The Greenspan Agenda
STERLING'S WORLD REPORT

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2005 Outlook: The Greenspan Agenda

According to the old saying, "The fox knows many things, but the hedgehog knows one big thing." Here's one big thing worth keeping in mind about the year ahead: Alan Greenspan has an agenda.

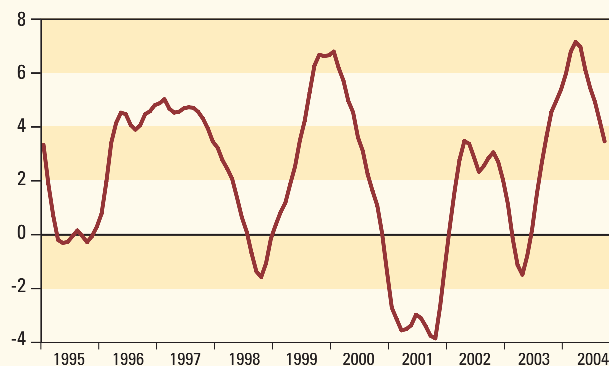
Based on a series of unusually direct speeches, the U.S. Federal Reserve chairman and his fellow policymakers appear to have come to the conclusion that the current pattern of U.S. economic growth is unsustainable. Their main concerns are clear: (1) interest rates are too low to create any incentive for consumers to save, and (2) the U.S. has become dangerously dependent on huge inflows of foreign money to finance its large trade and budget deficits.

These are tricky problems that may be painful to fix. Politically, the best time for any administration to fix challenging economic problems is at the beginning of a new presidential term. The hope is that voters' memories are short and that any painful adjustments will be forgotten by the time the next election rolls around in four years. That may explain why officials from both the Fed and the U.S. Treasury have wasted no time in effectively talking down the value of the U.S. dollar following the election.

Operation Twist?

In what might be called "Operation Twist," it looks as if the plan is to twist the pattern of growth away from reliance on a turbo-charged housing market and consumer spending and toward greater growth of net exports. That can be achieved by a combination of higher interest rates to dampen housing and consumer spending, and a weaker dollar to encourage exports and discourage imports. Greenspan has also noted that it would be helpful to trim the government's budget deficit as well, but he is most likely not holding his breath on that one.

Global Expansion Losing Momentum
OECD Leading Economic Indicator



Source: OECD
Chart: Client:/Economics Charts/OECD

Chart 1: High oil prices have crimped global growth prospects in recent months, but global growth momentum remains positive and should pick up again if oil prices recede.

The tricky part is to engineer a shift in the pattern of growth without causing a recession or an inflation problem that would lead to a recession. In a recent speech that spooked the foreign exchange markets, Greenspan was explicit about the R-word: "Alternative approaches to reducing our current account imbalance by … inducing recession to suppress consumption obviously are not constructive long-term solutions."

At the same time, Greenspan was about as clear as he has ever been about where interest rates are headed. In response to a question on that topic, he noted, "Rising interest rates have been advertised for so long and in so many places that anyone who hasn't appropriately hedged his position by

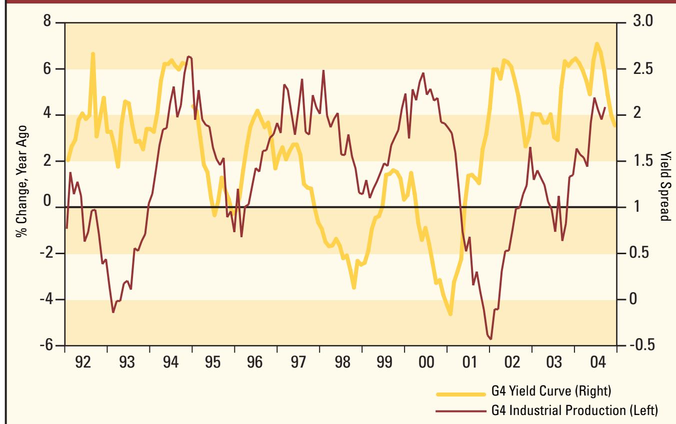


Chart 2: Yield curves in the major industrial nations remain positively sloped and suggest little risk of recession in 2005.

now obviously is desirous of losing money." For a central banker, that is practically the equivalent of shouting at the top of one's lungs.

Will Operation Twist be successful? In other words, can Greenspan and his colleagues steer the economy into a new growth pattern without triggering a recession? And what does this mean for foreign economies and financial markets? Here is our take on these issues and other key issues confronting investors in 2005.

