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Waiting for Goldilocks

In what seems like the blink of an eye, we are already well into the new year and will soon have one full quarter behind us. We argued in January that 2005 was likely to be a year of modest positive returns in global equity markets, with an outside chance of big gains.

So far, the "modest" part of that outlook seems on track, with the MSCI World Index having risen about 3% in Canadian dollar terms in the first two months of the year, but only about 1% in U.S. dollars.

We have no reason to make major changes to our views about this year – that global growth should continue, that the global commodity boom is in late innings, that stocks should outperform fixed income, that non-U.S. equity markets should outperform the U.S. market, and that the U.S. dollar remains at risk. However, we now have a bit more information about how the global investment environment has evolved and will use a simple Q & A format to update our views on these topics.

Q: How firm is the global economic outlook?

A: We have been in the "Goldilocks" camp with respect to the outlook for global growth – i.e. not too hot and not too cold. Following boom-like conditions in 2004, numerous leading indicators point to slower – but still solid – global growth in 2005. Thanks to gradual monetary tightening by the U.S. Federal Reserve and a few other central banks, short-term rates have been rising. The U.S. yield curve – the gap between short- and long-term rates – has flattened substantially and that is almost always a harbinger of slower growth in coming quarters. And continued high oil prices are widely expected to dampen both consumer and business spending in most of the world outside of the oil-producing nations.

That said, recent economic data suggest that boom-like economic conditions remain the norm in most of the world so far this year. Commodity prices, including the price of oil, have powered to new highs. Housing markets generally remain firm. Emerging markets continue to be strong, with many showing double-digit gains for the year-to-date.

Wall Street strategist Ed Yardeni has concocted a simple Boom/Bust Indicator for the U.S. economy, which is based on the CRB Raw Industrials commodity price index and the weekly U.S. initial unemployment claims data. As shown in Chart 1, the indicator shows the U.S. economy having moved further into boom territory in recent weeks, despite higher interest rates and oil prices. That kind of data strongly suggests that the Fed still has more work ahead to normalize interest rates. We continue to believe that the federal funds rate will move from its current level of 2.5% to around 3.5% by the end of the year – with some risk that the Fed will have to become more aggressive.

Q: If the global economy is booming, why do you think the commodity price rally is in late innings?

A: Commodity prices could remain firm well into the year since it appears that the odds of a global economic recession are quite low. But what the central banks giveth, the central banks also taketh away. The Fed put emergency low interest rates into effect in 2001 and 2002 when it had legitimate reasons to worry about the risk of global deflation. At the stroke of a pen, it created huge amounts of "high-powered money" that sloshed through global capital markets and super-charged private-sector credit creation – not only in the U.S. but also in places like China and India. Global demand boomed and commodity prices reflected that boom.

U.S. Boom/Bust Indicator Soars

CRB Raw Industrials Index/Initial Unemployment Claims (4-Week Moving Average)

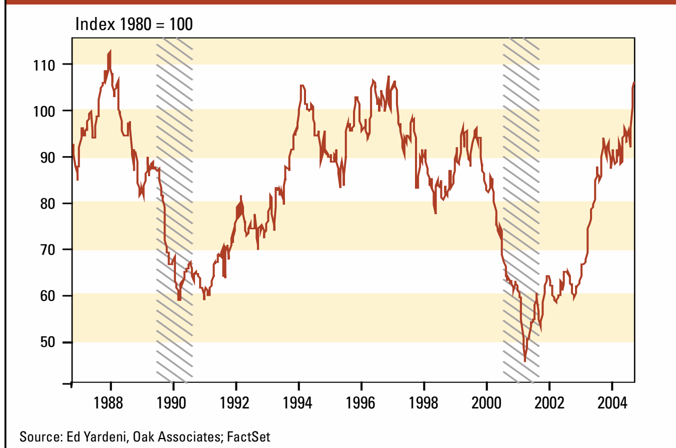


Chart 1: The Boom/Bust Indicator, which is based on raw industrial commodity prices and initial unemployment claims, suggests that the U.S. economy moved further into boom territory in early 2005.

