ARS INVESTMENT PARTNERS

THE OUTLOOK

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What Should I Do Now?

How U.S. Economic Strength and the Global Divergences Are Defining Investment Opportunities

"Our main expectation is not at all that we are expecting a recession. I did mention that there are these risks and we are monitoring them very carefully, and we are conducting policy in a way that will address them, but no I would not see a recession as the most likely outcome for the United States or the world for that matter."
– Jerome Powell, Federal Reserve Chairman in a speech in Zurich on 9/6/19

"What should I do now?" is one of the questions most frequently asked by our clients today. Many are trying to adjust to dramatic changes in the terms of global trade, geopolitical instability, and considerable shifts in monetary and probable fiscal policy initiatives against the backdrop of a slowing global economy. Amid growing talk of a possible recession, the recent drone attack on Saudi oil fields, the sharp drop in government bond yields, street protests and currency devaluations, it is easy to understand how investors could feel confused and uneasy. However, it is our strong belief that those very concerns as well as the relative strength of the U.S. and the growing economic divergences are clearly defining the best relative opportunities for investors. To be sure, there are valid reasons that the current economic and political climate is causing concerns for investors, but our base case is for the slow-growth expansion of the United States to continue for some time barring a major policy misstep. We view the recent yield inversion in U.S. Treasury Bonds as a reflection of the negative interest rate and currency issues of other nations as well as the strength of the United States economy rather than the traditional warning sign of a nearing recession. Given the character of the post-financial crisis global economy, we have been and continue to be in uncharted waters.

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Our base case is for the slow-growth expansion of the United States to continue barring a major policy misstep.

Based on current conditions, our answer to the "What now?" question is that this continues to be a time to be both appropriately cautious and opportunistic in order to take advantage of the mispricings of quality businesses that naturally occur in periods of heightened volatility. Today, investor focus should continue to be on companies that can grow revenues at an above-market rate, those with strong balance sheets that provide stable and growing dividends that are yielding more than bonds and the overall market, and

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those that are special situations including the beneficiaries of the many merger and acquisition transactions taking place. Additionally, many companies with higher-than-desired debt levels are taking advantage of the sharp decline in interest rates to refinance their debts and thereby increase shareholder value.

In these times of greater volatility and uncertainty, the typical investor tends to be more inclined to reduce equity exposure or pull out of the market rather than take advantage of the opportunities being presented. That is a speculative market-based approach rather than an investment-based approach, and generally leads to significantly lower long-term returns. Investors should always be focused on finding the best relative opportunities consistent with their specific goals and objectives. While growing social stresses, political divisiveness and trade tensions will likely remain top-of-mind issues, they should not lead to all-or-nothing market decisions as the best opportunities to build capital are born out of periods of great uncertainty.

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Why Growing Economic Divergences Are Driving Significant Capital Flows Into the United States

"Global growth is sluggish and precarious, but it does not have to be this way because some of this is self-inflicted."
– International Money Fund (IMF), World Economic Outlook, July 2019

As illustrated in Chart 1, the United States economy remains a standout due to the combination of relatively strong Gross Domestic Product (GDP) and population growth as well as our strong consumer spending, manageable debt levels and dynamic businesses. However, it is not without its own challenges. China and India, which have had strong growth rates and rising middle classes, are each struggling with their own country-specific social, political and economic issues that are contributing to a slowdown in their growth. Europe is challenged by flawed monetary and institutional structures, slow growth and difficult demographic issues. Europe's economic growth continues to deteriorate, and the slowdown in German manufacturing suggests further challenges lie ahead. Germany is the economic engine of Europe, and concerns about its growth have spurred discussions of the need for significant fiscal stimulus. Japan, the world's third largest economy, has had three decades of economic problems and is also plagued by a major demographic challenge as its population is forecast to decline by up to one million people per year over the next two decades. Slowing population growth in China and leading developed nations is a significant factor in the slow-growth and deflation-prone environment we have been writing about for several years. Adding to the divergences is the weakening of global currencies with respect to one another and the U.S dollar which has negative implications for U.S. dollar-denominated debt and demand for goods and services traded in U.S. dollars. These dollar-related stresses are especially acute in emerging market economies such as we have just seen in Argentina. [Editor's Note: For purposes of this Outlook, we are focusing on a high-level discussion of the issues and we acknowledge that there are many nuances that we are not addressing here.]

