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STERLING'S WORLD REPORT

The Recession Is Over. What's Next?

There is now little doubt that the global economy has begun to recover from the "Perfect Storm" recession of 2001 caused by tight money, high oil prices and the post-Y2K bust in technology spending.

Even though oil prices have been rising again, interest rates remain extremely low, consumer spending has firmed and there has been some improvement in labour markets.

In the face of increasingly strong economic numbers from the United States (see Chart 1), one prominent economic guru was forced to recant his forecast of a "double-dip" recession, while warning that he may still be right about renewed weakness ahead. This reminds me a bit of comedian Jerry Seinfeld's comment on hapless drivers who leave their turn signal blinking for miles as they drive down the highway. According to Seinfeld, that is the signal for "an eventual turn" – because eventually the car will turn again.

Fact: We have never had a down quarter in the United States in the first year of an economic recovery (see Chart 2). That doesn't mean it can't happen. It just means that it's unlikely in the absence of the type of shock that's almost impossible to forecast (more on that later). Since a variety of economic data suggest that U.S. growth in the first quarter has come in at an annual rate of 4% to 6%, worrying about whether there will be a double-dip recession seems fairly pointless.

It is also encouraging that the recovery appears global in nature. Emerging markets stock indexes have been soaring. European business confidence has picked up notably. And even Japan's index of leading economic indicators is now pointing toward economic recovery.

Key Issues for 2002 and 2003

We think the key issue for financial markets is not whether the global economic recovery will continue. Instead, it's likely that investors will focus on the following issues:

1. Central bank policy. It is now more a matter of when, not if, central banks will begin to tighten monetary policy. The question is whether they will tighten so aggressively that they materially dampen profit growth in 2003.
2. Equity market valuations. Even if the global recovery continues, equity markets appear to already be pricing in a lot of good news while bond yields have drifted higher. The result could be a frustrating trading range in the markets.

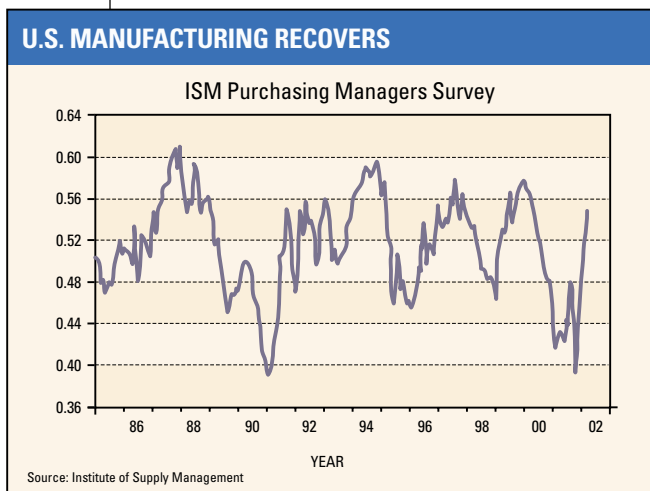


Chart 1. The Institute of Supply Management index (formerly known as the National Association of Purchasing Managers' survey) shows that a strong upswing in manufacturing activity is underway, indicating that the recession is over.



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3. Geopolitical and energy risks. The situation in Israel has heated up at the same time that the Bush administration is preparing to confront Iraq. Oil prices have already gone up in response to war risks. The key market questions will be: What kind of war or confrontation, and for how long?

We think it makes sense to take a fairly benign viewpoint on the first two issues. The third issue is more complicated, but must be considered seriously.

How Aggressively Will the Fed Tighten?

Fed officials are reportedly stunned by the U.S. economy's resilience and now appear to believe that the ultra-low interest rates put in place after September 11 have become highly inappropriate. As a result, it is quite likely that the Fed will soon begin to take away at least some of the emergency easing that was put in place after the terrorist attacks.

The first round of tightening could well occur at the Fed's mid-May meeting. Since Fed Chairman Alan Greenspan generally likes to move gradually, we would expect the first change to be a quarter-point hike in the Fed funds rate from 1.75% to 2.0%. If economic data remains firm in June and July, it would not be surprising to see the Fed increase the rate to 2.25% to 2.5%.

Over the next 12 months, the financial futures markets are now pricing in nearly 250 basis points

of tightening, or roughly 10 moves of one-quarter point each. If that turns out to be correct, equity markets could be in for some rough sledding even if economic growth remains firm. The fear would be that aggressive Fed tightening could set the stage for slower growth and weakening profits in 2003.

