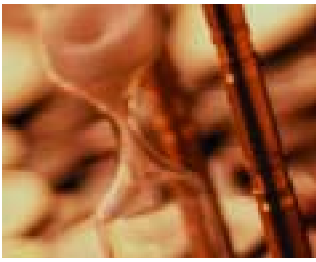

WILLIAM STERLING GLOBAL STRATEGIST

STERLING'S WORLD REPORT

Looking Forward to 2002

Old Man Time may be a welcome visitor this New Year as he ushers out 2001, a year filled with more bad news than we have had in a long time. We think there are a number of good reasons to look forward to 2002 as a year of economic and financial recovery, but have no choice but to add a major caveat: all of the variables we normally look at could be overshadowed by further negative shocks from the terror front. We will come back to that point as part of a general survey of the global investment climate in a question-and-answer format.

Q: Why do you think that recovery is the most likely scenario for 2002?

A: The simple reason is this: Economic policy around the world has generally moved in the direction of stimulating economic growth. The U.S. has been most decisive in this regard, with both monetary and fiscal policy being used to fight the shock effects of the September 11 terror attacks. In addition, most other industrial nations have also moved in the direction of more aggressive monetary easing since September 11 and that strengthens the case for a global recovery in 2002.

Looking back, there were three major macroeconomic developments in 1999 and 2000 that set the stage for global recession in 2001: tight money, higher oil prices and a boom/bust cycle in technology industries. Notably, these were all global factors that affected most major economies at the same time and with similar effects. That helps explain the highly synchronized nature of the downturn, and why there were few places to hide in global markets.

Looking ahead, the outlook is brighter because tight monetary policies have been replaced with easy policies, and because oil prices have fallen dramatically from more than $35 US per barrel at one point last year to a recent level of around $20 per barrel. The huge distortion to technology sector activities associated with the 1999 computer upgrading binge ahead of Y2K and the subsequent bust should also be passing from the scene, setting the stage for a resumption of more normal growth patterns.

Q: What about the shock effects of the events of September 11?

A: It is now absolutely clear that the dynamics of the global recession were rooted in the factors just discussed – factors that were present for months before the terror attacks triggered widespread concern about recession. In fact, the panel of economists charged with dating business cycles in the United States just recently made it official: The U.S. recession is judged to have begun in March this year, precisely when employment peaked. That meant that if the recession was going to have a typical duration of six to nine months, it should have been in the process of bottoming out around the time of the terror attacks.

As we indicated soon after the attacks, the concern in the markets was that the terror attacks would effectively notch a "V" onto the bottom of the economy's trajectory, by hitting consumer and business confidence all at once. Based on recent data, however, it appears that the decline may have been confined largely to just a few weeks following the attacks, outside of a few industries such as airlines and hotels (See Chart 1). Encouragingly, October data on retail sales, durable goods shipments and unemployment claims have all been better than expected.

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Stunningly good progress on the military front in Afghanistan may also be boosting consumer and business confidence, even though public officials continue to warn that the war on terror will be long and drawn out. If anything, the surprising bounce in auto sales and other indicators mean that we should not be surprised by a bit of softening in the economic data as auto companies scale back on zero-rate financing incentives (See Chart 2). But the basic trajectory of recovery should remain intact.

The Federal Reserve's monetary policy response in the wake of September 11 is also worth noting in two respects. First, Fed policy was extremely well executed in the immediate aftermath of the terror attacks, when the Fed reportedly provided over $50 billion of liquidity to financial institutions within 48 hours. By preventing accidental bankruptcies from cascading, the Fed's timely actions prevented a bad situation from becoming far worse. Second, the Fed has been aggressive in cutting rates since the attack, having brought the Fed Funds rate down to 2%.

Q: Are the central banks finished cutting rates?

A: We are probably getting to the tail end of this particular rate cutting cycle, but we suspect that both the Fed and the European Central Bank will cut rates one or two more times in coming months to ensure recovery. In addition, we expect both central banks to hold down rates down for many months to come to avoid a relapse into recession, thereby maintaining a positive interest rate backdrop for equity markets. As we have discussed in previous World Reports, equity markets have tended to post their best performances when short-term rates were low and yield curves (the gap between long-term and short-term rates) were positively sloped. So, the monetary backdrop for markets remains highly constructive.

