



WILLIAM STERLING

STERLING'S WORLD REPORT



## The Message from the Markets – A Good Year Ahead

Financial markets sometimes reward investors handsomely for contrary thinking. Like Rudyard Kipling said, “If you can keep your head about you while others are losing theirs, you can make excellent investment returns.” Well, maybe he didn’t put it exactly that way, but that’s our recollection.

That said, the markets do not always reward investors for contrary thinking. Sometimes, figuring out what the primary trend happens to be and just going along for the ride can also be rewarding. In other words, as the famous trader Jesse Livermore once said, “the trend is your friend.”

The tricky part, of course, is knowing when it pays to be a contrary thinker and when it pays to go with the flow.

In our experience, contrary thinking makes the most sense when investors’ emotions are running high and when valuation and sentiment measures reflect extreme emotions. In

most other circumstances, we tend to have more respect for consensus forecasts for a simple reason: They are often correct.

Central bankers, for example, pay a great deal of attention to surveys of private sector economic forecasts because, on average, they tend to be on the mark. What’s more, numerous studies have found that the average forecast – i.e. the “consensus” – tends to be more reliable over the long haul than forecasts from any one individual or institution.

In other words, collectively we possess a lot more information about the future than any one individual or institution can process. And that is the main reason that market mechanisms allocate capital based on collective opinions more efficiently than boards of “expert” economic planners ever could.

That doesn’t mean that the markets never get it wrong – far from it. It’s just that markets tend to do a better job at allocating scarce capital resources than other alternatives. It’s like what Winston Churchill said about democracy being the worst possible system – except for all the others.

### Feeling Good About 2004

We have made these points about contrary versus consensus thinking because our outlook for 2004 is currently pretty conventional. We see the continuation of a strong, synchronized global expansion, a continued upward trend in commodity prices, and inflation remaining at tame levels. Interest rates are likely to begin rising, but central bankers

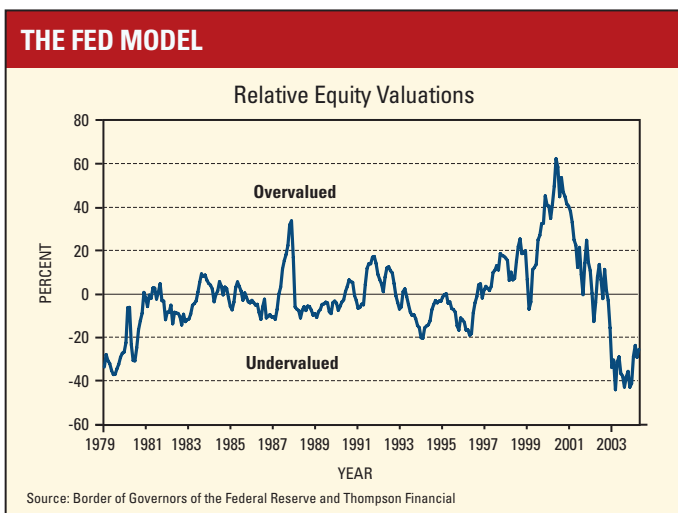


Chart 1: The Fed Model, which compares the P/E Ratio on the S&P 500 to the “P/E Ratio” on 10-year bonds, still shows stocks to be nearly 25% undervalued versus bonds.



will probably tread gingerly so as not to derail the global expansion. Stock markets should do pretty well against this backdrop, although the main drivers should be profit growth and modest multiple expansion rather than interest rates and liquidity trends. The U.S. dollar should continue to weaken based on relatively low interest rates and large trade and current account deficits.

These are not just our opinions – they also reflect a variety of consensus forecasts and messages from financial market indicators as well. And we think it is worth explaining why we are giving such an outlook this year, compared with our more contrary views of a year ago.

A year ago, our message to readers was that 2003 was likely to turn out to be a better year than many in the markets expected. Major financial institutions were warning of a global “double-dip” recession, while various financial market measures showed an extreme degree of fear and loathing among investors. For example, in October 2002, the “Fed model” showed U.S. stocks to be nearly 50% undervalued relative to 10-year government bonds, which suggested that investors were demanding a large risk premium to hold stocks versus bonds. (See Chart 1.) The riskiest corporate bonds in the U.S. were yielding 14% versus an inflation rate of only 2%, reflecting widespread fears of bankruptcy. (See Chart 2.)