We think that Fed tightening will be less aggressive than such forecasts imply. Our reasons are as follows:

1. We believe that the current acceleration of growth is largely related to inventory rebuilding and overstates the underlying strength of the economy. Weakness in the commercial paper and corporate bond markets reflects ongoing credit concerns that are likely to dampen investment spending. The usual engines of recovery, housing and autos, have already hit peak levels and can be expected to contribute little in the way of new growth. Furthermore, unusually warm weather this winter boosted growth in some areas like construction that might come at the expense of the next few quarters. So, we expect growth to slow to a more sustainable rate of about 3% in coming quarters.
2. The Fed can afford to remain quite relaxed about inflation for now. The dollar remains strong, the U.S. and the world economies have ample spare capacity in the wake of the recession, and productivity growth has been astonishingly high. Excluding tobacco, goods prices in the U.S. have been falling and corporations report little pricing power.
3. Politically, the Fed is certainly aware of two issues that will be important to the Bush administration. One is the mid-term elections in November. To use language associated with George Bush Sr., "it wouldn't be prudent" to create a renewed bear market in stocks and recession fears ahead of the elections. Secondly, the Fed is also likely to be sensitive to the administration's efforts to prepare for a military confrontation with Iraq and realizes

FIRST 4 QUARTERS OF RECOVERY							
Real GDP, Quarter/Quarter % A.R.							
Quarter of Recovery	Recovery						
	1954	1958	1961	1971	1975	1983	1991
1st	4.4	9.3	7.7	11.6	3.6	4.7	2.3
2nd	8.2	9.3	6.7	2.2	7.1	9.8	1.0
3rd	11.9	8.6	8.4	3.1	5.1	7.3	2.2
4th	6.5	10.9	7.2	1.0	9.8	8.5	3.8

Chart 2. In recent decades, the U.S. has never had a down quarter in the first year of economic recovery.



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that this may not be the right time to be overly zealous about anti-inflation measures.

How Much of a Problem Are Equity Valuations?

One frustration for equity investors in this cycle is that valuations have remained much higher during a recession period than any time in memory. Whether you are a “growth” investor or a “value” investor, it is hard to find bargains out there and has been that way for a long time. Even the recent bear market did not bring most stocks down to bargain levels historically associated with recessions.

We have long argued in our Boomernomics research that interest rates in this decade would remain surprisingly low at the same time that equity valuations remain surprisingly high. The reason is based on the demographics of the baby boom, which has created strong secular demand for financial assets. Since we wrote Boomernomics in 1998, there has been a great deal of additional research that supports the association between baby boom demographics, low interest rates and high stock valuations. We intend to bring our readers up to date on some of this research in upcoming issues of *Perspective*.

A simple way of understanding why valuations remain so high is simply to consider how far interest rates have fallen. As shown in Chart 3, short-term interest rates are not much higher than the U.S. equity market's dividend yield, which is a paltry 1.4%. As interest rates have fallen over the last several decades, the dividend yield on equities has fallen as well (which means that other valuation measures, like the price-earnings ratio, have risen). It's no mystery.

In fact, the dividend yield on the market historically has been nearly three percentage points lower than the yield on three-month Treasury bills. Now it is only about one-half point lower, which means that, relative to the return on cash, stocks are priced at the cheap end of the range that has prevailed for the last two decades (see Chart 4).

We have looked at numerous valuation measures, and this simple measure seems as good as any for deciding whether stocks are reasonably priced and whether they are set to outperform cash. Note that even if the Fed tightens interest rates by two points, the relative valuation of equities should not move into highly negative territory as long as companies continue to pay healthy dividends. We doubt that the Fed would raise rates by that much unless it was quite confident about the outlook for corporate profits.

That said, a key message of high stock valuations and low interest rates is that we are likely to be in a world of lower stock returns than during the 1980s and 1990s. So in periods of economic expansion when there are other issues for the market to deal with, like tougher accounting standards or geopolitical risk, it would not be surprising to see the development of more “trading range” market patterns.

Current valuation levels do not necessarily imply that equity market returns will be negative, but do suggest that they will not be turbocharged by the continued increase in P/E ratios that characterized the last two decades. If that is correct, then total returns will depend mostly on corporate earnings growth in the years ahead.

