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Back to Business: The World After Iraq

It is easy to be gloomy about the future against the backdrop of 24/7 war coverage and massive swings in sentiment associated with the news of the day. Our best guess at the time of writing at the beginning of April is that the worst of the fighting will be over in four to six weeks, although there is clearly a risk that the war could drag on longer.

But after the war, what then? There are many who argue that problems with the world economy are structural, not cyclical, and that even a relatively benign outcome in Iraq will not mean the end of the secular bear market in stocks. To be sure, if the war drags on and consumers

retrench, there could be another recession and further bear market pain ahead.

While we acknowledge these risks, we think the far more likely scenario is that an end to the military conflict will let oil prices decline and allow policymakers around the world to focus on economic and market revival. We continue to believe that economic reflation and recovery will be dominant market themes this year, even though investors were essentially paralyzed during the first quarter as rising oil prices and war worries took their toll.

From a purely economic viewpoint, perhaps the most important feature of the Iraq war so far is what has not happened. Aside from a few isolated

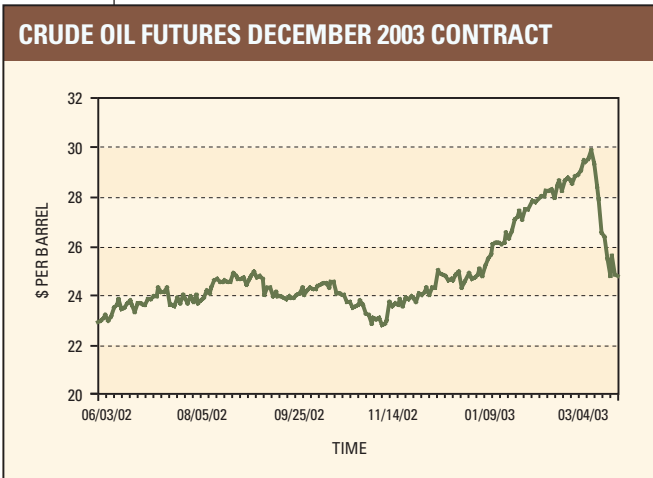


Chart 1: Oil prices for December delivery plunged to \$25 US as soon as the U.S. secured Iraq's southern oil fields. Further downward pressure is likely once the northern fields are secured.



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incidents, Iraq has not been able to torch its oil fields or the oil fields of its neighbors. Moreover, its capacity to do so has rapidly faded as it loses military control of its territory.

This positive development is reflected in oil futures markets. As shown in Chart 1, futures markets have recently priced in oil prices falling to the range of \$25 to \$26 US a barrel by the end of the year, versus expectations of around \$30 a barrel before the war began. As the end approaches for the Iraqi regime, we would not be surprised to see further downward pressure on oil prices as the war premium continues to fade.

If the futures markets are on target, that means oil prices should be posting year-on-year declines

in the second half of this year and early next year. Since a \$10 decline in the price of oil is equivalent to a tax cut of \$40 billion to \$50 billion for the U.S., this would be very good news for both consumer and business spending.

Addressing Global Divergences

Economic reports in coming months are likely to reflect a pause in world growth during the first quarter. At the same time, the data should continue to reflect unusually extreme divergences across regions. China has been booming, Europe has been flirting with recession, Japan remains mired in chronic deflation, and the U.S. has been muddling through with sluggish growth.

We would caution investors not to be too gloomy in the face of lacklustre economic reports. Economic policymakers are likely to respond to these trends by keeping policy extremely expansionary. The European Central Bank needs to cut rates again and almost certainly will once war clouds lift. Japan's new central bank chief is likely to pursue more expansionary policies than his predecessor. And the Federal Reserve stands ready to ease policy further to ensure recovery later this year.

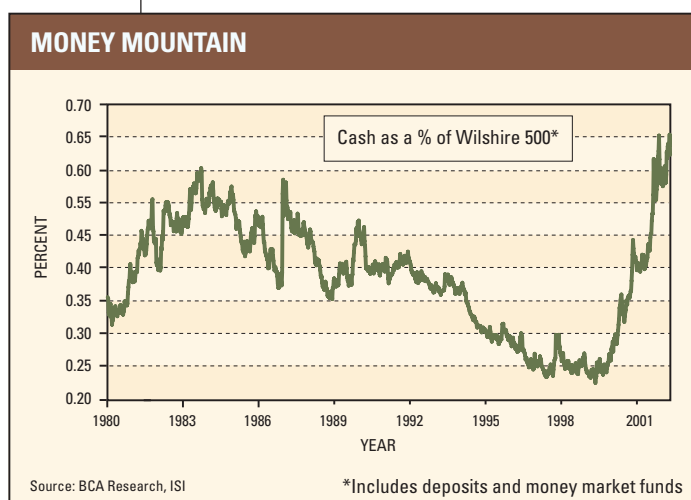


Chart 2: An enormous "cash mountain" of \$5 trillion in money market funds and savings accounts has built up in recent years. This money is earning next to nothing and could be poised to flow back into stocks when investor confidence improves.