Looking beyond the U.S. market, analysts at Credit Suisse First Boston track a global “Risk Appetite Index,” which ranges from “panic” to “euphoria” (See Chart 3). The index

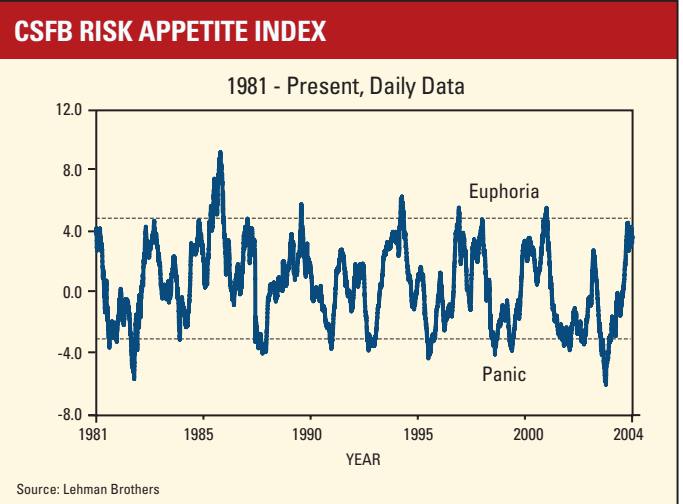


Chart 3: Investor sentiment across a wide range of global assets clearly entered the “panic” zone in late 2002 and early 2003, but has since recovered significantly.

is based on trailing market performance and volatility data for more than 40 asset classes around the world ranging from developed market equities to emerging market debt.

As is clear from the chart, global markets had entered the panic zone in late 2002 and early 2003. Historically, investors who have put money to work during panic periods have been well rewarded. For example, since 1981, the U.S. stock market has delivered average annualized returns of 25% in the six months following panic zone readings compared with returns of 12.5% over the entire period.

So maybe Rudyard Kipling had it right. Statistically, the best time for contrary thinking appears to be when others are in a state of panic. We would add that it is also helpful, when others are in a state of panic, to look for factors that suggest the panic will be short-lived. Last year, for example, there was a reasonable case to be made that the Iraq war would be over quickly and that the SARS scare would abate.

**Are Investors Too Optimistic?**

As shown in Chart 3, the CSFB Risk Appetite Index approached, but did not cross into, the euphoria zone at the end of 2003. Interestingly, we found that euphoria readings have not provided useful sell signals even though panic readings appear to generate good buy signals. With the Fed model (Chart 1) still suggesting that U.S. stocks are nearly 25% undervalued versus bonds and with global yield curves still pointing toward robust growth, we are not particularly

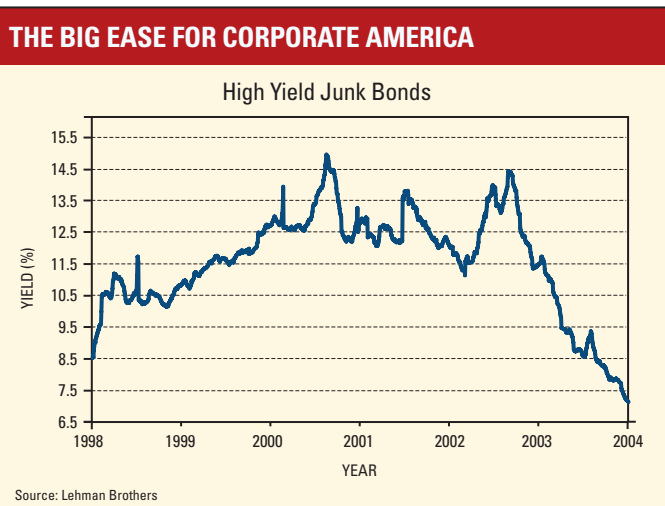


Chart 2: Capital spending should improve in 2004 thanks to a huge drop in rates faced by corporate borrowers.



worried that the CSFB Risk Appetite Index shows that people are happier about their investments than they were a year ago.

