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2003 Outlook: Iraq, Oil and the Economy

After another brutal year in global equity markets, investors have finally had a bit of a respite as most global markets have posted gains for the last eight weeks. These gains have come despite widespread fears of a U.S. military conflict with Iraq sometime in the next few months. Is the recent market rebound just another bear market rally, or are there more fundamental reasons for optimism about the investment outlook for 2003?

There is no denying the geopolitical risks that continue to cloud the outlook. However, we continue to believe that a lot of bad news is still factored into market prices, and that even a modest amount of good news is likely to trigger further market equity market gains in 2003. Our views on key issues facing the markets are summarized here in a question-and-answer format.

Q: Let's start with the geopolitical risks. How should those be factored into the investment outlook?

A: There have always been geopolitical risks facing markets and they are probably most dangerous to your portfolio before they become front-page news. No one talked about geopolitical risks in 1999 and 2000, but with hindsight we know they were lurking in the background with the potential to bring down equity market valuations in a major way.

Conversely, now that geopolitical risks are front-page news every day, it can be argued that any perceived reduction of those risks has the potential to raise market valuations significantly. In fact, a major part of the recent market rally may reflect relief that the United States gained UN support for its attempt to disarm Iraq, instead of going it alone.

Regarding potential scenarios for a military conflict, the recent behaviour of the market seems to suggest that market participants are now anticipating a relatively benign outcome. That would imply a short war that does not seriously disrupt global oil markets or economic activity. We have been assuming for some time that a conflict is highly likely sometime in the first few months of next year and that it would be over in four to six weeks.

That said, a range of other more disturbing scenarios must be considered. The Center for Strategic and International Studies (www.csis.org), a Washington-based think-tank, recently tapped experts from various fields to attempt to quantify the likely impacts of war. The three war scenarios they considered were: a benign war lasting four to six weeks (40-60% probability); a more serious conflict that lasts up to three months (30-40% probability); and a "worse" case that lasts as long as six months (5-10% probability). The group did not even formally try to assess even worse possibilities, such as the use of nuclear weapons.

Interestingly, the study concluded that a no-war scenario could depress markets and add an ongoing risk premium to oil prices that

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would depress global growth. At the other extreme, they concluded that a long, drawn-out war could push oil prices as high as $80 a barrel and, perhaps even more damaging, leave them at around $40 a barrel for many months thereafter (See Chart 1). The more benign and most probable case anticipates a brief spike in oil prices, and then a prolonged drop to around $20 a barrel.

In short, it can be argued that markets have been depressed this year due to the small probability of a very ugly war scenario. But when a more benign outcome develops, both equity markets and economic activity should make a quick rebound as market participants and corporate executives become willing to take on more risk.

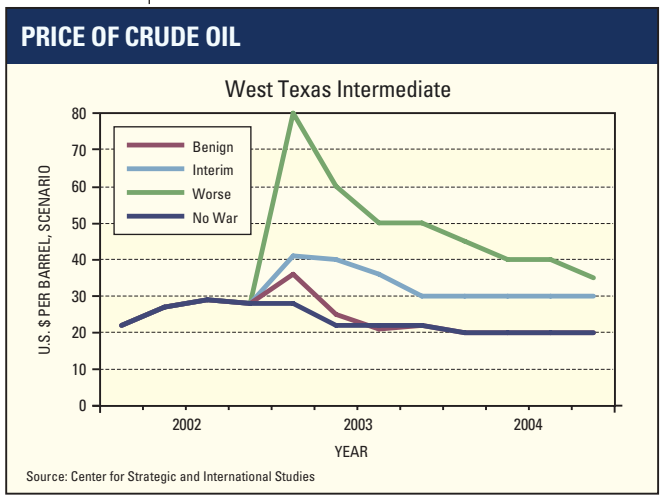

Chart 1: Oil experts expect oil prices to drop toward $20 a barrel following a benign war scenario, but much worse scenarios are possible if war is prolonged.

