



WILLIAM STERLING

GLOBAL STRATEGIST



STERLING'S WORLD REPORT

War, Peace and Interest Rates

In our book *Boomernomics*, we ventured the opinion that interest rates would reach shockingly low levels in this decade. Our basic reasoning was that global competition and an ample supply of goods

would keep inflation low at a time when aging baby boomers would be competing furiously against each other for high returns on their retirement assets – and driving down those returns in the process.

We also quoted a widely respected historian of bond markets named Sidney Homer, who once noted: “Almost every generation is eventually shocked by the behaviour of interest rates, because, in fact, market rates of interest in modern times have rarely been stable for long. Usually they are rising or falling to unexpected extremes.”

Sidney Homer’s classic study of interest rates over 40 centuries, *A History of Interest Rates*, implied that the end of the Cold War was highly positive for bonds – and, not coincidentally, equity valuations as well. As Homer and co-author Richard Johannesen noted in 1969: “Those who are attempting a long-term forecast of interest rates should always ask themselves first of all: ‘Is the outlook for more war or more peace?’ If the answer is ‘more war,’ then more inflation and higher interest rates seem inevitable until we reach the point of wartime controls. If the answer is ‘more peace,’ then less inflation and stable to lower interest rates seem more likely.”

During recent visits with clients, one of the most frequently asked questions was, “How have the events of September 11 changed some of the long-term themes you discussed in *Boomernomics*?”

With respect to long-term trends such as baby boomer demographics and prospects for an acceleration of technological change, the answers are straightforward. Barring cataclysmic developments on the terror front, we think the huge baby boomer generation is still going to face pressure to increase its savings in coming years in order to prepare for the retirement wave that should begin in earnest around 2010 to 2015. And despite the current shakeout in technology industries, we expect that strong waves of accelerating technological change will resume with force in coming years in industries ranging from biotechnology to telecommunications. If we are correct, those forces would still argue for a climate of low inflation and low interest rates that should be positive for financial assets over the next five to 10 years.

Counting Higher Costs for Security

The tougher issue, obviously, is Sidney Homer’s question: “Is the outlook for more war or more peace?” Is “America’s New War” to contain terrorism likely to put as much of a strain on the nation’s fiscal and physical resources as the Cold War that aimed to contain communism?

The honest answer to this question is that we don’t know yet. Many analysts are guessing that the direct costs of the military effort now underway in Central Asia will be on the order of \$30 billion to \$40 billion, compared with about \$65 billion for the Gulf War. If the conflict remains



War, Peace and Interest Rates *(cont'd)*

limited to Afghanistan and turns out to be a decisive victory over Osama bin Laden's Al-Qaeda organization, then the direct fiscal impact could turn out to be rather modest.

However, that estimate doesn't factor in increased costs of homeland security, which will be borne partly by the government and partly by private businesses and consumers. Economist David Hale of Zurich Financial Services estimates that the United States currently spends about \$250 billion, or about 2.5% of GDP, on domestic security, including police (\$70 billion), private security guards (\$110 billion), fire departments (\$21 billion) and prisons (\$47 billion). Hale argues that such costs are likely to rise 10 to 20% over the next two years, representing an effective "security tax" of \$25 billion to \$50 billion annually.

The cost of insurance is also likely to rise substantially as a result of the September 11 attacks. Hale estimates that the cost of personal insurance is likely to rise by five to 10% while the cost of business insurance could increase 100 to 150%. Other costs that will be more difficult to

estimate include lost productivity due to increased security at airports and border crossings, mail decontamination and so on. How much of these costs will fall on the public sector and how much will fall on the private sector also remains to be seen.

Overall, Hale estimates that the cost of increased security will probably be equal to a new tax on business and government equivalent to at least 0.3 to 0.4% of GDP per annum for a number of years. And that would be in addition to the increased federal expenditures on the military and the higher costs of property and casualty insurance premiums.

Will all of this new spending create inflationary pressures or end up depressing the economy? Hale points out that its impact may be compared to the impact of business spending on pollution control in the 1970s and 1980s. Such spending, which now totals about \$180 billion, may have been a modest drag on growth because it increased business costs without directly boosting productivity or profits. But such spending hardly crippled the economy or prevented inflation rates from declining in the 1980s in response to monetary policy.

