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STERLING'S WORLD REPORT

All Stressed Up and Nowhere to Go?

Investing in equity markets in the past two years has been painful. Two years of back-to-back declines in most major indexes have prompted many investors to throw in the towel on stocks. The appeal

of safe investments like money market funds has also soared following the September 11 terrorist attacks and, more recently, the Enron and Kmart bankruptcies.

Even safe investments are painful these days, with short-term interest rates having plunged to under 2% in the U.S. and Canada. With such low rates, investors can expect to lose some of the buying power of their money after they consider inflation and income taxes.

In fact, it is a deliberate policy of central banks to make it painful for investors to keep money on the sidelines. A key goal of low interest rates is to prompt investors to take more risk, whether by

buying corporate bonds or equities. As that happens, companies can raise money in the capital markets, repair their balance sheets if necessary, and move back into a position to invest in their businesses and put people back to work.

Such aggressive monetary policy has worked reliably in the past to deliver economic recovery. Encouragingly, a wide range of economic data now suggests the U.S. economy bottomed last November. The debate among analysts has shifted in recent weeks from whether there will be a recovery to how strong the recovery will be and what industries will lead the way.

Enron Aftershocks – How Severe?

That said, there is still much unsettling news out there. Despite the Federal Reserve's "pedal-to-the-metal" monetary policy, equity markets in January have pulled back following a strong recovery in the fourth quarter. A shocking series of revelations about Enron's misleading accounting have begun to shake investor confidence in the integrity of the numbers used for investment decisions.

In political terms, Washington insiders have not yet been able to promote the scandal to "Enrongate," despite vigorous efforts to pin some blame on the Bush administration. In market terms, however, the scandal is already having

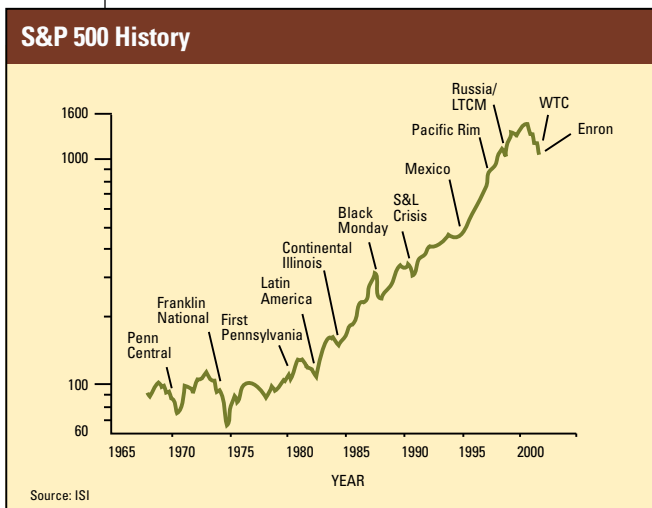


Chart 1. Over the past several decades, the stock market has typically resumed its upward course following many crises that have unsettled investors.



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important effects by subjecting many companies' accounting to intensive scrutiny. All at once, investors, rating agencies and other accounting firms are scrambling to ensure that "the next Enron" will not hurt them.

U.S. Senator Jon Corzine recently spoke for many market participants when he wondered about "whether the concerns and issues that have been revealed here are not more broadly applicable in the economy." He further questioned whether the Enron scandal is likely to "lead to a rise in the cost of capital, lead to serious concerns about foreigners wanting to continue to invest in America in the way that they have supported us with regard to our foreign trade balance." As a former co-chairman of Goldman Sachs, Senator Corzine is in a better position than most to understand how important the accounting issues are for the health of financial markets and the economy.

For now, the U.S. dollar remains strong. Economic data continue to point toward recovery. And despite the Enron scandal, the

U.S. still enjoys a reputation for having the most open and transparent accounting in the world. However, the Enron scandal may have opened a Pandora's box that could keep markets off balance for a while, even though we think economic recovery and renewed earnings growth will eventually drive the markets higher.

