Review and Outlook

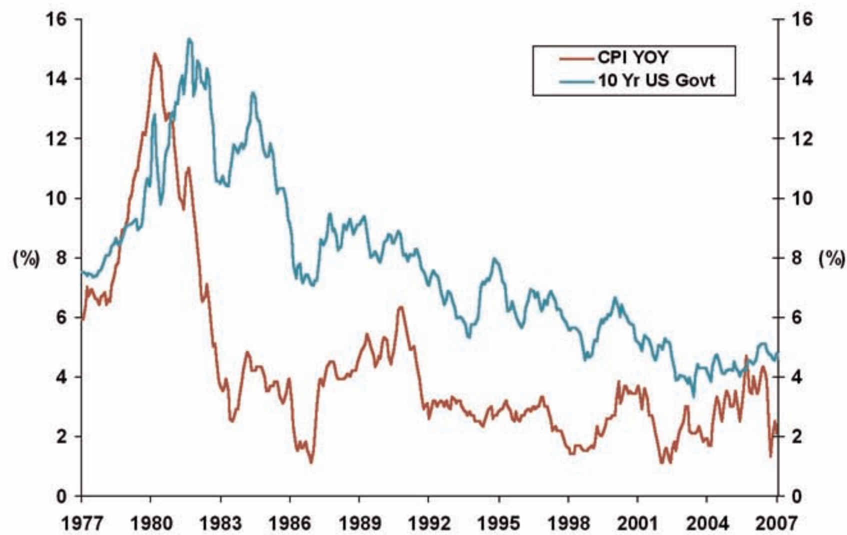
WILL HIGHER INTEREST RATES STOP THE EQUITY RALLY?

Global equity markets have had a strong rally year to date on better than expected earnings and reasonably low interest rates. However, short and long-term interest rates have been rising in most countries, as economic growth surprises on the upside. This has pushed up longer term (10 year) U.S. interest rates to above 5%, breaking a long-term secular decline in interest rates in place since 1981. Long-term interest rates actually bottomed at 3.1% in June 2003 but equity markets have continued to post solid gains. The question on our minds now is: "Will interest rates stay within the range in place since 2001 or are they about to break out and begin an uptrend?"

Short Term Interest Rates

The financial market consensus has been (up until recently) that the Fed would ease short-term interest rates some time in 2007. However, generally stronger than expected U.S. economic growth coupled with growing global inflation concerns has led the market to all but eliminate the chance of any cuts by the Fed through to year-end. Ben Bernanke and the Federal Reserve continue to voice their concerns about inflation and retain an "inflation bias" in their policy. Inflation indicators are somewhat volatile, but over time, a trend emerges, while we view the current risk as modest, inflation does remain a risk.

U.S. Inflation & 10 Yr Interest Rates



Long Term Interest Rates

The level of long-term interest rates is determined much differently than shorter-term rates, which are largely set by central banks globally. Long-term rates are essentially set by the market on the basis of supply and demand. When the demand of bonds outweighs supply, long-term interest rates go down and bond prices rise (remember that interest rates and bond prices have an inverse relationship) and vice-versa. The growth of significant pools of capital has been a major contributor to the demand for both fixed income and equity financial products. This demand has helped to maintain an environment of low long-term interest rates, a phenomenon referred to as a "conundrum" by Mr. Alan Greenspan. The impact of petro-dollars, central banks, private equity, and hedge funds have all lead to growing competition for financial assets and continue to provide a back-drop of underlying support in the marketplace.

