WILLIAM STERLING GLOBAL STRATEGIST

STERLING'S WORLD REPORT

Thinking the Unthinkable

Our grief and shock about the September 11 attacks remain fresh. Our New York-based investment team and our immediate family members were fortunate to have been out of harm's way, but many of us have lost friends and neighbours. Our thoughts and prayers go out to all of those directly affected by this abomination.

We are now back to work, the financial markets have reopened and the world is trying to get back to normal, as difficult as that may be. It may seem tactless to talk about our finances at a time like this, but for those of us in the financial services industry it is our job. All of our clients are wondering what this event will mean for the stock markets and the economy. And they are quite naturally wondering what they should do about their personal finances.

Thinking about financial markets inevitably requires us to think about the future. Thinking about the future is difficult even under the best of circumstances, and has now become far more challenging. But to make sensible investment decisions, we still have to make educated guesses about how the markets and the economy will behave going forward.

In this month's *World Report*, we will provide some of our educated guesses on a number of key questions about the post-September 11 investment climate. However, we also want to be clear about some of the major uncertainties that have now been created. We think there are some valuable lessons from the history of other crises that can help us keep a sense of perspective. We would also emphasize that each crisis is unique and is likely to have its own unpredictable dynamics. We will use a question-and-answer format, focusing first on short- to intermediate-term issues and then turning to a longer-term perspective.

Q. How big of an impact will the attacks have on the U.S. economy?

A. The direct economic impact is likely to be less than many might think, given the horrifying images of damage that we have all seen. The amount of office space in New York City permanently destroyed by the attack is estimated to be about 15 million square feet, compared with 375 million square feet of office space in Manhattan alone and 3.5 billion square feet in the entire country. Notwithstanding the unbearable scale of human suffering, the physical damage is on par with a major natural disaster, like Hurricane Andrew or the Los Angeles earthquake – both of which caused short-term but ultimately manageable disruptions to U.S. economic growth.

Unlike a natural disaster, the indirect impact of the attack is likely to be much larger for a number of reasons. First, the spillover effects on industries such as airlines and hotels have already been huge, even though these industries are relatively small as a percentage of the economy (about 1% of GDP each). What is still highly uncertain is the impact on business and consumer confidence, with consumer spending accounting for roughly two-thirds of the economy and business investment about one-sixth of the economy.

Consumer confidence plunged in the U.S. when Saddam Hussein invaded Kuwait in mid-1990,

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which acted as the trigger to the Gulf War. Some economists at the Chicago Federal Reserve Bank likened the impact of the Gulf War crisis to a "gapers' block" on a highway. On highways, traffic jams can develop on the clear side of the road even if only a small number of drivers slow down to look at the accident on the other side. Likewise, a consumer slowdown can occur in an otherwise peaceful country if even a small number of consumers cut back on their shopping in response to the crisis.

As a result of the uncertainties created by the attack, forecasts for U.S. economic growth in the fourth quarter have been downgraded. Economists are now expecting a decline of 0.5% to 4% at an annual rate, instead of modest growth of 2% to 3%. So if the economy had been heading for a U-shaped recovery before the slowdown, the attack has notched a potentially deep "V" to the bottom of the growth trajectory. If there was any debate prior to September 11 about whether the U.S. and global economies were in recession, that debate is basically over – recession appears inevitable.

The problem for financial markets at this point is that nobody knows exactly how deep the "V" will be, or when a recovery will begin. To an uncomfortably large extent, the outcome will also depend on a chilling factor that nobody can easily forecast – namely, whether there will be more devastating attacks on the U.S. in coming weeks.

