William Blair

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# Current Macroeconomic Crosscurrents: Market and Portfolio Implications
Conference Call Transcript

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**With George Greig, Partner, Investment Management**
**Global Strategist and Portfolio Manager**
**Moderated by Stephanie Braming, Partner, CFA**

## Introduction

**Braming:** The market has declined over the last several months given recent political events in Europe, and the potential impact on previous agreements on austerity measures for Greece and the other peripheral European countries. In addition rhetoric has increased regarding Greece's potential departure from the European Union, increasing concerns that other peripheral European countries could follow and the potential for circa-2008 contagion effects globally. In Asia, after abating earlier this year, concerns have increased about a potential hard landing in China along with the ramifications for global growth. How should investors think about these macroeconomic issues in relation to investment opportunities and risks? Are the opportunities for risk assets compelling? And, if so, how should investors look for opportunities? George will address these questions and more in his prepared remarks.

## Current State of the Market

**Greig:** Stephanie set the stage for the issues that have caused the second quarter market correction, which has pushed a number of year-to-date Index returns close to or below zero percent. A number of equity indices are at or below fourth quarter 2011 lows in valuation and, in some cases, at low absolute levels in an historic context. Over a 25-year period, valuations outside the U.S. are similar to year-end 2011, and in Europe close to two standard deviations below the long-term Euro-area P/E ratio. The U.S. is not as undervalued but it is in the range of one standard deviation below its long-term norm. This pattern is repeated both in developed and emerging markets.

Using prospective measures of long-term return potential, such as a combination of dividend yield, excess free cash flow yield and expected growth, generates return expectations of 8-15% for global equities. Using a dividend yield plus a historical growth measure also yields a similar return expectation. Mixing into these expectations a projection of the probability distribution of future normalized P/E ratios only enhances this return potential. As a result, this is a market environment in which the realistically expected rate of return for equity investing is equal to or above long-term normal trends compared with a psychological environment in which equity allocations are at a minimum. The fear factor exhibited by both retail and institutional investors has pushed allocations to an extreme in the direction of low risk and safe fixed income assets. This presents an asset allocation and valuation dilemma, which is analogous to the dilemma in assessing fundamentals.

## The Corporate Performance and Global Growth Environment

**Greig:** We believe that the global recovery and growth pattern is modestly decelerating, paralleled by a pattern of fairly strong 10% global returns on invested capital and mid-teens returns on equity. Global corporate performance is fairly strong. We believe there is a stable recovery pattern in the U.S. and a low growth slump recession in Europe (in a low volatility way as most cycles tend to be in Europe), combined with some degree of decelerating Chinese growth that seems like it is neither a hard or soft landing but something somewhere in between: a measurable deceleration but not one that appears to be unstable or out of control. In that context there is fairly stable fundamental performance globally. Shorter term measures of corporate and economic performance, such as earnings revisions ratios or leading economic indicators, reflect the same results: a basically stable up and down trend in which the market is now in a trough. There has been some deceleration in earnings growth expectations from six months ago as expected 2012 earnings trends fell from the mid-teens to mid-single digits, with a similar downshift in economic expectations, although both appear to have stabilized globally. As a result, as we read the headlines and assess the risk associated with headline events we are not making a connection between the tone of those headlines and the data that is reflective of the fundamental trends. The only way to reconcile that is to project the probability of an unstable event as an outgrowth of risks either in Europe or in China. Current conventional interpretation of events is not enough to justify valuations or the extremely conservative asset allocations that currently exist. In order to justify minimal equity exposure at the current extreme valuations, investors must expect a financial system destabilization equivalent to 2008 but with a longer duration, more severity and less recourse to solve. Our interpretation is that is a highly unlikely scenario. Our central case interpretation of what to expect in Europe continues to be a muddle through scenario in which a combination of political measures, ad hoc financial solutions, central bank assistance, and fiscal measures are thrown at the problem, as political compromises are pushed to the brink by both European and national politicians. The end result is a set of messy compromises that in the final analysis preserves the capital, the integrity, and the liquidity of both the fiscal regimes and of the underlying banking systems. It will clearly be something investors will not be satisfied with from an intellectual point of view. It will be enough to hold back growth in 2012 and lead to a sub-par recovery in 2013. Combining that outlook with what we expect in other principal world economies essentially results in a blend of 2012 global growth slightly slower than 2011 with a moderate recovery in 2013, but not significant volatility in overall aggregate global growth.

