CAMBRIDGE ASSOCIATES LLC

GLOBAL MARKET COMMENTARY

UNCERTAINTY REIGNS

June 2012

Sean McLaughlin

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June 2012 Global Market Commentary

Uncertainty Reigns

Sean McLaughlin

Mid-year update on the challenging macroeconomic environment and our portfolio advice.

On May 31, Cambridge Associates hosted an internet-based presentation to provide our investment outlook and address questions from clients. All clients are invited to join these events, which typically occur three times per year. This report adapts and updates the remarks and exhibits presented during the May 31 event.

In late February, in our 2012 global outlook market commentary, we noted that our base case for the year was a "more of the same" environment, with volatility, growth scares, and debt flare-ups—all temporarily forgotten when policymakers unleash unorthodox new monetary measures.[1] We noted at the time that three *alternate* scenarios could not be ruled out, but were less probable: a deflationary bust that would likely be bad for all assets except for the highest-quality sovereign bonds; a high-growth reflationary environment that would benefit risk-tilted portfolios; and a stagflationary bust that would drive down values of both equities and nominal bonds. We cannot rule out the latter three environments, but our base case remains "more of the same." For the most part, 2012 has followed that pattern; however, deflationary pressures are rising and it remains to be seen whether central bank reflationary efforts and possibly fiscal stimulus from emerging markets (particularly China) will stem these pressures.

While we believe that the environment will continue to offer more of the same, below are the three key risks that need to be highlighted:

- European politicians and central bankers now appear less resolute about preventing a Greek exit from the euro currency, and we worry that an unmanaged exit could prompt a contagion of debt buyers stepping away from other stressed European countries, including Spain or Italy.
- Chinese growth remains a concern.
- As we head into the second half of the year, the markets may begin to focus on the potential for a dangerous year-end political battle surrounding the fiscal and tax cliff in the United States.

While there are significant worries, there are positives as well. Home prices in the United States look like they might be bottoming, supported by very low mortgage rates and investor demand. In addition, central bankers may discover other rabbits in their hats if the situation deteriorates. Finally, for the most part, equity valuations are reasonable.

The following is our advice, given these conflicting risk and reflation messages:

- Reasonable equity valuations cannot spare investors from market volatility, although current valuations do not argue for underweighting risk assets.
- There are few good alternatives to risk assets, given the very low yields of bonds and cash.
- In this environment, where we are long-term sanguine and short-term nervous about risk assets, and where valuations of bonds and cash are abysmal, we remain enthusiastic about the defensive equity strategies covered in our March 2012 overview.[2]
- Within equities, we advise investors to underweight the United States, neutral-weight Europe, and overweight emerging markets.

[1] Please see our 2012 Outlook Global Market Commentary *2012: More of the Same?*

[2] Please see our March 2012 Market Commentary *Defensive Equity: Scanning the Field.*

- Finally, investors should ensure they have adequate liquidity to meet needs in a potentially stressed environment to prevent volatile markets from forcing one's hand.

Political and Regulatory Uncertainties: The Known Unknowns

Investors today face a broad range of uncertain outcomes with regard to global politics and the regulatory and policy frameworks, and in some cases, the regulatory outcomes are closely tied to politics (Exhibit 1). In this report, we highlight uncertainties in **Europe**, **China**, and the **United States**.

European Political Instability and the Debt Morass

In Europe, numerous political uncertainties remain. Anti-austerity sentiment has influenced election results in France and Greece this spring, and Ireland on May 31 ratified the country's participation in the recent EU fiscal pact, but results were not a landslide and turnout was lukewarm. Continued support from German citizens and their representatives for endless bailouts, including the newly announced €100 billion Spanish bank rescue, is far from assured.

As recently as early 2012, politicians and central bankers publicly refused to even consider a currency union without Greece—a possibility that is now discussed openly. Election results earlier this month made plain that a Greek exit—or "Grexit" as the media have dubbed it—cannot be ruled out. Greek voters in May favored politicians that rejected austerity and curbs on heavy government spending, but according to public opinion polls, Greeks favor retaining the country's use of the euro currency. It is clear why rejecting austerity *and* continuing to embrace the euro appeal to the Greek electorate, but the German and French taxpayers on the hook for continuing Greek bailouts may see those two aims as fundamentally opposed. How will Greek voters and their soon-to-be-elected representatives square that circle?

If Greece leaves the common currency, the resulting chaos could get ugly fast. The May election failed to generate a coalition government, so new elections are scheduled for June 17. A Greek departure from the currency union could have a significant negative impact on financial markets. The European public and private sectors would be able to absorb losses on Greek debt holdings (and banks have written down Greek bonds already), but the losses could precipitate a real backlash. Additionally, if Greece were to exit the common currency, it would likely lose access to government funding and face an acceleration of the current bank deposit outflows, making it unlikely the government could fund continuing operations. As a result, sharp currency depreciation would likely crimp the ability of Greek companies and households to purchase imported fuel and other supplies. Clearly, this scenario would present a highly volatile environment. Perhaps cooler heads will prevail during the next round of Greek elections.

While the situation in Europe is a political minefield, the existence of the problem stems from overindebtedness in the "peripheral" economies of Greece, Ireland, Italy, Portugal, and Spain. These countries, on average, grew their debt levels from 2005 through 2011 by 41%, even as their real GDP grew by only 11% over the period (Exhibit 2).

In 2007, European government bonds were a commodity, with German and Spanish bonds trading quite similarly; however, more recently, the market has treated peripheral bonds more like doppelgangers than kissing cousins. As market

strains have increased in recent months, investors have dived into German bunds, driving the ten-year bund yield to 1.1% and pushing yield spreads of peripherals, including Spain and Italy, to levels around 500 basis points (Exhibit 3). Spain is considered particularly vulnerable to market contagion and has suffered more than most countries during the periodic Greek flare-ups, because many Spanish banks are thought to be stuffed full of assets left over from the country's property bubble and still carried on their books at cost. Investors have been questioning whether the Spanish government, facing a deep recession and 24% unemployment, has the ability to shore up the banks without precipitating a debt crisis of its own. In mid-June, Spain requested up to €100 billion to recapitalize its banks. The amount appears likely to be sufficient, although it adds to Spanish sovereign indebtedness and details have yet to be finalized.

These market tensions have not, of course, been limited to bond markets—equities and the euro currency have sold off as well (Exhibit 4). At US$1.24 per euro, the common currency is just a few percentage points higher than its lowest levels of the past five years. Continental European equities are roughly equal to their low point last fall, although they remain about 50% higher than their early 2009 trough level.

Many European countries have a significant vested interest in maintaining the status quo. Banks in the relatively healthy European markets of Germany and France have nearly double the combined exposure to weak European "peripheral" markets than the large U.S. and U.K. banking sectors (Exhibit 5). It is also clear that the open borders and common currency have expanded trade flows.

