



Sterling's

World Report



SNAKES ON A PLANE

Hollywood film producers have developed a shorthand way of communicating a great deal of information about potential film projects in terms of older, well-known films with a new twist. For example, the film *Speed* was pitched as “*Die Hard* on a bus.”

Or the film *Alien* was “*Jaws* in space.” In a class by itself (the best bad movie ever?) was the 2006 film *Snakes on a Plane*, where the pitch, the plot summary and the advertising tag line were all summarized in the title.

Not surprisingly, *Snakes on a Plane* draws on the template of earlier airplane disaster movies, with the twist being deadly snakes attacking the plane’s crew and passengers. Complications ensue.

Taking a cue from Hollywood, if we had to sum up investors’ perceptions of the market climate in a type of shorthand, we would offer the following equations:

Credit Crisis + Massive Fed Easing =
Muddle Through Markets

Credit Crisis + Massive Fed Easing + Energy Shock =
Global Bear Market.

Maybe *Snakes on a Plane* is an apt title for the present environment, with Captain Bernanke and his valiant crew struggling against snakes in the cockpit while things turn very ugly in the passenger cabin.

Odds of a Global Recession are Rising

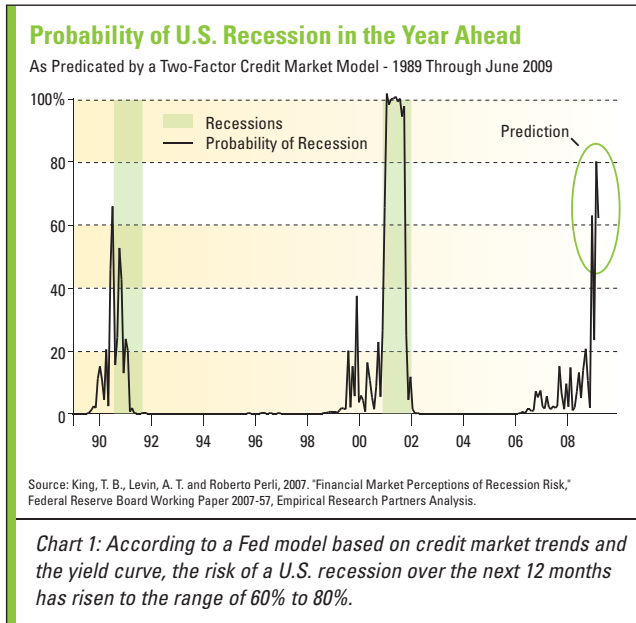
Putting aside the movie metaphors, the recent economic and financial news flow has been unrelentingly negative:

- Global stock markets plunged in June, as the MSCI World Index fell by 8% and many markets posted “bear market”

declines of more than 20% from their 2007 peaks.

- The price of oil rose by 38% from April to US\$143 a barrel, eclipsing previous records even after adjusting for inflation.
- The U.S. unemployment rate for May rose by 0.5% to 5.5%, which is the type of move only seen during past recession periods.
- U.S. home prices continued to fall, with prices in 20 U.S. cities down 15% in May from a year earlier. Consumer confidence fell to the lowest level in 16 years.
- The European Central Bank warned that it will raise rates; the U.S. Federal Reserve warned that it may hike rates, and central banks in emerging markets have been increasing rates virtually every day.
- European business confidence plummeted, suggesting that recession dynamics are spreading to Europe.
- Japanese consumer confidence fell to the lowest level in six years as Japan’s overall economy continued to stagnate.

If all of that economic and financial news were not bad enough, concerns are mounting that Israel may be preparing to attack Iran in a bid to halt Iran’s development of nuclear weapons. According to contracts traded on www.intrade.com, the odds of an attack on Iran occurring on or before September 30, 2008 are now being put at nearly 20%.



In the beginning of the year, we were hopeful that the U.S. would narrowly avoid recession and that other major economies would experience more modest slowdowns. That suggested to us that global markets would muddle through and perhaps surprise to the upside. We were clearly far too optimistic. All of the major economies that are not oil producers now are being hit by a common energy shock with the potential to create a global synchronized slowdown. The jury is still out whether Europe and Japan will avoid recessions, but one model used by the Fed has recently given odds of 60% to 80% that the U.S. will be in recession over the next 12 months (see Chart 1).

To be sure, many emerging market nations, like China, are still experiencing strong domestic growth and may continue to post solid growth in the very near term. But inflation in the emerging markets has accelerated in a far more pronounced fashion than in the developed world (see Chart 2), with more than 50 emerging market countries now recording inflation rates of more than 10%. That suggests the need for more pronounced monetary tightening and elimination of energy subsidies, which seems likely to result in recessions in many developing nations in 2009.

