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By William W. Priest, CEO

2006 – More of the Same (But with a lot less confidence)

All things considered, 2006 looks like a decent year for the equity markets. Many of the trends that led to healthy returns in 2005 remain at work in the new year. The positive effects of globalization on real growth, productivity, earnings, and inflation continue. In addition, valuations continue to appear reasonable in light of current interest rates and corporate earnings are expected to grow at or above the number determined by revenues plus productivity – a value of six percent or higher. If we combine that six percent with current dividend yields, we get an estimated return for equities of six to eight percent. And with low inflation added to the mix, real return prospects for equities look even more appealing. We are not the only ones who are encouraged by the investment potential of the coming year. Private equity firms continue to have billions of dollars earmarked for the purchase of public companies, which is a very tangible indication that investors are entering 2006 with a widespread sense of optimism.

At Epoch, however, we know that being a good investor requires a detailed, nuanced understanding of the drivers that will shape the future performance of the equity markets. While 2006, much like 2005, is widely expected to be a strong year for equities, there are larger forces at work in our world economy that call for a deeper knowledge of the international markets and, therefore, an added measure of caution for investors. This paper will review some of the trends and issues that may complicate the new year's investment landscape, and will offer concrete solutions for preserving and growing capital.

As mentioned earlier, the outlook for market returns in 2006 is about the same as it was in 2005 – between six and eight percent. For the statisticians among us, the first question is likely to be: “What confidence do we have in that estimate? What is the range of probabilities surrounding that number?” In order to fully comprehend the larger economic trends that could affect the six to eight percent approximation, it will first be helpful to indulge this statistical query. So, let's consider the issue from a probability distribution point of view. To do this, we will use a standard bell-curve distribution, the relevance and functionality of which is described in the following quote from the January 7th edition of *The Economist*:

The best known...probability distribution[s] is the “normal,” or Gaussian, distribution. This has a curve similar to the cross-section of a bell, with events of middling magnitude being common, and those of small and large magnitude rare, so it is sometimes known by a third name, the bell-curve distribution.”

If one asked us for a “confidence interval” surrounding this six to eight percent number, what would it be under the bell-curve model? Historically, if one wanted an annual confidence interval of 95 percent surrounding the mean expected return (two standard deviations), the answer would be six to eight percent plus or minus 35 percentage points. Put another way, this is the answer that would capture 95 percent of the historical range of possibilities. So, if we are to use this logic to predict equity market returns in 2006, we would say the market could range from -28 percent to +42 percent. This range would represent a “normal curve” (the familiar bell-shaped one) that would have an equal probability on either side of the mean (average). However, in order to gain a more accurate estimate of the true range of future returns, we need to weight the curve with the potential risks that threaten to impact the global marketplace. When we take these risks into account, the space to the left of the mean return (the negative side) is larger than the space to the right (the better-than-expected side). This leads us to believe that the investment landscape in 2006 should be navigated with a considerable amount of caution, despite some of the positive economic trends that have carried over from 2005.

Now that we’ve done the math, let’s discuss the trends and drivers that may threaten to disrupt our equity return bell-curve in 2006.

At the heart of our concern is the floating dollar. Its hegemony allows the major players in the world economy to act in ways that may initially appear beneficial to national self-interest. But, when viewed under a wider, multi-national lens, the behavior of these individual nations, who are all operating under a dollar-based currency, are fundamentally illogical and potentially irresponsible. As Clyde Prestowitz points out in his book, Three Billion New Capitalists: “Americans consume too much and save too little, while Asians save too much and consume too little. Some are playing a mercantilist game while others are playing more or less free trade and open markets. Yet all are pretending that all are playing the free trade game.” Prestowitz’s essential question is this: Can trading partners of the U.S. really be happy with a reserve currency they have to earn while we simply have to print it? In order for a satisfactory currency equilibrium to be maintained, there has to be a certain amount of faith placed in the U.S. with regard to its policy toward the dollar. So far, we have been able to avoid major international disagreements on this front. But, the world is changing and so is our country’s continued ability to control the value of the dollar in our own favor. So what will happen when the tides turn and we can no longer win the “fair” way by strengthening the dollar through competitive behavior? Will we simply print money and inflate away the liabilities? These are complex questions with complex answers. But one thing is abundantly clear: when the economic interests of dollar-reliant nations are so disparate, the potential for misunderstanding and conflict is enormous. Therefore, it is easy to

imagine how the complications surrounding the floating dollar could have an unfavorable effect on equity returns in 2006.

