William Sterling

STERLING'S WORLD REPORT

Is an Election Year Rally Still Possible?

Global equity markets have had a disappointing start to the year so far, with the MSCI World Index up only 1.7% in the first five months (in U.S. dollars). Global economic activity and profit growth have been robust, but much of that good news was already discounted in last year's equity market rally.

This year, markets have had to contend with higher bond yields, higher oil prices, fears of the U.S. Federal Reserve raising interest rates, and a steady drumbeat of disturbing geopolitical news, including the ongoing insurgency in Iraq and terrorism in Saudi Arabia. For Canadian investors, one saving grace has been a modest recovery in the U.S. dollar that has boosted the value of foreign holdings by a bit more than 5%.

For what it's worth, we have not given up on prospects for global equity markets this year. Yes, the Fed is likely to begin tightening monetary policy this month, but that will have to be one of the most well-anticipated monetary events of the past few decades. If Fed officials are true to their word and rate increases proceed at a measured pace, we do not believe that a move in short-term rates to 2% from 1% over the course of the year will be highly disruptive to growth prospects or the stock market. The yield curve – the gap between long-term and short-term rates – remains very steep, which has been a good leading indicator of profit growth and positive market returns historically.

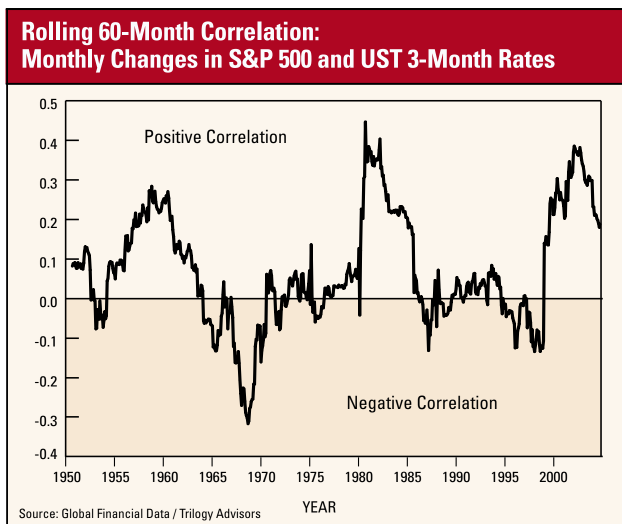

Chart 1: While market participants often fear higher short-term rates, it has often been the case that short-term rates have been positively correlated with stock market movements.

Even if the Fed tightens as advertised, the yield curve is still likely to remain positively sloped at the end of this year, which would point toward further economic expansion and positive market returns in 2005. In other words, if the Fed "taps on the brakes," we shouldn't be too worried about financial markets slamming into the windshield. If inflation data accelerate dramatically from here, that would be another story. However, there still appears to be ample slack in the global economy, China is slowing down, and we think the next major move in oil prices is more likely to be down rather than up. We will come back to that point in a moment.

Can Markets and Rates Move Together?

Regarding interest rates and the markets, it is worth reflecting on Chart 1, which shows the historical correlation between monthly changes in the S&P 500 Index and monthly changes in short-term interest rates over 60-month periods. Oddly enough, the correlation has more often than not been positive – meaning that higher short rates have often gone hand in hand with higher stock prices. Certainly in the last few years, the reverse was true when the market declined even as interest rates fell.

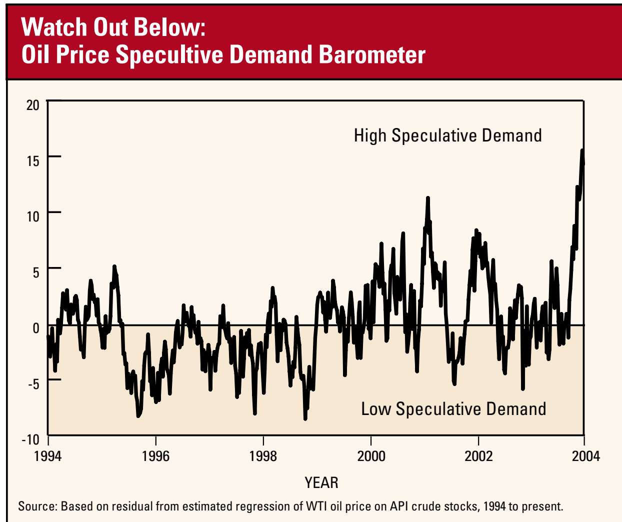

Chart 2: Our barometer of speculative demand for oil is at a record high, with oil prices trading at nearly $15 above the level that would typically be associated with current inventories.

