



Sterling's

World Report



2006 – The Pause That Refreshes?

Global markets in 2005 were dominated by two main forces: commodity prices and the U.S. Federal Reserve. Markets that benefited from buoyant resource prices – like the Canadian market – did quite well. But the relentless upward march of U.S. interest rates meant that many other markets delivered lacklustre returns, whether measured in U.S. dollars or Canadian dollars.

And both dollars – the U.S. and Canadian – rose in value substantially against other major currencies like the euro and the yen.

Will these trends continue in 2006? Or is it likely that an end to Fed tightening and an easing of commodity prices will become major factors in the year ahead? To be sure, this New Year is likely to bring a few more U.S. rate hikes early in the year. However, it is also increasingly likely that the game will change for the Fed as the U.S. economy begins to cool due to the cumulative impact of rising interest rates and high energy prices.

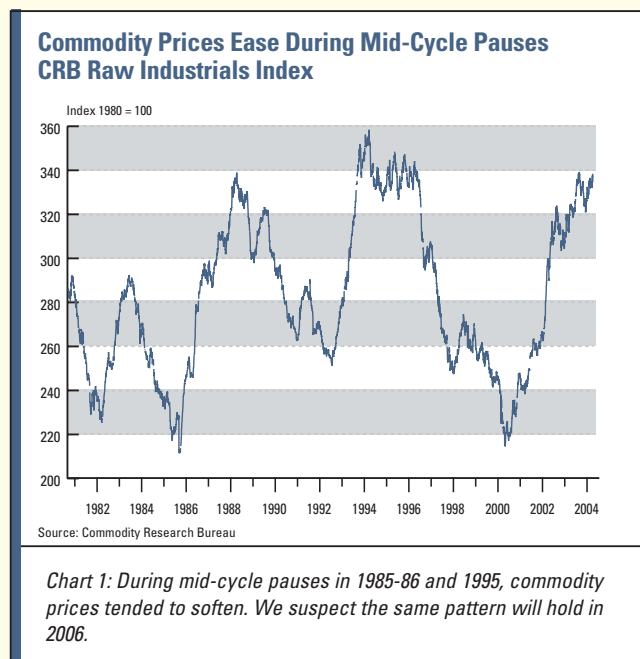
Here is our take, in question and answer format, on this and other key issues for investors in 2006.

Q. *Are Fed interest rate hikes likely to result in a relatively benign “mid-cycle pause” – as experienced in 1985-86 or 1995? Or is a more serious slowdown or even recession likely?*

A. The answer will largely depend on whether the Fed is able to justify a pause in its monetary tightening cycle sometime in the next few months. Current indications are quite favourable in that regard. There is increasing evidence that the U.S. housing market is beginning to cool off in many regions, especially in formerly overheated markets in California, Florida and New England. The combination of high home prices and rising short-term interest rates has priced many potential first-time buyers out of the market. That is affecting the ability of other

homeowners to generate capital gains that permit them to trade up or to withdraw equity from their homes.

Analysts at Goldman Sachs estimate that the growing inability of homeowners to use their homes as turbo-charged ATM machines may represent a drag on growth equivalent to about 1.5% of GDP over the coming year. If that view is correct, it is easy to envision that the underlying momentum of U.S. growth will slow from a recent rate of nearly 4% to a more subdued rate of around 2.5% in coming quarters. That would represent a material slowdown, but not a recession.





If we are wrong and the U.S. economy does not begin to show signs of slowing in coming months, then the Fed may have to be more aggressive. If the Fed needs to raise rates beyond 5% and invert the yield curve for an extended period, then risks of a recession in late 2006 or early 2007 would begin to rise substantially. But for the time being, that represents a risk scenario – not our view of the most likely outcome.