However, there are costs as well. The common currency wipes out the flexibility of each country to manage fiscal policy according to domestic economic conditions. Germany wants to tighten policy to control inflationary pressures and could stomach a stronger euro, while the periphery craves a weaker euro and much looser fiscal policy. Around the inception of the euro, Greece and the peripherals had similar levels of unemployment; now, they are widely divergent (Exhibit 6). German labor costs have been flat since 1999, while the periphery has seen an average increase of 31%. Improved competitiveness in the core has resulted in the migration of jobs away from less-competitive markets such as Spain and boosted the German economy. The resulting pockets of high unemployment have brought about social unrest and limited political support for tough medicine.

European equities trade at a discount to peers, and we believe that they price in *some* negative potential outcomes and are showing some country-by-country return differentiation (although share prices would likely suffer further in a chaotic Greek exit). However, stripping out non-financials removes about half of the valuation discount. The bottom line is that we advise holding European equities at a neutral weight versus global equity benchmarks.

China: Amid a Power Handover, How Aggressively Will Policymakers Prop Up Growth?

Observers generally anticipated little drama in the lead-up to this year's scheduled power handover from Chinese Premier Wen Jiabao and President Hu Jintao to their successors, but the downfall of popular regional leader Bo Xilai has been anything but bland. On the economic front, Chinese growth is cooling noticeably as the pace of property and infrastructure investment—led by free-spending local leaders like Mr. Bo, as well as millions of eager homebuyers—decelerates. However, Premier Wen in May announced a variety of policy initiatives aimed at supporting credit growth and boosting property invest-

ment activity. Chinese inflation, which hit 6.5% last year, is now a more moderate 3.4%, giving policymakers more freedom to ease rates; indeed, in early June, China announced its first policy rate cut since 2008, lowering the official one-year borrowing rate to 6.3%.

Chinese economic growth continues to decelerate, although at more than 8%, it remains quite strong relative to most of the world's economies (Exhibit 7). Over the past five years, China has invested massively in property, infrastructure, and other fixed assets (Exhibit 8). The pace of investment growth has slowed modestly (despite the recent uptick), and the direction in coming quarters is a question mark. Chinese citizens continue to pull back from property speculation as home prices fall from their recent highs. Given the debt incurred by infrastructure programs similar to Mr. Bo's efforts in Chongqing, it is not clear whether those efforts will accelerate. Alternatively, if global demand for Chinese products slows amid recessionary conditions in Europe, the government may well crank up investment. Indeed, media reports in late May indicated the possibility of a stimulus package in the works.

One of China's growth headwinds comes from manufacturing wages. From the end of 2005 to the end of 2010, wages more than doubled when measured in the domestic renminbi currency (they increased 140% in euro terms and 170% in US$ terms) (Exhibit 7). This has eroded some of China's attractiveness as a manufacturing base.

While China continues to encourage growth in domestic consumption, exports remain key to the Chinese economy. A global recession would hit exports and trigger a hard landing, where GDP growth dropped well below recent levels and commodity prices would likely plummet. Chinese exports are slowing, but Europe is clearly the outlier, with Chinese exports to Europe flattening out (Exhibit 7).

We believe Chinese policymakers have some room to loosen the strings and perhaps enact a round of stimulus to support economic growth, although that certainly does not guarantee that a hard landing will be averted, particularly if the European situation deteriorates.

United States: Brinksmanship Over Fiscal Cliff Is Likely; Housing Shifts to a Positive Influence?

In the United States, the November elections bring plenty of uncertainty. Investors will be paying close attention to the fiscal/tax economic brick wall that awaits at year-end. The Bush tax cuts are scheduled to roll off in December and a new health care tax is to roll into place; if those both happen as scheduled, the top tax rate would rise by one-quarter, capital gains would increase by more than half, and dividend taxes would nearly triple.

At the same time, last summer's debt-ceiling compromise included provisions for trillions of dollars in automated spending cuts, and those are scheduled to begin phasing in at year-end as well. This could certainly be beneficial long term in reining in the deficit and debt crises, but the near-term hit from the spending cuts and tax hikes could scrub several percentage points off of GDP growth. Regardless of the eventual result, expect a volatile situation: during last summer's debt ceiling standoff, some legislators were mulling what they saw as benefits from a Treasury debt default.

While the two parties within the legislative branch are likely to cross swords over the looming fiscal cliff in coming months, potential Federal Reserve actions could also have a significant impact on asset prices. The Fed could take additional actions, but support for these is

far from clear at this point. The same caveat is generally true for the European Central Bank and the Bank of England. Policymakers in China do appear to be exhibiting a more pro-growth bias, but this is unlikely to fix Europe.

There are some tentative bright spots for the U.S. economy, which has been nothing but rot for the past half-decade. Following five years of decline, U.S. home prices appear to be finding a bottom, supported by rising rents, investor demand and homebuyer affordability, and low mortgage rates. After falling about 40% in inflation-adjusted terms, U.S. home prices are roughly back to 2001 levels on a national basis (Exhibit 8). Interest rates for 30-year fixed-rate mortgages can be had at well below 4%, and 15-year fixed-rate mortgages are just above 3% (Exhibit 8)—well below yields of Australian sovereign bonds with the same maturity.

Combine low mortgage rates with much lower home prices and rising rents, and buying starts to look pretty sensible for many Americans. Monthly rents are now higher than the monthly cost of a mortgage in dozens of American cities (Exhibit 8).

In some housing markets, market conditions once again favor sellers, in part because traditional buyers now have to compete with investors. Mid-teens rental yields without leverage are available in some distressed markets (Exhibit 8).

Considering these factors together, we believe housing prices may be near their lows, which could relieve what has been a constant source of negative pressure over the past five years.

Looking beyond housing, it appears that the U.S. economic recovery is continuing at its plodding pace; however, much of the world appears to be reversing course back into recession, so fairly weak U.S. growth looks better when viewed through a relative lens. We are concerned about the upcoming battle over the tax increases and automatic spending cuts scheduled for year-end, which could engender market volatility, echoing the debt ceiling standoff last year.

Equity Valuations: No Shelter from Volatility, but Consistent with Decent Long-Term Returns

In addition to stabilizing U.S. home prices and the possibility of dovish monetary policy, another positive factor among the global grimness is that equity valuations are generally reasonable. Developed equities as a group are moderately below their average valuation levels over the past four decades (Exhibit 9).

U.S. equities have held up better than other developed markets, but we would not call U.S. stocks overvalued at this point. That said, we would underweight U.S. equities, even though the U.S. economy appears to be on more stable ground than most other developed markets economies. We believe that current valuations reflect a premium for the healthier U.S. economy, and we recognize that U.S.-listed equities have plenty of exposure to less-healthy economies (30% of revenues for S&P 500 companies are non-U.S., according to Deutsche Bank). Furthermore, many European countries have exposure to healthier markets (according to Morgan Stanley, companies in the MSCI Europe Index pull only 54% of revenue from developed Europe, and 29% now comes from emerging markets economies).