We have found that during periods of low and declining inflation, higher interest rates have sometimes been welcomed by the market as a sign that deflation dangers have been avoided, and that would seem to be the dynamic now. That was the case in the late 1950s and early 1960s following a bout of deflationary fears.

Even higher bond yields do not guarantee that stock markets will get hit. Consider that the U.S. stock market has risen by more than 20% since a year ago. At the same time, the yield on the benchmark 10-year U.S. government bond has risen from 3.3% to 4.7%. So rising long-term rates have not hurt equities during this period of a recovery from a deflation scare.

Oil Price Spike Looks Overdone

We wrote in April that it would take a move in oil prices to above $48 US a barrel before we were seriously concerned about an oil price shock severe enough to trigger a genuine bear market in equities. Since then, Saudi Arabia has announced its intention to boost production and avoid further upward pressure on prices. The Saudis' self-interest is clear: they do not want to trigger a global economic crisis that hurts their best customers and prompts an accelerated move toward alternative energy sources.

That said, terrorist activities and the ongoing insurgency in Iraq have kept the oil market on edge and prices continue to hover a bit above $40 a barrel. At that level, prices are high enough to represent a material drag on global growth, but probably not high enough to trigger a global recession.

One way to gauge whether prices have been driven higher by speculation rather than fundamental demand and supply trends is to look at oil inventories. Historically, falling inventories are a symptom of tight markets and rising oil prices. Rising inventories are typically associated with easing oil market conditions and falling oil prices. The correlation between inventories and prices has been quite strong, with inventory movements explaining about two-thirds of the variation in weekly oil prices over the past 10 years.

Notably, crude oil inventories this year have been on the rise at the same time that prices have risen. That unusual pattern suggests an increased speculative demand for oil, probably among hedge funds, which now manage about $1 trillion of assets.

To assess how much speculation is currently driving oil prices, we created a simple statistical barometer of speculative demand for oil (See Chart 2). This barometer measures the difference between actual oil prices and the level of prices that should be expected based on the current level of crude oil inventories. Currently, there is a record divergence of nearly $15 a barrel. Put differently, current inventory levels would normally be consistent with a price of $25 a barrel rather than the current price of about $40 a barrel.

The last time the speculative demand barometer was in this range was in May 2001. That was followed by a drop in oil prices of nearly $10 a barrel over the subsequent six months. Against this backdrop, it is no wonder that some OPEC members are fretting about the possibility of a crash in oil

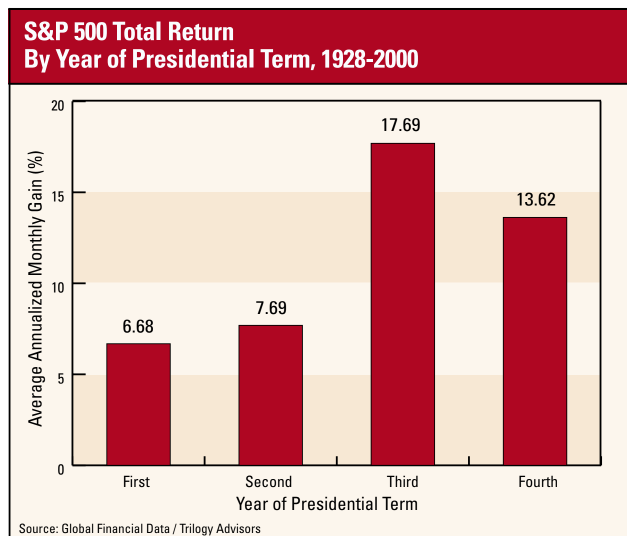

Chart 3: The fourth year of a Presidential term has historically generated solid double-digit gains for equity markets.

prices at some point. To be sure, market participants are right to be worried about the potential impact of terrorism on the stability of Saudi Arabia. However, our speculative demand barometer indicates that these worries appear to have been generously factored into the current price of oil.