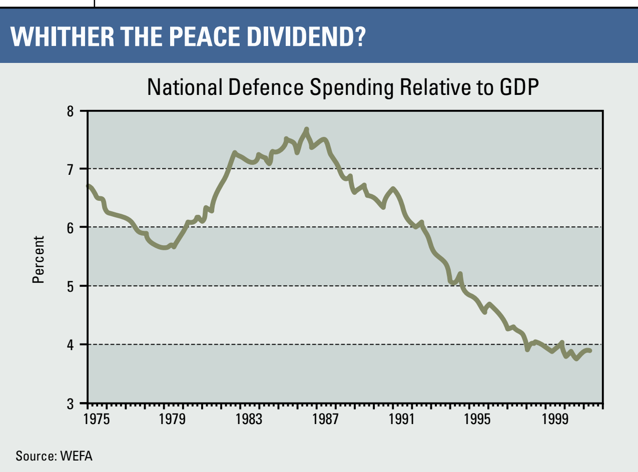

Chart 1. A decline in military spending as a share of the U.S. economy coincided with rising P/E multiples in the 1990s, so markets may be sensitive to a prolonged military buildup.

Q. What will be the effects of government efforts to stimulate the economy?

A. Historically, wars have been associated with economic stimulus and stock market recoveries, and there is no doubt that government policies around the world are now aimed at fighting recession and fostering growth. To their credit, central banks around the world moved rapidly to provide liquidity to financial markets to limit the risk of financial accidents that might have made a bad situation much worse. A co-ordinated rate cut of one-half point on September 17, which included the Bank of Canada, the European Central Bank and the U.S. Federal Reserve, was also an indication that policymakers around the world are determined to limit the damage to consumer and business confidence.

We have little doubt that government policy will continue to focus on stimulating economic growth. After cutting interest rates by another one-half point on October 2, the Fed made it clear that it still sees risks of further economic weakness ahead. Accordingly, it can be expected to continue to ease policy in coming months if the economy weakens further. We wouldn't be surprised to see the Fed funds rate fall to 2% by the end of the year in response to weak fourth quarter growth.

We also expect to see further easing by the European Central Bank and even by Japan, which is under pressure to increase its money supply even though interest rates are already close to zero.

In addition, the quick approval by Congress of $40 billion in military spending and a like amount to help New York recover is almost certainly not the end of the story in terms of

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fiscal stimulus. A number of options such as accelerated tax cuts are now being considered. When all sources of government spending are included, it seems likely that the total fiscal stimulus to hit the economy over the next year will be $100 billion to $200 billion, or 1% to 2% of GDP. Whatever the exact number turns out to be, it's clear that both the administration and the Fed are poised to pump a lot of money into the economy.

The ultimate effect could be to create a stronger V-shaped recovery for the economy by the second quarter of next year than otherwise would have been the case. We might see growth as strong as 4% to 5% at an annual rate starting in the second half of 2002 thanks to the combined effect of monetary easing and government spending. Again, however, much depends on whether there are additional terror attacks and on how the U.S. military response develops.

HISTORY LESSONS

Six past attacks...

02/15/1898:	USS Maine bombed
05/07/1915:	Lusitania torpedoed
12/07/1941:	Pearl Harbor attacked
08/02/1990:	Iraq invaded Kuwait
02/26/1993:	World Trade Center bombed
04/19/1995:	Oklahoma City bombed

...and how the Dow Industrials reacted

TIME AFTER EVENT	*AVERAGE GAIN/LOSS (%)*
One day	-1.9
One week	-3.0
One month	-1.7
Six months	11.4
One year	18.4
Two years	30.8
Three years	50.1
Five years	82.2
10 years	128.0

Source: MarketHistory.com

Table 1. Markets have usually sold off immediately following crises, but have tended to rebound strongly over the next few years.

Q. What impact is the U.S. military response likely to have on the investment climate?

A. The nature and the timetable of the U.S. military response represents another major uncertainty that markets simply will have to live with for some time to come. The clearest statement of the administration's objectives to date came in President George W. Bush's September 20 speech, in which he expressed his administration's resolve to go after terrorists groups "with global reach," wherever they may be. This suggests strongly that the military response will not be limited to hunting down Osama bin Laden, but is more likely to be aimed at destroying the "root and branch" of global terror organizations.

