



WILLIAM STERLING

STERLING'S WORLD REPORT



## Modest Expectations, Immodest Hopes

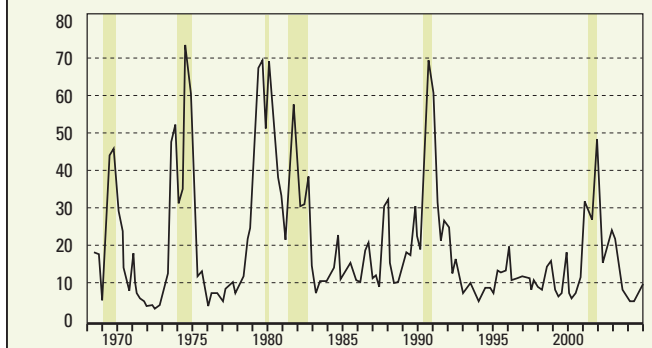
Global equity markets posted decent returns in U.S. dollar terms in 2004, with the MSCI World Index up 14.7% including dividends. Non-U.S. stocks, as measured by the MSCI EAFE Index, were up a healthy 20.2% including dividends. Unfortunately for Canadian investors, this otherwise pretty picture was marred by further weakness in the U.S.

dollar, which cut about 8% off both indexes' returns when measured in Canadian dollars.

As we discussed last month, we see no reason to be bearish about global markets in 2005, although we do think that non-U.S. markets are likely to outpace the U.S. market due to prospects for more supportive monetary policy and more attractive valuations. The possibility of further weakness in the U.S. dollar also argues for a tilt toward non-U.S. markets, although the potential for a counter-trend rally in the U.S. dollar will increase as the Federal Reserve continues to raise interest rates.

There are a number of reasons for holding modest expectations about equity market prospects for 2005. Leading indicators of economic growth around the world have softened in recent quarters, pointing toward slower profit growth ahead. Monetary policy is being tightened in the U.S. and China. That is significant because those two economies have accounted for about two-thirds of global growth in recent years. Equity valuations are certainly not cheap, although they look reasonable by a number of measures. For example, the MSCI World Index is trading at about 15 times estimated earnings for next year. And the "Fed Model" for the U.S. – which compares the relative price of stocks versus bonds – shows that equities are still nearly 30% undervalued versus government bonds.

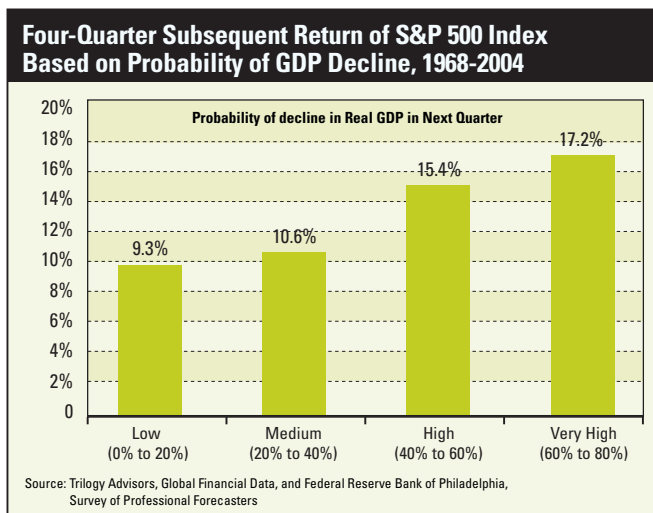
**The Anxious Index –  
Probability of Decline of Real GDP in the Next Quarter**



Source: Federal Reserve Bank of Philadelphia, Survey of Professional Forecasters. Shaded areas denote recessions.

*Chart 1: The "Anxious Index" by the Philadelphia Fed shows that most professional forecasters see little risk of recession in the U.S. in 2005 despite prospects for higher rates.*

One drawback of the Fed model is that it may flatter stock valuations simply because bonds are quite expensive by any historical measure. That includes not only government bonds but also emerging market debt and both investment and non-investment grade corporate debt. With the Fed expected to push the Fed funds rate from 2.25% currently to 3.0% to 3.5% by the end of the year, it is hard to get excited about bonds or stocks, although stocks look to be the better value.



