters.

With Europe and Japan having recently eased monetary policy and some signs of stabilization visible in those regions as well, we think the odds are growing that 2002 will be a positive year for world economic growth – even if that does not spell a return to the boom conditions of the late 1990s.

Consider some recent signals from U.S. economic data:

- U.S. housing starts increased 2.8% in July, reaching their highest levels since February 2000.
- The Conference Board's index of leading economic indicators for the U.S. was up 0.4% in July, its fourth consecutive monthly increase.
- The closely watched purchasing managers' survey rose to 47.9 in August, reflecting a surprising degree of stabilization in the manufacturing sector.
- Although unemployment rose to 4.9% in August, initial unemployment claims have stopped rising in recent weeks.
- Long-term interest rates, which reached almost 7% at the beginning of 2000, fell recently to 4.9%.

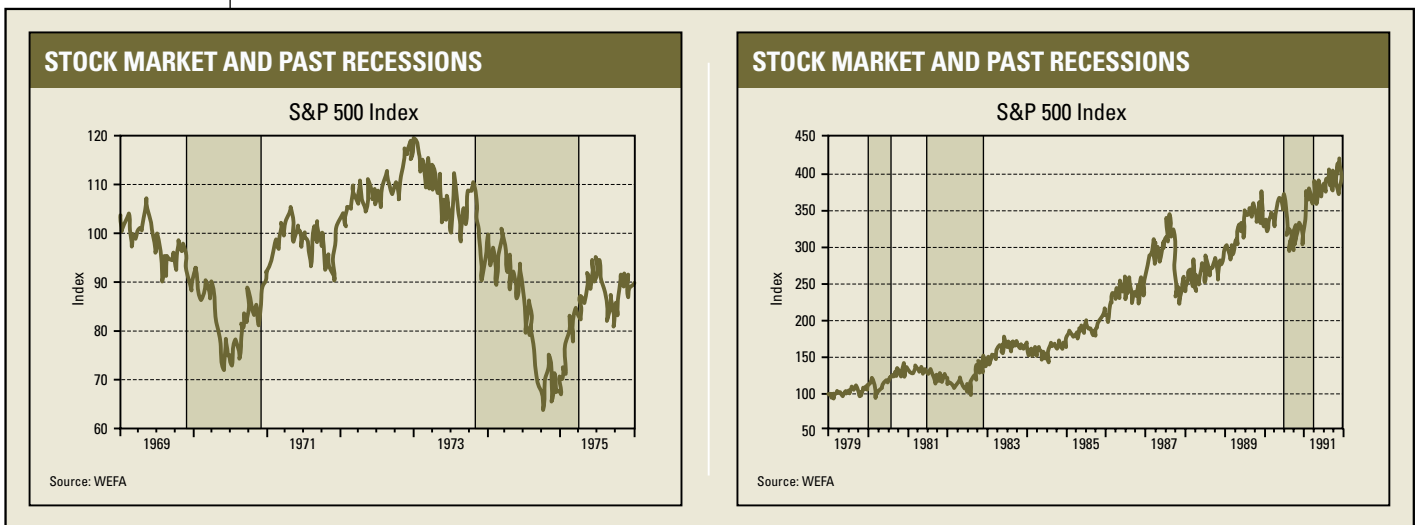


Chart 1. The stock market typically goes up before recessions end.



Is There Light at the End of the Tunnel... (cont'd)

And while overseas news has generally been dismal, especially regarding profits, there are other straws in the wind suggesting improved times ahead:

- Germany's IFO survey of business confidence showed surprising improvement in the latest month.
- Japan's index of leading economic indicators has averaged above the so-called "boom or bust" line of 50% for the past three months, pointing to some stabilization ahead.
- Other leading indicators around the world have also recently turned up, including the U.K. retailers survey and the Eurozone purchasing manager's index.
- Political pressures are building in both Europe and Japan for more aggressive monetary easing in the near future.

But with global stock market averages having recently fallen close to their bear market lows of early April – or in the case of many markets, below the April lows – the question for equity markets is whether this will be a joyless recovery. In other words, are we in a "this time it's different" world where economies and corporate profits might be on the rebound while the stock market continues to languish?

That would certainly fly in the face of historical patterns. As shown in Charts 1, the experience of the U.S. market during past recessions, which are marked by shaded bars in the graph. As is evident, the market in the past has invariably acted as a discounting mechanism, rising sharply toward the end of recessions as a rebound in the economy and corporate profits became widely anticipated.

It is also worth noting that previous market bottoms have typically occurred when news on corporate profits has been dismal and at times when analysts, journalists and corporate managements tend to be gloomy about the future. As shown in Chart 2, past market bottoms have historically occurred when earnings reports have shown major double-digit declines on a year-on-year basis. Conversely, market tops often occur when profits are booming and when optimism is widespread.

Don't Drive by Looking Out the Rear-View Mirror

For investors, a clear implication of the fact that markets often stage impressive rallies precisely when economic news and commentary is uniformly dismal is this: If you try to "sit on the sidelines" and wait until the economic news improves before committing money to the market, there is a good chance that you will miss some of the most impressive returns and end up with mediocre results.

We've discussed in these pages why we place a great deal of emphasis on forward-looking indicators, like the shape of the yield curve, rather than gazing out the rear-view mirror at lagging

MARKET USUALLY BOTTOMS WHEN PROFIT NEWS IS BAD

PAST MARKET BOTTOMS			
1970	1975	1982	1991
3Q	1Q	3Q	1Q
S&P 500 EPS YEAR / YEAR % CHANGE			
-11.7	-22.6	-16.7	-15.0

Source: ISI

Chart 2. Recession rallies have historically been in down quarters for earnings.



