Sterling's
World Report

Will 2008 be a Happy New Year?

Global equity investors may be forgiven for approaching the new year with more than the usual degree of trepidation. There is certainly no shortage of things to worry about, with the financial media devoting considerable ink to the global credit crisis, high oil prices, the weak U.S. dollar, and associated fears of global recession, stagflation, or worse.

That said, it's our sense that many current fears are overblown. If we are correct, that implies that global equity markets are in a corrective phase of an ongoing bull market, rather than at the beginning of a severe bear market. We will elaborate on this view in a question and answer format that will try to address a number of key questions that are on many investors' minds.

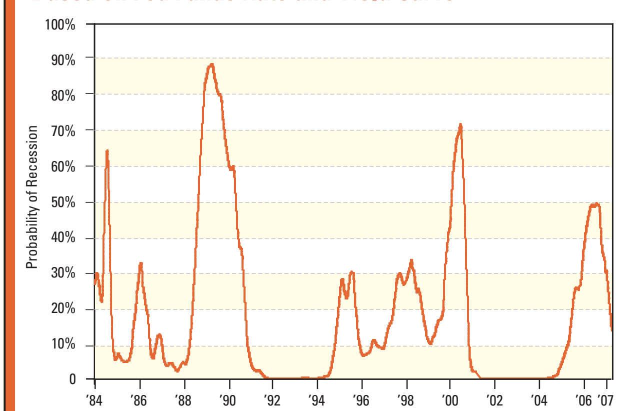
Q. With prominent analysts like former U.S. Federal Reserve Chairman Alan Greenspan and former U.S. Treasury Secretary Larry Summers putting the odds of a U.S. recession at nearly 50% or higher, why shouldn't we anticipate a global bear market in stocks?

A. We respect grey eminence as much as the next fellow. But when it comes to market dynamics, we also give considerable weight to an old adage: "Investors can stop panicking when central bankers start panicking." Whether it is the Bank of England's embarrassing about-face on monetary policy, or Fed Chairman Ben Bernanke's series of rate cuts, or the Bank of Canada's capitulation to the soaring Canadian dollar, or the December attempt at co-ordinated liquidity injections to deal with ongoing credit market strains, many central bankers went into full panic mode. We view opinions like those of Greenspan and Summers as public encouragement to their fellow policymakers not to dither, and to decisively embrace pro-growth policies.

We would also suggest that several key preconditions for a severe bear market are happily absent. One would be recession signals from forward-looking indicators like yield curves or credit spreads. The second would be excessively high equity valuations. The third would be excessively optimistic investor sentiment.

As we will explain shortly, we think odds of recession are lower than commonly perceived, particularly if one takes a global viewpoint. With global equity markets trading at around 13.5 times expected earnings, equity valuations do not look particularly stretched. In fact, a comparison of equity yields to bond yields would suggest that equities are nearly 40% undervalued relative to bonds on a global basis. Finally, aside from a group of wildly bullish local investors in Chinese stocks, we see few signs of excessively optimistic investor sentiment.

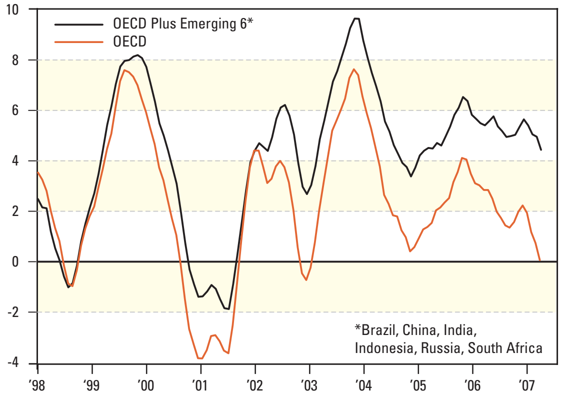
Feb Model Shows Fading Probability of Recession Based on Fed Funds Rate and Yield Curve



Source: Jonathan Wright, U.S. Federal Reserve Bank and Trilogy Global Advisors, LLC

Chart 1: A recently developed Fed model suggests that the probability of a U.S. recession over the next 12 months has fallen to less than 20%, thanks to recent interest rate reductions.

Strong Momentum in Emerging Markets Drives Global Economy: Year-on-Year Change in OECD Leading Economic Indicators (%)



Source: OECD/Haver Analytics

Chart 2: Leading indicators for the advanced industrial nations point to slower growth ahead, but a global index including key emerging market nations depicts a more robust outlook.

Q. Why should we believe that the odds of recession are relatively low?

A. We will answer this question in two parts, considering both the U.S. outlook and the broader global outlook. We have recently been monitoring "man in the street" recession fears by following a futures contract offered at Intrade.com on whether the U.S. economy will go into recession in 2008. That contract currently puts the betting odds of a 2008 recession at nearly 50%, validating concerns expressed by Greenspan and Summers.