*Chart 2: Historically the stock market has delivered modest returns during times when economic anxiety is low – and vice versa*

### Low Risk of Recession – But So What?

One piece of good news – maybe – is that most economists see very little risk of recession in 2005. Even with the Fed having raised interest rates, the yield curve (the gap between long-term and short-term interest rates) still has a strong positive slope. Historically, that has been an excellent leading indicator of further good news on the economic front. Banking systems are currently quite healthy around the world and companies are generally flush with cash.

The Philadelphia Fed has for many years conducted a survey of prominent private-sector economic forecasters. Among other things, it has used that data to create what it calls the “Anxious Index,” which reflects the degree of anxiety about the economy. The index is based on the percentage of forecasters who believe that the next quarter’s real gross domestic product (GDP) will decline. As shown in Chart 1, the Anxious Index has risen to high levels in the past when the economy was slipping into a recession.

Currently, the forecasting community is pretty relaxed about the outlook, with fewer than 10% of the forecasters surveyed in November expecting the economy to begin to decline in the

current quarter. Since there are almost always a few Nervous Nellies out there, that is a very benign reading of the economic tea leaves.

Here’s the catch: As Warren Buffet once said, you often pay a high price in the stock market for a cheery consensus. As shown in Chart 2, the U.S. stock market has tended to deliver the strongest returns in periods after the Anxious Index has shown high levels of anxiety about the economic outlook. For example, when 60% to 80% of forecasters reckoned that the economy would contract in the next quarter (which often meant that the economy was already in a recession), the market posted average gains of 17% over the next four quarters.

In contrast, when the forecasting community was most relaxed about the outlook – as they are now – the market subsequently posted more modest returns. For example, when fewer than 20% of forecasters anticipated an economic decline in the next quarter, the market posted average gains of only 9% over the next four quarters. That is not terrible, but it clearly reflects the fact that it takes courage to put money to work when everything looks bleak. That courage tends to be accompanied by higher rewards.

We wish we had similar “Anxious Indexes” for many foreign economies to compare with the U.S. index. Our strong impression is that the forecasting community is currently much more nervous about the outlook for Japan, Europe and much of Asia, reflecting the fact that recent economic data has been weaker overseas and concerns that the weak dollar will hurt those regions’ exports.

Those concerns are understandable, but we believe many analysts often overstate the negative effects of a stronger currency and understate the positive effects. Think back 18 months ago when the Canadian dollar began to soar. Many analysts raised valid warnings about the potential negative effects on Canadian growth. It turned out, however, that



despite a meaningful impact on export-oriented industries, the strong currency had positive effects as well – including lower inflation and interest rates. Since then, the Canadian economy and stock market has thrived.

Accordingly, we suspect that forecasters may currently be overly pessimistic about many overseas economies. If we are correct, that means that stock returns will be more favourable in overseas markets as economic conditions turn out to be surprisingly positive.

**Presidential Cycle Favours Modest Expectations**

Another reason to have relatively modest expectations for the U.S. market is based on where we are now in the political cycle. Since 1945, the U.S. stock market has tended to post lower-than-average returns during the first two years of each president's term and higher returns in the third and fourth years. (See Chart 3.)

The idea is that presidents try to get the bad news out of the way early in their terms, whether that means tax hikes, interest rate increases or even foreign military actions. The hope is that voters' memories are short. So even if those actions initially have a negative effect on the economy and the markets, all will be forgiven if conditions have improved by the time the next election rolls around four years later.

According to this theory, the third year in the presidential cycle is when the president pulls out all the stops with tax cuts and other stimulus to make sure the economy is doing well the following year ahead of the election. That certainly seemed to be the game plan for the Bush administration and, sure enough, the third year (2003) was a strong year for the market. The fourth year was a strong year for the economy and a decent year for the market.

