Macro Markets and Micro Opportunities

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In 2010, the equity markets were driven predominantly by "macro" forces, resulting in an environment characterized most accurately as "risk on" or "risk off". High correlations of returns existed among and within many industry sectors. Now, with the New Year upon us, many investors are hoping that 2011 will herald a return to a more "micro"-driven investment landscape, in which the effects of skillful stock selection play a bigger role in market performance. Regrettably, this outcome is unlikely. As in 2010, macro issues – such as reflationary policy efforts, currency tensions, fiscal issues and pipeline inflation – will dominate the investment scene in 2011.

For perspective, let us borrow the lines from former Secretary of Defense Rumsfeld; there are "known knowns", "known unknowns" and "unknown unknowns". What are the "known knowns" of the investment landscape for 2011? First, we know that a global economic recovery is underway, primarily centered within the emerging economies. In less than two years, more than half of the world's GDP will be derived from the G-13 (the G-20 less the original G-7, which consists of the U.S., Canada, Japan, U.K., France, Germany, and Italy), as shown in Figure 1. If capturing growth matters, an investor needs to be invested in these emerging economies, notwithstanding the inflation scenarios currently evolving in places like China.

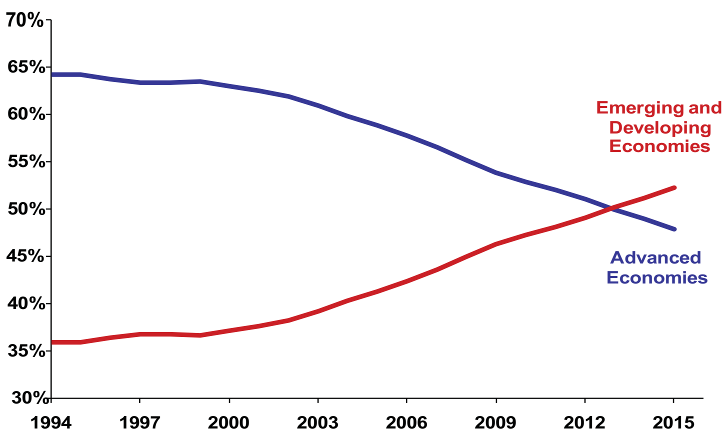

Figure 1: Share of world total GDP based on purchasing power parity (PPP)

Source: International Monetary Fund, World Economic Outlook Database, October 2010

A second "known known" is the fiscal situation reflected in the sovereign debt status of the developed countries and the policies being pursued to address this issue including austerity budgets in Europe, and the reevaluation of municipal spending and tax policies in the U.S.

Thanks to QE II, the extension of the Bush tax cuts, unemployment insurance and the payroll tax cut, a "double dip" recession in the U.S. is unlikely to occur in 2011. However, none of the aforementioned policy decisions will suffice as long term growth stimulants. Developed nations, particularly the U.S., will have to address these long term budget deficit issues eventually, and that will result in slower than normal economic growth for these countries.

Current equity valuations, while not at bargain levels, are not overly expensive by some measures. According to the Shiller CAPE (Cyclically Adjusted Price Earnings) ratio, the market is overpriced by nearly 20%. This methodology, however, ignores current interest rate levels, which suggest the market is actually undervalued by around 20%. But this observation, in turn, ignores the debt burdens of the G-7 countries, the negative demographic reality of these nations, and the situation in China where a property bubble and inflation are occurring alongside growth-oriented policy decisions. Nevertheless, equity cash flow yields relative to bond yields have not been higher in over 50 years, and that fact suggests that equities are attractive, at least in a relative sense.

Another important consideration: ever since the Great Depression, deflation has been this country's social nightmare. Today, U.S. politicians and policy makers will do anything to avoid it, especially in the current environment of large outstanding credit balances. Deflation and large debt balances are a recipe for calamity. As a result, the U.S. government has pursued deflation-averse monetary and fiscal policies, which, when combined with the fact that the U.S. dollar is the world's reserve currency, makes deflation unlikely[1].

[1] "As the central bank, we and we alone can control inflation - if not precisely in the short run, then over the medium term. By clarifying our intentions, we can reduce the risk of further disinflation," William Dudley, Vice Chairman, U.S. Federal Reserve, speech, October 1, 2010.