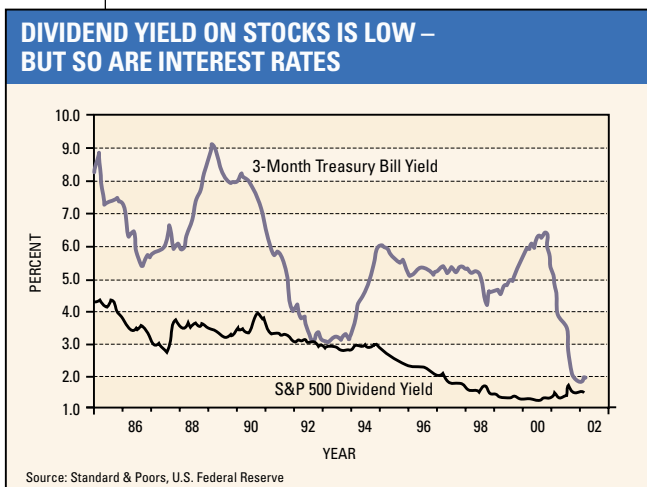


Chart 3. A major decline in the U.S. equity market's dividend yield (or a rise in valuations) over the past 15 years has been driven by a trend toward lower short-term interest rates.



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On the valuation front, probably the best thing that could happen at this point would be for economic growth to moderate a bit. That would permit long-term interest rates to come down a bit and take the pressure off central banks to tighten aggressively. And as we noted earlier, we think the odds that growth will moderate in the second half of the year are quite high.

Geopolitical Risks

Late-night comedians may joke about the Bush administration's decision to issue colour-coded domestic security alerts, but there is no doubt that the administration firmly believes that there is a significant risk of future terrorist acts inside the United States. There is also a strong belief that such attacks could use nuclear, biological or chemical weapons.

Our Washington sources also believe that the administration is convinced that Saddam Hussein intends to facilitate the use of weapons of mass destruction against the U.S. or U.S. interests abroad. It therefore appears that a decision to confront Saddam Hussein has already been made, and that the major questions are how and when.

How the markets would react to a confrontation with Iraq is unclear, and would depend on how long it lasts, what happens to oil markets and what happens politically in the region outside Iraq. A prolonged ground war could destabilize other major countries in the region that are threatened by extremist movements from within. These include Pakistan, which has nuclear weapons, and Saudi Arabia, which dominates oil markets.

The intensified conflict between Israelis and Palestinians complicates the situation, because Arab governments want the U.S. to halt the violence before they can consider the Iraq question. However, in the complicated world of the Middle East, it is still assumed that many Arab leaders will generally support U.S. action against Iraq even if they cannot do so publicly.

In short, the key geopolitical question is whether the U.S. can act quickly, decisively and successfully against Iraq. If not, there could be negative impacts on global financial and energy markets. How best to handicap this issue is anyone's guess at this time.

In conclusion, the global business cycle backdrop has become relatively benign and we believe that fears of aggressive tightening by the Fed are overdone at this point. We are also optimistic that the U.S. will successfully face up to its complex geopolitical challenges, although it is clear that investors' concerns about these challenges help explain why the markets have remained skittish despite much better economic news.

Our portfolios' positions continue to assume that the economic recovery will continue and that Fed tightening will be modest. Accordingly, we remain fully invested in our global equity portfolios and we maintain an allocation of 60% equities, 40% fixed income in the international balanced portfolio.

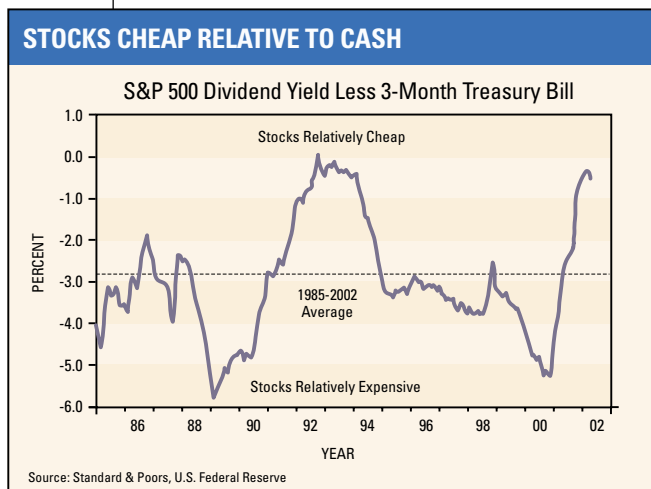


Chart 4. The difference between the dividend yield of equities and short-term interest rates is a good barometer of the relative value of equities. Relative to cash, equities now look attractive.

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