

The Year of Living Dangerously



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Long before one year ends and another begins, it is possible to observe and make educated guesses about near-term investing patterns. Predictions are certainly not science—perhaps they are not even art. But by talking with and listening to a multitude of people around the world, you can develop a perspective that is useful for investing.

Fear versus Greed

Over the years, I've learned that one of the most meaningful indicators is the swing of the fear-greed pendulum. Since Sept. 11, the pendulum has been stuck on the side of fear. First, it was because of terrorism, then the threat of terrorism, and then persistent problems in the Middle East or from SARS, avian flu, tsunamis, earthquakes, rising energy prices and massive US deficits. Ordinarily, when the pendulum swings too far to the side of fear, investors hide money under the proverbial mattress, preferring the safety of bonds to the risks of equities. Sure enough, bond markets have performed well over the past five years, and, until mid-summer, developed-market stocks stagnated. But the success of emerging-market equities and the recent stock run-ups in the

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US and Europe despite high or rising interest rates tell us that something else is going on. Is fear abating? Is the pendulum now shifting toward greed?

The Five Stages

Not exactly. To understand what is really going on, it might be useful to consider an analogy to the five stages of grief Elisabeth Kubler-Ross identified in her 1969 book, *On Death and Dying*. Kubler-Ross wrote that when people learn that they are dying, they go through five stages: denial (This isn't happening!); anger (Why is this happening to me?); bargaining (If things get better, I promise to be a better person); depression (Who cares anymore?); and, finally, acceptance (I get it). After Sept. 11, the US and the world went through a brief period of intense denial; the attacks on the Pentagon and World Trade Center were simply unimaginable.

Denial was quickly followed by anger, which manifested itself in an immediate, visceral response by the US military in Afghanistan and Iraq. The response was deemed necessary but was poorly thought through, and it generated more denial and anger around the world, as well as a kind of collateral outcome—a “the world is coming to an end” perspective, which was reflected in the rapid decline of stock markets all over the world.

By 2003, though, investors had entered a new stage. It was akin to Kubler-Ross's notion of psychological bargaining; since the world had not come to an end (at least not yet), investors focused on putting money to work in a world hemmed in by fear. There was the carry trade, as central banks pumped liquidity into the global monetary system to avoid a recession, or worse—a market meltdown. And there was the run-up of emerging-

market equities, which benefited from the carry trade as investors noticed that certain nations were using lower interest rates to put their economic houses in order and build global export markets. It is perhaps surprising that between 2003 and 2006, a period marked by many dark days, investor performance sparkled in so many areas, as nations marched along the path of reform.

Prospering from Fear. Watching for Greed

This brings us to 2007. In many ways, depression pervades—many things are not going right, and it is harder than ever to guess the future. Yet smart investors are poised to prosper—not necessarily from the prospects of a better tomorrow, but from the fears of others. Depression always makes investors cautious, so investors who can confront fear and use it to their advantage can move way ahead of the game.

Are you afraid that governments are going to subject your company to increasing scrutiny and regulation? No problem. Use private equity and pursue a management-led buyout, like the chief executive officers of Kinder Morgan and Aramark did this past year. Those two deals, valued at \$27.4 billion and \$8 billion, respectively, are just the beginning of what I believe will be a wave of management-led buyouts.

Afraid your company won't be competitive in the future, given the unparalleled progress of the Chinese? No problem. Use more private equity and buy dependable cash flow for years to come. As psychological depression about the future makes investors more risk averse, look for more of those types of deals in 2007.

Concerned about your own personal future? Nearly 3 billion Asians are worried, which is why they are pouring money into savings, private pensions, real estate and educa-

tion for their children. You might consider this a positive response to fear, but it is a reaction to fear nonetheless. Limited access to education in Asia will unleash an explosion of new educational venues there in 2007. Just as the city of Palo Alto, Calif., and Stanford University formed a partnership that benefited both, cities in India and China could form similar town-gown partnerships that would benefit municipalities and investors alike.

Scared of globalization? It's making several hundred million Latin Americans nervous, which helps explain why the region is shifting toward populism. Bolivia, Ecuador, Nicaragua and Peru moved left of center in 2006; look for other nations in the Western hemisphere to follow in the coming year. We're even hearing protectionist noises in the US from Republicans and Democrats alike. The same goes for parts of Eastern Europe, where the first blush of economic liberalization has faded. There, people who are not making enough money to enjoy the gilded life of the European Union are worrying about whether there will be enough gas to avoid freezing to death this winter.

Finally, for anyone worried about energy prices, take comfort in the expectation that an economic slowdown, albeit a soft one, will depress the high cost of crude oil, just as alternative energy sources begin to take hold. That ought to brighten the prospects for all—perhaps not enough to get us to acceptance, but certainly enough to allow us to live with our fears for one more year. Meanwhile, notice what happens when fear is replaced by opportunity. Having just returned from China and India, which are experiencing high growth rates, I wonder what would happen if the rest of the world could share the same sense of opportunity and begin moving forward. ■

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