Q: So how likely is the dreaded "double-dip" recession that has received so much attention in the media?

A: Aside from the geopolitical risks, the low level of interest rates in most nations, combined with the likelihood of further rate cuts in Europe in coming months, suggest low odds for a renewed move into recession. This is reinforced by the fact that recent economic data, while mixed, still indicate positive economic momentum in most major countries.

The U.S. in particular has been supported by record rates of mortgage refinancing that appear to have improved household cash flow by more than $200 billion this year. Also, as shown in Chart 2, the job market has stopped deteriorating in recent months as reflected in a decline in initial unemployment claims. In our opinion, the jobs data will be an important signpost of whether the economy is likely to slide into renewed recession. So far, the data are clearly not supportive of the double-dip scenario.

The National Bureau of Economic Research has done careful quantitative work trying to estimate the probability of renewed recession. Based on data through September, the Bureau's "Experimental Recession Index" (XRI) suggested that the odds of the economy being in recession six months later (in March 2003) stood at only 3%. We think 97% odds of not being back in recession are pretty favourable!

That said, the Bureau's XRI is based completely on a purely data-driven approach, and therefore may not adequately handicap the geopolitical risks discussed above. Adding in the geopolitical factor, we would say the odds of a double-dip recession may be closer to 20%. Still, that suggests 80% odds of continued expansion ahead and very good odds that perceived geopolitical and economic risks will fall significantly in a post-Saddam world.

Q: What is the outlook for interest rates, and how does that tie into various geopolitical scenarios?

A: We think that the most recent half-point rate cut by the U.S. Federal Reserve was probably the last cut for this cycle. However, the Fed will not be in any hurry to raise interest rates until it is clear that the economic recovery is gaining momentum. Under the scenario of a short war, that suggests that Fed tightening might begin in the second half of 2003.

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Make no mistake: the Fed would dearly like to be in a position to be raising rates. That would mean that risks to the economy have faded and that there is a strong and self-reinforcing recovery underway. Under a relatively benign geopolitical and economic scenario, it would not be surprising to see the Fed move the funds rate up from its current ultra-low level of 1.25% to somewhere in the range of 2% to 2.5% by late 2003 or early 2004. Under that scenario, bond yields are also likely to move up, but probably not by as much, settling perhaps somewhere near 5%.

That would still leave the yield curve – the gap between long rates and short rates – positively sloped, which would signal continued economic growth ahead. From the Fed's point of view, they would simply be taking away some of the emergency easing that was put in place in the dismal period following the terrorist attacks of September 11, 2001. With inflation still likely to be a back-burner issue, Fed officials emphatically would not want to put a major brake on the economy.

For bond investors, however, even a modest tightening of monetary policy could still represent a shock after a long period when bonds became the only "no lose" investment vehicle. A recent study by The Vanguard Group in the U.S. found that 70% of investors surveyed did not understand that bond prices fall when bond yields rise – and this was a survey of people with an above-average interest in investing.

As shown in Chart 3, Treasury bonds would post negative total returns if rates begin to rise, with the largest negative returns coming in long-duration bonds like 10-year or 20-year Treasury bonds. This does not mean that there is now no place for bonds in an investor's portfolio – they could once again shine if things go badly in the Mideast. But they are by no means a no-risk investment now that interest rates have fallen this low. For this reason, we are currently maintaining a below-average duration in our bond portfolios.

And what about interest rates if things go badly in the Mideast? This question is tricky because, if oil prices shoot up to $80 a barrel under a "worst-case" scenario, the first fear of many investors might be about a repeat of the inflationary 1970s, complete with soaring interest rates. In our view, however, the most likely direction for interest rates under a worst-case geopolitical scenario would be down, not up. That's because the impact on global growth, stock markets and corporate bond markets would be sufficiently negative that the Fed and other central banks would be more concerned about deflation than inflation once the initial oil price shock faded. This is particularly true since business spending remains depressed around the world amidst a large amount of excess capacity and high debt levels.

