

With global tensions mounting, it's time to take stock

With hostilities mounting in the Middle East, missiles flying in North Korea, militia-led killing sprees in Baghdad and terrorist attacks in India, it is no wonder investors the world over are losing their appetites for stocks.

Combine these flaring geopolitical tensions with slumping market averages and sharply rising oil prices, and it's hard to blame people for their lack of confidence in the global capital markets.

Today there are enough reasons for investors to be concerned about the political effects of world events on their investment portfolios, even if it only partly informs their decision-making process.

So, to which asset class should investors now turn?

Gold is consistently the most negatively correlated asset to stocks and has long been considered a safe-haven in times of uncertainty. But before you start packing your bags for El Dorado, it is worth considering another traditional investment that has been neglected for several years – the large cap US stock.

Large caps, sometimes referred to as blue chips, are companies with a total market value (or market capitalization) of \$5 billion or more. These are the big firms of the financial world, typically considered to be relatively stable and secure. Many well-known companies fall into this category which includes household names such as Wal-Mart, Microsoft, and General Electric.

Although large caps have been outperformed by their smaller peers by an astounding 33% over the last 3 years, their attractive valuations should limit downside risk in today's uncertain times. In fact, a down market may just be what it takes for large caps to break their underperforming ways.

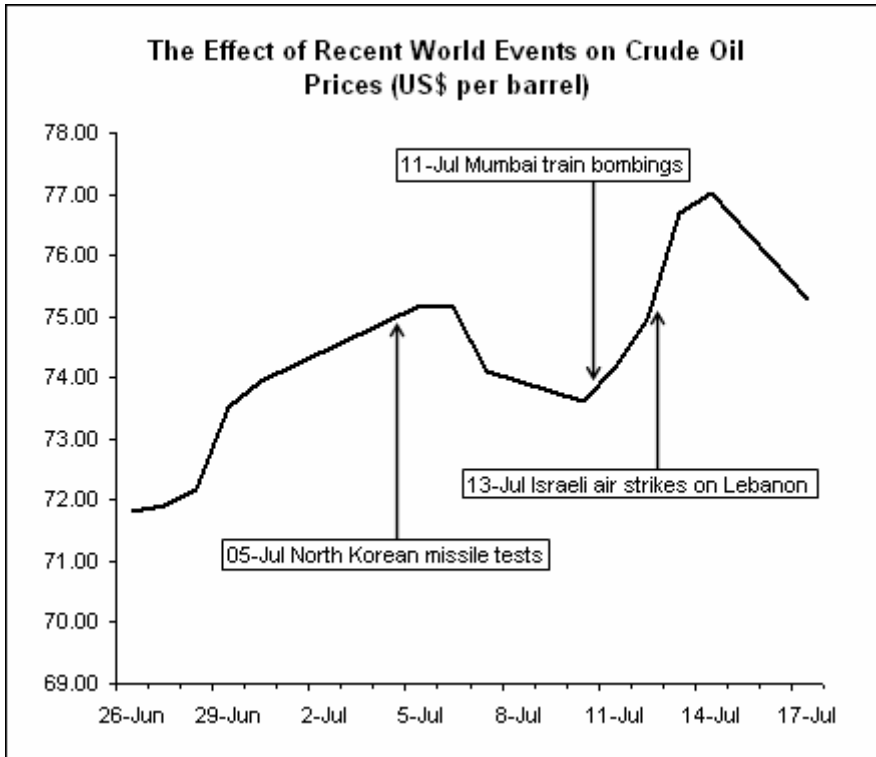
It takes courage to buy in times of trouble and wait out in times of war when everyone else is succumbing to fear, dumping shares and contemplating flight. We are talking, of course, about the war between Israel and Hezbollah, the guerrilla group in Lebanon.

The accelerating conflict is raising tension in a region that is already strained by the ongoing chaos in Iraq. The result has been steep price corrections, especially of riskier asset classes such as stocks, while volatility has also increased significantly.

But the danger posed by ethnic conflict is hardly new. Crises come and go, and the markets digest and re-price as events require. Middle East fighting has almost never done long-term damage to the US stock market, except when economic fundamentals have been seriously damaged, usually by a disruption in the supply of oil.

For the oil market, the real danger is that the situation escalates to the point that Middle Eastern producers feel the need to become embroiled in the turmoil. Iran, in particular, has become increasingly confrontational in promoting its anti-Western agenda and any Iranian involvement poses a real threat to the already tight global oil market.

