



Sterling's

World Report



RECENT MARKET VOLATILITY:

Much Ado About Nothing?

Whenever we encounter significant spikes in stock market volatility, we tend to recall research by the well-known Yale University economist Robert Shiller. He once demonstrated that there is anywhere from five to 13 times more volatility in

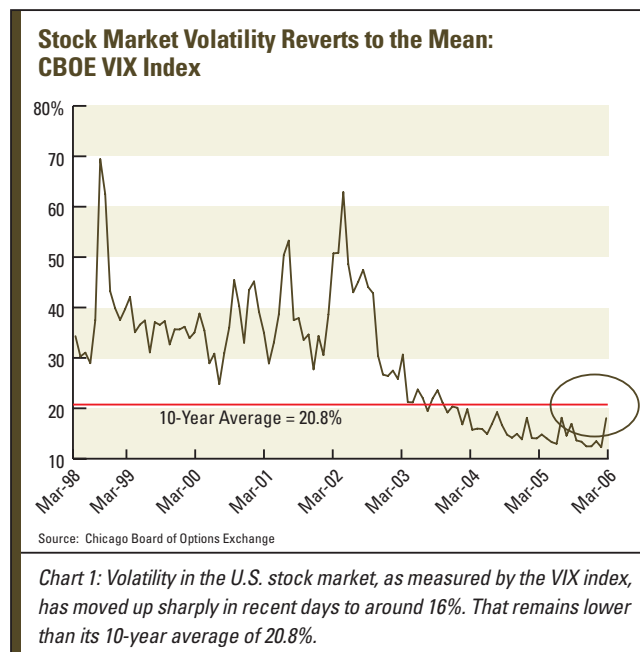
the market than can be justified by actual news about company fundamentals (most notably about expected changes in dividend payments).

So we are tempted to conclude that the recent bout of volatility may be nothing more than the market once again chasing its own tail, as Investor A tries to guess what Investor B is going to guess about Investor A, and so on, ad infinitum. We are doubly tempted to draw that conclusion when we learn from the media that the trigger for the recent global equity sell-off was an overnight slide in China's stock market, which represents only about 2% of the market capitalization of global equity markets. Can the tail really wag the dog to that degree?

That said, the rise in volatility needs to be kept in perspective in at least two ways: First, it comes against a backdrop of the extraordinarily low volatility of recent years. So some sort of reversion to the mean – i.e., the return of normally choppy markets – should not be such a surprise. Second, there has been a spate of weak fundamental economic data from the U.S. that have raised recession fears and contributed to a torrent of commentary of the “glass is half empty” variety. Former Fed Chairman Alan Greenspan contributed to those fears by telling an investor group in late February that a recession was possible over the course of 2007. Why that pronouncement was considered noteworthy is highly puzzling, since the Fed's own research department has for many months published a model based on the yield curve that puts the probability of recession above 40%.

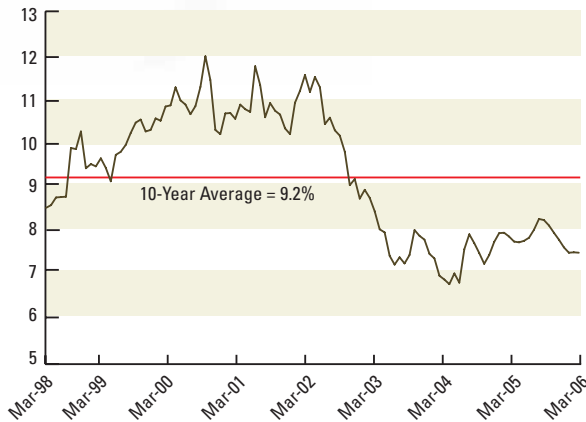
Volatility: How Low is Low?

To put the current bout of volatility into perspective, consider a long-term chart of the so-called VIX index, which is based on the implied volatility of S&P 500 options traded on the Chicago Board of Options Exchange. Without getting too technical, one way to read the VIX index is that when it trades at close to 10%, which was the case in recent months, it indicates that market participants are willing to bet that there is about a two-thirds chance that stocks will trade within plus or minus 10% of their current level over the next year. When volatility reached 40%, as in September





Corporate Borrowing Costs Remain Low: KDP High Yield Index



Source: Bloomberg and KDP Investment Advisors

Chart 2: Despite recent stock market volatility, borrowing costs for risky borrowers remain low in both absolute terms and relative to "risk-free" government rates.