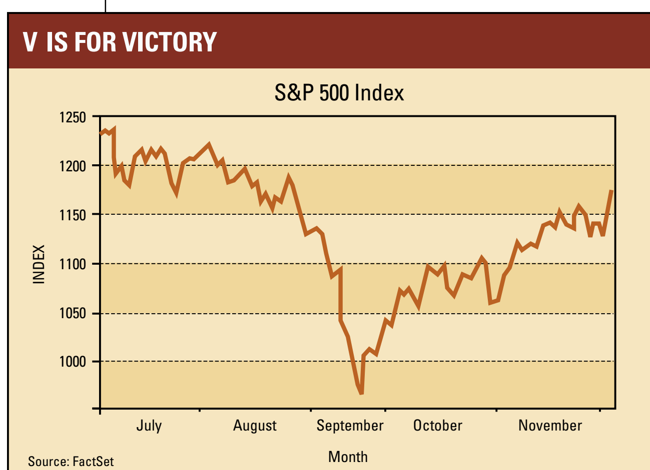

Chart 1. Equity markets have generally recovered from their September losses, thanks to aggressive monetary easing and encouraging military news.

Bond yields may have already seen their lows for this cycle, with yields having snapped back to pre-September 11 levels in response to increasing optimism about a recovery. That said, with huge excess capacity around the world and unemployment expected to rise through much of next year, it is difficult to be bearish on bonds. If history is any guide, inflation can be expected to decline for a year or so even as economic recovery takes root. And with U.S. bond yields close to 5% and the inflation rate likely heading to below 2%, then the real yields will be about 3%. That can be viewed as reasonably attractive, especially compared to short-term interest rates that are now below the rate of inflation. Currently, financial futures markets are pricing in interest rate hikes in the second half of 2002 that seem far too aggressive, and bonds should benefit as it becomes clear that central banks are in no hurry to tighten policy.

Within bond markets, we expect investors to be scrambling for corporate bonds, high-yield bonds and emerging market bonds, which offer higher yields than government bonds and which should benefit from economic recovery and reduced fears of bond defaults.

Q: Are foreign economies likely to recover in step with the United States?

A: Europe and Japan have been less aggressive than the United States in terms of cutting interest rates or pursuing expansionary fiscal policy, so it is likely that the U.S. economy will lead the global recovery. However, those economies should benefit from a reduction in oil prices and from inventory rebuilding that should accompany any stabilization in demand associated with lower interest rates.

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Even if the global economy continues to weaken for several months after the U.S. begins to recover, we expect global equity markets are just as likely to move together to the upside as they were to the downside. Historically, the Fed has often led other central banks in both tightening and easing monetary policy, and foreign markets have moved more in response to the baton movements of Alan Greenspan than they have in response to local developments.

As usual, Japan remains a conundrum. Hopes for economic reform led by Prime Minister Koizumi have faded in recent months as the economy has slid further into a deflationary slump. There is pressure growing on the Bank of Japan to try radical measures such as buying foreign bonds and driving down the value of the yen. It remains to be seen whether the Bank will cave into such pressure, or whether the situation will have to deteriorate further before Japanese policymakers move more decisively. We are watching the situation very carefully for signs of an important inflection point in policy that could turn around the economy and Japan's equity market. In any case, we are hedging yen exposure in our global portfolios because we believe that most plausible scenarios for the Japanese economy over the next year point toward a weaker yen.

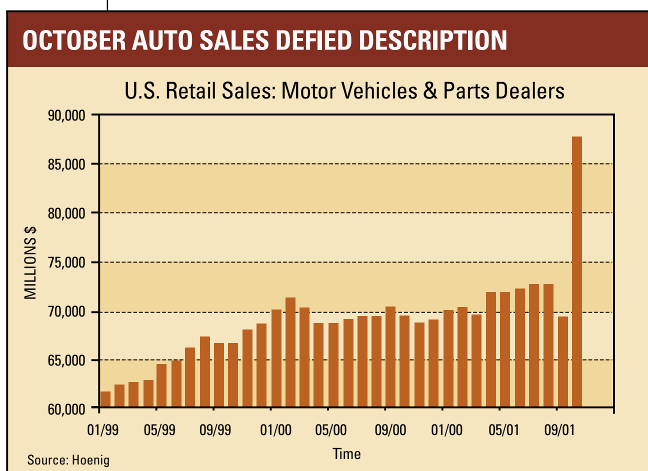

Chart 2. The good news from recent auto sales data is that consumers remain responsive to incentives such as lower interest rates, but some softening in sales should be expected.

Emerging markets such as Latin America and Asia have suffered from the global recession because of their high dependence on exports and on commodity markets. However, we continue to believe that the emerging markets will be major beneficiaries of a reflation of the major industrial economies. As with the developed markets, we think some of the most explosive gains in those markets are likely to come a few months ahead of the end of the global recession. If the yield curve and developed nations' equity market trends are any indication, that time may be upon us now.

Q: What major currency trends do you anticipate?