We mention the yield curve – the gap between long-term and short-term interest rates – because historically a steep curve has been a good predictor of strong growth and stock market returns ahead. That is, when short-term rates are much lower than long-term rates, as is decidedly the case right now, it means that monetary policy is actively promoting stronger growth and good stock market returns. (See Chart 4.) In contrast, when central banks jack up interest rates and the curve becomes flat or inverted, bad things often happen to the economy and the stock market.

It's not a perfect indicator – there is no such thing – but it still merits close attention by investors. In our view, even if the U.S. Federal Reserve starts raising short rates sometime in 2004, which looks increasingly probable, it is unlikely to raise interest rates so aggressively that we end up with an inverted yield curve and a highly risky monetary environment.

With steep yield curves around the world and with stocks up sharply in most markets in 2003, the message from the financial markets is that 2004 will be an excellent year for global growth and corporate profitability. A similar message comes from the large drop in corporate bond yields shown in Chart 2. That represents a huge drop in financing costs that has made it much easier for companies to raise capital at attractive rates. It also reflects much reduced fears of bankruptcy and is a good leading indicator of improved business spending.

What could mar this rosy picture? Obviously, a major terrorist attack is one possibility, albeit very difficult to forecast. Another risk is that global growth turns out to be so strong that inflation jumps sharply and forces central banks to tighten monetary policy aggressively. In our view, there is still enough slack in the global economy that if growth rates are anywhere close to current consensus forecasts that is not too much of a risk.

Finally, there is the risk of a “disorderly” U.S. dollar collapse in which the dollar moves so far and so fast that the Fed is forced to hike rates aggressively to prevent a major increase in inflation. We see low risk of that because support for the dollar from major Asian central banks, especially the Bank of Japan and the Bank of China, should keep the dollar's decline from turning into a rout. Interestingly, the Japanese just approved a war chest of \$570 billion dollars for further dollar support activities, showing the depth of their commitment to the current monetary system.

**Beware of Bonds?**

In any event, whether it is a declining dollar or rising inflation – or both – any signs of trouble would likely show up first in the global bond markets, where yields remain remarkably well behaved despite the major improvement in global growth. With bond prices having risen dramatically in recent years, with low current yields signalling low future returns, and with the volatility of yields having moved up as well, the risk-reward equation for bonds does not look particularly favourable at the moment. Accordingly, we are running below-average exposure of only 30% fixed income versus 70% equities in CI International Balanced Fund. We are also running below-average duration exposure within our fixed-income holdings. We have also begun to lighten up on interest-rate-sensitive sectors such as the consumer discretionary and financial sectors.

Despite our “beware of bonds” caveat, we still believe that the message from financial markets about 2004 is an encouraging “Happy New Year.” And we wish our readers a prosperous and healthy New Year as well.

*William Sterling*  
 William Sterling, Chief Investment Officer  
 Trilogy Advisors, LLC

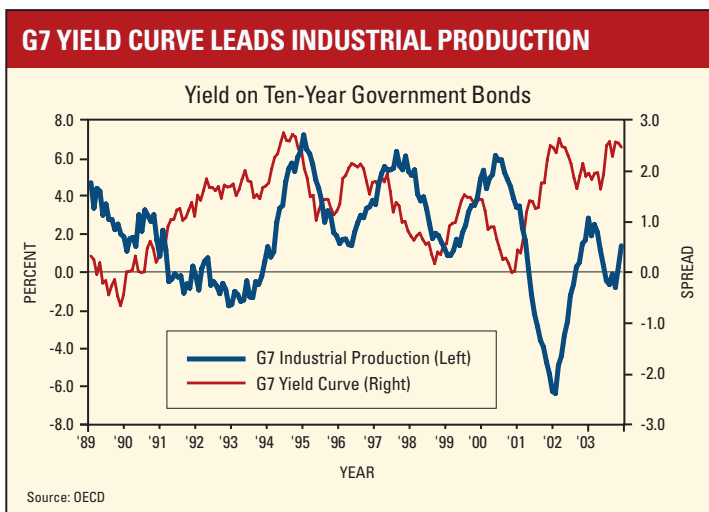


Chart 4: Positively sloped yield curves in the major developed nations have historically been a good leading indicator of robust growth and favourable stock market trends.