The weakening of global currencies has negative implications for U.S. dollar-denominated debt and demand for goods and services traded in U.S. dollars.

Chart 1: Diverging Economic Fortunes

	2019 (Estimates)						
Country	**GDP (Billions)**	**Projected Real GDP (% Change)**	**Dollar Change in GDP (2019 – 2020)**	**Gross Debt to GDP (%)**	**Current Population (2019)**	**Projected Population (2024)**	**% Pop. Growth (2024)**
United States	$21,344.67	2.60%	$853.45	106.70%	329.56	338.66	2.76%
China	$14,216.50	6.20%	$1,251.59	55.36%	1,400.17	1,411.18	0.79%
Japan	$5,176.21	0.90%	$319.22	237.54%	126.18	124.20	-1.57%
Germany	$3,963.88	0.70%	$193.24	56.93%	82.95	82.78	-0.21%
India	$2,972.00	7.00%	$285.72	69.04%	1,351.77	1,424.33	5.37%
United Kingdom	$2,829.16	1.30%	$97.92	85.67%	66.87	68.27	2.09%
France	$2,761.63	1.30%	$114.42	99.20%	65.02	66.22	1.84%
Italy	$2,025.87	0.10%	$64.58	133.43%	60.74	60.62	-0.19%
Brazil	$1,960.19	0.80%	$102.31	90.36%	209.79	215.11	2.53%
Canada	$1,739.11	1.50%	$93.38	88.01%	37.47	38.88	3.78%
World	**$87,265.23**	**3.20%**	**$5,045.04**	**225%**	**7,544.53**	**7,959.16**	

Source: International Monetary Fund (World Economic Outlook), July 2019

This has set the stage for the significant refinancing of U.S. government, corporate and household debt which would be highly positive for the economy.

Because of these factors, money continues to flow into the U.S. markets and with respect to fixed income is driving U.S. interest rates down. This has set the stage for the potential for the significant refinancing of U.S. government, corporate and household debt which would be highly positive for the United States economy. Current conditions remain relatively favorable for U.S. equity valuations as corporate profits are grinding higher, inflation remains muted, and central banks are reconfirming their commitments to keeping interest rates near historic lows. Norway has the world's largest sovereign wealth fund which owns an estimated 1.5% of every listed company globally. The fund recently announced its plans to shift its equity allocation by reducing its European equity weighting by around 15% and increasing its North American weighting by almost 17%. This change reinforces our view that the U.S. will continue to be the beneficiary of capital flows.

Why a Strong Fiscal Policy Response Is Even More Necessary Today

"Ever since the onset of the crisis, central banks have been widely regarded as the only institutions capable of taking action. I think that's wrong."
– Jens Weidmann, head of Germany's Bundesbank

The global fiscal policy responses, which have generally been insufficient and not well targeted, need to be more forceful to stimulate growth.