Stress Test – Watch Corporate Bonds

Big bankruptcies have often occurred in the past during bear markets and recessions. As with Enron, many major bankruptcies often triggered significant political and economic aftershocks. As shown in Chart 1, however, equity markets have resumed making gains following most major bankruptcies or financial crises in the U.S.

Such crises are naturally unsettling to investors. More often than not, however, such crises have turned out to be the denouement to a bear market or recession. This is often because the crises themselves have coincided with countervailing efforts by policymakers to keep the economy from worsening.

One sensitive indicator of financial strains is the gap between long-term corporate bond yields and the yield on (supposedly) risk-free U.S. Treasury bonds. Alan Greenspan and his colleagues at the Fed watch this gap closely. Put simply, a rising gap reflects fears that corporate bond investors will not get their money back because of increasing risk of debt defaults.

Currently, BAA-rated corporate bonds yield close to 8%, while the yield on 10-year U.S. Treasury bonds is about 5%. In other words, there is now a generous spread of nearly three percentage points in favour of corporate bonds. While corporate spreads have sometimes been higher in the past, they are now extraordinarily high

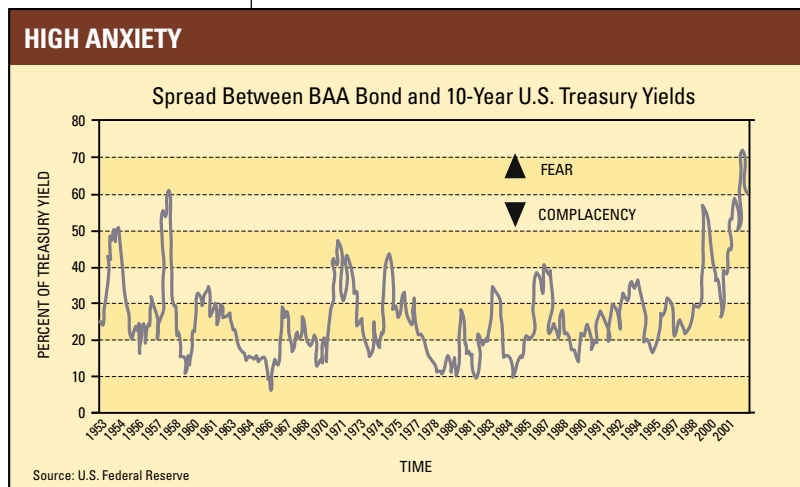


Chart 2. Corporate bond spreads are extraordinarily high compared with the yield on safer assets like U.S. Treasury bonds, reflecting widespread fear of more debt defaults ahead.



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compared with the low yield on Treasuries. Chart 2 shows the spread measured against the 10-year yield in percentage terms (currently, it's 3/5 or 60%).

Based on this indicator, hard-nosed bond investors expect there will be a wave of new debt defaults in the not-too-distant future. Not surprisingly, the corporate bond market has been in high anxiety for most of the last year as the world economy slipped into recession. Note that it also spiked up into high anxiety territory during the Russian debt default/Long-Term Capital Management panic of 1998. When financial headlines are scary, the stress indicator rises. When economic conditions are benign and boring, the indicator moves down.

Stocks Typically Do Well Following Crisis Periods

Our corporate debt stress indicator is giving a painfully obvious message: times are tough and investors fear the worst. Apart from that, can it tell us anything useful? Interestingly, if you look back

at history and ask how equity markets fared after periods of high financial stress, you get a result that makes sense – even though it may surprise many investors.

Using U.S. market data from 1954 to 2001, we found that following periods of “high anxiety” in the debt market, the equity market typically gained around 30% over the next 12 months (see Chart 3). In other words, when our stress indicator was over 50 – that is, when corporate bond investors demanded a steep yield premium over safe government bonds – the equity market typically posted robust gains over the next year.

Conversely, in periods when the indicator was extremely low, meaning that investors felt little financial risk, stocks returned about 2% over the next year. Other measures of risk and reward also show that stocks were often the best investment, even in risk-adjusted terms, when financial strains were extreme.