An "Iran Risk" and other speculative premiums have certainly been factored into the oil price, although their amount cannot be determined exactly. If the oil price remains for a longer time at a level of US \$70/barrel or higher, inflationary fears can be expected to persist or even increase. This would spell bad news for investors and present a threat to US and global growth.



Source: Bloomberg, 2006

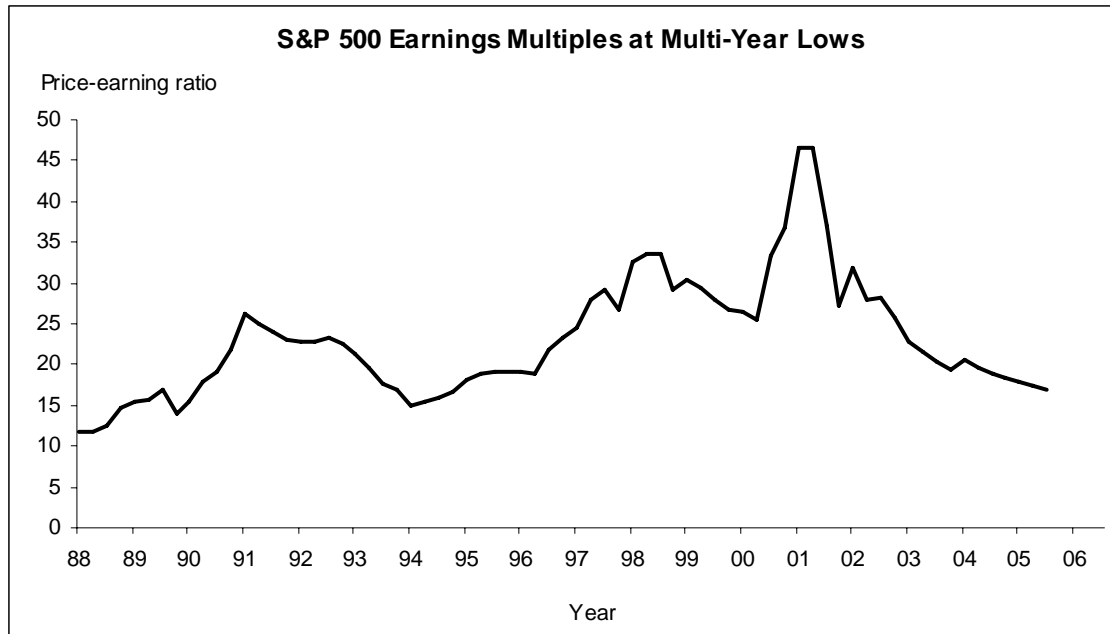
No one knows how long these elevated tensions will last or the extent to which they will create real supply disruptions. But it's probable that today's persistently resilient economy and markets are less sensitive to energy shocks than in the past and may even create opportunities for investors.

The underlying strength of the world economy and financial markets resulting from improved fundamental data and solid company balance sheets remains intact such that even a modest relief from the geopolitical turmoil could promote healthy rallies.

Fundamentally, the recent downside volatility in the global equity markets is an overreaction to an oil-driven inflation scare and presents a buying opportunity. This is especially true against the backdrop of expected growth rates in the world economy. The global economy should grow by slightly more than 4% in 2006 and somewhat less than 4% in 2007, which is still above the long-term average of 3.5%.

In the US, the economy showed an extremely strong first quarter with a growth rate of 5.3%. Although a slowdown is expected for the later half of the year, the S&P 500 earnings (a widely used benchmark for large cap US equities) are expected to grow 13.1% for the year, well above the historical average of 8.5%.

Despite strong earnings, valuations continue to price in downside risk. The chart of S&P 500 price-earnings ratios over time highlights just how inexpensive these stocks are by the standard of the past decade.



Source: Standard & Poor's Investment Services, 2006

In addition to reasonable valuations, strong corporate balance sheets continue to add to the attractiveness of large cap stocks, while limiting downside risk. Their well-capitalized, multinational holdings are better equipped than small caps to deal with the immediacy of what could well be a serious geopolitical shock, complete with sharply rising oil prices and related blows to consumer confidence.

Other factors supporting large caps include better ability to weather the deceleration of economic growth, higher dividends, better capital accessibility, and a higher percentage of revenue generated overseas.

So if you haven't taken advantage of the recent US market correction, and have cash to deploy, this remains a buying opportunity.

Investors need to be more than just aware of the possible threats to their wealth and should keep an eye out in the weeks ahead for opportunities to exploit the downturn in the stock market. History has proven that, even in times of crisis, the disciplined long-term minded investor still manages to make a buck and no less will be true in the future.