That suggests a long conflict with varying levels of intensity, one that could extend beyond Afghanistan to Iraq and other rogue nations. There still appears to be a significant debate within the administration whether to narrow or broaden the scope of the military response, and that too creates uncertainty.

Furthermore, any conflict that disrupts the supply of oil, or the political stability of key producers like Saudi Arabia, could cause sharp spikes in the price of oil that could disrupt financial markets. That said, the OPEC nations have so far been quite co-operative in keeping oil prices down in the wake of the attacks, because it is in their best interests to have their consumers' economies recover.

Whatever form "America's New War" takes, it seems clear that military spending and other government spending on security will go up substantially over the next few years. That could mean a partial reversal of "the peace dividend" that market participants enjoyed in the 1990s, when military spending fell from 7% to under 4% as a share of GDP (Chart 1). Historically, lower military spending has been associated with higher P/E ratios. One very crude estimate is that every 1% increase in military spending as a percentage of GDP reduces the market's P/E ratio by about 1.3 points. So the market could be quite

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sensitive to any turn of events that causes a major increase in military spending beyond what has already been announced (which represents about 0.4% of GDP).

Q. What can we learn from history about the market's reaction to military crises?

A. As Table 1 shows, the Dow Jones Industrial Average has fallen modestly in the immediate wake of past military crises. But the index recovered by an average of 18% one year following these crises. After five years, the Dow had increased by an average of 82%, and after 10 years it had advanced by an average of 128%.

To be sure, there is no guarantee that history will repeat itself. But if there is any lesson from a look at the historical data, it is this: Markets often seem to have over estimated the long-term impact of each crisis and underestimated the remarkable resilience of the U.S. economy in the face of many shocks.

Q. In view of all of the uncertainty, wouldn't investors be wise to sell their stocks and stock funds and wait until the outlook improves?

A. That could turn out to be the right strategy if things get ugly enough. For long-term investors, though, it does not make a lot of sense. First of all, it doesn't get any easier to time the markets after a crisis. Markets often bottom out amid horrible news on profits or when military conflicts are front-page news. Missing just a few days of sharp market rebounds when the market recovers can be very damaging to investors' returns, as Table 2 illustrates.

TIMING IS TRICKY

Dow Jones Industrial Average Returns After Tragic Events

Crisis Event	Rebound After 1 Year	Missed 5 Best Days
Pearl Harbor	2.2	-8.2
Cuban Missle Crisis	25.9	14.2
1987 Market Crash	23.1	-6.8
Invasion of Kuwait	7.0	-8.4
Desert Storm	24.5	9.7

Source: Navellier Marketmail

Table 2. Investors who missed just five of the best trading days in post-crisis market recoveries had very disappointing returns relative to those who rode out the volatility.

For example, in the year following the Kuwait invasion, the market was up 7%. However, an investor who missed the best five trading days during that period would have been down more than 8%. Other examples show similar patterns. If the V-shaped business cycle pattern we discussed earlier is correct, the market could be much closer to a bear market bottom than many investors might appreciate.

As Warren Buffet recently advised investors, few business people would consider selling their businesses in response to a military crisis. If you owned a good business a few weeks ago, it will probably still be a good business a few years from now. The same logic applies to stock investors, who are business owners whether they invest directly in stocks or in diversified mutual funds.

In short, if investors were satisfied with their asset allocation a month ago, they probably should not make major changes in response to the crisis. The wealth-creation process that helped U.S. corporate profits grow 63-fold since the Second World War is still intact. Despite the crisis, we believe that corporate profits are likely to continue their upward path in the next 10 years and have the potential to be dramatically higher over the next 20 years.

Bear markets are painful, and this has been the worst bear market in more than 25 years. But the recovery periods have typically created gains that far eclipsed the losses. No one can predict for sure how this crisis will pan out, but I continue to believe in the resilience of the U.S. economy and financial markets.

William Sterling, Global Strategist
CI Global Advisors LLP