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# The Global Business Cycle: From Bust to Boom?

When the leaves fall each year, we usually spend a number of days travelling in Canada to discuss our global market outlook with our clients. With equity markets having made strong gains since the dark days of March, we found clients feeling slightly more optimistic, though many felt that we are seeing just another “bear market rally.”

However, we still have a very positive view of the global economic and market environment, and believe that markets are likely to remain in a “sweet spot” for a considerable

period. The key reasons are that the global economy continues to recover, while central banks are maintaining market-friendly monetary policies. In addition, relative valuations still favour equities over fixed income (see Chart 1) and there remains ample cash on the sidelines to fuel further equity market gains over the coming year.

A. It does. We now think there is a greater risk that the Fed will hike interest rates in the first half of next year. The latest GDP report was truly stunning. It was only six months ago that many Wall Street economists were warning that the economy was at great risk of a recession in the second half of this year. Instead, the 7.2% growth for the third quarter looks more like a boom than a bust and is confirmation that the aggressive monetary and fiscal stimulus measures of the last year have started to generate a sustainable recovery.

Many of our clients’ questions naturally focused on the risks to the markets. So, in this month’s World Report, we will revisit some of those key questions. In addition, we will discuss new economic data, including the surprising report that real U.S. GDP grew at an annual rate of 7.2% in the third quarter – the strongest growth in more than a decade.

Furthermore, the composition of the data augurs very well for growth continuing to be strong. Investment spending was strong. Inventories remained weak and will almost certainly have to be rebuilt in the next several quarters. That should provide a “slingshot” effect to both investment spending and job creation that will create additional economic momentum that should last well into next year.

Q. You have been optimistic that the U.S. Federal Reserve would not raise interest rates for most of 2004. Does the latest data change the outlook?

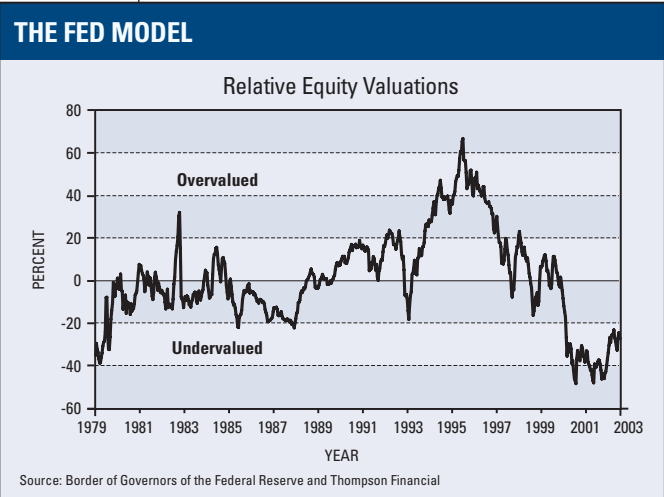


Chart 1: The Fed Model, which simply compares the earnings yield of stocks to the yield on 10-year government bonds, shows that stocks are still undervalued by nearly 25% relative to bonds.

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In addition, although the GDP report did not explicitly include a profits number, it makes it highly likely that economy-wide profits were up something like 30% from a year earlier, which certainly provides fuel for further investment spending and new hiring.

The GDP number also came against the backdrop of booming commodity prices (see Chart 2) and very good growth numbers from many foreign economies. Japan reported that industrial production in the September through November period is expected to rise nearly 9%. China is booming along with GDP growth of nearly 9% and Japan's exports to China have taken off. Even Europe is

reporting improved business confidence and the Bank of England is so confident about its economy that it recently raised interest rates for the first time since 2000.

*Q. So why hasn't the Fed signalled that it will begin raising rates?*

In the U.S., the missing link in the recovery is the labour market, which until September was experiencing month after month of job losses (see Chart 3). Since the Fed is concerned not only with price stability, but also with maintaining full employment, it is in no hurry to raise interest rates until it is confident that the labour market is in a sustainable recovery. That said, if the Fed sees several months in a row of strong jobs growth, then it will probably begin backing away from its policy of super-low interest rates.