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This suggests that the liquidity backdrop to global equity markets should remain quite supportive in coming quarters, at a time when the relative valuation of equities is as attractive as it has been for decades. One measure of the supportive monetary environment is the extraordinary buildup of cash in money market funds and savings deposits in the U.S., as shown in Chart 2. This \$5 trillion cash hoard is equivalent to a record 63% of the equity market's capitalization. And what is truly extraordinary is that this cash has continued to build even though returns on short-term deposits have plummeted.

Investors have so far been content to earn virtually nothing on this cash hoard during the bear market. That's because earning nothing has been

better than posting losses in stocks. However, there is little doubt that once sentiment towards stocks changes, the potential will exist for major flows of money into the market.

Valuations Back to Earth

Equity market valuations have improved notably during the course of the bear market. The S&P 500 currently trades at around 15 times forward operating earnings, compared to a multiple of 24 at the peak three years ago. That is in line with its historical average over the last 30 years, a period when interest rates were generally much higher than they are currently. Naturally, a P/E ratio of 15 represents far better relative value when bond yields are 4% than when they are 10%.

A straightforward way to adjust for interest rates when looking at equity valuations is to add the 10-year U.S. Treasury yield to the forward price-earnings ratio. By this measure, as shown in Chart 3, the equity market's valuation level looks quite reasonable by the standards of the last several decades.

Looking around the world, as shown in Table 1, many major markets are trading at substantially lower multiples than the U.S. market. What's

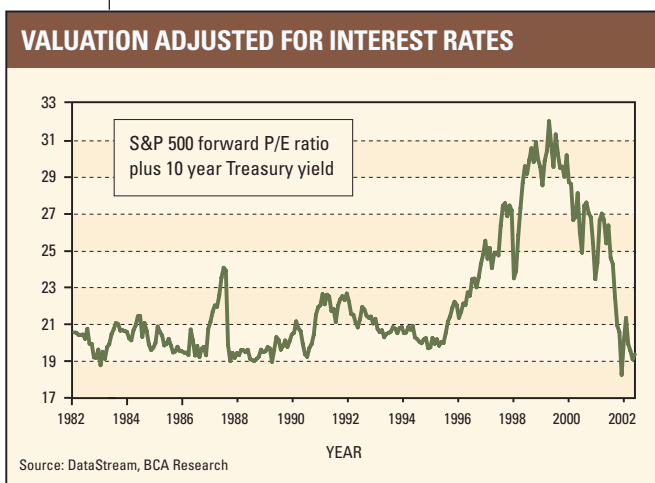


Chart 3: Adjusting for the low level of interest rates, the equity market's valuation level looks quite reasonable by historical standards. This chart simply adds the 10-year Treasury yield to the forward price-earnings ratio.

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OVERSEAS MARKETS OFFER VALUE

	12 month Forward PE					World
	U.S.	Europe ex-UK	UK	Japan	Asia ex-Japan	
BASIC INDUSTRIES	17.4	9.5	11.4	18.3	11.5	13.2
CAPITAL GOODS	15.1	12.1	7.5	19.9	9.3	14.3
CONSUMER CYCLICALS	16.1	8.5	11.1	14.3	9.0	13.6
CONSUMER STAPLES	14.8	12.5	11.4	21.2	12.9	14.6
ENERGY	14.8	11.1	14.0	18.7	8.8	13.4
FINANCIALS	11.2	8.9	9.5	17.8	10.7	10.8
HEALTH CARE	18.3	14.8	15.5	17.0	19.5	17.6
TECHNOLOGY	24.2	24.4	11.0	23.9	15.2	23.7
UTILITIES	10.8	9.6	10.8	15.9	9.2	11.4
TELECOMS	14.8	14.3	17.3	19.1	9.5	29.8
MARKET	15.6	11.0	12.0	17.4	10.9	14.6

Source: Lehman Brothers

Table 1: Most foreign markets now have price-earnings ratios substantially cheaper than the U.S. market. Numerous sectors now have single-digit price-earnings ratios.

more, numerous sectors within those markets are now sporting single-digit price-earnings multiples. Accordingly, we would argue that the case for global diversification is currently quite compelling.

To be sure, cheap markets can get cheaper and low valuations are no guarantee of great returns in the immediate future. However, what is clear is that the risk/reward profile for equities has improved dramatically relative to that of fixed income. Peering through the fog of war – and the hot air of war coverage – we expect this year to be a year of both economic and market

recovery. And we doubt that the markets will wait for a surrender ceremony in Baghdad to begin pricing in economic revival.

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