However, we also like to monitor the Fed's in-depth research into recession probabilities, which currently suggest much lower odds of recession. One model is based simply on the level of the federal funds rate and the slope of the yield curve (as measured by the gap between 10-year Treasury bond yields and three-month Treasury bill yields). As shown in Chart 1, that model had put the odds of recession at nearly 50% earlier this year when the yield curve was inverted. With the Fed having cut rates, the model now puts recession odds at slightly less than 20%.

Are credit market strains pointing to a different outcome? No, not really. Fed researchers have also created another model based on both the yield curve and credit spreads on five-year AA-rated corporate bonds. That model also suggests that the risk of recession is less than 20%.

With respect to the global outlook, we think odds of a co-ordinated global recession are quite low for several reasons. First, if we naively apply the "Fed model" to the world, we get a risk of global recession at roughly 10%. As judged by central banks' interest rates and yield curves in major nations, global monetary policy is simply not that tight. From that viewpoint, the odds-on bet is: no global recession.

Leading economic indicators from the Organization of Economic Cooperation and Development (OECD) also tell an interesting story. As shown in Chart 2, the year-on-year change in economic leading indicators for the OECD nations as a group turned negative in October for the first time since 2003 – which, incidentally, was a great year for global equity markets. That validates some near-term caution about the global business cycle, particularly for the advanced industrial nations.

Notice, however, that we have shown a second global leading indicator in Chart 2, labeled "OECD plus Emerging 6." That refers to what we now consider to be the true global economy, since it incorporates data not only from the major advanced industrial nations but also from increasingly influential developing nations – Brazil, China, India, Indonesia, Russia and South Africa. That indicator has moderated somewhat, but is still expanding at a robust year-on-year pace of more than 4%.

In short, we believe that the broad-based global economic dynamism will provide an important cushion in 2008 for incipient slowdowns in the U.S. and some other advanced industrial economies. Although we expect that the OECD's global leading indicators will have decelerated a bit further as of the end of 2007, we doubt that they will signal global recession. Instead, we suspect the correct outlook will be for a global "mid-cycle pause," implying a healthy moderation of growth, but not outright recession. By cooling off the world economy, without crushing profit growth, a mid-cycle pause should help lengthen the duration of the global expansion through the end of the decade.

Q. So if odds of a global recession are low, shouldn't we be worried about inflation instead?

A. With oil prices and other commodity prices still at elevated levels, concerns about potential global overheating cannot be easily dismissed. On the other hand, if the global economy does experience a mid-cycle pause, we should expect that energy and commodity prices will ease somewhat based on demand destruction. In fact, a key objective of nearly two years of monetary tightening by central banks in North America, Europe and elsewhere was to curb credit growth and avoid global overheating. Clearly, many observers are now concerned that the central banks have been too successful in that regard. If commodity prices begin to ease in coming quarters, which we believe is likely, we will know that inflation fears have been overdone.

We would also point to a potentially important wild card in the outlook for commodity prices, namely China. With China's year-on-year consumer price inflation having accelerated to 6.9% in November (see Chart 3), Chinese officials can no longer ignore the clear and present danger to economic stability posed by runaway monetary growth of 18% per annum. Not surprisingly, China's authorities recently have adopted increasingly stringent credit controls to tame the boom.

With China now representing more than 50% of the uptake of numerous global commodities, we expect that it will remain an important swing factor in global commodity markets for the rest of our lifetimes. And while China may well be a tremendous secular story with respect to commodity-related themes, it is also likely to experience powerful cyclical swings. Based on our readings of monetary excess in China at present, we suspect the next major movement in leading indicators for China will be to the downside, which should help ease both commodity prices and broader concerns about global economic overheating.

Q. What about the risk posed by the weak U.S. dollar?

A. A true dollar crisis would involve foreigners exiting en masse from the dollar, pushing U.S. bond yields up dramatically and triggering a severe recession independent of Fed policy. From that perspective, the pronounced dollar weakness of recent months has not come close to that nightmare scenario. Instead, dollar weakness has been accompanied by falling rather than rising U.S. bond yields.

In our judgment, it would take a deliberate move to unload official holdings of dollars by the largest surplus countries like China and Japan to trigger a true dollar crisis. But the consequences for their own export sectors and overall economies are likely to be so dire that the odds of such a scenario appear remote. By the bizarre MAD (Mutually Assured Destruction) logic of the Cold War, the current system of official recycling of U.S. trade deficits by central banks in key surplus nations could be surprisingly durable – since neither side has an interest in trying to unwind international imbalances in an abrupt fashion.

