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The Year Ahead: Looking for the Pony

There is an old story about a young boy who bounds down the steps on Christmas morning only to find the living room brimming over with horse manure. Ever the optimist, the boy finds a shovel and

starts digging with enthusiasm. When asked why he seems to be so excited, the boy cheerfully replies, "With all this manure, there must be a pony in here somewhere!"

Those of us who invest in stocks for a living are basically optimists. We believe that economic growth creates wealth and that stock ownership will continue to be an important tool for building wealth over time. Obviously, these have been extremely trying times for optimists, with most major stock markets around the world now having posted three consecutive years of negative returns.

It seems that the United States will be at war with Iraq within weeks. At the same time, an unstable regime in North Korea has decided to play a dangerous game called "No Nukes for Food." Prophets of doom see prolonged economic and geopolitical catastrophe looming, with comparisons being drawn to Japan in the 1990s or the U.S. in the 1930s. Against this backdrop, should those of us who remain optimistic feel as naive as the young boy searching for the pony?

We think not. There is no denying that the financial arena has been filled with unpleasant aromas recently. In addition to geopolitical fears, we have had to deal with one of the worst profit slumps in the postwar era, not to mention odoriferous scandals like Enron, WorldCom, Adelphia, Tyco, ImClone and so on. And even though the recession technically appears to have ended a year ago, unemployment has continued to edge higher, raising fears of a double-dip recession.

That said, with the exception of North Korea's recent brinkmanship, all of the above is basically old news. Barring worst-case scenarios involving Iraq and North Korea, it is fairly easy to imagine a substantial improvement in investor sentiment over the next few quarters. In our view, the improvement in sentiment is likely to come from three major sources:

1. A successful regime change in Iraq.
2. Firmer economic growth in North America and non-Japan Asia.
3. Improving prospects for Europe, key emerging nations and perhaps even Japan.

Naturally, there are other market-friendly scenarios, including a "peaceful" resolution to the Iraq crisis, with Saddam Hussein leaving Iraq for an extended vacation. However, we will focus on the scenarios and trends that we consider most likely.

We would also note that sudden upward moves in markets often happen when they are least expected and when pessimism is the dominant emotion in the markets. As shown in Table 1, investors who remained unemotional and disciplined through other periods of back-to-back negative years were ultimately rewarded with strong market recoveries. While there are no guarantees that the market is about to turn, it is important to realize that markets can anticipate and respond to potential positive economic and political developments long before news headlines turn positive.



The Year Ahead: Looking for the Pony *(cont'd)*

Aftershocks from War with Iraq

Even though a variety of nasty surprises could result from a conflict with Iraq, most military analysts still believe that it will be no contest and will be concluded quickly. If that's the case, there could be some positive surprises resulting from the conflict. A recent article by military historian Victor Davis Hanson makes some interesting points about the aftermath of an Iraq conflict:

"The results will have ramifications that make those in Afghanistan pale in comparison – and perhaps change both the complexion of the present war and the Middle East itself in ways we can now scarcely imagine. Current polls reflect widespread dislike of the United States in the Middle East. But what will such surveys reveal in six months, when an odious Saddam Hussein is removed and something follows far better than both him and the other autocrats in the region? Look at the change in Kabul for the answer.

"In the post-Saddam chaos, a daily staple of news reports will be tours of Saddam's Ceausescu-like palaces and exposés of material excesses that would make Imelda Marcos blush – along with horrific tales from survivors of his gulag and glimpses into his labyrinth of torture. It won't be a pretty picture. Just as Venetian sailors used to stare aghast at what floated up when they deliberately sank their galleys right outside the harbor to cleanse the ballast of vermin, so too a post-Saddam Baghdad will disgorge especially foul residents that may well make the late Abu Nidal,

Abu Abbas, and the Hussein progeny seem innocuous."

Hanson goes on to speculate that other autocratic regimes in the Middle East, including regimes in Egypt, Iran, Jordan and Saudi Arabia, will then come under intense pressure to begin democratic reforms. Other analysts have speculated that oil prices could quickly fall following an Iraq conflict, which would represent an effective tax cut for the oil-consuming nations.

Are the positive scenarios of spreading freedom in the Middle East far-fetched? Perhaps. But it is interesting to note that one of the best-performing stock markets in the world in 2002 was none other than the Iraqi stock market itself. The market rose sharply after the November 8 vote by the UN mandating tough weapons inspections. According to one market veteran, "People think that six months from now, the situation in Iraq could be much better." Of course, the analyst was quick to add that his remarks were not intended to imply any disrespect toward Iraq's current fearless leader. However, apparently some of those closest to the action are betting with their pocketbooks that the outcome will be positive.

