



Sterling's

World Report



Global Outlook 2007: Goldilocks or the Three Bears?

It's the time of year for crystal ball gazing and story telling. We have already noticed many guest appearances of Little Miss Goldilocks, who is the investment community's favourite fairy tale character. With world stock markets hitting new

highs in recent months, even as growth slows in many countries, it somehow seems right – just right – to summarize the outlook as “not too hot and not too cold.”

As we show in Chart 1, the financial media have been making record use of the word Goldilocks to describe the outlook. Even if it is accurate, that should clearly make any contrary thinker a bit nervous. So in summarizing our outlook for 2007 we will also try to consider whether any of the three bears will show up and add more drama to the Goldilocks story.

U.S. – Soft Landing Scenario Dominates

In recent months, economic data from around the world have been mixed in a rather comforting way. The U.S. economy, which was widely feared to be overheating as recently as six months ago, is now clearly experiencing a cyclical slowdown centred on weakness in the auto and housing sectors. However, strong corporate cash flow, buoyant exports, and ever-resilient consumers have nicely offset the weak areas. One sign of that is that the job market remains firm. The mixed data appear to have convinced most investors that odds of a recession are low despite the higher short-term interest rates put in place by the Federal Reserve. Instead, the slowdown is widely viewed as a healthy mid-cycle pause similar to slowdowns in the mid-1980s and mid-1990s that relieved inflation concerns and set the stage for continued growth – and bull markets in stocks – through the end of both decades. Welcome back, Goldilocks.

Europe – Strong Momentum Prompts Bias Toward Higher Rates

Economic reports from the rest of the world have generally

been stronger, and in some cases much stronger, than those in the U.S. Business confidence surveys from Europe, like Germany's closely watched IFO survey, have been posting robust numbers throughout the year, as the European economy fires on all cylinders. Consumer credit is growing in the low double digits, while capital spending and exports are also posting solid gains. At the same time, a gradual tightening of European monetary policy and a strengthening euro have convinced most investors that inflation will remain under control. A long-awaited hike in Germany's consumer taxes next year is also expected to act as a restraining factor, but not enough to derail the considerable economic momentum that has build up in the Eurozone.

Cliche Alert:

Word Count of “Goldilocks” in Financial Media

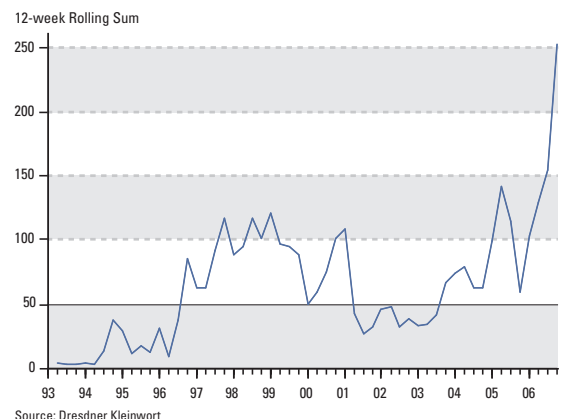


Chart 1: The comforting mix of data in recent months showing reduced inflation pressures but no recession has led to a surge in the use of the term “Goldilocks” in the financial media.

Valuation Comparison: International Stocks vs. Bonds

Data as of November 30, 2006

Market	12-Month Forward P/E Ratio	Earnings Yield	10-Year Nominal Bond Yield*	Relative Valuation Stocks vs. Bonds
Canada	16.6	6.0%	3.9%	-35%
US	15.1	6.6%	4.5%	-33%
Europe ex. U.K.	13.2	7.6%	3.7%	-51%
U.K.	12.3	8.1%	4.5%	-45%
Japan	16.8	6.0%	1.7%	-71%
Pacific ex. Japan	14.9	6.7%	5.0%	-25%
World	14.2	7.0%	4.0%	-44%

Source: Lehman Brothers, Bloomberg and Trilogy Global Advisors

Table 1: Equities remain undervalued versus government bonds in most countries and regions, especially in Europe and Japan where bond yields are unusually low.

Japan – Mixed Data, But Outlook Remains Solid

Japan's economic picture has been more puzzling, with leading indicators for Japan's economy having weakened across the board in recent months. This includes both the OECD's leading indicators for Japan and the nation's own diffusion index of leading indicators, which has fallen well below the 50% "boom or bust" line in recent months. Consumer spending data for Japan have also been disappointing for most of the year, leading many investors to question whether Japan is slipping back into the deflation-prone stagnation of the past decade.