Q. *Wouldn't a U.S. slowdown in 2006 be bullish for bonds?*

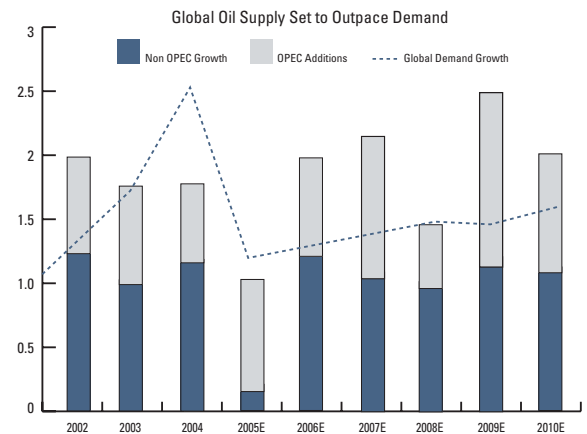
A. Other things being equal, yes. However, it is worth keeping in mind that other major central banks like the European Central Bank and the Bank of Japan may be raising interest rates modestly in 2006 even if the Fed goes on hold for as long as six months. Also, by some estimates, huge purchases of U.S. Treasuries by Asian central banks may have shaved as much as 150 basis points from U.S. long-term interest rates during this cycle, compared with what normally might have occurred. If that is correct, a potential rally in the bond market as the economy slows down might be far more muted than in previous cycles.

Our bottom line on interest rates: We think the Fed funds rate will peak in the range of 4.5% to 5.0% sometime in the first half of the year, while 10-year U.S. rates will remain in a broad trading range of 4.00% to 4.75%. We expect yields to test the low end of that range as the year progresses and markets begin to anticipate the beginning of a Fed easing cycle beginning late 2006 or in early 2007. We expect the U.S. bond market to outperform European and Japanese bond markets, which will be coming to grips with the impact of somewhat tighter monetary policy.

Q. *What does that interest rate outlook imply for the U.S. and Canadian dollars?*

A. That scenario also suggests that the U.S. dollar rally, which has been in force for most of the last 12 months against the euro and the yen, will begin to stall as 2006 progresses. As European and Japanese monetary policy is tightened, interest rate spreads will provide less support to

Global Oil Supply Growth Set to Outpace Demand



Source: Credit Suisse First Boston

Chart 2: After several years of global oil supply growth not keeping up with demand, the effects of slower demand growth and increased supply changes the picture looking forward.

the U.S. dollar. At some point, foreign exchange markets are likely to refocus on the long-term structural challenges facing the U.S. dollar associated with the nation's large trade and budget deficits.

For the Canadian dollar, much will depend, of course, on the trajectory of oil and other commodity prices. To the extent that strong resource prices helped to boost the Canadian dollar against most major currencies over the last several years, an easing of resource prices will tend to have the reverse effect going forward.

Accordingly, over the next 12 to 18 months, we believe the Canadian dollar is in the process of peaking against most major currencies and may be set to decline by 5% or more on a trade-weighted basis over that period. If we are correct, that would set the stage for international stock and bond markets to outperform Canada's market following the huge outperformance posted by Canadian markets over the last several years.

Q. *What are the reasons for caution on resource markets?*

A. Resource markets were major beneficiaries of the Fed's concerted effort to pump liquidity into global markets from 2001 to 2004. Since 2004, however, the Fed has been moving to dampen global growth. We believe that the increasingly flat U.S. yield curve is a strong indication that the Fed is going to be successful in slowing growth and reducing inflation expectations. Previous mid-cycle pauses in 1985-86 and 1995 have coincided with easing resource prices, as can be seen in Chart 1, which shows the CRB raw industrial price index. We expect this time to be no exception.

Our oil analyst, Jim Tschudy, has pointed to the huge increase in investment in new energy supplies in places like Saudi Arabia that should begin coming on stream even as global demand slows. As shown in Chart 2, energy supply growth is now projected to exceed demand growth by a significant margin over the next several years. Barring a major shock to energy supplies, we expect that easing demand and ample supply will lead to a substantial correction in energy prices over the next 12 to 18 months.

Q. *Even if the U.S. slows, won't the China factor still point to large upward pressure on the demand for resources?*

A. To be sure, if global oil production peaks in coming years, as "peak oil" theorists believe is likely, the long-term implications for oil prices could be highly positive. But even if that is true in the long run, we think the next few years are still more likely to be characterized by modest energy demand growth and rising supplies.

It is worth keeping in mind that China will not be immune to a U.S. economic slowdown. In fact, to the extent that China has become a key source of supply of goods to U.S. consumers, the U.S. may have effectively "outsourced" much of its inventory cycle. If inventories begin to pile up as U.S. consumption slows down, the cutback in production and resource demands will increasingly be felt in China rather than the U.S.

If the Chinese could simply flip a switch and create a domestic consumption boom to replace faltering demand from the U.S., then their demand for resources would remain strong. However, we doubt that the adjustment in China will be that easy. Just as the U.S. has outsourced much of its manufacturing capacity, the Chinese in turn have effectively outsourced much of their monetary policy to the Fed. So a Fed-engineered U.S. slowdown is likely to have major ripple effects in the Chinese economy as well.