Accordingly, we continue to believe that the next major move in oil prices is more likely to be down than up. If we are correct, that would be excellent news for global equity markets. Lower oil prices would not only take the edge off of inflation fears, they would also represent a moderate economic positive – much like a tax cut – for oil-consuming nations.

Elections Bring Summer Rallies

A somewhat related aspect of stock market dynamics this year is that it is an election year in the U.S. As many market participants know, election years have historically delivered above-average returns, second only to returns generated in the year prior to a presidential election. This pattern is shown in Chart 3.

What is less well known is that stock market returns in election years tend to be concentrated in the summer months and the period immediately prior to the election. This pattern is shown in Chart 4, which illustrates a pronounced pattern of strong summer rallies during the 19 election years from 1928 to 2000.

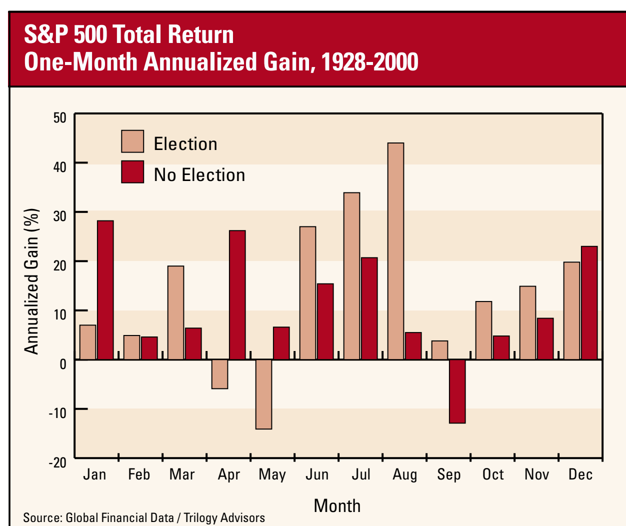

Chart 4: Historically, above-average market returns during election years have been concentrated in the June-to-November period.

To be sure, this pattern could simply be a historical quirk. However, as with the overall presidential election market cycle itself, the reasoning is fairly simple. The year ahead of the election tends to be favourable for equities because incumbent presidents usually pull whatever policy levers they can to ensure that the economy is doing well leading up to the election. The corollary is that they pull out all the remaining stops in the last few months ahead of the election.

If the market does not follow its historical pattern this year, it would not be for lack of effort on the part of the Bush administration. Tax cuts, easy monetary policy and a weak dollar have all been employed to get the economy moving. Profits have grown by more than 30% over the last year and the market has responded accordingly.

The question now is what else is left for an encore. The answer to us seems fairly obvious: pressure on OPEC to cut oil prices. Famed journalist Robert Woodward recently told CBS News that the Saudis promised the president they would attempt to lower oil prices in the months before the election to ensure that the U.S. economy is strong on election day. Denials of a secret deal notwithstanding, the Saudis now appear to be leading a movement in OPEC to boost production with the goal of lowering prices.

Against the backdrop of high speculative demand that we described above, we suspect that they will be successful soon. The risk, of course, is that Al-Qaeda or other terrorist elements succeed in destabilizing Saudi politics to the extent that their ability to boost production is significantly dented. In any event, it is difficult to imagine that oil, politics, and financial markets could possibly interact in a more direct way than in the run-up to this year's presidential election.

In short, we continue to see the potential for a year of solid equity market returns despite the lacklustre performance of the last few months. And as we have discussed in recent months, we still see equities offering better relative value than fixed income.

In any case, we do not think that the old traders' advice of "sell in may and go away," is likely to be a great guide to markets this year – especially if we are correct about the rise in oil prices being overdone.

William Sterling, Chief Investment Officer
Trilogy Advisors, LLC