## Strategy and Investment Implications

**Greig:** As a result, current strategy suggests a significant overweighting in equities and real assets (including real estate) relative to fixed income and commodities. In 2011 it was possible to be bullish on both low risk fixed income assets and commodities at the same time. That unusual confluence is over. The global growth deceleration really takes the heat off the commodities markets, resulting in a potentially weaker commodity pricing environment. At the same time, low risk government bonds have been overexploited and provide an unusually unfavorable risk/reward picture, whereas equities and real estate in particular offer the potential for returns approaching a double digit level. As a result, there is a major gap between assets that appear to offer double-digit return potential and safer assets that offer little or no return potential. In that context, I would focus on an asset allocation strategy that tilts toward active return-seeking strategies both in terms of asset class selection and in terms of security and asset selection within asset classes. Investors should focus on a strategy that tilts towards cash-generating assets (in particular assets with free cash flow and distribution capability to ultimate investors).

The safe asset allocation in today's market is to seek assets that can generate high returns on a cash basis. What that suggests is not speculating about the relative performance of high quality versus low quality assets, but emphasizing offensive quality assets (those that generate high quality growth and cash flows) as opposed to high quality assets defined as those with low volatility. Within an equity strategy framework geographically, I believe the emphasis should be on developed markets, which currently have the real standout valuation opportunities as opposed to emerging markets, although the recent emerging markets correction has brought that playing field closer to level. It also suggests emphasizing consumer and producer markets as opposed to commodity and infrastructure markets. For instance, within developed markets Europe, Japan and the U.S. would be emphasized, while markets such as Canada, Australia, and other industrial and resource-oriented markets would be de-emphasized. A similar strategy exists in emerging markets: emphasize consumer-oriented markets and high end trade-oriented markets at the expense of commodity-focused and infrastructure development focused markets. From a sector perspective, the tradeoff between earnings trends and valuation leads to an overweighting of Discretionary, Healthcare and IT – high value added parts of the global economy. Industrials and Financials are neutral as they are a mixed bag globally, while commodities and non-growth, non-pricing power sectors such as Telecoms and Utilities are underweighted.

There is also currently a significant discrepancy in valuation and fundamental performance between large cap and small cap equities, which is almost unprecedented in recent memory, as large cap equities are significantly advantaged relative to their smallcap counterparts both in terms of return on equity, return on invested capital and valuations. That discrepancy highlights an interesting point on the nature of the market environment, which is the increasing bifurcation by both retail and institutional investors between totally safe assets and totally speculative assets. It is a strange phenomenon in which investors seem to be saying, "I'm going to be safe on the one hand with low and no risk assets. On the other hand, I'm going to speculate with very high risk, speculative strategies often involving derivatives or other speculative alternative vehicles." What gets neglected is the body of assets in the middle, the plain, efficient market-based cash flow return assets in terms of mainstream equity, mainstream fixed income, and mainstream real estate. It is those "plain vanilla" areas that seem to have the strongest return opportunities both on an absolute and relative basis today.

## Questions and Answers

**Braming:** Given what you said about your muddling through outlook for Europe, coupled with current valuations, are you thinking about increasing bank exposure now? This is one area that we increased late last year and then decreased as stock prices rose through early February.

**Greig:** The European banking sector is a mixed bag. Investors know what the problems are within European banking. There are two broad areas that are problematic for European banks. The first is that European banks are extended in terms of their lower capital ratios relative to the rest of the world, the standards proposed under Basel III, and certainly relative to their U.S. counterparts. The process of deleveraging the European banking system by raising capital, reducing assets and consolidating the asset base is a process that inhibits growth and has a necessary negative impact on returns. That has occurred as returns on equity in European banks have been reduced from the high teens to approximately 10x. There has also been a dramatic hit to the European bank return on equity both absolute and relative to the industrial sectors. The second problem for European banks is that in some markets there has been a significant increase in non-performing assets: Spanish and Irish real estate and in general lending in Southern Europe. That is just a normal, typical phenomenon that has contributed to the decline in returns on equity. On the other hand, it is worth noting that European bank price/book ratios have over-discounted these effects. Now in many cases there are relatively strong performing banks at 0.4x, 0.5x, 0.6x tangible book which, in our opinion, more than discounts the contraction in profitability. It is worth remembering that a lot of the sovereign debt exposure has really been taken off the balance sheets of many banks. It does not provide a systemic risk to a lot of these banks with a small handful of notable exceptions such as Dexia and Bankia. I believe the perception of risk in this sector is out of proportion to the fundamental trends. And in that context, we have stuck with and, in some cases, increased some of our exposure in European banking and insurance exposed assets. Although we are not overweighted in Financials broadly, I believe the exposure that we do have in higher quality financials should produce satisfactory returns over the remainder of this year and next year.