In continental Europe, valuations are reasonable, although about half of the undervaluation is due to the impact of vulnerable financials (Exhibit 10[3]), so we would not consider them compel-

[3] Please note that the Datastream indices shown are not our preferred source for valuation assessments as they exclude negative earnings. The intent of the exhibit

lingly cheap. We would hold a neutral position in European equities.

Emerging markets offer good value at current levels and we would overweight them; however, emerging markets equities remain volatile and would likely suffer from a sharp Chinese slowdown or disorderly Greek exit.

Relative valuations are instructive as well (Exhibit 11). U.S. equities are rich relative to other developed markets. In contrast, Europe is cheap relative to the rest of the developed world, although excluding financials from both indices diminishes the relative valuation differentials somewhat. Emerging markets equities are roughly fair valued relative to developed equities. Both inside and outside the United States, large caps appear attractively valued versus small caps. We also believe that large caps should be more defensive in the event the market environment sours further.

While normalized earnings *multiples* are generally reasonable, earnings *growth* may be stalling out. After rising to new cycle highs last year, aggregate earnings per share (EPS) have started to trend lower outside the United States (Exhibit 12). EPS for the MSCI World ex U.S. peaked in September and are now 10% lower, driven mainly by weakening in Japan and continental Europe. Emerging markets EPS peaked last August and are about 12% below peak now. In the United States, EPS continue to reach new highs, but momentum is flagging. U.S. earnings are already 1 standard error above their trendline, and the cycle appears to be long in the tooth. EPS may struggle to power ahead amid fragile economic conditions. Reaccelerating economic growth may be a requirement for the next stage of earnings growth.

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is merely to highlight the relative valuation of non-financials versus broad markets.

Bonds and Commodities Have Little Appeal

Outside of equities, valuations are more problematic. The core inflation-sensitive portfolio asset, commodities, is a real challenge for asset allocators today, while the core deflation-support asset, sovereign bonds, is very overvalued.

Commodity Valuations Stretched; Implementation Challenging

While commodity spot prices have fallen sharply, valuations are now at the upper bound of the fair value range, and implementation conditions remain frustrating. To bootstrap a potential five-year annual return for commodities from this starting point, investors need to examine four components (Exhibit 13). These components are:

- The breakeven yield of inflation-linked bonds indicates market expectations for **inflation** of approximately 2% per year.
- Historically, the **cash collateral yield** has been the strongest return component for commodity investors. Cash today yields essentially nothing, but at some point that will change. We could do worse than to assume a 2% annual return from cash, on average, over the next five years.
- Over the past century, commodity prices have tended to keep up with inflation. **Spot prices** have come down recently, but remain elevated. To get back to their long-term inflation-adjusted average, spot prices would need to fall by about 5% per year over the next five years in real terms.
- The **roll yield** is the return that comes from selling futures contracts before they mature and buying the next available contract. Over the past year, that has cost investors about 5%, roughly in line with the average roll yield for the Dow Jones-UBS Index back to 1991. This factor has shown a lot of variability over the past 20 years, ranging from 13% to -17%

annually, but has been consistently negative since mid-2004.

The sum of these components is -6%, providing a bootstrapped estimate of annualized nominal commodity index returns. The actual return may differ dramatically from this estimate, but the four primary commodity return components do not tell a compelling story today. Absent unanticipated inflationary conditions in the global economy, it is not easy to envision attractive or even positive returns from commodities.

As an alternative to commodity futures, we believe natural resources equities offer reasonable inflation resistance and much better return prospects. Valuations are reasonable, with multiples that are not particularly demanding (Exhibit 14), although earnings have certainly been supported in recent years by elevated commodity prices. We would offer two caveats: (1) these are stocks first and foremost, and they tend to trade more like equities than commodities; and (2) like commodity futures, they would be quite vulnerable to a Chinese hard landing or a global recession. Leveraged loans are another asset that would likely hold up in a moderately inflationary environment, although we would expect little or no positive linkage to inflation.

Do Not Expect Miracles From Bonds at Stratospheric Valuations

Bond returns have been a significant boost to portfolios, and investors correctly note that given the high duration of low-yielding bonds, continued appreciation is possible if risk aversion builds. However, it is worth noting that initial yields are accurate indicators of eventual returns for high-quality bonds (Exhibit 15), and current yields are vastly below historical averages.

With ten-year Treasuries at about 1.6%, non-U.S. government bonds at 2%, and ten-year municipal bonds also at about 2%, it is unlikely that investors will see nominal returns above 2% to 3% from their high-quality bonds over the next five to ten years. That said, investors need to own some assets that would offer spending support in a malign, protracted deflation. We would continue to hold *some* bonds, which support that need, but as yields fall and valuations rise, we would substitute some cash, even at a zero yield, for a portion of the bond allocation. Cash would still support liquidity, while reducing the interest-rate risk of overvalued bonds.

Defensive Equity Strategies Continue to Appeal

With yields of bonds and cash thoroughly unattractive, and the potential for continued and even increased equity volatility in coming months, we are reluctant to get more aggressive in our equity ownership posture. To that end, we have been proponents of defensive strategies for quite some time, and we continue to recommend these strategies, recognizing that they will likely underperform straight equity indices in a very strong market like first quarter 2012.

While we published a detailed overview of the defensive equity landscape in March,[4] Exhibit 16 provides a brief overview. The common thread is that we would expect all of these strategies to have less volatility than broad equities, to compound at similar rates to the broad equity market over full market cycles, but to do so with a different return pattern, falling somewhat less sharply in a market rout, and tending to lag broad equities somewhat in a strong market.

Quality, **low volatility**, and **equity income** are long-only equity strategies, but they frequently have the above-mentioned return characteristics. Typically, these are available via quasi-active

[4] Please see our March 2012 Market Commentary *Defensive Equity: Scanning the Field*.

index products, as well as via fully active managers (either quantitative or fundamental).

High-yield bonds are not equities, of course, but they often exhibit the return pattern we mentioned earlier. They tend to be low-quality companies rather than high quality and can be illiquid in stressed environments, although the high bond coupon supports bond prices in a crisis, assuming there is a reasonable chance that the coupon will continue to be paid out. **Covered-call strategies** offer some income enhancement from the option premium, while **long/short equity hedge funds** tend to have only moderate net exposure to equities.

While these strategies should provide at least a modicum of downside protection, they will have significant tracking error versus equities, and the benefits would reveal themselves over a full market cycle. Do not underestimate the potential for regret during an extended market rally. Track records for some of these strategies, such as low-volatility, are often short and reliant on back-testing. While long/short equity concentrates the potential for manager alpha, it also distills the organizational risk inherent in active management, and lockups can limit investors' flexibility to allocate elsewhere. Consequently, investors should enter these strategies with their eyes wide open.