In contrast, however, the Bank of Japan's highly trusted quarterly Tankan survey depicts strong business confidence and robust corporate cash flow and capital spending intentions. Bank of Japan officials also point to the low level of interest rates, the extremely competitive level of the yen, and evidence of a very firm labour market to suggest that the economy remains on track for solid growth (by recent Japanese standards) of 2.0% to 2.5%. The authorities remain biased toward further monetary tightening, even though they have clearly been in no hurry to raise rates. We think the Bank of Japan is probably right in its read on the Japanese economy and know from experience that a lot of Japan's business cycle data can be excessively volatile and misleading.

Emerging Markets – Full Speed Ahead

The developing world continues to boom, particularly China, whose stock market rose by 55% in the first 11 months of 2006. Most analysts expect China to continue to grow by 9% to 10% in 2007 after several years of growth above 10%. Other emerging and developing nations continue to grow rapidly, including India, Russia, many former Soviet republics, Africa, and of course Asia. Latin American growth lags behind somewhat, but remains firm. Overall, the emerging and developing nations are expected to post growth of 7.0% to 7.5% in 2007, continuing nearly the same momentum posted in 2006. That is more than double the pace of 2.5% to 3.0% expected for the advanced industrial nations in 2007 and continues a performance gap that has been seen for much of this decade.

The Three Bears: U.S. Recession, Inflation, Geopolitics

The base case outlook for the world economy described above, if it materializes, should be constructive for global equity investors. With the MSCI World equity index trading at a reasonable 14 times estimated 12-month forward earnings, prospects for continued global expansion suggest further healthy gains for equity markets in 2007 following solid performance in 2006. The low level of market volatility in recent quarters, with few large daily drops in major equity indexes, suggests broad-based investor confidence in the global outlook. As shown in Table 1, equity market valuations look reasonable across every major region, especially when compared to the low level of bond yields around the world.

No economic or market outlook is without risks and we see three major risk scenarios worth considering. The first two have to do with the most obvious departures from the Goldilocks scenarios, namely that growth is either "too cold" or "too hot." We think the former risk – namely recession in the U.S. – is significantly greater than the latter risk of economic overheating. But both scenarios are worth considering.

U.S. Recession Risk is Not Trivial

Very few economic forecasters have been so bold as to forecast recession for the U.S. However, the pronounced inversion of the U.S. yield curve has focused increasing attention on the



possibility that weakness in autos and homebuilding will spill over into broad-based weakness in consumer spending. That could trigger an outright recession – including several quarters of negative GDP growth – and would require analysts to slash earnings forecasts for the year ahead.

Since analysts and economists are understandably reluctant to stick their necks out, we like to track objective quantitative indicators of business cycle risks. The Fed has developed its own model of recession probability over the next 12 months based on just two variables: the level of the Fed funds rate (currently 5.25%) and the slope of the yield curve (currently minus 0.30% for 10-year bond yields vs. three-month U.S. Treasury yields). Plugging those two numbers into the Fed's model yields a recession risk of 46% – which is decidedly not trivial.

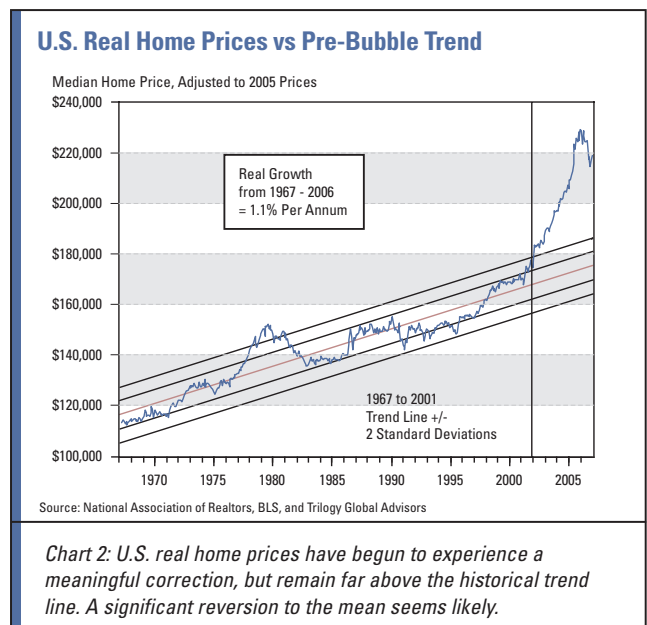
The hard-landing scenario that many market participants are concerned about is that an ongoing fall in real estate prices will tip the consumer into recession, especially given the large degree to which U.S. consumers have been using their homes as ATM machines. As shown in Chart 2, U.S. real home prices remain far above the historical trend line. That suggests significant pressure on consumer spending if home prices revert to their historical relationship with rental prices, other consumer prices, or personal income. A sharp slowdown in consumer spending would almost certainly result in further weakness of the U.S. dollar against other major currencies (except perhaps commodity-sensitive currencies like the Canadian dollar), since lower interest rates and dollar weakness would probably go hand in hand.