Q. *Won't a U.S. economic slowdown also curb profit growth and reduce the attractiveness of stocks versus bonds?*

A. Profits have risen rather dramatically around the world over the last several years and a meaningful slowdown in profit growth in many countries looks almost inevitable over the next 12 to 18 months. Historically, however, a peaking of profits growth relative to the trend has not prevented further meaningful gains in equity markets. Lehman Brothers researchers have looked at peaks in the U.S. profit cycle in 1977, 1985, 1989 and 1997 and noted that equity values over the subsequent two years grew by 13%, 75%, 28% and 47%, respectively.

Relative valuations still suggest that equities are likely to provide better returns than bonds in the coming year. The developed markets are currently trading at 14.5 times expected earnings for the next 12 months. That represents a compelling valuation picture for stocks measured against the low level of bond yields available in most national markets. Comparisons based on various versions of the "Fed model," which compare the relative valuation of stocks versus bonds, still show stocks on average to be more than 40% undervalued relative to bonds.

Accordingly, we continue to favour stocks relative to bonds and CI International Balanced Fund currently maintains a target of 70% equities/30% fixed income. Barring a major change for the worse in the global monetary policy environment, we are likely to maintain that target until relative valuations change significantly.

**Valuation Comparison: International Stocks vs. Bonds
Data as of December 14, 2005**

Market	12 - Month Forward P/E Ratio	Earnings Yield	10 - Year Nominal Bond Yield*	Relative Valuation Stocks vs Bonds
Canada	16.9	5.9%	4.1%	-30.7%
US	15.1	6.6%	4.5%	-32.1%
Europe ex. U.K.	13.2	7.6%	3.4%	-55.1%
U.K.	12.4	8.1%	4.3%	-46.7%
Japan	19.4	5.2%	1.5%	-70.9%
Pacific ex. Japan	12.6	7.9%	4.9%	-38.3%
World	14.5	6.9%	3.9%	-43.5%

* Weighted average for World and Pacific ex. Japan using MSCI World Index weights

Source: Lehman Brothers, Bloomberg and Trilogy Advisors

Chart 3: Price-earnings ratios in major markets continue to trade at reasonable multiples, with the overall developed world market trading at about 14.5 times expected earnings.

Q. Which regions and sectors look most attractive?

A. In global portfolios, we currently have 55% of our equity exposure in non-U.S. markets, with 31% in Europe, 14% in Japan, and the balance in either non-Japan developed markets or emerging markets. With the performance of the U.S. market having lagged that of most other major markets in 2005 and with the Fed apparently close to the end of its tightening cycle, we are relatively more optimistic about the U.S. market than we were a year ago and have boosted its weight in our portfolios by nearly 8%. Most of the increase in our exposure to the U.S. came from reduced exposure in Japan and the emerging markets. That shift does not reflect a bearish view on those markets, where the fundamentals still look quite sound. Instead, it reflects the fact that those markets have done so well over the last 12 months that the upside potential for many stocks in those markets no longer looks as compelling as was the case a year ago.

That said, foreign markets continue to offer more attractive valuations and more supportive monetary climates. Price-earnings ratios in the Europe, non-Japan Asian markets and the emerging markets still are trading at 12 to 13 times expected earnings, compared to 15 times in the U.S. and

19 times in Japan (See Chart 3). And even if monetary policy is tightened in Europe and Japan in 2006, the degree of tightening is likely to be very modest. Thus, monetary policy is likely to remain more pro-growth in orientation in overseas markets compared to the U.S.

In terms of sectors, we remain tilted away from financials although we have recently increased our exposure to the insurance industry. We are also tilted away from highly defensive sectors like utilities and consumer staples and from the energy sector, which appears relatively expensive and vulnerable to a correction in oil prices. We are emphasizing sectors that will benefit from continued global growth, including the consumer discretionary and technology sectors.

Q. Any other comments?

A. The big story of the last several years was global deflation, which gave a huge boost to resource markets in general and the Canadian market in particular. It was a result of the Fed's strong desire to fight deflation from 2001 to 2003.

The Fed succeeded. It has now returned to its more traditional role of fighting inflation. It will probably succeed again. In our opinion, that points to a very different environment for resource markets over the next few years.

Best wishes to all of our readers for a happy and prosperous New Year.

William Sterling

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