Moreover, the U.S. current account and trade deficits are beginning to shrink as exports boom and the nation's savings

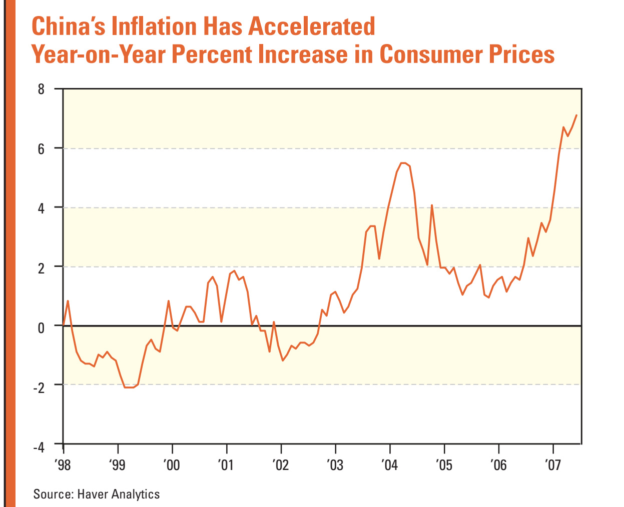


Chart 3: China's year-on-year inflation rate accelerated to 6.9% in November and is prompting China's officials to impose increasingly stringent curbs on credit growth.

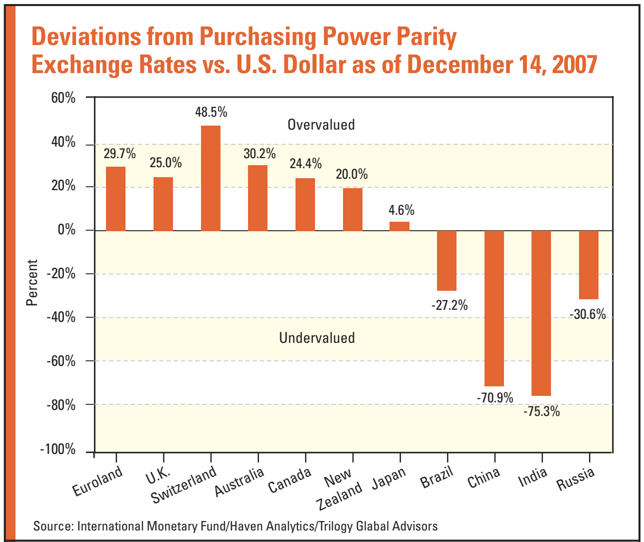


Chart 4: Most currencies of developed nations have become significantly overvalued against the U.S. dollar, but key currencies of emerging market nations remain seriously undervalued.

rate rises. That suggests that the imbalances may become easier to finance and perhaps create room for the dollar to rise against overvalued currencies like the European currencies and commodity-related currencies like the Australian, Canadian and New Zealand dollars.

Although the U.S. current account imbalance is expected to remain at a disturbingly high level of $750 billion to $800 billion in 2008, the number must be viewed in the context of a world that is expected to generate nearly $12 trillion of new savings during the same year. If foreign savers are willing to put a bit more than 6% of their new savings into U.S. assets over the course of the year, the imbalance can be easily financed. Since the U.S. still represents nearly 20% of the world GDP and has a significantly higher share of marketable securities, there is a reasonable chance that foreigners – including central banks and newly surging sovereign wealth funds – may wish to allocate more than 6% of their new savings to U.S. financial markets. That would help stabilize the dollar against major currencies that have become dramatically overvalued against the dollar on a purchasing power parity basis (See Chart 4).

The next major leg of adjustment for the U.S. dollar, in our opinion, is likely to be necessary against currencies of the emerging markets. Based on data from the International Monetary Fund, emerging market currencies as a group appear to be more than 40% undervalued against the greenback on a purchasing power parity basis. Astonishingly, currencies like China's renminbi and India's rupee appear to be undervalued on the order of 70%. The tremendous competitive advantage this degree of currency undervaluation has given to such nations has been contributing to economic overheating. So for domestic reasons, it may become wise for a number of emerging market nations to begin letting their currencies rise against the U.S. dollar in a controlled fashion. But the emphasis is "in a controlled fashion," so that the adjustment occurs over a number of years. With China's policymakers known as "radical incrementalists," we expect any changes to their currency policy to be made in a very gradual manner. And we think many other Asian nations will be content to follow China's lead.

In conclusion, pick your favourite investment cliché: Bull markets climb a wall of worry. Be fearful when others are greedy and greedy when others are fearful. Don't fight the Fed. Such clichés may be overly simplistic, but we suspect they are worth keeping in mind when thinking about the year ahead.

May it be a happy and prosperous one for all of our readers.

William Sterling

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