Q. Isn't the global economy losing momentum already due to high oil prices? Doesn't that suggest a significant risk of recession in 2005?

A. There is no doubt that recent economic data does show the global economy having slowed considerably in the last few quarters, with high oil prices being the main culprit. As shown in Chart 1, the leading indicator series for the OECD nations clearly shows the momentum slowing in the second half of 2004.

That said, we think that risks of global recession are still quite low. In most countries, the yield curve – the gap between long-term and short-term interest rates – is the best single leading indicator of growth over the next six to 12 months. As shown in Chart 2, an aggregate yield curve for four major industrial economies is still positively sloped, meaning that short rates are much lower than long rates. That suggests that monetary policy remains very supportive of economic growth – unlike the case in 2000 when an extremely flat yield curve correctly signalled global recession ahead.

Other financial indicators give a similar message. The spread between higher-risk corporate bonds and government bonds remains quite low, indicating reduced fears of corporate bankruptcies. Those spreads usually widen dramatically ahead of a recession, as investors seek shelter in safe government bonds. The same can be said of emerging market bond spreads, which suggest a great deal of confidence in continued growth for developing nations. Also, the level of real interest rates remains very low, despite recent tightening moves by the Federal Reserve.

Finally, the recent downward trend in oil prices is quite encouraging as well. Against a backdrop of pro-growth monetary policy, the key risk for the global economy in 2004 came from the steady escalation of oil prices. However, as we have argued for some time, the gradual build up in oil inventories – which was temporarily interrupted by recent hurricanes – indicated that supply was beginning to outpace demand in global oil markets. If oil prices continue to moderate in line with expectations built into oil futures markets, we think the outlook for growth in 2005 will brighten substantially.

Against this backdrop, most economists expect global GDP growth to come in at a respectable level of 3.5% to 4.0% in 2005, compared with a robust 4.0% to 4.5% in 2004. If that view turns out to be on target, it would suggest a reasonably positive environment for global financial markets this year, despite the risks posed by global trade imbalances.

Q. But doesn't eroding confidence in the U.S. dollar raise the risk of a "hard landing"?

A. The nightmare scenario, which we have mentioned in previous World Reports, is that foreigners sell U.S. stocks

and bonds en masse, pushing U.S. interest rates up sharply and triggering a recession, irrespective of the Fed's policy intentions. We think the odds of this scenario are still quite low despite the fact that President Bush noted that not everyone was waving at him with all five fingers on his trip to Canada.

Although private sector investors have been stepping back from investing in the U.S. recently, the U.S. has been able to avoid a financial crunch primarily because Asian central banks, led by the Bank of Japan and the Bank of China, have found it in their best interests to buy large amounts of U.S. Treasury bonds to keep their currencies from rising too rapidly against the U.S. dollar. Since they can literally print money to buy U.S. bonds, this is not too costly to them and could persist for quite some time.

Worries in financial markets that China cannot possibly maintain its currency policy seem ill founded. It is actually quite easy for central banks to resist a rise in their nation's currency when the country is running a significant trade surplus, unlike the case when fundamental forces are pushing a country's currency down. We do think it is probable that China will begin to move toward greater currency flexibility. However, China is most likely to start with only a modest revaluation of 3% to 5% of its currency against the U.S. dollar. More dramatic measures may be put off until 2006 and it does seem likely that the Chinese currency will have to move up by as much as 30% against the U.S. dollar over the next five years.

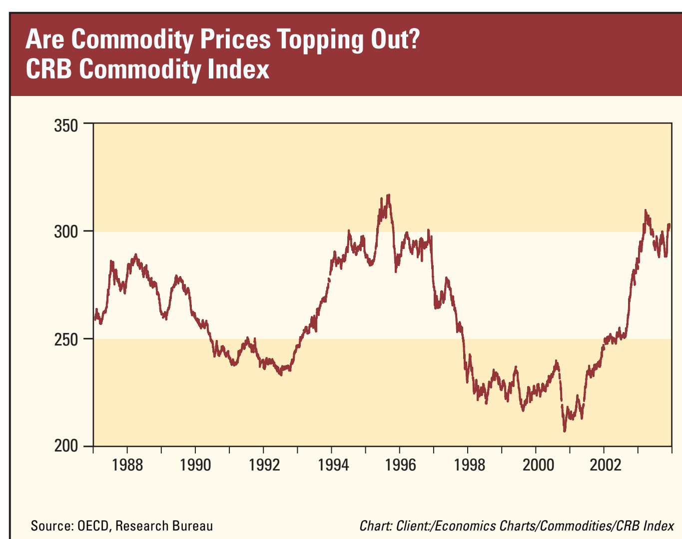


Chart 3: With both China and the U.S. Federal Reserve tapping on the monetary brakes, commodity prices may be topping out and entering a sideways trading pattern as seen in the mid-1990s.

