

The Global Bull Market has Further to Run

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May 31, 2007

Despite record highs in global equities, we continue to have an optimistic view on global stocks and remain overweight both in the U.S. and overseas. Global equities have recovered shakily but steadily since 2003 from the steep drop that began in 2000. With many markets at record highs, it is not surprising that some investors may be getting nervous and are suffering from acrophobia.

Global stocks remain cheap.

Despite over four years of rising prices, stocks remain cheap by our valuation measures. Stocks are cheaper because earnings have grown faster than prices and the price/earning multiple has fallen. Yet we believe a higher multiple is justified, as inflation and interest rates remain relatively low and there is little to suggest they will move significantly higher. In addition, the volatility of economic growth, employment, inflation, interest rates and the markets themselves has declined on a secular basis. Lower volatility implies less uncertainty and helps justify higher multiples. There are a number of reasons to expect volatility to remain muted. Monetary policy around the world has become

more disciplined, acting as a regulator on growth and inflation. Growth and profits have become more stable, as corporations continue to outsource low value-added functions to low cost providers and focus on knowledge based value-added functions. While corporations retain R&D, product design, marketing, distribution and financial functions, they outsource production. If economic growth slows, production may have to be cut, but profit, employment and growth become more stable. Globalization is creating greater economic stability for everyone.

Market fundamentals remain very healthy.

- The slowdown in U.S. economic growth can be attributed to weakness in housing and an unseasonably cold, wet winter throughout the country. Looking forward, we see housing stabilizing which should remove a big drag from growth. A return to normal weather should also lead to a snap-back in demand.
- Global economies, with the exception of Japan, have been surprisingly robust. We believe they are likely to remain so as the world continues to move toward free market capitalism. Global growth

and trade are booming. Taxes are being cut around the world, with income tax cuts in Hong Kong and Singapore, and the elimination of the capital gains tax in Malaysia. Even Europe has shown more resilience than expected. As it continues to move forward with labor and regulatory reform, the prospects for growth remain positive.

- We are seeing a major structural shift underpinning global growth that is in its early stages. Two to three billion new producers and consumers in countries like China and India are moving from a rural subsistent existence to urbanization and middle class status. As a result, we are likely to see growth and investment opportunities accelerate. The magnitude of this shift is even larger than what was experienced in the U.S. from 1945-66, when the middle class was built out, with increasing homeownership, booming auto sales and massive infrastructure projects driving strong economic growth and productivity gains.
- Contrary to popular fears, global economic activity appears to be accelerating. Real interest rates around the world remain low and below economic growth rates. With real rates low relative

to GDP growth, there should be plenty of opportunity to leverage growth. Global monetary aggregates are increasing everywhere and liquidity remains abundant. Significant market declines generally don't occur when interest rates and inflation are low, growth is picking up, and monetary aggregates and liquidity are expanding.

- If we are right on our outlook for a growth reacceleration, earnings are likely to continue to surprise to the upside. Despite much better than expected earnings in the first quarter, expectations for the second quarter remain muted and could prove to be a low hurdle to clear. Global forward earnings continue to hit record highs in spite of modest expectations. This is an extremely bullish sign for the global economy and world stock markets. Corporate profit is among the best leading indicators of economic growth. Profits drive employment, capital spending and construction.

- The supply of stock continues to shrink. Corporate cash flow remains strong, cash balances are growing, and the level of debt remains low. Successful corporations don't sit on piles of cash and little debt. They either find attractive investment opportunities through expansion or mergers and acquisitions

(M&A), or they return money to shareholders through dividends or share buybacks. This reduces the supply of stock outstanding and pushes prices higher. Announced corporate buybacks of stock for the first four months of the year totaled \$430.5 billion, which is on a pace to set a new record. In 2006, \$1.04 trillion in stock was bought back.

- In addition to corporate buybacks, M&A activity and private equity deals shrinking the supply of stock, governments and central banks are diversifying their massive reserves. Over the last few months, China, South Korea, Taiwan, Japan and Russia have announced plans to reallocate accumulated reserves away from government bonds to riskier assets. In all, there are 24 government investment funds around the world that have been created to diversify reserves.

Market internals remain positive (trend, momentum, breadth, sentiment)

Global market momentum remains very positive. The only fault we find is that markets are getting stretched as they rise well above their long-term trends. However, the long-term trend is clearly up and the advance has been broad based. Most global equity markets are at or close to all time highs. The breadth within markets is also very healthy, with

most stocks moving higher. From a sentiment perspective, there still seems to be an active contingent of "gloom and doomers." Although investors are clearly optimistic, they don't yet appear to be overly, rabidly optimistic. Short interest on the New York Stock Exchange, even adjusting for the increase in the number of hedge fund traders, is at a record high, so short covering could propel stocks higher. The put/call option ratio is also relatively high and indicates some internal skepticism.

What could derail the bull market?

Although we are optimistic, we continue to assess risks and wonder what could go wrong. Outside of some geopolitical shock, we believe the most likely catalyst for a market pull-back would be higher interest rates. If the ten-year U.S. Treasury bond yield were to climb above 5.25%, bonds would start to become more competitive with stocks and the housing slowdown could be more protracted. The market set backs in the summer of 2004, the spring of 2005 and the spring of 2006 were all preceded by higher rates. Another risk factor is the threat of tighter Fed policy. Currently the Fed is on hold but, if growth accelerates, investors may begin to price in additional Fed rate hikes. Stocks could also be hurt if the prospects for higher tax rates on income

and capital investment were to increase. Finally, ahead of the 2008 election there is the risk of policy mistakes such as overt protectionism that could undermine confidence in the global economic recovery. In addition, during heated election years when political rhetoric is at its highest, uncertainty is created as investors ponder the implications of potential policy changes.

Sources: Bailard Research, Ned Davis Research, Bear Stearns, GaveKal, Bloomberg

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