We think the Fed's model may somewhat overstate the odds of a U.S. recession because it does not factor in the extent to which a glut of global savings may have driven down U.S. long-term rates and thereby distorted the message from the yield curve. Likewise, we see few signs of stress in equity or credit markets that would normally herald the imminent arrival of a recession – so maybe the odds of a recession are closer to 30% than 50%. But such a level of risk is still quite significant and, in our opinion, real estate and credit market dynamics are likely to hold the key to the eventual outcome.

Risk of Overheating Seems Low

The polar opposite view is that the current U.S. slowdown will prove to be very short-lived once temporary weakness in housing and autos runs its course. Corporate profits and cash flow are so strong and the boom in the rest of the world is so strong that some forecasters expect that the U.S. economy will revert to above-trend growth by mid-year. That would put the Fed back in the business of raising rates in the second half of the year and generate stress for equity and credit markets that could herald a renewed slowdown or recession in 2008.

This is not an entirely implausible scenario since we have seen a housing boom in the United Kingdom unwind in recent years with little in the way of major consequences for the nation's overall economy. Indeed, U.K. authorities have now resumed raising interest rates after a brief interlude of monetary easing. That said, we suspect the U.K.'s experience is not a good model for the U.S. because the U.K.'s regulatory and financial system constraints prevent the type of homebuilding excesses that are possible in the more laissez-faire U.S. system. In the U.S., home construction activity has far outstripped demographic projections in recent years, and we believe that the widespread availability of "nothing down" and "pay later" financing options (like "Option ARMS") may



have prompted greater speculative excesses than elsewhere. These excesses presumably will take longer to correct and have greater impact on consumer behaviour.

We are also a bit skeptical about risks of inflationary overheating because we believe that commodity prices have probably peaked for this cycle. Although oil prices may continue to be an important wild card for geopolitical reasons, we would point to work by the International Monetary Fund (World Economic Outlook, September 2006) that suggests a cautious outlook for base metals prices. In particular, the IMF forecasts that important non-fuel commodity prices like the price of aluminum and copper could fall in real terms by 35% and 57%, respectively, by the end of the decade in response to increased supply against a backdrop of continued demand growth.

Geopolitics – The Ever-Present Wild Card

It almost goes without saying that the risk of geopolitical shocks is a given, especially with respect to the complex situation in the Middle East. The low level of volatility in global equity markets suggests that market participants are currently fairly relaxed about potential geopolitical risks. However, in our experience, financial markets tend to simply react to geopolitical developments since they are inherently very difficult to discount in advance.


The invaluable website www.tradesports.com does provide an interesting barometer of one prominent geopolitical risk, namely that of a Middle East military conflict involving Iran. According to the Tradesports futures contract on whether the U.S. and/or Israel will launch an overt air strike on Iran by December 2007, the odds are put at about one in five that such an event will occur. Since that would likely result in an Iranian blockade of the Straights of Hormuz and a major supply shock to world oil markets, it is a risk that cannot be excluded. That said, another way to read the Tradesports barometer is that it implies an 80% probability that such an event will not occur.

The World Doesn't Build U.S. Houses

In any event, the old line that “bull markets climb a wall of worry” is probably worth keeping in mind. As we have noted in our recent reports, we are encouraged by large-scale share buyback activity by corporate managements coupled with relatively low net issuance of equities. Corporate managers have historically been quite good market timers and the fact that they are generally more apt to be buying rather than selling shares now is a positive sign for equity investors. So too, we would add, is the impressive amount of private equity money that is actively taking companies' shares off public markets. The private equity activity tends to validate the notion that equities are attractively priced relative to fixed income since such players typically leverage their equity purchases with debt obtained in fixed-income capital markets. If debt costs were viewed as onerous relative to the prospective return from equities, this type of activity simply would not be occurring in any meaningful size.

In short, since we think the case for a U.S. soft landing is reasonably persuasive, we maintain a constructive outlook on global equity markets for 2007. And even with the risk factors we have noted above, it is worth keeping in mind that the U.S. housing sector accounts for only about 1% of world GDP. As a recent report from Merrill Lynch aptly reminded its readers, “the whole world doesn't just build U.S. houses.” So we will spend a lot of time looking for opportunities amidst the other 99% of global economic activity.

We wish our readers a happy and prosperous 2007.



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