Now the process is working in reverse, albeit at a very gradual pace. The Fed and other central banks are more worried about inflation than deflation and are likely to continue to raise interest rates until they see signs that the economic boom is moderating. A key signal to the Fed that its policy is working will be if commodity prices stop rising or, better yet, decline. Fortunately, there is no reason for the Fed to be slamming on the brakes. Most – but not all – measures of core inflation have remained subdued.

Q: Speaking of China, when is it finally going to revalue its currency from its current peg to the U.S. dollar?

A: We are reminded of the old Confucian riddle about where 800 pound gorillas sit – wherever they want. Okay, maybe that wasn't Confucius, but you get the point. Despite ongoing pressure from the U.S., China will revalue only when it thinks it is in its own best interests to do so.

When the Chinese economy is overheating, an increase in the value of its currency would make sense because it would lead to lower import costs and reduce exports – helping to ease the inflation rate. Somewhat surprisingly, the most recent inflation readings from China have been quite benign. China's inflation rate has dropped from nearly 5% at the peak last year to a more recent reading of about 2%. So the domestic case for a currency revaluation is now less pressing.

This must be somewhat frustrating to Fed Chairman Alan Greenspan, who recently suggested that the persistence of low long-term interest rates in the U.S. was a "conundrum." Perhaps some of the conundrum can be explained by the Chinese and other Asian central banks buying huge amounts of U.S. Treasury bonds – and thus depressing long-term rates – in order to keep their currencies cheap against the U.S. dollar. That in turn has kept U.S. jobs growth much lower than in previous cycles and forced the Fed to keep interest rates lower for longer. Apparently, much of the job growth triggered by Fed policy has been in China rather than in the U.S.

This means that Fed watching has increasingly become a game of China watching as well. We started the year thinking that there was a 50/50 chance the Chinese would revalue the yuan in 2005, but given recent statements and lower Chinese inflation we now think the odds of a meaningful revaluation have fallen to 25/75. That may be viewed as a positive for U.S. equity markets in the short run because it suggests that the Fed will need to remain measured in its approach to raising interest rates. However, it also suggests that the trade deficit may continue to widen, raising the longer-term risk of a dollar crisis.

Q: How can equities outperform fixed income if there is a risk of a dollar crisis?

A: As we discussed in recent World Reports, we continue to believe that foreign central banks have a strong interest in

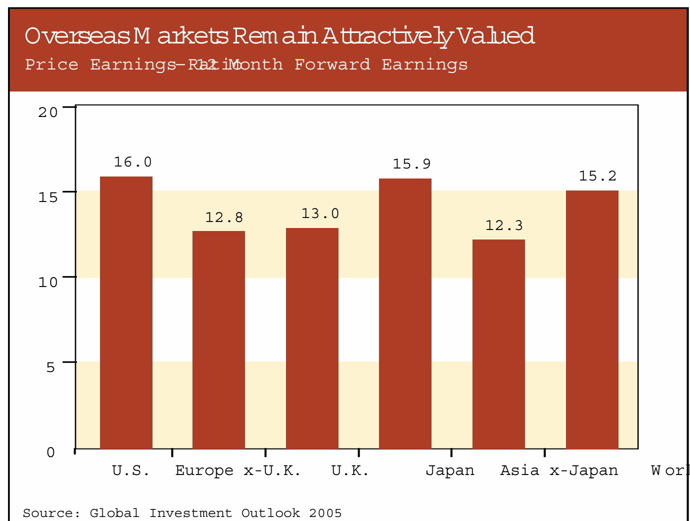
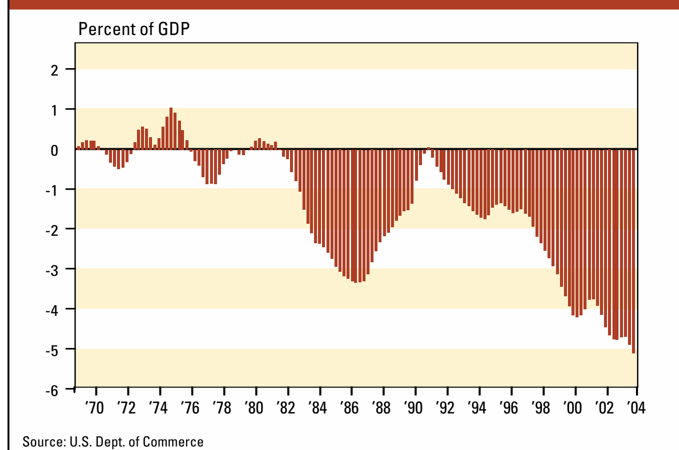