These strategies are more likely to outperform equities when the starting point is fairly placid and the market and earnings cycles are getting long in the tooth. Conversely, they may struggle to outperform broad equities if liquidity were to rush back into the market (e.g., via aggressive central bank policy action). The relative return charts on the bottom of Exhibit 15 highlight the significant tracking error of these strategies versus broad equities, and the relative performance compared to broad equities over the past five years (which has varied significantly).

Summary of Portfolio Advice

Equity valuations are generally reasonable today. That said, good valuations cannot prevent bad short-term outcomes, although we clearly do not see overvaluation that encourages us to underweight equities. However, we would be defensive within equity and equity-like strategies. Among these, we like quality-oriented strategies that focus on sustainable and defensive earnings streams, and we are a proponent of overweighting those, particularly at the expense of small caps. We continue to employ long/short equities as part of this mix. In addition, we would take some cyclical risk by overweighting emerging markets equities relative to developed markets, as these assets are relatively cheap and attractive from a strategic perspective. Finally, we would hold Europe ex U.K. at a neutral weight, given current valuations.

Portfolio hedges are certainly no bargain today. Bonds could continue to rise in value if yields fall to Japan-like levels or below, but because of their very high durations today, the base case return is pretty ugly, especially if rates increase. In the event ten-year Treasury yields suddenly fell from their 1.6% month-end yield to the 0.8% level of ten-year Japanese debt, Treasury prices would jump, but only by 7.5%. We continue to advocate substituting some cash for a portion of sovereign bond holdings. Similarly, commodities could do well in their sweet spot of strong unanticipated inflation, but in most environments we would not have high hopes from this point forward. As a substitute, consider natural resources equities, or even leveraged loans—both should be relatively resilient in a moderately inflationary environment. Cash at 0% is a lousy investment, but it does provide investors with flexibility to harvest the fruits of volatility. Tail-risk protection in the form of equity put options is expensive. The VIX is not particularly high, but longer-term protec-

tion and options on European equities are both quite rich.

We see opportunities in European distressed strategies and in certain non-Agency mortgage strategies. There has been more fund raising than deal volume in recent quarters, but we believe banks will be under some pressure to accelerate asset disposals, although it may take some time for this to evolve. Non-Agency mortgage strategies are positioned to deliver attractive returns in a market with stable home prices, and to return capital in the event home prices fall significantly further. Manager selection is critical for both of these strategies.

Finally, we stress the need for adequate liquidity to ensure that investors can manage through the potentially difficult and volatile conditions in the months ahead. ■

Exhibit 1

Elevated Political, Regulatory, and Tax Uncertainty

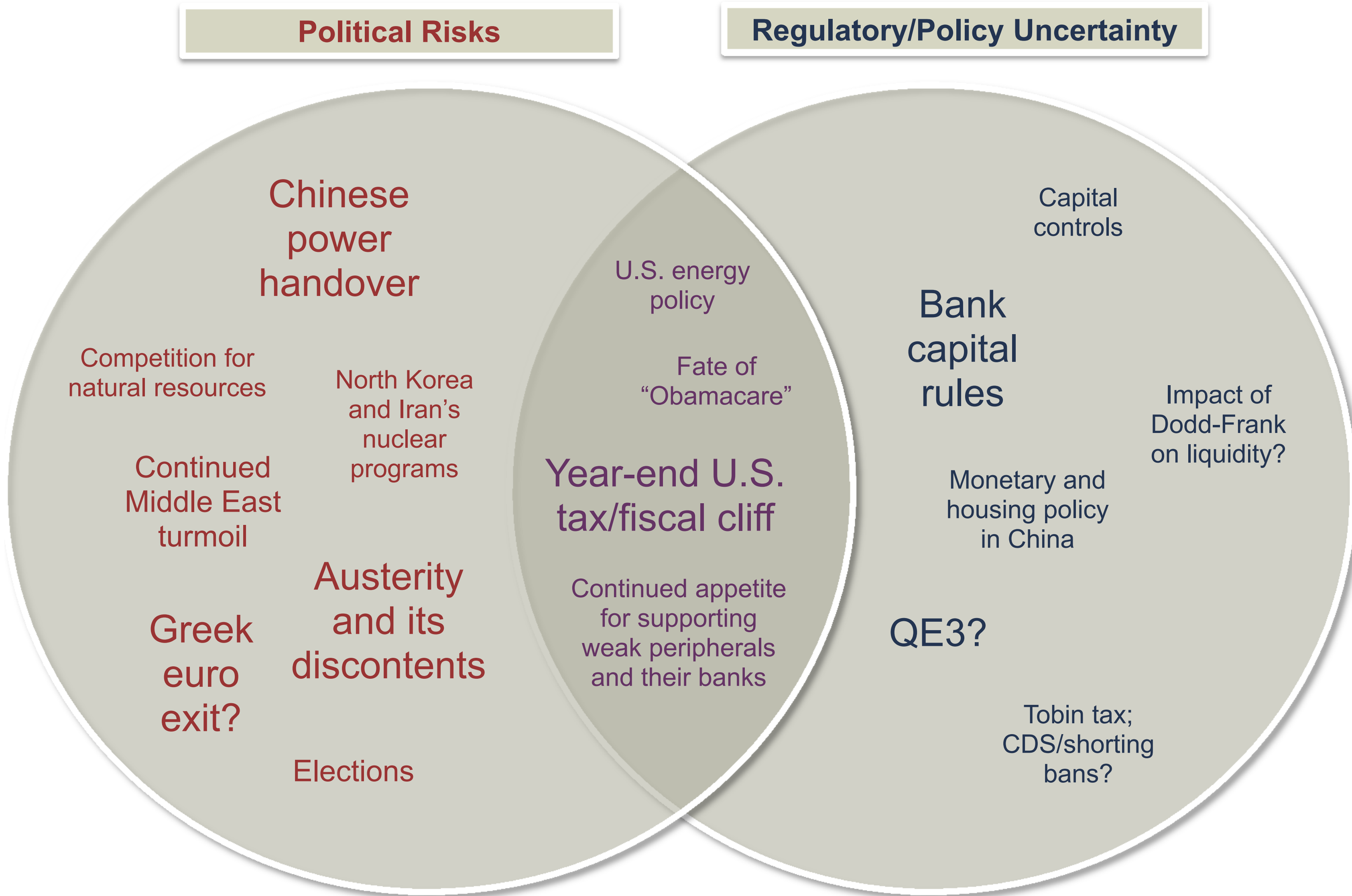
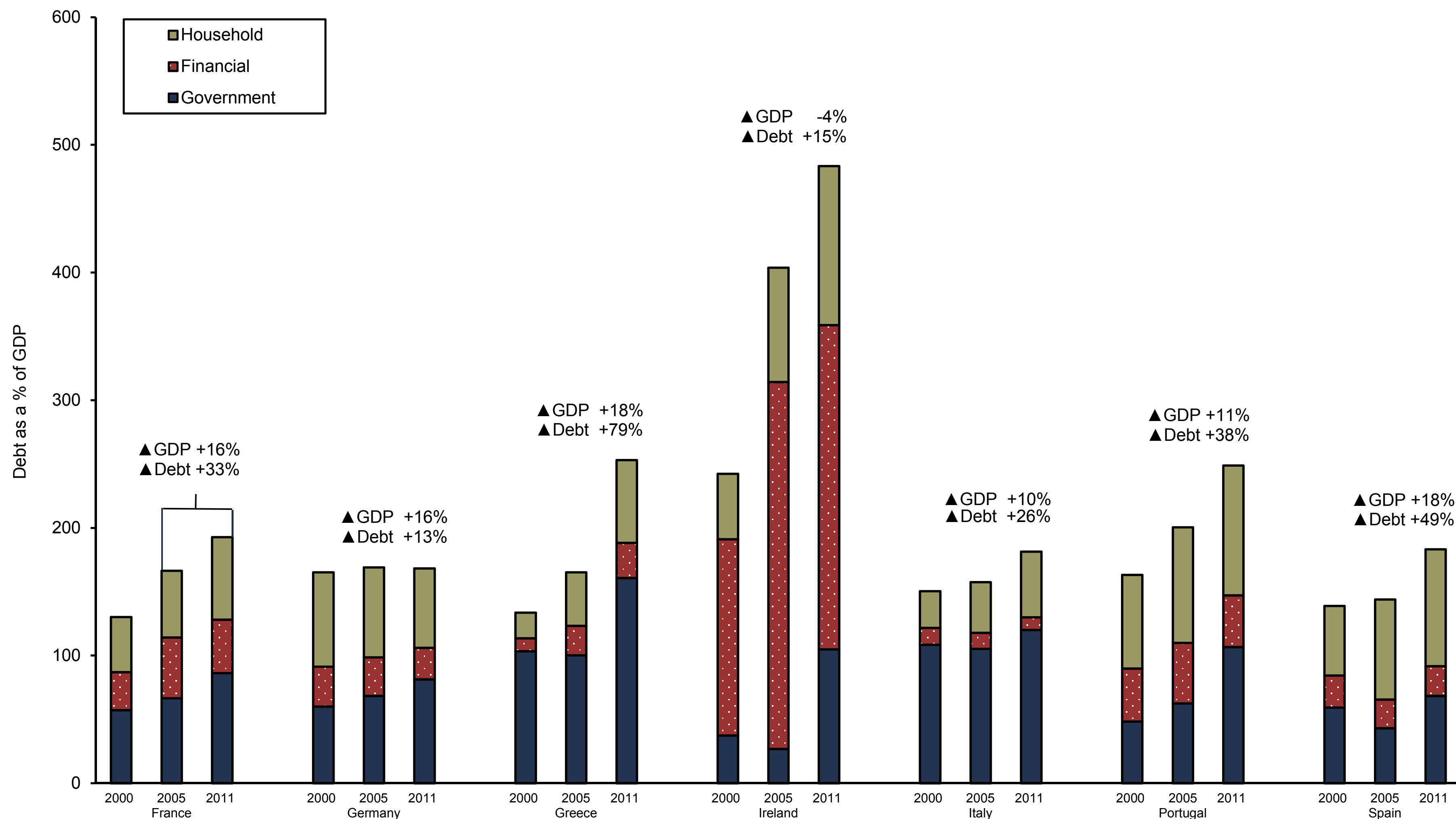