Does that guarantee the market will do well over the next 12 months? Of course not. No indicator works all the time. The stress indicator went above 50 at the beginning of last year and obviously did not call it right for 2001. “Sometimes a cigar is just a cigar,” said critics of Sigmund Freud. So sometimes a financial crisis is just that – and may not be an opportunity to buy. On average, however, the odds have been in favour of those who bet on recovery when times were tough.

Mutual Fund Flows and Human Nature

The stress indicator may have some predictive power for how equity markets will do in the future because of its “buy low, sell high” nature. When financial stress is high and investors are

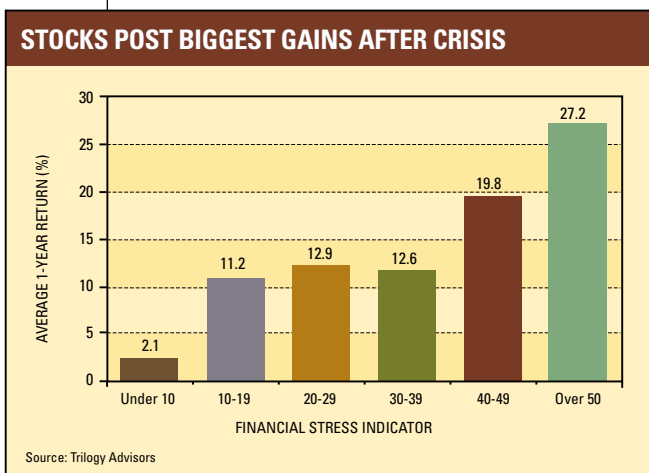


Chart 3. Stock market returns have historically been most generous following periods of financial stress and most modest following periods of calm markets and investor complacency.



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most apprehensive, stocks are typically down as well. When financial stress is low and investors are relaxed about risk, stocks are typically fully priced.

A look at historical data on mutual fund flows is instructive. As shown in the nearby chart, the flow of money into U.S. equity mutual funds has typically been a lagging indicator – more like “buy high, sell low.” That is, the biggest flows of money into mutual funds have typically come after the market has posted major gains, while the biggest outflows have occurred after the market has fallen.

Even though cold logic would suggest “buy low, sell high,” it seems hardwired into human nature to think along different lines: “The market’s up, it must be a good time to buy stocks,” or “The market’s down, it must be too risky to own

stocks.” And people naturally pay close attention to what their friends and neighbours are doing – if others are buying (or selling), it must be right.

There are only a few defences against the emotional tugs that often cause investors to do the wrong thing at the wrong time:

- Have a good adviser who creates an investment plan and helps you stick with it even when emotions are tugging you in a different direction.
- Adopt some discipline, such as dollar-cost averaging, which allows you to steer through emotional and market storms on autopilot.
- Study market history and investment theory in depth, devise a plan, and accept the fact you can still get it wrong.

In short, we have a simple bad news, good news story. The bad news is that investors currently face painful choices – whether to invest in stocks and bonds amid an unsettling market environment or whether to accept excruciatingly low returns for safe investments like money market funds. The good news is that economic recoveries have usually followed crisis periods. If history is any guide, equity markets usually reward investors who stay the course.

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FUND FLOWS LAG STOCK MARKET			
	U.S. Equity Mutual Fund Inflows		S&P 500
	\$ in billions	Yr/Yr % Chg	Yr/Yr % Chg
1985	\$8.5	44%	26%
1986	\$21.9	159%	15%
1987	\$19.1	-13%	2%
1988	-\$16.2	-185%	12%
1989	\$5.8	-136%	27%
1990	\$12.9	123%	-7%
1991	\$39.9	209%	26%
1992	\$79.0	98%	4%
1993	\$127.3	61%	7%
1994	\$114.5	-10%	-2%
1995	\$124.4	9%	34%
1996	\$217.0	74%	20%
1997	\$227.1	5%	31%
1998	\$157.0	-31%	27%
1999	\$187.7	20%	20%
2000	\$309.4	65%	-10%
2001*	\$40.8	-87%	-13%

* denotes inflows thru November 2001

Source: Investment Company Institute

Chart 4. Mutual fund investors have historically poured money into funds after the market has had a large rise, and sold funds after the market has tumbled.