2002, it indicated a much higher degree of uncertainty about the outlook. At that point, market participants took the not-so-bold view that stocks would trade within a range of plus or minus 40% over the next year.

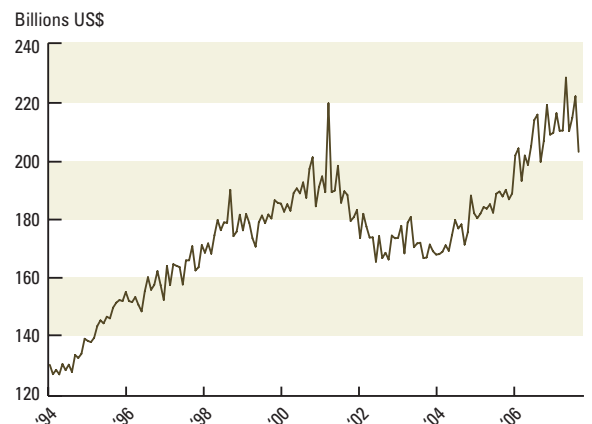
Chart 1 shows the history of the VIX over the last 10 years in order to make a simple point: Even with the recent spike in volatility to 18%, it is still below the average of 21% recorded over the last decade. So, current volatility only looks high from the perspective of the extraordinarily low volatility of the last several years. That is not to say that the recent jump in volatility will not have real-world consequences. In particular, higher volatility tends to make lenders more cautious in response to greater uncertainty about the market value of corporate assets, which ultimately serve as collateral for their borrowing. So we are already seeing credit spreads widen, which means that borrowers will have to pay somewhat more for loans than they were before the spike in volatility.

However, the overall impact on credit markets has been fairly subdued as of early March. For example, in Chart 2 we show

that an index of high-yield bond rates shows only a slight uptick in borrowing rates facing relatively risky companies. As is evident, that rate remains extraordinarily low at 7.1% and is still much lower than the average rate of 8.3% over the last five years. Despite the well-publicized problems in the sub-prime mortgage market, where a credit crunch of sorts is now well underway, there is still no sign of a broader credit crunch. Such evidence has undoubtedly helped to persuade current Fed Chairman Ben Bernanke that a recession is not the most likely scenario. Mr. Bernanke took great pains last year to underline why he thought the negative message from the inverted yield curve about future economic prospects needed to be tempered by considering the otherwise healthy state of credit markets.

Incidentally, we are truly perplexed by commentary suggesting that Mr. Greenspan and Mr. Bernanke are at odds over the economic outlook. If Mr. Greenspan states that in his view there is a one-third chance that the economy will slip into recession over the next year, doesn't that suggest a two-thirds chance of no recession? So when Mr. Bernanke says

New Orders Plunge for U.S. Manufacturing New Orders for Manufactured Durable Goods



Source: Census Bureau

Chart 3: U.S. durable goods orders fell sharply in January, suggesting that sluggish growth and higher unemployment lie ahead. The next move in Fed policy should be for lower rates.

the most likely scenario is no recession, how exactly does that contradict Il Maestro, Mr. Greenspan?

Note to talking heads: We are dealing with a discipline with roughly the same accuracy as weather forecasting, so it's probably best to not get too frenzied about tiny nuances in the views of various sages regarding the economic outlook. When the Fed raises interest rates significantly, as it has, growth almost always slows down a lot, as it has. Sometimes recessions ensue, earnings forecasts get slashed, and stock markets get hit for a while. Other times, as in the mid-1980s and mid-1990s, soft landings ensue, which permit prolonged economic expansions, earnings forecast upgrades, and strong stock market performance.

Recession Watch: Global Picture Benign

If the spike in volatility can be interpreted as simply a return to normality, what about evidence that the economy may be sliding toward recession? Since the second quarter of 2006, the U.S. economy has been reporting sluggish growth rates averaging in the range of 2.0% to 2.5%, but that is not exactly news. One sign of potentially even slower growth ahead came in the form of disappointing orders for durable goods, which were down by nearly 9% in January (See Chart 3). That was far more than expected and cannot be easily explained away, even after allowing for surprisingly weak demand for aircraft.