In a world full of uncertainties, there are a few facts that are important for investors to consider. First, economic growth is decelerating around the world driven in large part by restrictive terms of trade, disruptions to global supply chains, worsening demographic trends in the developed world, and too much debt in the global system. Second, the global fiscal policy responses, which have generally been insufficient and not well targeted, need to be more forceful to stimulate growth by addressing the specific needs, including infrastructure expansions and upgrades, that have developed and have been unmet for many years. As Jean-Claude Junker, the outgoing President of the European Commission once said about the political willingness to approve a strong fiscal policy response, *"We all know what to do, we just don't know how to get re-elected after we've done it."* However, one major benefit of a strong fiscal response would be the reduction of income inequality by raising living standards, stimulating wage growth and closing the skills gap. Third, monetary accommodation by central banks as an exclusive tool has reached the limits of its ability to meaningfully stimulate growth. However, that does not mean that central banks won't continue to push interest rates even lower, as evidenced by the nearly $17 trillion of government debt around the globe now carrying negative yields. As shown in Chart 2, the yields in major advanced nations are quite low already. The European Central Bank (ECB) recently announced yet another interest rate cut, and it is likely that the Federal Reserve will lower interest rates again at its upcoming meeting. Fourth, central bankers' efforts to manage inflation rates have failed as developed economies continue to be more deflation prone than anticipated, and inflation remains stubbornly low in those countries. In fact, it can be argued that the monetary policies intended to push inflation rates closer to desired levels have had the opposite effect, as the subsequent investments in technology have increased productivity and lowered input costs. In recent months, despite more than 30 central banks having announced interest rate cuts including the Federal Reserve's recent "mid-cycle adjustment," the world is still experiencing slower growth. We believe that governments must now take the baton from the central banks to stimulate growth. We see that many governments are now considering new fiscal stimulus programs, which should not be lost on investors, as it has a positive impact on the outlook for corporate earnings. However, policymakers need to act now as the impact of stimulus initiatives is typically felt two or three quarters after being introduced.

One major benefit of a strong fiscal response would be the reduction of income inequality by raising living standards.

Chart 2: Uncharted Waters — Global Yields

	As of September 16, 2019			
Country	2-Year Gov't Bond	5-Year Gov't Bond	10-Year Gov't Bond	30-Year Gov't Bond
United States	1.76%	1.70%	1.84%	2.31%
United Kingdom	0.50%	0.48%	0.69%	1.13%
Japan	-0.25%	-0.26%	-0.16%	0.34%
Italy	-0.28%	0.28%	0.85%	1.96%
Spain	-0.46%	-0.21%	0.26%	1.19%
Sweden	-0.60%	-0.53%	-0.13%	1.41%
Belgium	-0.66%	-0.50%	-0.15%	0.77%
France	-0.69%	-0.60%	-0.20%	0.69%
Netherlands	-0.72%	-0.65%	-0.34%	0.07%
Germany	-0.73%	-0.72%	-0.48%	0.08%
Denmark	-0.79%	-0.70%	-0.47%	—

Source: FactSet

The United States and other nations must not waste the opportunity afforded by the current low-interest-rate environment to implement productive fiscal policies.

As we have written frequently over the past decade, the United States and other nations must not waste the opportunity afforded by the current low-interest-rate environment to implement productive fiscal policies. So, while sentiment is fairly negative at present, the implementation of new stimulus initiatives should result in a better economic outlook and could counter some of the social and political divisiveness that exists today.

What Are the Investment Implications of This Outlook?

"As the markets finally come to terms with increased political risk, currency risk, credit risk, and the growing likelihood of left-wing governments, it's clear that the shifts and the shocks are coming fast and furious. No wonder that everyone is now asking, 'What comes next?'"
– Rana Foroohar, *Financial Times*, 8/19/19

Based on the economic considerations expressed in this Outlook, there is increased clarity as to where capital will likely flow. The three primary beneficiaries are companies with above-average revenue growth in a low-growth world, companies with stable, above-market dividend yields in a low-interest-rate environment and special situation companies including publicly traded small capitalization companies. While the economic outlook remains both volatile and uncertain, the secular drivers we have written about for several quarters remain intact with the beneficiaries continuing to attract capital. The major areas of emphasis for portfolio holdings include:

Dividend growers with strong balance sheets and the ability to increase their dividends. With central banks aggressively lowering interest rates, companies that are increasing their dividends and offering above-market dividend yields will become increasingly coveted.

- It is worth noting that at the time of this writing, investors have a choice between buying 10-year treasury securities yielding 1.84%, an S&P 500 Index fund with a yield of 1.85% or a portfolio of leading U.S. businesses with dividend yields of over 2.6% that has historically provided 70% of the volatility of the S&P 500 for the past eight years and has outperformed in down markets.