Under an oil shock/recession scenario, look for the Fed funds rate to go a Japan-like level of 0.25% or even zero. Under those circumstances, bond yields could head to 3% or lower. As for equities, as Tony Soprano would say, FUGHEDABOUTIT. However, this underscores a point we have been making for the last several months, which is that a big bet on long-duration bonds at this point is

NO DOUBLE DIP IN JOBS DATA

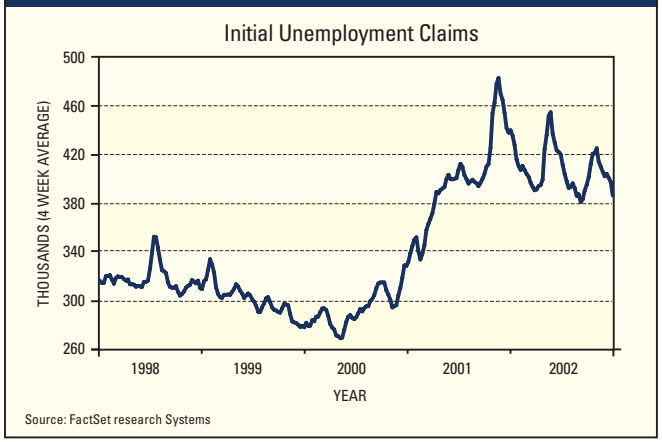

Chart 2: A recent drop in initial unemployment claims data does not support fears of a "double- dip" recession for the U.S.

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equivalent to a bet on deflation/depression. That's not to say that it can't happen – just read the harrowing Center for Strategic Studies report – but it is a low-probability scenario.

Q: Speaking of deflation, how big a risk is there for a Japan-style, decade-long deflationary slump?

A: On that topic, please refer to last month's World Report, in which I argued that fears of a Japan-style deflation for the United States are overdone, particularly since the Fed is well aware of the risk and is determined to fight it with every tool at its disposal. In that vein, since last month's piece was written, a truly remarkable speech was given by a new Fed Governor, Ben Bernanke, an academic economist from Princeton University.

Here is his conclusion: "I believe that the chance of significant deflation in the United States in the foreseeable future is extremely small." He then went on to discuss the resilience and stability of the U.S. economy and, in considerable detail, the broad range of tools that the Fed could and probably would use to make sure that Japanese-style deflation doesn't cripple the U.S.

In fact, Bernanke's conclusion was basically in the title of his speech (available online at www.federalreserve.gov), which was "Deflation: Making Sure 'It' Doesn't Happen Here." Even though Prof. Bernanke is a new member of the Fed and presented his comments as his own personal views, it is doubtful that he would have given a speech on such a sensitive topic if it didn't have the blessing of most of his fellow Fed governors.

In a sense, the speech could have been called "The End of Disinflation." For years, the Fed was happy to see inflation rates continue to come down year after year and deliberately tilted its policies accordingly. Now, with overall inflation around 2% and with many industries experiencing outright deflation, the Fed is basically shouting to investors that it does not want to see inflation fall further. It is declaring victory and retreating.

That doesn't mean that financial markets are done worrying about deflation, because in a world of low inflation, some industries will inevitably experience falling prices. However, it does mean that the big trend of falling inflation, a trend that has been in place since the early 1980s, has probably ended. The new trend the Fed would like to see is steady, but low inflation somewhere around 2%. Sounds boring, doesn't it? But after the last few years, boring sounds good to us.

Q: So what asset classes, regions, and sectors look most attractive?

A: If we are correct in anticipating a benign geopolitical scenario, the major theme in international markets next year is likely to be a reduction in risk aversion. That means that higher-risk assets, like equities, should do better than lower-risk assets like fixed income. Within fixed income, as we mentioned above, shorter duration bonds are likely to outperform, while higher-risk credits, like corporate bonds and emerging market debt, are also likely to outperform.

