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THE OUTLOOK

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Volatility, Valuations and Debt

"There are going to be market reactions whenever you're shifting from an economy that has had very low interest rates for a long period of time to an economy that has more normalized interest rates. While that is a positive story overall, there is a possibility that it will be a bumpy ride."

– Boston Federal Reserve President, Eric Rosengren in a recent WSJ interview

The shifting and uneven global recovery and ongoing divergences continue to place strains on the world economy and capital markets. In our April Outlook, we described a global economy that was undergoing an adjustment process that would lead to increased volatility as the rapid changes in currencies, oil prices, interest rates and central bank policies work through the system. Since that writing, the markets have not disappointed as evidenced by the sharp increase in the yields of government bonds as the amount of sovereign debt with negative yields decreased from approximately $3 trillion to an estimated $1.7 trillion. The 10-year German bund yield rose from a multi-year low of 0.03% on April 17th to 0.70% on May 12th. This likely contributed to 10-year Treasury yields backing up by approximately 0.50%, while the popular strong U.S. dollar/weak Euro trade, which had become quite crowded, reversed as well. Notwithstanding these recent short-term moves, the current global economic and geopolitical dynamics strongly suggest a continuation of low interest rates, low inflation rates and low growth for the foreseeable future as the global economy cannot tolerate a normalization of interest rates at historical levels under the present conditions. Due to the recent volatility, we wanted to remind our clients what we believe should matter most for investors in the coming quarters:

1. Longer term, the U.S. is and should continue to be the standout economy due to a number of structural advantages described in past Outlooks;
2. The U.S. economy, which slowed in the first half of 2015 due to weather, a stronger dollar and the west coast port problems, should continue to improve in the second half;
3. It would not surprise us to see a cyclical improvement in overseas economies (as signaled by strong international stock markets in recent months) as the benefits of lower oil, expansionary monetary policy and lower interest rates finally work their way through these systems; however, we view these to be transitory factors as the structural challenges for these economies remain unresolved;
4. A prolonged period of low interest rates will extend this business cycle and should result in higher corporate earnings and equity valuations over time;
5. We anticipate the recent increase in government bond yields can only go so far before higher rates eventually cause a slowdown in economic activity, but we have likely seen the near-term lows;
6. The low interest rate environment combined with rising concerns about illiquidity in the bond market and price distortions caused by what is essentially "forced buying" of sovereign bonds by many European financial institutions has raised concerns that bonds might be losing their value as an asset class; and
7. We share Mr. Rosengren's view that it may be a bumpy ride, so we suggest that investors focus on companies that can improve profitability in a world of increasing pricing pressures and where such companies should command premium valuations in the market.

Valuations

"I guess I would highlight that equity market valuations at this point generally are quite high. Now they're not so high when you compare the returns on equities to the returns on safe assets, like bonds, which are also very low. But there are potential dangers there. And in interest rates, obviously not only short but long-term interest rates are at very low levels. And that would appear to embody low term premiums, which can move and can move very rapidly. We saw this in the case of the taper tantrum in 2013 where there was a very sharp upward movement in rates and you do have divergent monetary policies, potentially around the world."

– Janet Yellen, interview with Christine LaGarde of the IMF

There has been a great deal of discussion about valuations with noted investors such as Bill Gross, David Tepper and Jeff Gundlach, each offering a different perspective on stock and bond market valuations. On May 6th, Federal Reserve Chair Janet Yellen weighed in during an interview with Christine LaGarde, President of the International Monetary Fund (IMF), at a conference in New York in which she said equity valuations "are quite high", which led to a selloff in the U.S. equity markets. However, a complete reading of her comments would lead to a different conclusion and one with better context – equity valuations are not so high when you compare their returns to those of bonds. Ms. Yellen was also preparing the markets for an eventual tightening move by the Federal Reserve which will impact not only the U.S. but also foreign markets as well. It has been our view that bonds will be a difficult investment at best with rising concerns about liquidity. Given the fact that the United States is moving closer to a tightening of monetary policy, it is likely that we will continue to see further volatility and movement toward a two-tiered market with clear delineation of the companies that benefit from those that do not, making security selection more critical than in recent years.

As a result of the strong dollar, the 15 largest emerging markets have experienced an estimated $600 billion of capital outflows during the past three quarters according to the Financial Times. Foreign exchange reserves for these nations have dropped by over $350 billion which reflects the stresses facing governments. The slowdown in China and the decline in oil prices have wreaked havoc on the finances of many emerging market economies. The Saudis have reportedly seen their foreign exchange reserves of $750 billion at the start of the year decline by $36 billion in just a few months as low oil prices, entitlement programs and the cost of military actions in Yemen are straining their budget. Elsewhere, the People's Bank of China (PBOC), on May 10th, cut its benchmark lending rate and one-year benchmark deposit rate by 0.25% as it seeks to lower borrowing costs and support the slowing economy. Brazil and Russia have raised interest rates in recent weeks to combat currency and capital outflow issues. The divergences in monetary policy and economic circumstances make the risks of chasing returns even greater which suggests that investment focus should be on markets with better liquidity and higher quality. For our clients, that means continued focus on the United States which is home to the most liquid and mature capital market system in the world.

Greece

"There is always a risk that other areas of policy will shy away from unpleasant measures and rely on monetary policy to sort things out … Sustainable growth cannot be built on a mountain of debt."