We are still optimistic that bond yields will not have to rise to levels seen in previous business cycles, but it's much more likely that the yields on 10-year U.S. Treasuries will rise to 5.0% to 5.5% in the first half of next year. That degree of an increase in bond yields could prompt the Fed to tighten monetary policy by perhaps a full percentage point next year as well. That could create a choppier environment for equity markets, although we expect that good news on growth and profits will outweigh the interest rate dynamics at this point in the business cycle. We would still

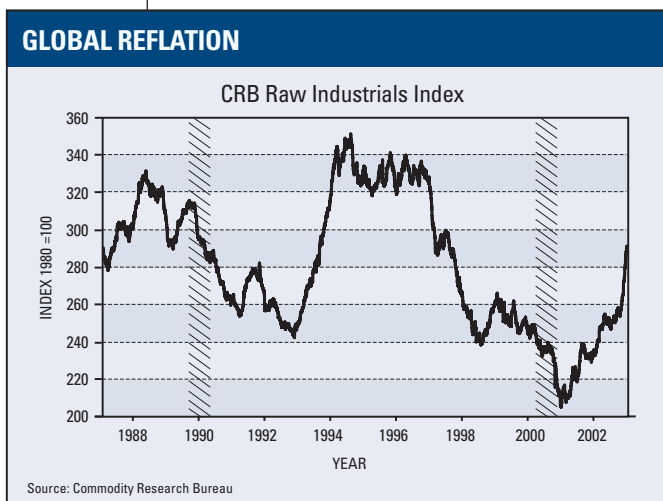
expect equities to outperform bonds in that environment.

*Q. The U.S. dollar has been extremely weak this year, especially against the Canadian dollar. Is that likely to continue?*

A. Regardless of what they might say about the "strong dollar policy," U.S. officials have welcomed the weaker U.S. dollar over the last year. With plenty of excess capacity and high unemployment, the Fed has not been worried about inflation and was well aware that pursuing a policy of low interest rates might weaken the dollar. With an election looming next year, the White House and the Treasury have also been increasingly concerned about the weak labour market.

With a large current account deficit of around \$500 billion, the U.S. is likely to continue to favour a weaker dollar in order to discourage imports and boost export competitiveness. So we wouldn't be surprised if we are only one year or so into a multi-year bear market for the U.S. dollar (see Chart 4). That said, U.S. equities have tended to post higher-than-average gains during periods of dollar weakness, so there is no reason to be apocalyptic about the impact on financial markets.

Although we would not be surprised to see the Canadian dollar rise as high as 82 cents US over the next six to 12 months, we doubt that



*Chart 2: So much for deflation fears. Industrial commodity prices are up 20% this year, reflecting a significant pickup in global growth.*

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it will repeat the huge move it made this year. One reason is that the strong Canadian dollar is hurting exporters, which has helped to force the Bank of Canada to begin cutting interest rates. Another reason is that the U.S. economy appears to be strengthening while Canada is slowing.

We continue to hedge a significant portion of our funds' U.S. dollar exposure back into the Canadian dollar or into other strong currencies, but we do not expect hedging to be as important over the next 12 months as it was over the past 12 months. Over the longer term, the best solution for the U.S. trade imbalance should be stronger growth overseas

combined with a gradual decline in the U.S. dollar – especially against the Asian currencies. Clearly, the U.S. trade imbalance with Asia, and most notably China and Japan, is the major issue.

*Q. Speaking of China, what impact is China having on the global economy? Is it a good place to be invested now?*

A. China's boom has had a major impact on global commodity markets this year, with its growing demand for everything from steel to copper to energy. In an odd way, some of the remarkable strength of the Canadian dollar this year was probably "made in China," since the currencies of most nations with significant natural resources have been strong this year, including Australia and South Africa. Other Asian countries, including Japan, have also benefited from China's boom, thanks to much stronger exports.

That said, we doubt that China will become an important source of global inflation pressure for several reasons. First of all, many economists are concerned that China's economy is beginning to show signs of overheating and that its growth is likely to slow substantially next year as authorities hit the monetary brakes. They are also concerned that China's growth is so focused on building up new manufacturing capacity in industries ranging from steel to autos to cell phones, that

a new wave of competition from China will produce additional intense pressure to cut prices in numerous industries globally over the next several years.