Exhibit 2

Economy's Debt Level by Sector as a Percentage of GDP



Source: Thomson Reuters Datastream.
Notes: All data are annual. Changes in GDP and debt are in nominal terms. Irish household debt data labeled 2000 are as of 2001. Household debt data for 2011 are as of 2010, except for Portugal, which is as of 2011. Greece's 2011 GDP is as of 2010.

Exhibit 3

Ten-Year Spanish and Italian Government Bond Spreads Over Bunds

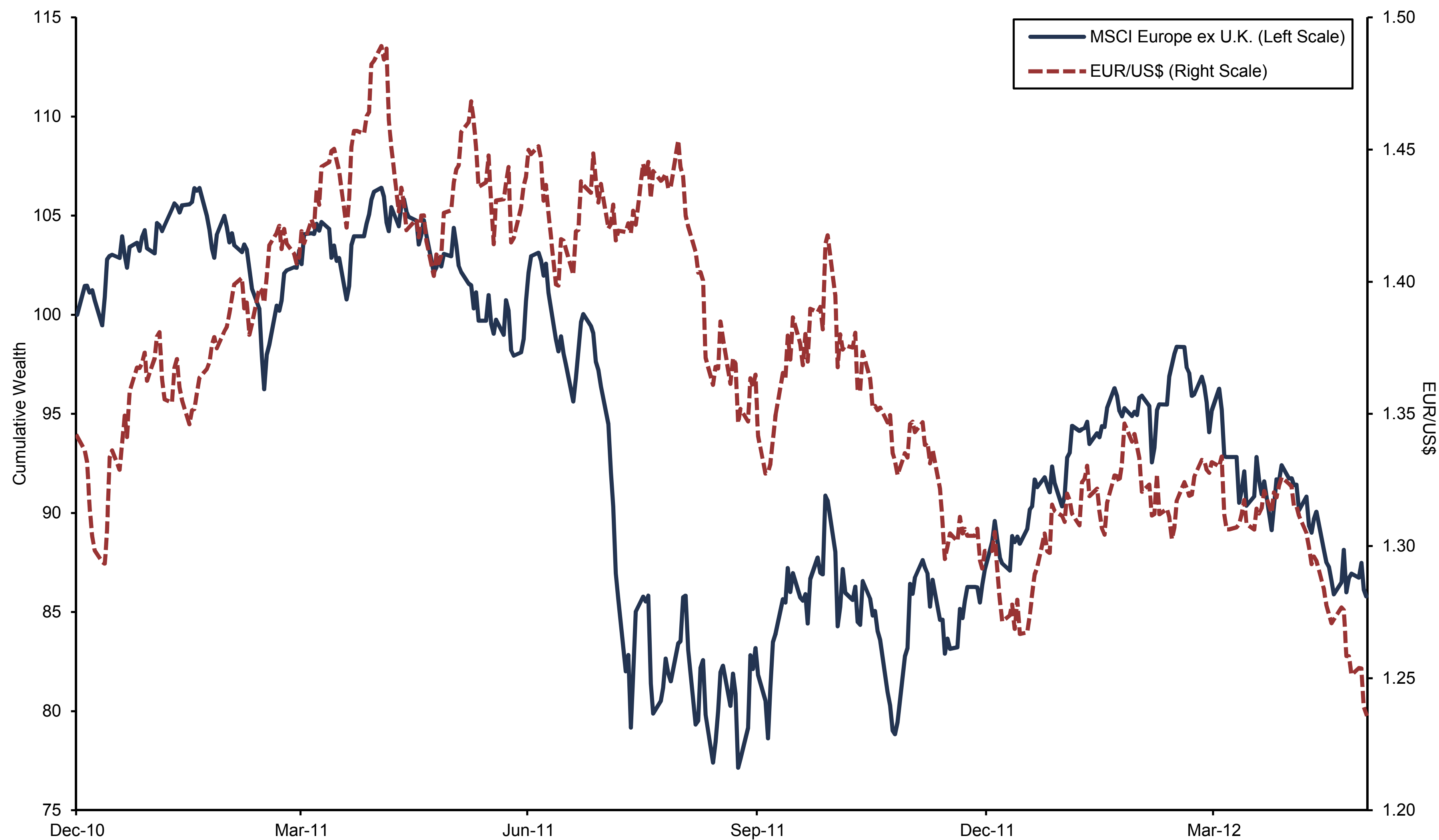
January 1, 2009 – May 31, 2012

Source: Thomson Reuters Datastream.
Note: Data are daily.