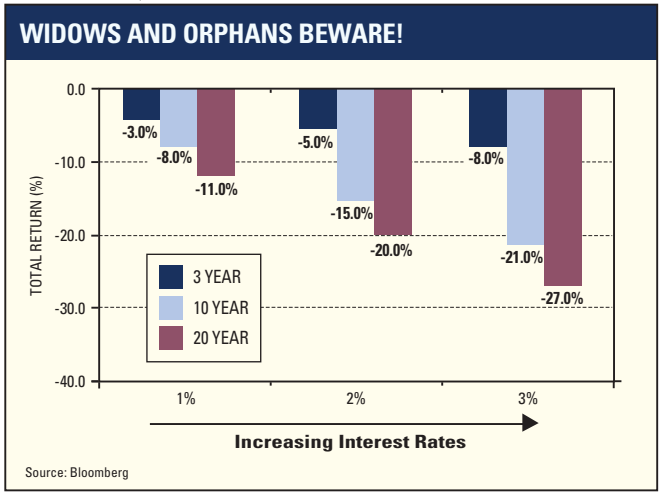

Chart 3: Here is how much Treasury bonds would lose in total return if interest rates climbed one percentage point or more over the next year.

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Will rising interest rates derail the equity markets? If declining risk aversion is the major theme, probably not. Lower rates did not help in recent quarters when rising risk aversion dominated all markets, and we suspect that rates will rise only when central bankers see equities already having risen a lot and economies having enough momentum to shrug off higher rates. In addition, under almost any growth scenario for next year, there will still be plenty of excess capacity in the world economy so inflation should not be a big concern. That means that central banks will still want monetary policy to be pro-growth, just not excessively easy once businesses get back to the business of investing and taking risks.

If we are correct about declining risk aversion, the regions that went down the hardest in 2002, like North America and Europe, may well be the best-performing regions in 2003. We have recently been increasing our exposure in Europe based on better relative valuations (the dividend yield is 3.1%, nearly double that of the U.S.) and prospects for monetary easing from the European Central Bank. In terms of sectors as well, what went down the hardest in 2002, like information technology, telecommunications, capital goods, and media, could well make the biggest gains as risk aversion diminishes and business spending finally begins to pick up again.

Q: Any final thoughts?

A: Mainly the obvious point: We reserve the right to change our minds. Our attitude to forecasting echoes the sentiments of the famous French mathematician Henri Poincare, who once said: "It is far better to foresee even without certainty than not to foresee at all." The degree of uncertainty we all have to deal with now clearly remains higher than normal, but we still have to make reasonable decisions about which investment scenarios are most likely.

What is clear is that investors are still paying an extremely high price for safety, with the "price-earnings" ratio on money market funds in the U.S. approaching 90 times. Cash reserves, as measured by the broad money supply in the U.S., have grown by a whopping $1.3 trillion over the last two years. With those cash reserves earning less than the dividend yield on equities, we have to believe that a good portion of those reserves will be reallocated back to equity markets with even a modest amount of good news in 2003.

Happy Holidays and Best Wishes for a Happy and Prosperous New Year.

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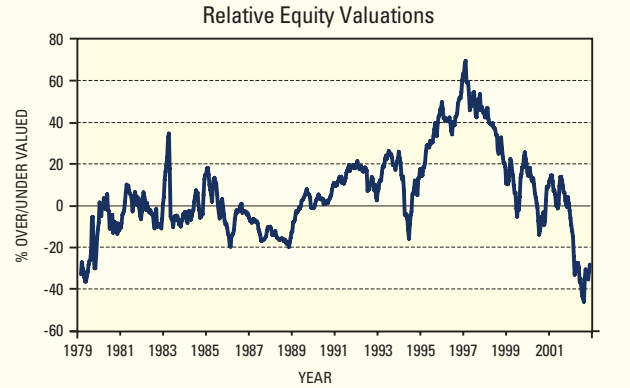
THE FED MODEL



Source: Prudential Securities

Chart 4: According to the Fed model of equity valuation, equities remain undervalued relative to 10-year U.S. Treasury bonds, despite the recent market rally.