Corporations are now under pressure to curb spending, since productivity growth and profit growth have slowed materially. We suspect that a cutback in corporate spending will soon affect hiring practices as well and result in rising unemployment in coming quarters. Although consumer spending has been surprisingly strong, we suspect the combination of rising unemployment and ongoing malaise in the housing market will result in quite sluggish growth for the remainder of the

year. That does not mean that a recession will necessarily result, but it does suggest that the Fed will begin cutting interest rates in the second half of the year.

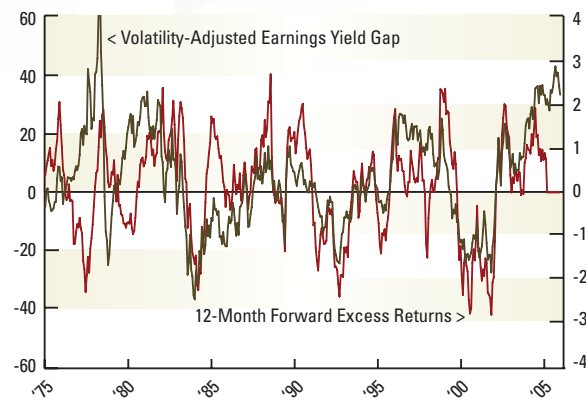
The good news is that the likely U.S. slowdown is coming against the backdrop of still buoyant global growth. That means that the trade sector is becoming an engine of U.S. growth even as the domestic economy slows. Looking around the world, we see strong economic momentum continuing in Europe, where domestic demand has become the main source of growth. Japan posted growth in the fourth quarter at an annual rate of more than 4%. While that may overstate the buoyancy of Japan's economy, it was apparently enough to prompt the Bank of Japan to raise interest rates in February. China and other emerging markets continue to report booming rates of growth as well.

As a result, even though there is currently an elevated risk of recession in the U.S., we believe that odds of a synchronized global recession remain low. Using the Fed's model of recession probabilities over the next 12 months with international data for the major economies, we estimate the risk of a global recession to be only about 20%, which suggests nearly 80% odds for sunny skies to continue.

Valuations Favour Equities

We would be far more concerned about risk of a severe global bear market in stocks if we thought global recession risks were high and saw stock valuations extremely stretched relative to bonds. Fortunately, that is not the case right now, with world equities trading at about 14.3 times 12-month forward earnings, while real government bond yields are generally trading in the low 2% range. Put differently, the earnings yield on equities is about 7% ($=1/14.3$), compared with real yields on bonds near 2%.

High Global Earnings Yield Gap Points to Strong 12-Month Forward Stock Market Returns



Source: Lehman Brothers

Chart 4: Stocks remain attractively priced relative to bonds, which should support further outperformance of equities over the next 12 months.

Lehman Brothers has looked at historical comparisons between equity yields and real bond yields and found the yield gap to be a reasonably good indicator whether equities are likely to outperform cash over the next year. As shown in Chart 4, after making some adjustments for the relative volatility of equities and bonds, they suggest that the current reading from this indicator is predicting healthy outperformance of equities over the coming year. In fact, when the (volatility adjusted) yield gap has been at least as high as is currently the case, equities have subsequently outperformed cash nearly 90% of the time in the past.

Specifically, equities failed to outperform cash over the next year in only three months out of 29 since 1970 when the adjusted yield gap looked at least as favourable for equities as it does now. Those three months all fell at the end of 1973 and beginning of 1974 – immediately following the imposition of OPEC's oil embargo in October 1973. That sudden oil shock triggered soaring inflation and interest rates around the world over the following year. That provides a valuable lesson that

geopolitical turmoil can trump favourable valuations in certain circumstances. But unless one believes that war with Iran is in the cards, the risk-reward picture for equities continues to look good despite recent jitters.

A potential silver lining to the return to more normal equity market volatility patterns is that it should provide more opportunities for active investors like us to profit from excess volatility in the marketplace. When stocks move in tight ranges, it is more difficult to find interesting opportunities. When more investors engage in manic-depressive trading behaviour, we are hopeful that it will provide the opportunity for cooler heads to prevail.

Like it or not, we live in interesting times. And they now appear to be getting more interesting.

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