**Braming:** What are you seeing in China and what are some red flags or opportunities to look for in that market?

**Greig:** There is a mixed picture in China. Last year's attempt by the government to slow down price increases and transaction activity in the most overheated housing markets and related real estate asset speculation was successful by restricting credit in those areas. At the same time, there was a degree of maturity being reached in some areas of infrastructure investment, as well as the growth of industrial capacity particularly to support primary and basic industry. All of those events meant that for a variety of reasons there could be the beginnings of the slowdown in the commodity industries in China, in the infrastructure investment-related industries, and in real estate investment. There are offsetting factors to a lot of these issues in that as high-end private housing slowed down, low-end government-subsidized housing accelerated. As housing sales slowed down, housing completions were accelerating. As industry in the coastal provinces slowed down, industrial investment in the interior provinces maintained a higher level of growth. There was also a change in the complexion of China's export industries which meant that as China was losing share in some parts of low value exports, it was gaining share in some areas of higher value manufacturing and assembly exports. The overall picture was a picture of deceleration but with a lot of crosscurrents from a regional and industrial perspective.

The current picture of China that has emerged is of an economy where the deceleration is focused on heavy industry, commodity intensive areas and lower value added production in which China's output is either not growing as fast as it was or is not as competitive as it was. This is somewhat but not completely offset by increases in growth, consumption, and in service areas of the economy and the continuing development of the interior of the country. The picture that emerges is not an unstable hard landing or economic crash, nor is it a soft landing, but something in between. I believe the government's growth target, which was reduced from 9% to 8% or 9.5% to 7.5% is going to be more like 9.5% to 6%. I do not believe the economy will hit the wall and have a panic of 1907-type air pocket in the Chinese economy. I believe there will be a pretty significant economic and profit deceleration but not a real crash. I would hasten to add though that given the complexity and obscurity of some of this data we are looking for new signals all of the time.

**Braming:** What is the likelihood of Greece actually leaving the European Union? What would the impact be on the European Union and the global economy if that were to happen?

**Greig:** I do not have an unbiased answer, as my viewpoint is not the consensus opinion. I believe the consensus opinion estimates that there is about a 40% chance (30-50% depending on the specific source) of Greece leaving the European Union or leaving the euro. I believe it is much lower than that. I believe that the new Greek government, whatever its composition, will find through feedback from the market, feedback from the European Union, and feedback from the Greek people that the desirability of renegotiating anything in such a way as to jeopardize membership in the euro is not going to be the right plan. There will likely be brinkmanship on this renegotiation from both sides but that in the end, the willingness and ability to compromise will be found. There are a million different variants on this scenario both for debt and for budget implementation compromises.

Now if it were to come to pass that some kind of impasse dictated that Greece withdraw or somehow was unable to continue in the Eurozone, I believe a way that it would come about would be through the adoption, promotion, or distribution of some kind of secondary currency. Some have speculated about the potential introduction of some kind of scrip or IOU, such as Continentals issued in the U.S. in 1777. It would likely be a parallel currency that would likely circulate on a temporary basis and possibly even a local basis. While that was going on, Greece might in some official way withdraw from the euro system in some local fashion: very messy, very speculative, hard to pin down and hard to know how it would work. Under any circumstances that might evolve, the euro would continue to be a dominant medium of exchange and store of value throughout the Greek economy. Any exit would be only a partial exit because asset holders would cling to euros, and contracts denominated in euros would be settled in euros if at all possible. There would be a big mess like in Argentina in the 1990s or in Ecuador earlier in this decade. It would be similar to Montenegro or other places with currencies that are not fully functional. That would prove to be unworkable for more than a brief period of time, and the end result would be some kind of re-assimilation back into the Eurozone.

I think that is a worst case scenario. What I consider to be extremely unlikely (<10% probability) is some kind of neo-Drachma that becomes a viable long-term alternative to the euro. I do not see that doing any good from an economic point of view. I do not see anyone accepting it. I do not see the ability of Greece to administer that efficiently from a central banking point of view. That is a pipe dream.

*[end of recording]*

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As William Blair & Company's Global Strategist for Investment Management, Mr. Greig has headed the firm's international investment management team since 1996. His hands-on, bottom-up approach takes Mr. Greig and his team around the world. As of 9/30/11, the team manages $21.9 billion in non-US assets. He has more than 30 years of experience in domestic and international research and portfolio management. Before joining our firm, Mr. Greig headed international equities for PNC Bank in Philadelphia and previously served as investment director, as well as managing global and emerging markets funds, at London-based Framlington Group. Mr. Greig received his B.S. from the Massachusetts Institute of Technology and his M.B.A. from the Wharton School of the University of Pennsylvania. Mr. Greig has been featured in numerous publications, including The Wall Street Journal and Barron's. In addition, he is a frequent guest on CNBC's Kudlow and Company and was a panelist on SmartMoney's Annual Investor Roundtable in 2006 and 2007.