Exhibit 4

Cumulative Wealth of the MSCI Europe ex U.K. Index and EUR/US$ Spot Rate

December 31, 2010 – May 31, 2012



Sources: MSCI Inc. and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties.

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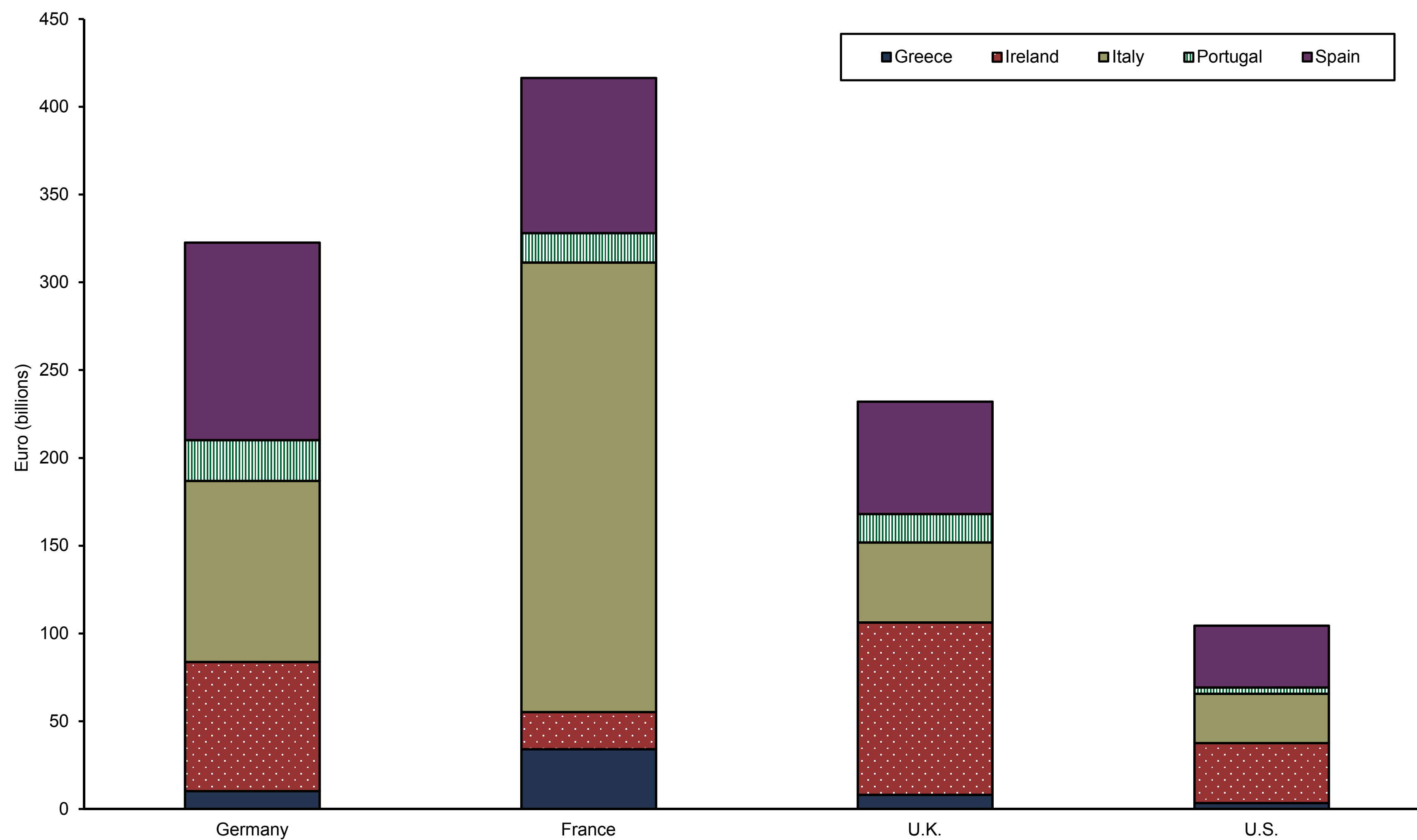
Exhibit 5