Is There Light at the End of the Tunnel... (cont'd)

indicators like the unemployment rate or past corporate profit reports. As we discussed last month, the yield curve (i.e., the gap between long- and short-term interest rates) historically has been one of the very best forward-looking indicators for anticipating improvements in both the economy and the stock market.

As shown in Chart 3, inverted yield curves – periods when short-term rates are higher than long-term rates – have historically meant bad news for both the economy and financial markets. That's because economic growth has historically been very weak for the year after yield curves become inverted. But growth following periods when the yield curve has turned positive – after short-term interest rate cuts by the U.S. Federal Reserve – has subsequently been buoyant and averaged over 4% per year.

You might ask: Isn't this just a different way of saying, "Don't fight the Fed?" And hasn't that theory – that you buy stocks when the Fed is cutting rates – gone seriously awry this time around?

There is no doubt that Fed easing has so far failed to turn the market or the economy around, although the markets and the economic outlook are undoubtedly in better shape than if they hadn't cut interest rates aggressively. However, we would advise against giving up on the power of Fed actions too quickly. The fact that the market has not yet reacted to Fed action is by no means unusual – but that is very different than saying it will not react at all in coming months.

According to research by Merrill Lynch, over the past 50 years there have been eight prior rate-cutting cycles when the Fed cut interest rates by 46% (the amount by which rates have been cut so far this year). In four of those cycles, the stock market fell between the time of the initial rate cut and the time that rates had declined 46%. But in the case of all eight cycles, the S&P 500 Index was up a year later, by an average of 28%. And on the four occasions when the market had declined after the initial easing, the market rose an average of 32% in the subsequent year (see Chart 4).

As they say in financial footnotes, past performance is no guarantee of future results. Even with the Fed and other central banks cutting interest rates, there is no guarantee that the markets will not visit new lows in coming weeks. Nevertheless, we believe that investors are better off not trying to "call the bottom," but instead should try to evaluate the overall risk/reward environment based on forward indicators. And by our reckoning, the forward-looking indicators are beginning to look increasingly positive for the market's prospects over the next six to 12 months.

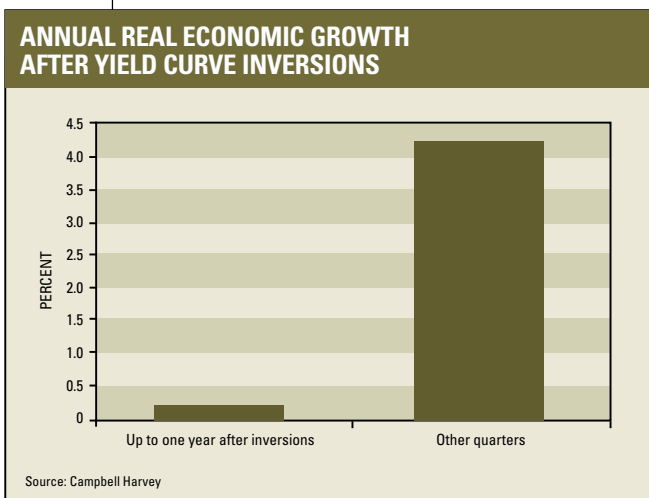


Chart 3. Inverted yield curves have historically preceded periods of economic distress, while positive curves have been followed by growth.

Is There Light at the End of the Tunnel... (cont'd)

Are Current Conditions the Mirror Image of Early 2000?

If anything, our sense is that the current investment environment is almost the mirror image of early 2000. At that time, the economy was booming, economic and market optimism was rampant, but there were some disturbing forward-looking indicators. These included rising interest rates, an inverting yield curve and soaring oil prices, which were likely to become a big drag on consumer and business spending. Despite those warning signs, strong positive momentum continued to propel stocks higher, at least until March.

Currently, negative momentum and terrible investor sentiment continue to drive the market down, even though a number of positive forward-looking indicators have appeared. Interest rates

nearly everywhere are falling, the yield curve is positive, and oil prices have now started to decline.

Ed Hyman, an influential Wall Street economist who described the worsening investment environment in 2000 as being "The Perfect Storm," is now speculating that a confluence of positive trends could be setting the stage for "The Perfect Recovery" in 2002. These include not only the decline in interest rates and oil prices, but also the positive impact of the U.S. tax cut, which is just now beginning to be felt.

No one can guarantee that there will be a "perfect recovery" in 2002 and it wouldn't be surprising to see market jitters continue for a while longer. That said, we think the odds are that the global economy will be in better shape next year than most market participants now anticipate. And we don't know too many wealthy pessimists.

*William Sterling
Global Strategist,
CI Global Advisors LLP*

S&P 500 PERFORMANCE AFTER 46% CUT IN FED FUNDS RATE

Date of 1st rate cut	Date by which rates fell 46%	S&P over the period	S&P one year after 1st cut
11/07/1957	02/20/1958	3.5%	35.0%
01/14/1960	12/01/1960	-1.8%	28.5%
10/09/1969	12/17/1970	-5.9%	12.3%
07/18/1974	01/30/1975	-7.1%	29.1%
04/10/1980	06/12/1980	14.3%	14.7%
07/02/1981	08/16/1982	-8.4%	57.0%
08/29/1984	08/21/1986	49.4%	34.5%
06/05/1989	09/13/1991	19.1%	9.4%
01/02/2001	08/21/2001	-8.5%	?
Average		6.1%	27.6%

Source: Federal Reserve Board, Standard & Poor's, Merrill Lynch

Chart 4. In past easing cycles, even when the S&P 500 has declined after the first rate cut, it was still up strongly one year later.