We do not recommend heavy investments in domestic Chinese equities because disclosure and legal protection for investors are poor, and the markets can be illiquid. We have preferred to invest in other Pacific Rim nations that have benefited from increased trade with China, but where disclosure and investors' legal standing is more transparent. And while China themes may be the "flavour du jour" in international markets, we are also concerned that the Chinese banking system may be fragile and could be headed down the same path as the Japanese banks of yesteryear. In other words, credit controls may be so lax that, during this boom, China's banks could be making a lot of high-risk loans that will go bad later.

*Q. What if the U.S. labour market fails to recover? What will it mean for financial markets, politics and the dollar?*

A. In the worst-case scenario, continued employment declines would mean a sharp slowdown in consumer spending and a drop in equities, resulting in an increasingly difficult political situation for President Bush. Some market strategists fret that if the economy becomes bad enough, Bush would be



*Chart 3: U.S. jobs growth has been anemic during this recovery, but the recent pickup in overall economic growth points to stronger job growth ahead.*



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tempted to support protectionist measures or get aggressive about talking down the dollar.

We think the odds of this scenario are now quite low. The best leading indicators we have found for jobs growth are trends in corporate profits and business spending. Both are picking up very nicely, so the odds are high that the economy has moved into a phase of self-sustaining growth, where higher profits beget more jobs, which begets higher consumer spending and higher profits. That's what so-called "multiplier effects" that are discussed in economics textbooks are all about.

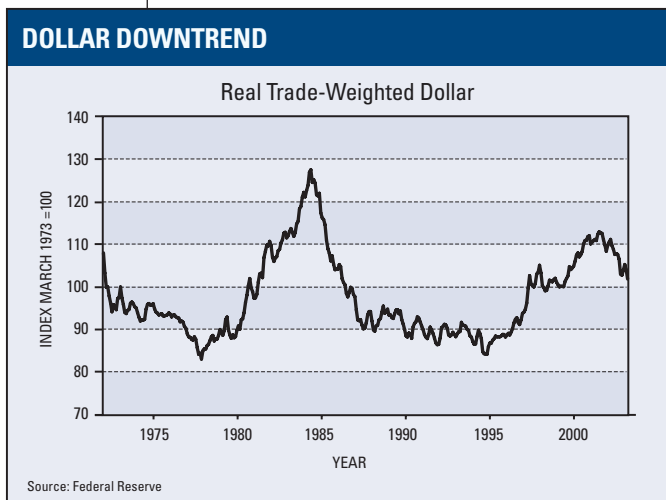


Chart 4: The bear market in the U.S. dollar could continue for some time to come, but we expect most of the pressure over the next year to be directed toward Asian currencies.

Since a number of labour market indicators have already started to improve, George W. Bush should end up being in much better political shape than his father was in 1992. During that similar "jobless recovery," job growth didn't take place until a few months ahead of the election – when it was too late to matter. In this episode, it looks increasingly likely that jobs growth and a more robust economic recovery will precede the November 2004 election by more than a year.

And we've said it before, but we'll say it again: The two best years historically in the U.S. stock market have been the year ahead of the presidential election and the year of the election. It's a simple-minded theory to be sure, but an incumbent president certainly has strong incentives to concentrate as much positive economic news as possible into the period ahead of the election. And that certainly seems to be the game plan for this administration.

*Q. Are there other wild cards out there?*

*A. Oil prices, as usual. One of the effects of the continued conflict in Iraq is the delay in restoring Iraqi oil production. Some strategists are speculating that the next move in the "pull out all the stops" campaign to re-elect President Bush would be a sharp increase in the U.S. oil supply, perhaps with some*

assistance from Saudi Arabia. That could provide a gift to global consumers – and probably to the equity markets as well – sometime over the next six months.

We have no insider information to support this scenario, but it would not surprise us. Given the importance of Saudi Arabia as the key swing producer, oil prices are not determined in an entirely free market. Instead, oil prices are to a large extent "administered prices" that are hardly immune to political forces.

In conclusion, we continue to believe that global economic expansion will remain the key market theme over the next year and have positioned our funds accordingly. To be sure, there are always risks to the outlook, but our strong sense is that most stock markets remain reasonably valued and that market sentiment is nowhere close to the levels of euphoria that prevailed a few years ago. Our simple conclusion: There is plenty of room for global equity markets to continue to recover.

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