The ultimate bugbear, then, would be inflation. But this just is not in the cards for the U.S. in 2011, with the possible exception of commodities. The world is awash in labor, and capital is cheap, particularly in the form of debt. However, for those countries that have pegged their currency to the dollar (e.g. China), inflation is a real issue, especially without a currency adjustment on their part. These diverging inflationary paths can be seen in Figure 2.

Figure 2: Diverging CPI Trends = Diverging Policy Trends
Source: Wolfe Trahan & Co. Portfolio Strategy, Bloomberg, November 2010

What does all of this mean for investors? As previously mentioned, the chances of a deflationary "double dip" this year in the U.S. are slim. Equities, despite having higher volatility measures than bonds, will be helped by any evidence of an economic expansion, no matter how muted. Bonds, however, will be hurt by any signs of fiscal profligacy and inflation, no matter how benign. Equities do two things for the investor that bonds do not: they provide a hedge against inflation, and they capture the benefits of productivity gains through earnings growth. Stocks may wobble in 2011, but in the longer term they will beat bonds hands down with ten-year U.S. Treasuries at 3.3%.

So what are the big risks, or the "known unknowns," for 2011? In the developed markets, particularly the U.S., the looming uncertainties are employment growth and government budget policies. How will we balance revenue enhancements (taxes) and spending cuts in a way that allows us to address our large and growing sovereign debt issues while simultaneously fostering employment growth?

In Europe, the Sword of Damocles hangs over the Euro. The Euro has been weakened by the web of debt that exists among its constituent financial institutions, and there is no easy solution (Figure 3). The gross sovereign funding requirement over the next three years for the peripheral countries in the Eurozone (Greece, Ireland, Portugal, Spain, Italy and Belgium) is €1.5trn. This funding requirement may well be underestimated because the debt of the banking system has become integrally linked with sovereign debt, as recently evidenced by Ireland.

Japan also has huge demographic and fiscal policy issues. Unless the Yen/U.S. Dollar relationship starts to work for Japan such that its exporters prosper, the country will be in serious difficulty.

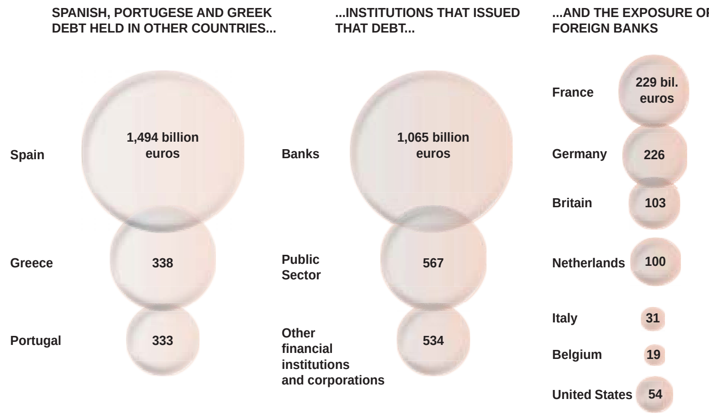

Figure 3: Following the Trail of Debt
Source: Royal Bank of Scotland, The New York Times, June 2010

The emerging countries will continue to grow but at a price; and that price is inflation. It is a major concern for China and will only get worse in the near term. The off-balance-sheet liabilities of Chinese banks, a national property bubble, and potentially weak export markets make China – and, hence, the other emerging economies – vulnerable to diminished capital flows, both directly and indirectly. This past quarter, we have already seen some exit of capital from mutual funds with investments in emerging markets.

Lastly, what are the "unknown unknowns"? By definition, no one can define them! But they are likely to be geopolitical in nature and predictable only in hindsight. That is why diversification matters for the investor. It is about shrinking risk around expected returns.

The message we leave you with is this one: even in a market that is likely to remain fixated on macro events, there are still plenty of micro opportunities. In the equity market, they will be found in companies that generate consistent free cash flow and whose management teams have a history of allocating capital to generate shareholder value. Seek firms that return capital to the business owners through cash dividends, stock buybacks, and debt pay downs, particularly in those instances when internal projects and acquisition opportunities offer returns that are less than the firm's cost of capital. Also look for those firms that can reinvest their cash flow internally or make acquisitions that are accretive to shareholder value creation. Many are available at reasonable valuations. All in all, the best opportunities are likely to be with companies that successfully grow the top line while protecting profit margins. In a world that may offer future equity returns consistent with historical levels of seven to ten percent per annum, such a focus should ensure very competitive outcomes for the informed investor.

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