Of course, this type of analysis is subject to some enormous caveats. As David Hale notes: "The ultimate cost of America's new security tax will depend upon events which are still unfolding. Will the U.S. win a decisive victory over the terrorists, in Afghanistan? Will the terrorist cells already here engage in further major acts of violence, such as detonating bombs in office towers or on airplanes? Will the biological war move from anthrax to more contagious diseases such as smallpox? Will the terrorists attempt to use nuclear weapons material that they obtained from the former Soviet Union during the 1990s? The nuclear scenario is the most chilling one because there would be great pressure on the

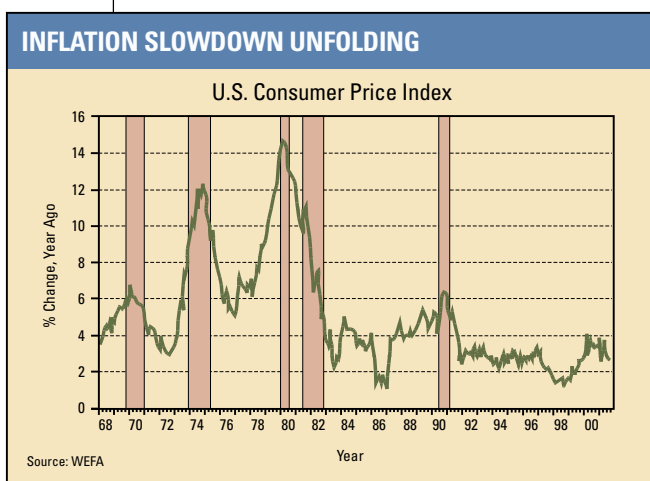


Chart 1. Inflation has typically fallen substantially in the year following a recession. This episode should be no exception in view of massive excess capacity and weak labour markets.



War, Peace and Interest Rates *(cont'd)*

U.S. to retaliate against countries with nuclear programs such as Iraq. In such a scenario, the current strategic offensive focused on Afghanistan could truly escalate into a clash of civilizations with massive costs for all of mankind extending over many years.”

The Deflation Debate

If these uncertainties were not daunting enough, it is remarkable to note that both short-term and long-term inflation expectations have actually plummeted since September 11, even though wars have historically been associated with higher inflation. One reason for this drop is that oil prices have come down in response to a slowdown in demand due to the global recession and ample oil production coming from non-OPEC sources like Russia.

A related reason is the widespread recognition that the global economy is in recession, meaning that economies nearly everywhere now have excess capacity and weak labour markets. Historically, as shown in Chart 1, inflation in the U.S. has come down substantially for a year or so

after economic recoveries begin. Currently, inflation is running at about 2.5%. If it were to decline by 200 basis points over the next year or so, as history suggests it could, then the U.S. could be seeing a near-zero rate of inflation.

If inflation ends up staying close to zero, it is virtually certain that many industries will continue to experience deflation – declining prices – on a rather sustained basis. While equity markets tend to respond well to low or declining inflation, they tend to perform very poorly in an environment of outright deflation. The reason is simple: during periods of deflation, corporate profits typically get hit hard, triggering a vicious circle of declining investment, declining prices and declining employment. Witness Japan’s economy in recent years or the more extreme case of the U.S. in the 1930s.

Could the U.S. be slipping into a period of deflation, where low interest rates fail to revive the economy? We doubt it. There are already some signs, such as booming mortgage refinancing activity, that suggest Fed rate cuts are providing ample stimulus to the economy (see Chart 2). Also, a variety of indicators of money growth are soaring now, which helps explain the rapid rebound in the stock market since September 11 (see Chart 3).

That said, some prominent U.S. economists such as Princeton University’s Paul Krugman have warned that the U.S. could face a Japan-like “liquidity trap” if business and consumer confidence continues to slide. The term liquidity trap refers to a situation where everyone is so intent on hoarding cash (or other easily liquidated assets) that even zero interest rates fail to stimulate borrowing and lending activity.