Could current talk about tax reform lead to the imposition of some type of business or consumer tax that would dampen growth? We will have to see. And while inflation remains

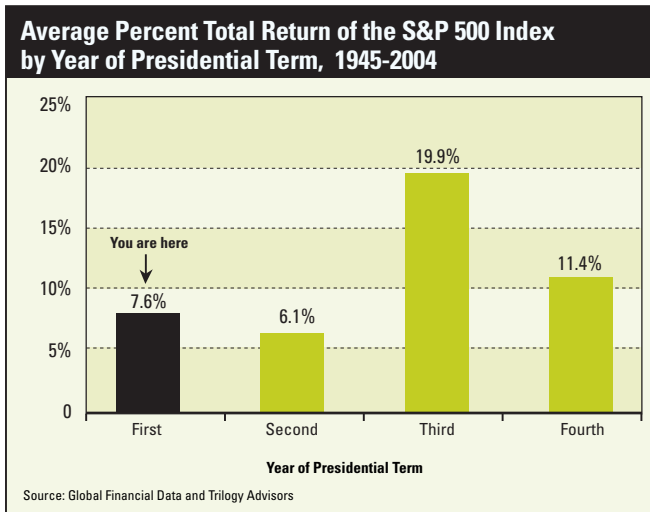
moderate, the administration certainly seems willing to take some risks in letting the dollar decline to deal with the nation's huge trade deficit. Finally, the Fed is certainly intent on continuing to raise interest rates and apparently is getting no flak from the White House as it goes about that task.

**Give Me a "High Five"**

At this point, we have given numerous reasons for modest expectations regarding the U.S. stock market in 2005. It is worth pointing out, however, that Murphy's Law does not always rule the investing universe. Sometimes things turn out to be better than expected and markets rise more than the consensus expects. We were frankly delighted to see year-end commentary in the financial press that said "market analysts doubt that 2005 will be a better year." That highlights the potential for positive surprises.

**Here is my short list of possible positive surprises to watch for in 2005:**

1. What if oil prices drop to a range below \$35 US a barrel or even below \$30, as some analysts think is possible?
2. What if corporate profit growth stays in the double digits thanks to higher-than-expected productivity gains?



*Chart 3: The first two years of presidential terms have historically delivered below-average returns since presidents tend to take any necessary tough measures early in their term.*



3. What if dividend growth accelerates to 20% as firms return to shareholders some of the huge cash holdings they have built up?
4. What if carefully managed Asian currencies are revalued in a controlled manner against the U.S. dollar, boosting the prospects for U.S. exports and helping the dollar stabilize against other currencies?
5. What if things get just a little better in the Middle East after elections in Iraq and the Palestinian territory?
6. Finally, what if the mysterious decade pattern of stock returns holds and years that end in "5" are just great years to be in market?

That last point needs a bit of elaboration. It is well known among technical analysts that years ending in "5" have by far delivered the best returns in the U.S. stock market. Table 1 shows the total returns of the S&P 500 for those years since 1945.

Curiously enough, the same pattern holds going back to 1885. Since then, there has never been a negative return in a year

ending in "5" in the U.S. market. This "high five" pattern easily passes the usual tests for statistical significance over the "brief" period since 1945 and even over the longer period since 1885. Since we are not aware of a good explanation for it (let us know if you are), it may well be just a statistical mirage. As they say, "past performance is no guarantee of future results, et cetera and so forth."

The point is that financial markets have a way of frustrating those holding consensus views. Since the consensus is currently looking for modest returns in 2005, we think it is also worth considering the case for optimism.

So with modest expectations, but some immodest hopes, we wish all of our readers very happy and prosperous year.

*William Sterling*

*William Sterling, Chief Investment Officer  
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**Table 1. Take the Fifth:  
S&P Total Return in Years Ending in "5"**

| Year                       | Total Return |
|----------------------------|--------------|
| 1945                       | 31.1%        |
| 1955                       | 27.3%        |
| 1965                       | 11.7%        |
| 1975                       | 31.6%        |
| 1985                       | 27.6%        |
| 1995                       | 31.9%        |
| Average Year Ending in "5" | 26.9%        |
| Average Year 1945-2004     | 11.2%        |

*Source: Global Financial Data and Trilogy Advisors*