Bank Sector Exposure to Peripherals

As of December 31, 2011

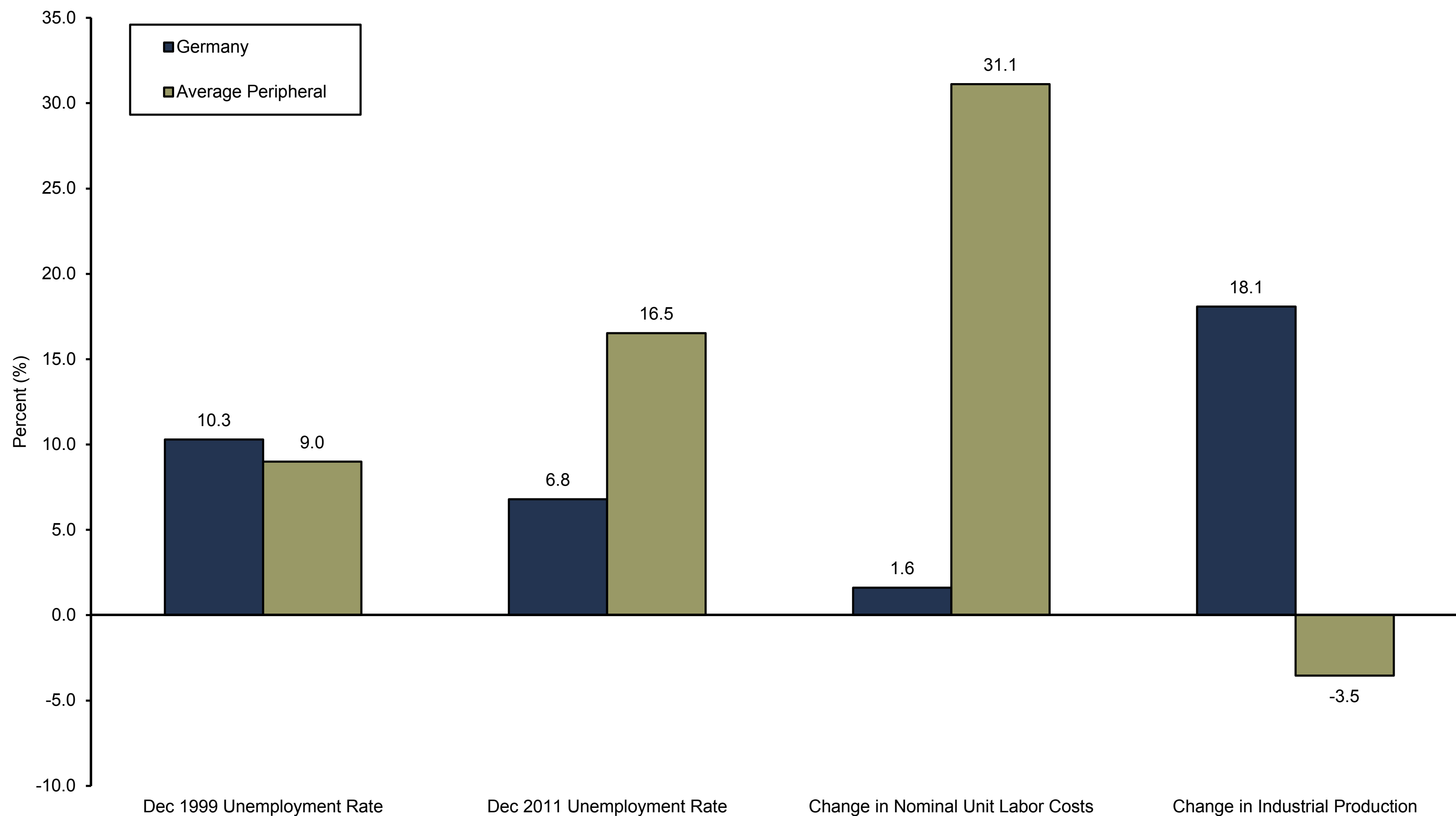


Source: Bank for International Settlements.
Notes: Exposures are represented as consolidated foreign claims. Foreign claims are represented as a total of public sector, bank, and non-bank private sector claims. BIS data are as of December 31, 2011, and converted to euros from U.S. dollars as of December 31, 2011.

Exhibit 6

European Economic Statistics

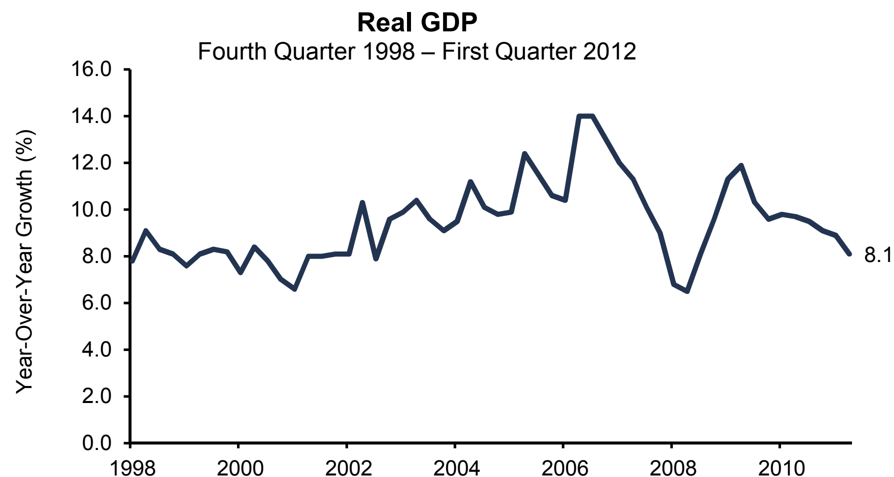
December 31, 1999 – December 31, 2011



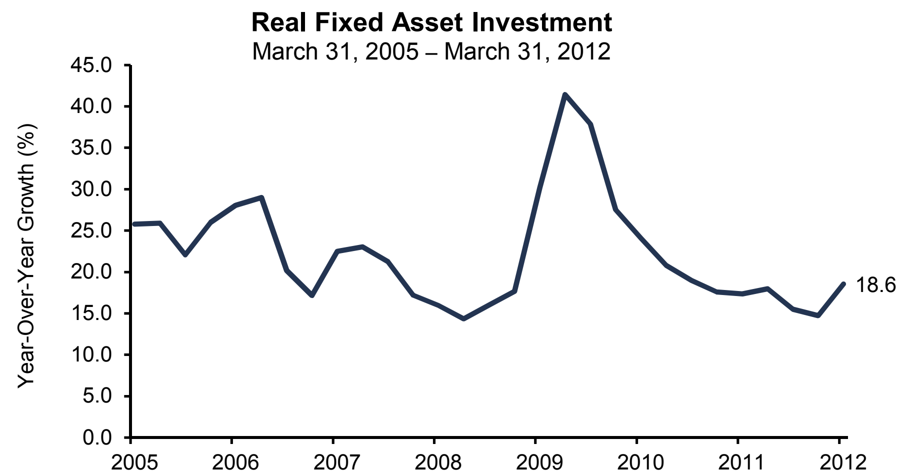
Source: Thomson Reuters Datastream.
Notes: Peripheral countries include Greece, Ireland, Italy, Portugal, and Spain. Nominal unit labor cost data are through December 31, 2010. The change in industrial production for Portugal reflects the period of January 31, 2000 – December 31, 2011.