Can There Be a Happy Ending?

In *Snakes on a Plane*, a plucky FBI agent, played by Samuel L. Jackson, finally gets the situation under control and the plane lands safely. We would not for a moment minimize the challenges currently facing the world economy and financial markets, but would offer the following observations:

There are some reasons to believe that the current oil shock may be less severe than previous shocks, in terms of both economic and market impacts. First, labour costs are under control in most advanced industrial nations, so there is no need for draconian rate hikes that were needed in the past to deal with wage-price spirals triggered by oil shocks. Second, energy used per unit of GDP has fallen by nearly 50% since the 1970s (see Chart 3), so the shock waves created by rising oil prices should be more muted than in the past. Third, equity markets are already pricing in a great deal of bad news, with developed world equity markets trading at around 12 times estimated earnings over the next year.

Let us elaborate on each of these points. In oil-related recessions of the mid-1970s and early 1980s, U.S. wage growth was so high and productivity growth was so poor that unit

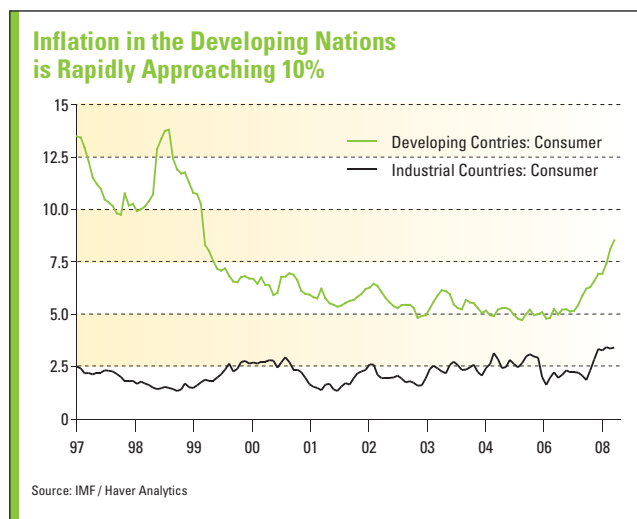
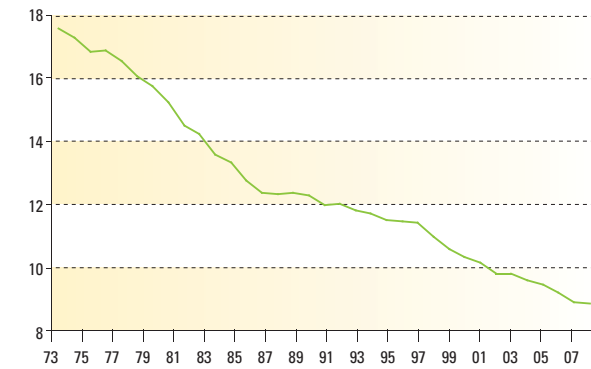


Chart 2: Inflation in the developing nations has accelerated much more than in the developed nations, putting pressure on their central bankers to aggressively tighten monetary policy.



U.S. Energy Consumption per Dollar of GDP

(1000 BTUs Per 2000 Dollar) 1973-2000



Source: EIA

Chart 3: Energy used per unit of GDP has fallen by nearly 50% since the 1970s, which should help mute the impact of the current energy shock compared to previous episodes.

labour costs rose at alarming double-digit rates. Since unit labour costs are by far and away the biggest driver of inflation, the Fed had no choice but to impose massive interest rate hikes to crush inflation. Most economists would argue that the magnitude of the interest rate shocks were far more important than oil prices themselves in generating severe recessions and bear markets during those episodes.

This time around, wage pressures in most major industrial nations remain modest and positive productivity trends are keeping overall labour costs well under control. In the U.S., for example, unit labour cost growth in the past two quarters has averaged only 1%, while productivity growth has surged to nearly 3%. So the Fed's cautious optimism that inflation pressures will moderate has considerable support from labour cost data.

The more efficient use of energy in most industrialized nations should also help mute the impact of the current energy shock compared to prior episodes. In 1980, the average car in the U.S. had a fuel efficiency rating of only 16 miles per gallon, compared to a current level of nearly 23 miles per gallon. So, adjusting for today's higher income

levels and more efficient vehicles, it takes only 7% of the average worker's disposable income to run a car for 15,000 miles a year at today's gasoline prices. That compares to nearly 14% of disposable income in 1980 when gas prices were US\$1.26 a gallon.