The Fed has watched Japan’s problems carefully and with a great deal of concern. One result of Japan’s experience is that the Fed may be willing to continue to cut interest rates aggressively

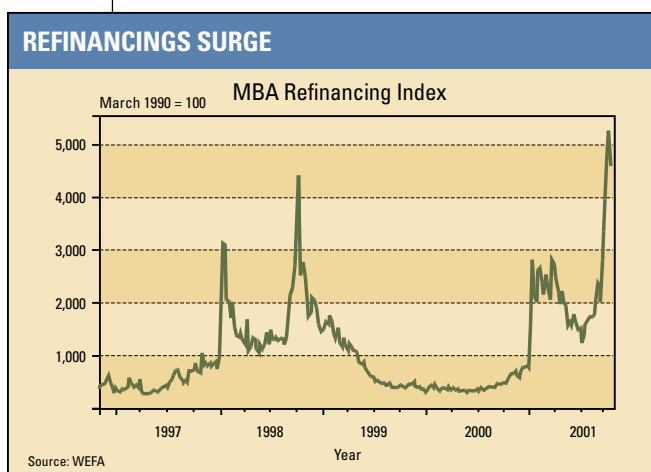


Chart 2. Fear that the Fed is cutting rates with no effect should be eased by evidence of a surge in mortgage refinancing activity that provides consumers with more spending power.



War, Peace and Interest Rates *(cont'd)*

STERLING'S WORLD REPORT

precisely to avoid slipping into deflation. We continue to look for the Fed funds rate to fall to about 1.75% by early next year, but would not be surprised to see it go even lower if the economy remains weak for a few months early next year.

Is that ultimately going to lead to higher inflation? At this point, we think the Fed is likely to think that inflation getting back to 3% in 2003 would be a “high-quality problem,” easily dealt with by nudging interest rates higher once the economy has regained some momentum. At the moment, though, it is in the business of fighting deflation and seems likely to end up with inflation in the 1.5% to 2.0% range next year. And if it wins the fight against deflation, as we expect it will, equity markets should be substantially higher in a year’s time.

What could go wrong? First, the Fed could be too timid, as the Bank of Japan was in the early 1990s, and cut rates too slowly to offset gathering deflationary forces. With hindsight, it was probably too timid earlier this year even though it cut rates substantially. Alternatively, even if the Fed is aggressive, there is still the risk that some

unexpected events on the terror front could further hit business and consumer confidence. In that case, the markets and the economy could fail to respond to the Fed’s medicine as they normally would and deflation would worsen for the time being.

Under normal circumstances, we would expect that the combination of aggressive Fed easing and substantial fiscal stimulus would almost guarantee an economic and market recovery in 2002. However, as we wrote last month, these are not normal circumstances and the risks are higher than usual. So, the old rules of thumb about investing (such as “Don’t fight the Fed”) may not work as they have in the past.

Accordingly, we are cautiously positioned for better times ahead with 60% equities and 40% fixed income in CI International Balanced Fund – but we are not advocating the more aggressive stance that might be warranted simply by focusing on Fed policy. Likewise, our sector allocations are tilted toward sectors we think will benefit from a recovery next year, such as consumer products and industrials, but we are still well diversified across sectors in recognition of unusually high uncertainty about the outlook.

In short, “America’s New War” may require new thinking – even about such issues as whether war is inflationary or not. We will do our best to analyse this complex situation as it unfolds, and position our clients’ portfolios to benefit from the global economy’s still very substantial growth potential.

*William Sterling, Global Strategist
CI Global Advisors LLP*

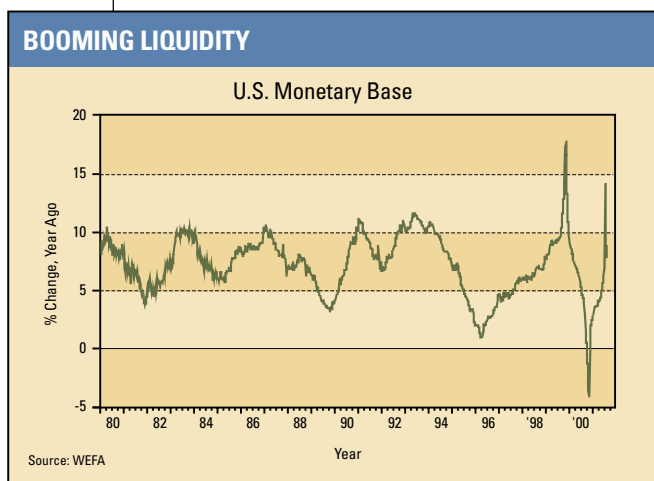


Chart 3. The Fed has massively accelerated the pace of money creation, which helps explain the equity market’s quick recovery from the September 11 shock.