A: We have been surprised by how resilient the U.S. dollar has remained despite almost anything that could be thrown at it, including war, terror, recession, the collapse of Nasdaq, record trade deficits – you name it. Part of the reason for the dollar's strength is that the two countries running large trade surpluses against the U.S., namely Japan and China, want to keep their currencies weak to encourage exports. That said, we think the dollar is quite overvalued against both the euro and the Canadian dollar, and would not be surprised to see the dollar weaken against both of those currencies over the course of next year.

Accordingly, we have tilted our currency exposures in our global funds toward the euro and Canadian dollar despite our view that the U.S. economy will lead the global recovery. Indeed, in other business cycle recoveries, the U.S. dollar has often weakened in the early stages of recovery in response to the low interest rates that have been needed to generate recovery.

Q: What are the risks to your optimistic economic outlook?

A: As I mentioned at the beginning, the key risk is what is euphemistically called "event risk" in financial markets. The biggest event risk would obviously have to do with another terror event that could match or eclipse the attacks of September 11. Now that the Taliban is in full rout in Afghanistan, that risk would seem to have receded. But cornered animals can be extremely

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dangerous. According to the Washington Post, U.S. intelligence officials have recently concluded that Osama bin Laden and his Al-Qaeda terrorist network may still have the capacity to wreak havoc in America.

In addition, it is widely believed that the U.S. administration is seriously debating a possible offensive against Iraq next year, even though no decision appears to have been made so far. To the extent that such a move could disrupt oil markets and add new dimensions of uncertainty to the global outlook, the potential for affecting markets is clear.

Q: Any other comments?

A: A more mundane risk to markets has to do with valuations, which have become somewhat stretched again in response to the market recovery. Based on Standard and Poor's data, the S&P 500 is now trading at 27 times trailing operating earnings and almost 40 times reported earnings. And even though earnings are cyclically depressed, those valuations are rich enough to suggest that upside potential for the market could be capped unless current earnings forecasts prove to be far too conservative.

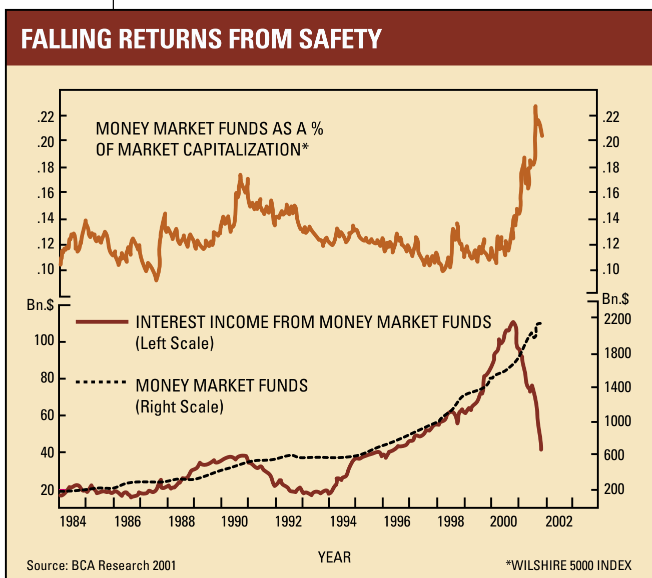

Chart 3. Investors have boosted their holdings in money market funds by 25% this year, and money fund assets are near record levels measured as a percent of stock values.

That said, the liquidity environment remains explosive and there is an enormous amount of money now sitting on the sidelines in cash. In search of safety, investors have boosted their holdings of money market funds by 25% this year and assets of these funds measured as a percentage of stock market value have reached record levels this year (See Chart 3). Because of the sharp drop in interest rates, the annualized interest income from money funds has dropped to $40 billion from $100 billion over the last year, and money funds are now providing negative returns to investors after inflation and taxes. Accordingly, as confidence in the economy and financial markets returns, the potential for a movement of funds back toward equities is substantial, which could keep valuations high for some time to come. We have long argued that a period of ultra-low interest rates would naturally be a period of surprisingly high P/E ratios, and this may now be the case.

Under normal circumstances, we would be tempted to have a much more aggressive allocation to equities in our balanced funds based on the explosive liquidity environment. That said, the unusual level of event risk – which is difficult to handicap – and our concern about valuations has kept us at a relatively balanced 60/40 split between equities and fixed income. That allocation expresses the view that equities will probably outperform fixed income, but with a wider-than-normal range of uncertainty around our expectations.

In conclusion, we see numerous reasons for optimism about 2002 but are fully aware that 2001 has not been a great year for professional optimists. So we remain cautiously optimistic about the outlook, and have positioned our portfolios accordingly.

From all of us at CI Global Advisors, please accept our best wishes for a joyous holiday season and a happy and prosperous New Year.

William Sterling, Global Strategist
CI Global Advisors LLP