Increasing Demand for Equities

Sovereign Wealth Funds (SWF's) have recently become more visible pools of capital representing about $2.5 trillion. This is larger than the hedge funds assets (approx $1.5-2.0 trillion) and SWF's are expected to grow at $500 billion per annum. These funds are being created as countries seek to diversify their central bank holdings outside of passive investments, mostly in U.S. Treasury Bonds, seeking better inflation adjusted returns. China is in the process of setting up a fund that will start with $300 billion. This will represent the single largest ever pool of cash set aside for investments by any government. These funds are often invested quite secretively, but will be watched more closely going forward:

Sovereign Wealth Funds

Largest funds ranked by assets

Country	Fund Name	Assets ($billion)
UAE	Abu Dhabi Investment Authority	875
Singapore	GIC	330
Saudi Arabia	Funds of various types	300
Norway	Government Pension Fund – Global	300
China	State FX Investment Corp and Hueijing Co	300
Singapore	Temasek Holdings	100
Kuwait	Kuwait Investment Authority	70
Australia	Australian Future Fund	40
U.S. (Alaska)	Permanent Reserve Fund	35
Russia	Stabilisation Fund	32
Brunei	Brunei Investment Authority	30
South Korea	Korea Investment Corporation	20
Malaysia	Khazanah Nasional BHD	18
Taiwan	National Stabilisation Fund	15
Canada	Alberta Heritage TF	13
Iran	Oil Stabilisation Fund	11

Source: Morgan Stanley estimates

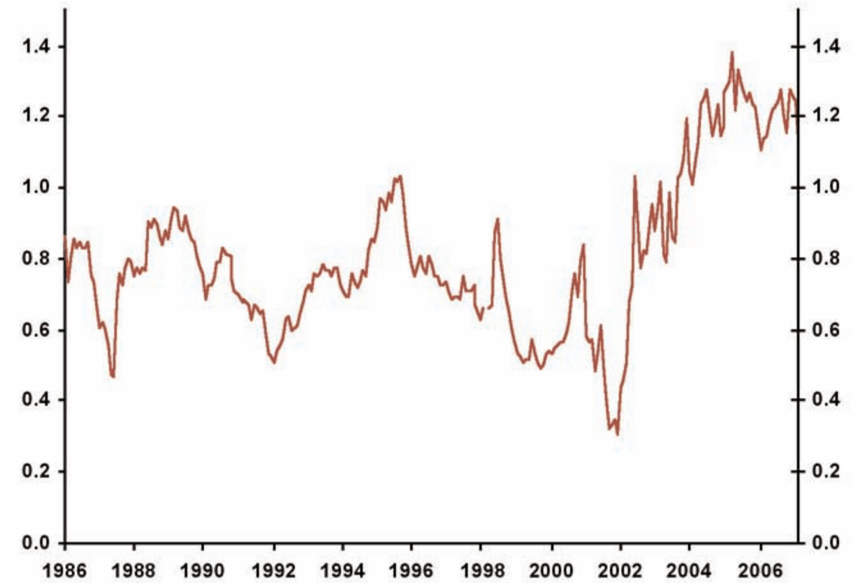
Shrinking Supply of Equities

The growing demand for equities is being offset by a shrinking supply due to high level of share repurchase or buyback programs, companies being acquired by private equity groups, and the low level of initial public offerings, resulting in a net reduction of stock available for purchase. The shrinking equity pool is especially the case in Canada where there were 1,968 mergers and acquisitions for a value of $257 billion in 2006.

Equity Valuations Still Attractive Relative to Bonds

We continue to view today's bond yields as less attractive than their equity counterparts (a ratio higher than 1 indicates a higher earning yield than bond yield). Equity earnings yields (earnings/price) are about 0.5% higher than bond yields. Suggesting continued good relative value in the equity markets compared to the historical average since the mid-80's of about 0.7.

S&P500 Earnings Yield Over U.S. 10 Yr Bond Yields



Conclusions and Outlook

We do not view the current level of interest rates as high enough to prevent a further stock market advance. It is, however, a reflection of global economic strength and some signs of inflation, which we view as a modest risk. As two thirds of inflation is wage dependent, we are comfortable that wage driven inflation will be contained through persistent globalization and efforts such as outsourcing. Inflation risks are modest, valuations are reasonable, balance sheets are strong and demand for equities by strategic and passive investors remains high. While we do expect that we will see some continued volatility, we are confident that financial markets will digest the recent interest rate increases and resume their advance later in the year.

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