The key point is that if the Chinese move gradually, which is decidedly their preference, they will still need to buy ample amounts of U.S. Treasury bonds as part of their currency policy. And other Asian central banks are likely to follow the lead of China, since none of them want to let their currencies move up massively against the Chinese yuan lest their exports become totally priced out of global markets.

Q. What impact would a slowdown in China have on global markets?

A. Most China watchers believe that the combined effects of China's credit controls and monetary tightening will deliver a moderate slowdown in 2005. If anything, China is faced with needing to perform its own "Operation Twist," but in exactly the opposite manner as the U.S. Unlike the U.S., where consumer spending has been outpacing production for a number of years, China has seen consumer spending lag while investment capacity and production have been soaring. So what we expect in China is a significant slowdown in industrial production and investment spending, but a pickup in consumer spending. Most likely, Chinese authorities will prod banks into lending to the consumer while simultaneously putting the brakes on the nation's capital spending boom.

In any event, what happens in China will be an important wild card for the global economy. Even though China represents only about one-eighth of global GDP, its boom has been so impressive that it has accounted for about one-third of global growth for the last several years. In that sense, one could argue that a good deal of Canada's recent boom has been "made in China" because of the huge impact China has had on pushing up global resource prices. Our sense is that with both the Fed and China tapping on the brakes, the so-called "reflation trade" is in its final innings.

In other words, the huge runup in global commodity prices since 2001 (see Chart 3) is probably over, and if global growth moderates, we may see more of a sideways pattern in commodity prices reminiscent of the mid-1990s.

Q. So what's the bottom line on currencies, interest rates, and equity markets for 2005?

A. We completely agree with the famous assessment by J.P. Morgan that "they will fluctuate." Our best estimate is that the dollar will fall another 10% over the coming year but will eventually stabilize thanks to higher U.S. interest rates. Based on that view, we continue to hedge a very significant portion of our U.S. dollar exposure. We expect China to continue to drag its feet on moving toward a flexible currency, but would not be surprised to see some token revaluation against the dollar as its currency policy evolves.

We expect the Fed to continue on a pace of gradual tightening and see no reason to disagree with financial futures markets, which see U.S. short-term interest rates reaching the 3.5% level by the end of 2005. We think that will also put some upward pressure on long-term interest rates, with the yield on the 10-year U.S. Treasury likely to head toward 5% or a bit higher over the course of the year. In contrast, we think that a super-strong euro will prompt the European Central Bank to keep rates unchanged despite recent rhetoric that it would like to raise rates. Likewise, we think Japan will keep monetary policy unchanged in 2005 as well in response to a strengthening yen and concerns that the economy has still not fully escaped the clutches of deflation.

Earnings growth around the world almost certainly will slow in 2005, with analysts projecting growth of about 12% in 2005 versus 24% in 2004. Against that backdrop, we expect equities to continue to outperform fixed income and continue to tilt toward equities in CI International Balanced Fund. If equity valuations remain around current levels, global equity markets should rise in line with earnings growth in the low double-digit range. If economic data suggest that interest rates need to rise substantially faster than what is currently priced into futures markets, greater caution would be warranted. On the other hand, if oil prices fall another $10 US a barrel and stabilize around $35, equity markets could be poised for a banner year. We continue to believe that foreign markets are likely to outpace the U.S. market based on more supportive monetary policy, more attractive valuations, and U.S. dollar weakness.

There is no doubt that current global economic imbalances are a bit scary. But as they say, bull markets typically climb a wall of worry. We are encouraged that U.S. policymakers are taking the issue seriously and are taking measured steps to ensure a soft landing.

Finally, for fund investors who want some foreign stock exposure, but no U.S. dollar exposure, this is probably a time to consider international equity funds rather than global funds. Most global funds are measured against the MSCI World Index, which has 53% weight in the U.S. market. In contrast, many international funds are measured against the MSCI EAFE Index (Europe, Australia and the Far East), which has zero weight in the U.S. One word of caution: some "international" funds do include the U.S. and are measured against the MSCI World benchmark while others do not include the U.S. So just as consumers with food allergies are urged to carefully read the ingredients label on food products, investors with an allergy to the U.S. dollar should be careful these days to read the "ingredients label" on their global and international funds.

Happy New Year!

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