Continued Growth in North America

One of the big surprises of 2002 was the resilience of the North American economy, despite the dismal performance of financial markets. It appears that the U.S. economy posted respectable growth in the range of 2.5% to 3.0%, despite a massive loss in wealth from the stock market decline, major corporate scandals and confidence-eroding effects of a looming war with Iraq. Canada's economy appears to have posted even more robust growth of 3.0% to 3.5%, based on stronger growth in employment and manufacturing and a shallower decline in non-residential construction.

Even though these growth rates are much lower than in typical postwar recoveries, they are still impressive against the backdrop of the collapse of the major telecom and information technology spending booms that drove growth in the late 1990s. To be sure, aggressive monetary easing by

BACK-TO-BACK NEGATIVE YEARS

S&P 500 Index 1926-2001				
YEARS	% DROP	1 YR LATER	2 YRS LATER	3 YRS LATER
1929-1932	-64.3	54.0	51.8	124.1
1939-1941	-20.6	20.3	51.5	81.4
1973-1974	-37.3	37.2	69.9	57.7
2000-2002	-37.6	??	??	??

Source: Morningstar

Table 1: Patient investors who have suffered through back-to-back negative years in the U.S. market have historically benefited from major rallies that followed.



The Year Ahead: Looking for the Pony *(cont'd)*

the Federal Reserve and well-timed tax cuts played a major role in supporting consumers during a period of major weakness in business spending. Remarkably, though, strong productivity growth has also been a key aspect of the economy's performance (See Chart 1).

The productivity story is noteworthy because it bodes well for the economy's long-term prospects. The reason is that strong productivity growth has created a type of "virtuous circle" that has permitted real wages to rise at a clip of 3% to 4%, while simultaneously keeping inflation in check and supporting reasonably firm growth in consumer spending. At a time when many analysts expected consumer spending to be weak because of the impact of lower stock prices, the benefits of strong productivity growth and rising real wages has been a major support for the economy. Presumably, as the drag from lower stock prices fades in coming quarters, consumer spending should gather momentum once again thanks to rising real wages. And the possibility of lower oil prices is another reason not to rule out the consumer as an ongoing support for the economy.

Capital spending has also made a slow and uneven recovery in recent quarters after falling sharply in 2001. With pre-tax corporate profits in

the U.S. up 12% from a year earlier in last year's third quarter, companies now have the wherewithal to replenish depleted inventories and invest more in new equipment. There are also other signs that capital spending is picking up, with business spending on equipment and software having risen in the past two quarters, led by technology spending. Although depressed stock prices and general business uncertainty continue to hold back capital spending, the positive effects of low interest rates and improved corporate cash flow suggest that capital spending momentum will build this year, especially if geopolitical uncertainties are reduced.

It is also highly likely that both monetary and fiscal policy will continue to remain supportive of growth in the year ahead. Even if economic growth picks up, the Fed will wish to wait for clear signs that the expansion is sustainable before raising interest rates significantly. Accordingly, short-term interest rates are likely to remain at extraordinarily low levels for most of 2003. The recent shakeup of President Bush's economics team also makes it clear that the president wants to avoid his father's apparent mistake of not dealing with a weak economy ahead of the 1992 presidential election. The primary objective of economic policy now is to ensure a strong economic upturn by the second half of 2003 through mid-2004, when it will matter most to the voting public. Proposed measures such as eliminating the double taxation of stock dividends are designed to promote growth, even if it means higher budget deficits for the next several years.

Of course, there is nothing new about presidents wishing to boost the economy in pre-election years. As shown in Chart 2, since 1832 the U.S. stock market has tended to put in its best performance in the year ahead of a presidential election as markets anticipate better economic news ahead. In contrast, the weakest years in the market have tended to be the post-election years and mid-term years, when unpleasant economic decisions tend to be made. If the so-called "presidential cycle" in the stock market fails to make an appearance this time around, it certainly will not be for lack of effort on the part of the Bush administration.