Finally, from the perspective of equity investors, it is important to note that today's stock valuations are already pricing in a great deal of bad news. With a P/E ratio of 12 times, global equities currently provide an earnings yield (the inverse of the P/E ratio) of 8.3% – which is among the highest in several decades. In contrast, the average 10-year government bond yields about 4.5%. According to Lehman Brothers' research, stocks are now priced as cheaply relative to "risk-free" government bonds as they were during the stagflation years of 1974 to 1978.

Despite daunting near-term uncertainties, we believe that today's equity valuations should help mitigate risks to long-term investors who must always ask themselves which asset class – stocks or bonds – is likely to deliver the best returns over the next five to 10 years. In our view, the answer continues to be equities.

History Lesson: Oil Prices and Stocks

Won't the rise in oil prices almost guarantee poor economic and stock market performance in the near future? To be sure, a sharp rise in oil prices can be considered a modestly reliable leading indicator of bad news for economic growth and inflation over the next few quarters. Ironically, however, oil prices have not had a good track record as a leading indicator of stock market performance. That's because the bad news from rising oil prices tends to be immediately discounted into stock prices. Just because rising oil prices have clobbered stock prices recently is no guarantee that they will continue to do so in the future.

Table 1 provides historical data for the U.S. stock market for the nine quarters since 1946 that had been preceded by an

Oil Price Increases Do Not Necessarily Lead to Future Stock Price Declines:

Quarters When Real Oil Prices Have Risen by More Than 80% Over One Year

Date	Percent Change in Real Oil Prices Previous 4 Quarters	Subsequent 4-Quarter Percent Increase in Real Stock Prices	Percent Change in Real Stock Prices Previous 4 Quarters	Subsequent 4-Quarter Percent Increase in Real Oil Price
1975Q2	157.8	6.3	-20.9	1.1
1975Q3	156.2	28.0	-22.9	2.3
1975Q4	109.5	28.1	-45.5	-6.7
1976Q1	131.0	21.0	-34.4	2.2
1981Q1	93.2	26.7	4.7	-9.6
1981Q2	109.2	10.0	-7.3	-16.9
1981Q3	81.0	-12.3	2.7	-9.9
2001Q1	125.2	-23.9	17.9	-11.5
2001Q2	96.5	-17.5	13.7	-16.0
Average*	116.3	5.5	-12.8	-7.5
Average, excluding 2001*	118.0	14.5	-19.6	-5.6

Source: Haver Analytics and Trilogy Global Advisors

*Geometric mean

Table 1: There have been nine quarters since 1946 when oil prices have risen over the previous year by more than 80%. Six out of nine times, stock prices rose over the following year.

annual jump in inflation-adjusted oil prices of more than 80%. As of the end of June, inflation-adjusted crude oil prices were up by 91% from a year earlier, so the historical oil-shock data points are clearly relevant to today's situation. Surprisingly, in six out of nine of those episodes, inflation-adjusted stock prices were up over the next year, with the average real increase being 5.5%. That is close to the historical norm of about 6% since 1946. It is also worth noting that the poorest results came early in this decade, when valuations had been exceptionally high following strong market gains. Excluding the 2001 data points, the average increase in stock prices over the subsequent year was 14.5%, well in excess of the historical norm.

Of course, one reason that stock prices often did surprisingly well after sharp rises in oil prices is because stock prices have historically become cheaper during periods of escalating oil prices. As shown in Table 1, real U.S. stock prices fell by an average of 12.8% during oil shock periods and by 19.6% excluding the 2001 data points. The table also shows that oil prices tended to either stabilize or fall substantially in the year following shockingly high increases. There is no guarantee, of course, that such a pattern will be repeated in the future. But,

if the historical record makes anything clear, it is that oil prices tend to be coincident indicators of stock performance and provide little guidance as to future stock price movements.


Enough is Enough!

Toward the end of *Snakes on a Plane*, Samuel L. Jackson delivered his most memorable line: "Enough is enough! I've had it with these vexing snakes on this vexing plane!" – or something to that effect. Thus emboldened, our hero straps in the passengers, shoots out some windows, depressurizes the plane, and the snakes fly out. He also has the presence of mind to call ahead for anti venom. The plane lands safely.

We sympathize with Jackson's "enough is enough" sentiments but, unlike his screenwriters, we cannot guarantee a happy ending. Seatbelts are recommended as Captain Bernanke considers shooting out some windows and depressurizing our plane – raising interest rates in the midst of a credit crisis ought to do the trick.

For those who are not blessed with clairvoyance about oil prices, we would be cautious about blithely extrapolating current trends. Extreme price trends tend to create extreme emotions, extreme valuations, and strong countervailing forces – like the energy demand destruction now evident in many nations. The risk of heroic policy measures to curb inflation is also rising, particularly in developing nations.

As far as metaphors are concerned, we sure miss Goldilocks.



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