Chart 2: Overseas markets are significantly cheaper than the U.S. market.

Dollar At Risk?
U.S. Current Account



Source: U.S. Dept. of Commerce

Chart 3: Correcting the massive U.S. external imbalance requires some combination of faster growth overseas, slower growth in the U.S., and a weaker U.S. dollar.

continuing to finance the large U.S. trade deficit by boosting their holdings of U.S. Treasuries. That alone has prevented a period of dollar weakness from turning into a dollar crisis. The easiest way to recognize a dollar crisis would be if the dollar sold off sharply and U.S. bond yields shot up in tandem. That clearly has not happened yet and it does not appear to be in the interest of foreign central banks to let it happen.

With U.S. 10-year government bond yields still trading at close to 4.25%, their implied "P/E ratio" is 23.5 times – i.e., it takes $23.50 to buy one dollar of annual income from a supposedly "risk free" government bond. In contrast, the MSCI World Index is currently trading at a 15.2 times expected earnings while the MSCI EAFE Index is trading at around 14 times. So by the logic of the so-called Fed model, which compares the P/E ratios of stocks to bonds, stocks still look 30% to 40% undervalued. Or put differently, bond yields could move up substantially from current levels and stocks would still look reasonably priced.

With the U.S. market trading at around 16 times expected earnings (see Chart 2), the U.S. remains relatively more expensive than the non-U.S. equity markets. Other factors supporting non-U.S. equities are that interest rates are probably likely to remain more subdued in both Europe and Japan and the prospects of further weakness in the U.S. dollar. In addition, compared with other developed markets, the U.S. is much more exposed to the financial sector, which may be squeezed as interest rates rise.

Q: Aren't higher U.S. interest rates likely to lend support to the dollar?

A: The sheer size of the U.S. external imbalance suggests that there is still considerable risk of further weakness in the U.S. dollar (see Chart 3). With leading academic experts arguing that the trade-weighted dollar may still have to fall by 30% or more from recent levels to help correct the trade imbalance, it can be argued that modest increases in U.S. interest rates are simply not enough to compensate foreign investors for the risk of owning U.S. assets.

A forceful summary of this line of thinking can be found in a recent paper by Nouriel Roubini, an international financial expert at New York University ("Will the Bretton Woods 2 Regime Unravel Soon? The Risk of a Hard Landing in 2005-2006," at www.stern.nyu.edu/globalmacro).

Even if the Roubini arguments turn out to be another example of academic economists "crying wolf" about financial imbalances, there is no doubt that senior policymakers around the world are quite concerned about the growing risks of a true dollar crisis. From an asset allocation perspective that has a simple implication: reduced exposure to the U.S. market and higher exposure to non-U.S. markets.

Q: Any other comments?

A: Maybe, just maybe, geopolitical risk is beginning to fade following the successful elections in Iraq on January 30. The George Bush "reconciliation tour" of Europe went as well as anyone could have hoped, and there have been a number of encouraging signs that democracy could be spreading in the Middle East. If geopolitical risk is easing, that suggests that the global undervaluation of stocks versus bonds mentioned earlier could also begin to fade as well.

To be sure, it is too early to break out the bubbly. But after several years of awful geopolitical news, it is a most welcome change to witness some genuinely hopeful developments.

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