Technology companies that are benefiting from unprecedented innovation, including those that are integral to the introduction of 5G wireless networks and its primary beneficiaries. ARS is also focused on cloud, software services, semiconductor and equipment, display, telecommunications, mobile communications, network infrastructure, connectivity solutions providers, and autonomous driving companies. One particular area of opportunity is in cybersecurity as highlighted by the following:

- There has been a significant increase in cyberattacks on state and local governments in the United States. This past June, the cities of Riviera Beach and Lake Worth in Florida paid to cyber criminals a combined $1.1 million in bitcoin to recover encrypted files from two separate ransomware attacks. Beginning on August 16th, 23 Texas towns were struck by a coordinated ransomware attack according to the state's Department of Information Resources. These attacks followed others in New York, Louisiana and Maryland.
- 5G will help change the world, and the United States should do everything it can to ensure that it sets the global standard. For all its benefits, 5G will provide significant opportunities for cyberattacks as the platform is being designed in a piece-meal fashion creating multiple points of vulnerability.

Industrial and materials investments in areas of need such as defense companies that are benefiting from increases in global spending, and infrastructure companies that are benefiting from programs supported by state and local governments as well as the impact of climate change on the rebuilding damaged areas.

- In the U.S. and Europe, the federal governments should take advantage of low interest rates to invest in their digital, educational and physical infrastructure.

Healthcare investments remain a strong secular theme due to breakthroughs in technology and favorable demographic trends, although the sector has been under considerable political pressure due to pricing concerns. The tension between the secular opportunity and near-term

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political pressures are creating strong buying opportunities, especially for those companies with critical technology-enabled breakthroughs in biotechnology and genomics as well as those with strong product pipelines. Climate change is having an increasing impact on global health as cases of some diseases are rising and the potential for epidemics to spread quickly is much greater.

- July was the hottest month on record according to the National Oceanic and Atmospheric Organization with temperatures 1.71 degrees Fahrenheit higher than the 20th-century average. Brazil recently reported almost 1.2 million dengue fever cases in the first half of the year, which represents a jump of almost 600% as extreme weather is contributing to the spread of this disease.

Consumer companies with pricing power that can increase profit margins, improve overall profitability and benefit from lower input costs and stronger consumer spending; and

Company-specific stories (including some smaller capitalization names) with compelling valuations and strong company-specific catalysts or growth drivers. With nearly $2 trillion in uninvested private equity capital seeking deals, many private equity transactions are being valued at 13–14 times cash flow compared to 7–9 times that private equity firms and their investors would typically expect. There are currently many compelling valuations in select publicly traded smaller capitalization companies that offer attractive return potential and better liquidity than typically offered by private equity.

In the current environment, there are corporations in most industries with strong balance sheets, revenue growth and future capital expenditure plans that are positioning themselves to gain market share in an increasingly competitive global economy. Those that are not will likely fall by the wayside. For example, JPMorgan Chase will spend approximately $11.5 billion on technology this year and will likely spend at comparable or higher levels in the future. Most of its competitors cannot come close to that amount of spending, so how will they compete going forward? Consequently, we would expect continued consolidation within that industry as well as in other industries, giving investors another opportunity to benefit from today's environment. That is one of the reasons this is not an environment where all businesses perform equally. So, as we stated at the start of this Outlook, our answer to the "What should I do now?" question is that while this is a time to be appropriately cautious, it is also important to recognize and take advantage of the investment opportunities being presented. Therefore, to have higher cash balances is not intended as a market call, but rather the means to be able to take advantage of the opportunities presented. Clients should not let headline issues distract them from the opportunities being presented by the dynamics in the world today.

September 16, 2019

On Tuesday, September 24th at 12:00 pm EST we will be hosting a conference call to discuss our current Outlook. Please take the time to register at:

Trade, Tweets and Politics: Investment Opportunities for an Uncertain Environment

Please email conference@arsinvestmentpartners.com or call us at 212-687-9800 to submit any questions for consideration prior to the call.

We encourage you to invite your friends and colleagues to join us.

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