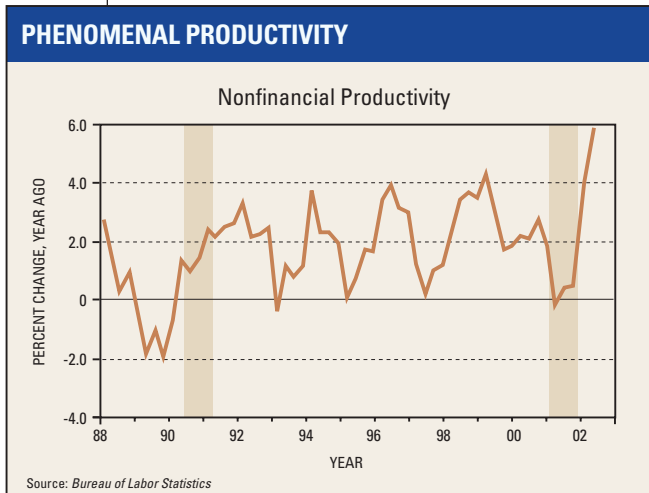


Chart 1: Robust productivity growth is driving down costs, boosting profit margins, and supporting firm growth in real wages and consumer spending.



The Year Ahead: Looking for the Pony *(cont'd)*

Is the Worst Behind Us Overseas?

Growth in Europe and Japan has been quite sluggish in 2002 and most analysts are currently projecting little improvement in 2003. That said, continued growth of 1% to 2% for Europe looks likely this year, with the risk being for somewhat higher growth if the European Central Bank follows up its recent 50-basis-point rate cut with additional rate cuts in 2003. Growth in money and credit is reasonably firm, which does not point toward an economy on the brink of deflation, as some pundits have suggested. In addition, over-investment and excess capacity problems are not evident in most European industries, and any improvement in global conditions is likely to prompt European companies to replenish depleted inventories, which could be another source of growth in 2003.

Japan's outlook is clouded by the prospect of painful economic reforms in the financial sector, which could effectively pull the plug on numerous "zombie" companies that have been kept alive for years on easy credit from the banks. Paralysis in Japan's banking system has stymied the Bank of Japan's monetary easing, which has flooded the system with zero-interest bank reserves, but failed to get banks lending

aggressively. However, the Bank of Japan has faced criticism by many monetary experts for not being aggressive enough in fighting deflation. If Prime Minister Koizumi chooses an aggressive deflation-fighter as head of the Bank of Japan, it could improve expectations for Japanese growth significantly.

Outside of Japan, other Asian nations generally posted reasonably buoyant growth rates of 5.5% to 6.0% in 2002, or more than double what was seen in most of the developed nations. Assuming moderate growth in the developed nations, non-Japan Asia is expected to see even stronger growth in 2003. Elsewhere, the emerging markets of Central and Eastern Europe are expected to grow by more than 4% in 2003, or more than double the rate of the Eurozone nations. Even Latin America could see some improvement in 2003 since Brazil seems intent on pursuing reasonably constructive economic policies, despite investor jitters about a new administration facing a daunting debt schedule. Improving global growth also would be a major plus for Latin America.

Barring geopolitical disaster associated with Iraq or North Korea, the year ahead looks basically positive for the global economy and financial markets. And if the geopolitical news is reasonably positive, as we expect, then a major theme in financial markets should be declining risk aversion amid improving estimates for consumer and business spending alike. In short, the environment should favour stocks over bonds. Within the stock market, well-managed companies that are positioned to benefit from a pickup in business spending should outperform companies in stable but slow-growing sectors like consumer staples.

Call it the year of the pony.

Best wishes for a happy and prosperous new year.

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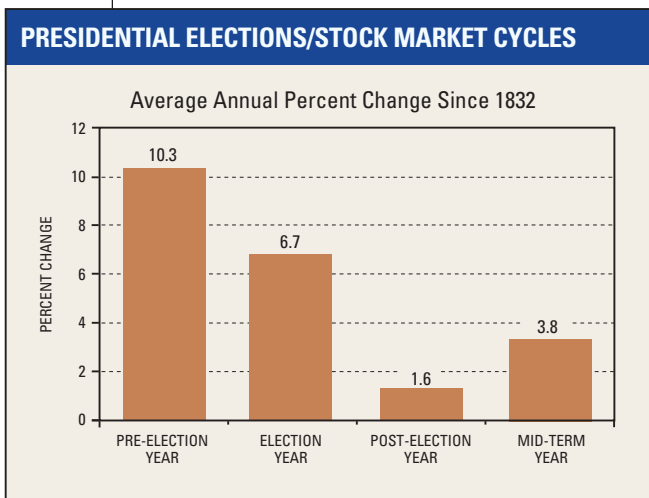


Chart 2: Historically, pre-election years in the U.S. have seen the strongest stock market performances.