The increasingly problematic role of the dollar is just one way in which America's relative economic superiority and power are slipping away just as China's prominence is ascending. China is like the new sun in the solar system, pulling the balance of world power toward the East for the first time in almost six hundred years. China's GNP was recently adjusted upward to \$2 trillion for 2004, compared to \$11-12 trillion in the US. At the present respective growth rates for the US and China, this GNP gap could be closed in two generations. Just as Portugal crushed Egypt and Venice by changing trade routes centuries ago, China is gaining power by becoming everyone's biggest customer. It has surpassed the U.S. as the biggest export market for South Korea, Taiwan, Japan, and Indonesia. It is the world's fourth largest economy after the U.S., Japan and Germany. In terms of purchasing power parity, it could have a larger GDP than that of the U.S. in just 15 years and, in nominal terms, by 2040 or shortly thereafter. All of this points to a gigantic paradigm shift in the world economy and, for the U.S. equity markets, China's impending dominance may be as disruptive as it is rapid.

Japan has long been seen as another important Eastern nation, and many have asked if the country is poised to experience growth on the same scale and magnitude as China. The answer is no. Far from being the hub of the ASEAN economy, Japan, like the rest of the world, is being drawn into China's orbit. Japan's loss of dynamism and its inward looking economic policies have greatly diminished its influence on the international stage. Its population actually declined in 2005 and its lingering protectionist policies hinder its ability to respond to or preempt Chinese offers of free trade agreements to Japan's Asia Pacific trading partners. Japan is becoming the Switzerland of the Far East: small, aging, rich, and insular.

On its own, the world's changing economic landscape, particularly in China, is certain to have a swift and meaningful impact on investors. But when we consider how the forces of technology will amplify and accelerate this impact, the situation becomes even more pressing. Specifically, the impending ubiquity of the internet will profoundly increase the rate at which economic power is redistributed. Remember that equation, $D=RT$? In junior high, it was introduced to me as Distance (D) equals the Rate (R) of travel multiplied by the Time (T) spent traveling. By transposing the variables, we determine T by dividing D by R. Time is distance traveled divided by speed of travel. Now let us apply this equation to the concept of the internet, where information travels at instantaneous speeds. In other words, with the internet as our informational conduit, distance no longer matters as it once did. China is now our virtual next door neighbor, and the impact of its growth will be quicker and more keenly felt than we ever thought possible. Time and distance are being negated and the globe is becoming a single community in which change is the only certainty. This means that policies that worked before the widespread adoption and application of the internet are in dire need of immediate revision if we are to maintain an environment of positive equity returns.

This need for revision should find its first outlet in the political and economic policies of the US. Unilateral behavior by even the most militantly powerful nation on Earth is no longer a viable option. Even the President's National Intelligence Council has stated, "At no time since the formation of the Western Alliance System in 1949 have the shape and nature of international alignments been in such a state of flux." "Flux" is not good for financial markets. It connotes uncertainty, whereas investors want as much certainty as possible. One way to provide a more stable outlook for equity returns would be a commitment from America's political leaders to acknowledge and address the problematic realities of current international dynamics. But, instead of tackling these issues effectively, our leaders continue to act in a unilateral fashion in a world where America's absolute status is unquestioned, but where its relative status has been declining for some time, particularly in the critical areas of saving, education, energy, conservation, critical infrastructure, research and development investment, and workforce training and education. While the US once led the world in these areas, we are now below the standards of many other nations. And this can only have a negative effect on future equity returns.

So how can an investor enter 2006 with a better chance of protecting and growing his capital? The most important answer is to diversify. Become a global investor, not a regional one. For example, if one owns the stocks of US companies, make sure those companies can compete globally. Fed Ex can, GM cannot. In addition, investors should watch the currency market and own some gold. Paper money, particularly the US dollar, is under stress. Consider the following scenarios and their impact on the dollar. What would happen to the dollar if oil was priced to a basket of currencies, not just to the dollar itself? What would happen to large holders of government debt instruments if the U.S. continued its profligate economic and diplomatic behavior? How would these investors protect themselves? Would they sell their government debt instruments? Not likely, but buying other currencies and possibly gold would be a very realistic alternative.

And what about bonds? Interest rates and the dollar are intertwined. Any substantial decline in the dollar, which would most likely result from a loss of confidence in America's willingness to address its fiscal issues and its longer term structural competitive position, will cause a rise in rates. If one assigns a low probability to a weakening dollar, bonds with lengthening maturities will probably be safe investments. Otherwise, focus on bonds with short maturities, and be sure to own equities with global capabilities.

In the end, it is hard to deny that we have entered 2006 on the coat-tails of a very positive 2005. While many of the encouraging trends of the year behind us are likely to continue into the year ahead, the changing international landscape will require more attention and understanding with each new day. At Epoch, we believe that the wise investor will heed the signs of coming change, and will manage his portfolio accordingly.



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