– Bundesbank President, Jens Weidmann, 5/4/15

The ongoing negotiations between Greece, the IMF and the European finance ministers are reaching another critical point in addressing the Greek debt crisis. On May 12th, Greece made a 750 million euro payment to the IMF with 600 million euros being paid with funds coming from Special Drawing Rights (SDRs) that IMF member nations can access in times of need from the IMF. In effect, Greece paid the IMF with the IMF's money. Greece's anti-austerity government, led by Syriza party leader Alexis Tsipras, was elected earlier this year with a mandate to end Greece's economic crisis that has seen crippling unemployment and poverty. The inability of the parties to reach agreement may push Mr. Tsipras to hold a referendum for the Greek voters to determine what austerity terms the people might be prepared to accept from their lenders in return for a bailout. The terms would include pension cuts and new laws that make it easier to lay off workers, similar to what the Germans implemented under the "Agenda 2010" program under Chancellor Schroeder. A referendum would be a risky but possibly clever political move by Mr. Tsipras to avoid backing away from campaign promises while letting the voters choose to accept the terms proposed by creditors or the potential alternative of exiting the Euro. Surprisingly, the idea of a referendum has recently received support from the German Finance Minister which is a sign of the frustration with the negotiation process. With high unemployment and ongoing challenges, many European nations need to continue the process of implementing structural reforms in order to return to sustainable growth, but high unemployment, especially for the youth, continues to make social stability a challenge for policymakers.

The Long Term Impact of Student Debt on U.S. GDP Growth

"For the moment, the depressing reality is that there is little chance of the $1.3 trillion debt shriveling. That is bad news for millions of households. But it is also unwelcome for the American economy, which can ill-afford to be weighed down by this oft-ignored debt mountain."

– Gillian Tett, Financial Times 5/8/15

There has been a lot written about the growing amount of student debt in the United States and the escalating costs of college education. Today, student loan debt exceeds $1.3 trillion and has risen from less than $325 billion in 2004. It is estimated that more than 20% of the payments are in deferral, delinquency or default which is a difficult way to build the foundation for future financial success. In 2012, 71% of college graduates left college with an average debt of over $30,000. The student debt problem has huge implications for the future as it keeps young people from starting families, buying houses and taking risks on new businesses. It also exacerbates the growing problem of wealth inequality and declining social mobility, since it gives debt-free graduates from wealthier families an enormous head start over their peers. Today's college graduates and younger workers are facing an improving, but challenged job market with stagnant wages. Federal and state budget cuts, meanwhile, have spiked tuition costs and cut public services that aid young workers, such as transportation and affordable housing. Unlike mortgage interest, interest on student loans has a maximum tax benefit of $2,500 and is not deductible for those earning over $80,000 as single filers and $160,000 as joint filers.

A different way to look at the impact of the student debt problem would be to compare the cost of servicing the debt to the potential loss of its contribution to GDP growth. Assuming the average student loan carries a 6.75% interest rate and has a 12.5 year term; the cost to service the debt is roughly $92.5 billion a year which is approximately 20% of the forecast for 2015 U.S. GDP growth of $450 billion. Given the aging demographics of the U.S., it is critical that our young people pick up the productive consumption spending that we are losing as the 11,000 baby boomers retiring each day will no longer spend at the same levels as they did during their working years. While the U.S. secondary education system is the envy of many nations around the world, the spiraling tuition costs are making it difficult for students to make a sufficient return on their investment if debt costs remain at these levels. More importantly, will students be able to justify the cost of college and graduate school in an environment of improving but still high youth unemployment and stagnant wage growth?

Investment Implications

As discussed in our last two Outlooks, the current global economic and geopolitical dynamics strongly suggest a continuation of low interest rates, low inflation and low growth for the foreseeable future as the world economy cannot tolerate a normalization of interest rates to historical levels under the present conditions. That being said, rates may not return to the recent lows and volatility is likely to persist. Under these conditions, investors should expect an extended business cycle resulting in higher corporate earnings and equity valuations over time. The United States remains the standout economy and we should see improvement in economic activity in the second half of the year. Under these conditions, areas of focus include:

1. **Technology companies** that are benefiting from unprecedented innovation and are helping their corporate customers drive down operating costs. These companies are familiar with operating successful businesses in price competitive environments. In addition, opportunities are developing from rapid technology advances including the large increase in the availability of wireless spectrum and the dynamic growth in mobility, connectivity, search, device sales, memory, data management and storage;
2. **Industrial investments** with well-defined end-market demand, including defense, transportation, power generation and aerospace companies;
3. **Consumer companies** with pricing power that can increase profit margins, improve overall profitability and benefit from lower input costs and stronger consumer spending;
4. **Financial companies** that benefit from continued low interest rates and easy access to financing such as real estate related companies;
5. **Healthcare companies** with technology-enabled breakthroughs, strong product pipelines and growing dividends; and
6. **Company-specific stories** with compelling valuations and strong company-specific catalysts or growth drivers.

As always there are risks to the investment outlook that we factor into our views. These include higher stock market valuations, illiquidity in the bond market, slowly rising labor costs, structural headwinds in developed markets (including demographic challenges and heavy debt burdens), rising student loan debt in the U.S., slower growth in China, the eventual interest rate increases by the Federal Reserve and ongoing geopolitical risks. However, our research continues to identify strong businesses that are well positioned to benefit from the conditions described above.