Exhibit 7

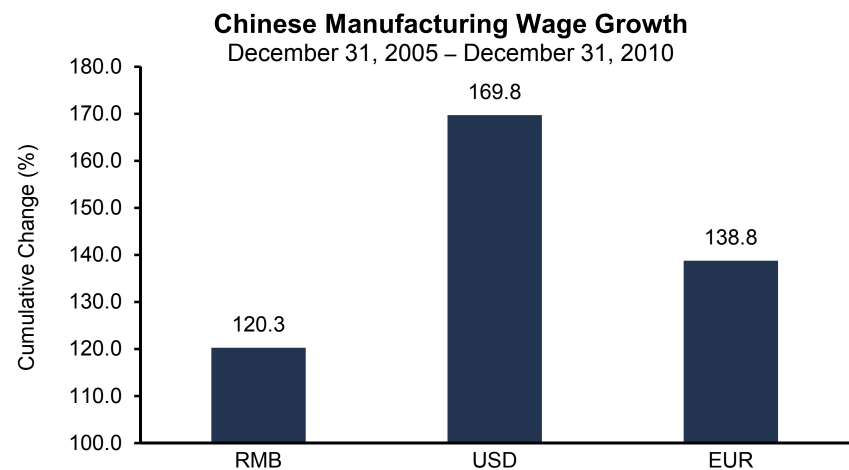
Chinese Economic Indicators



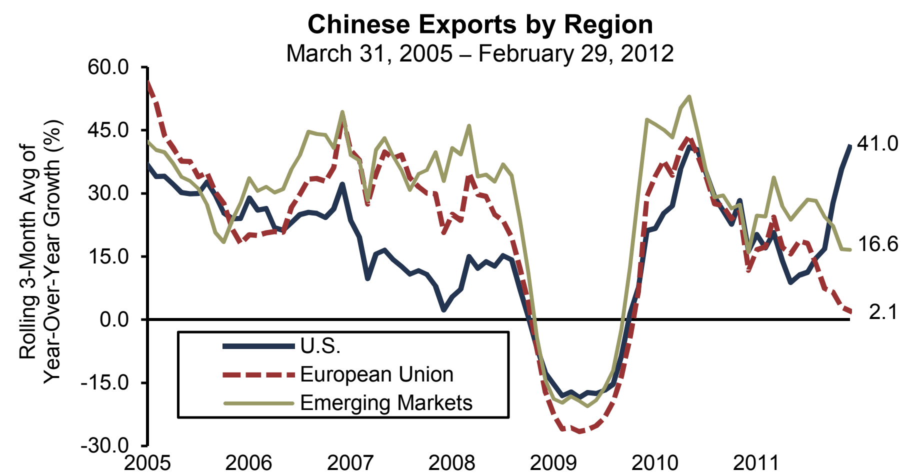
Source: Thomson Reuters Datastream.



Source: GaveKal.



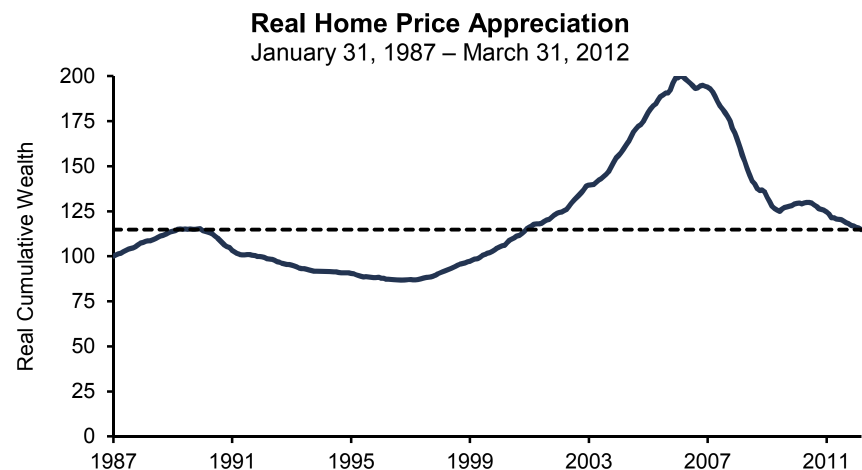
Sources: People's Bank of China and Thomson Reuters Datastream.

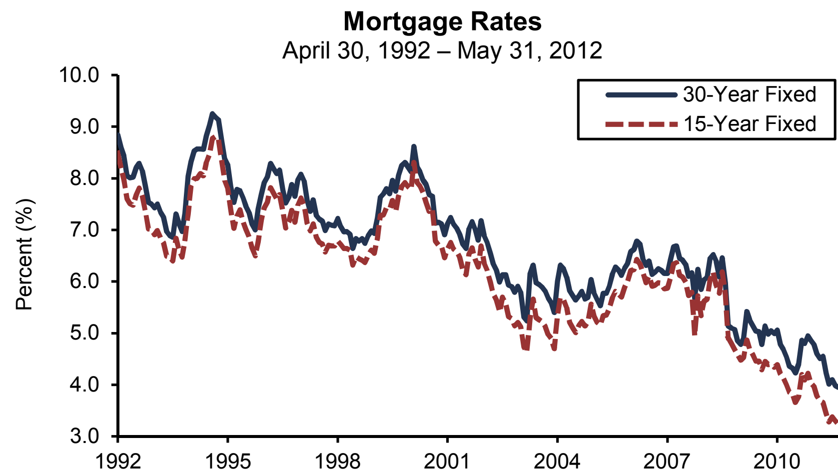


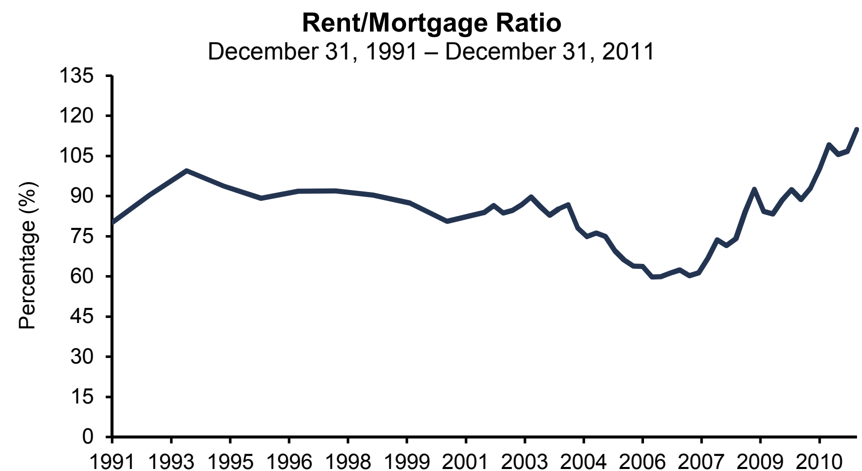
Source: GaveKal.

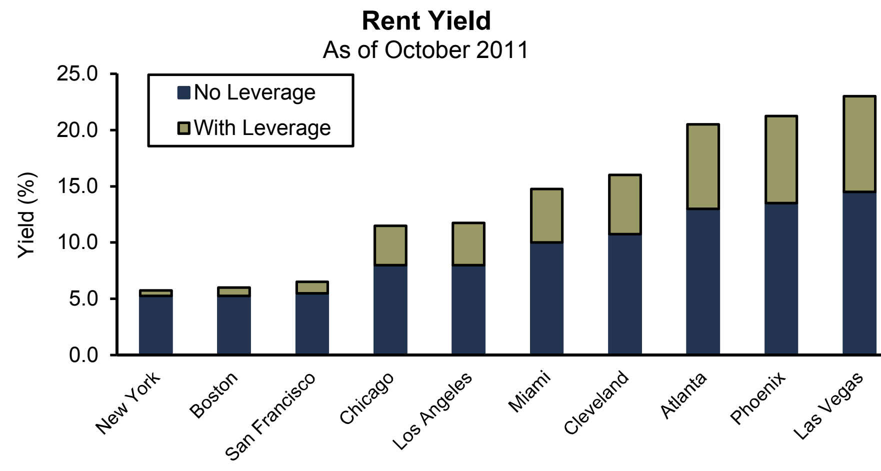
Exhibit 8

U.S. Housing Market Statistics





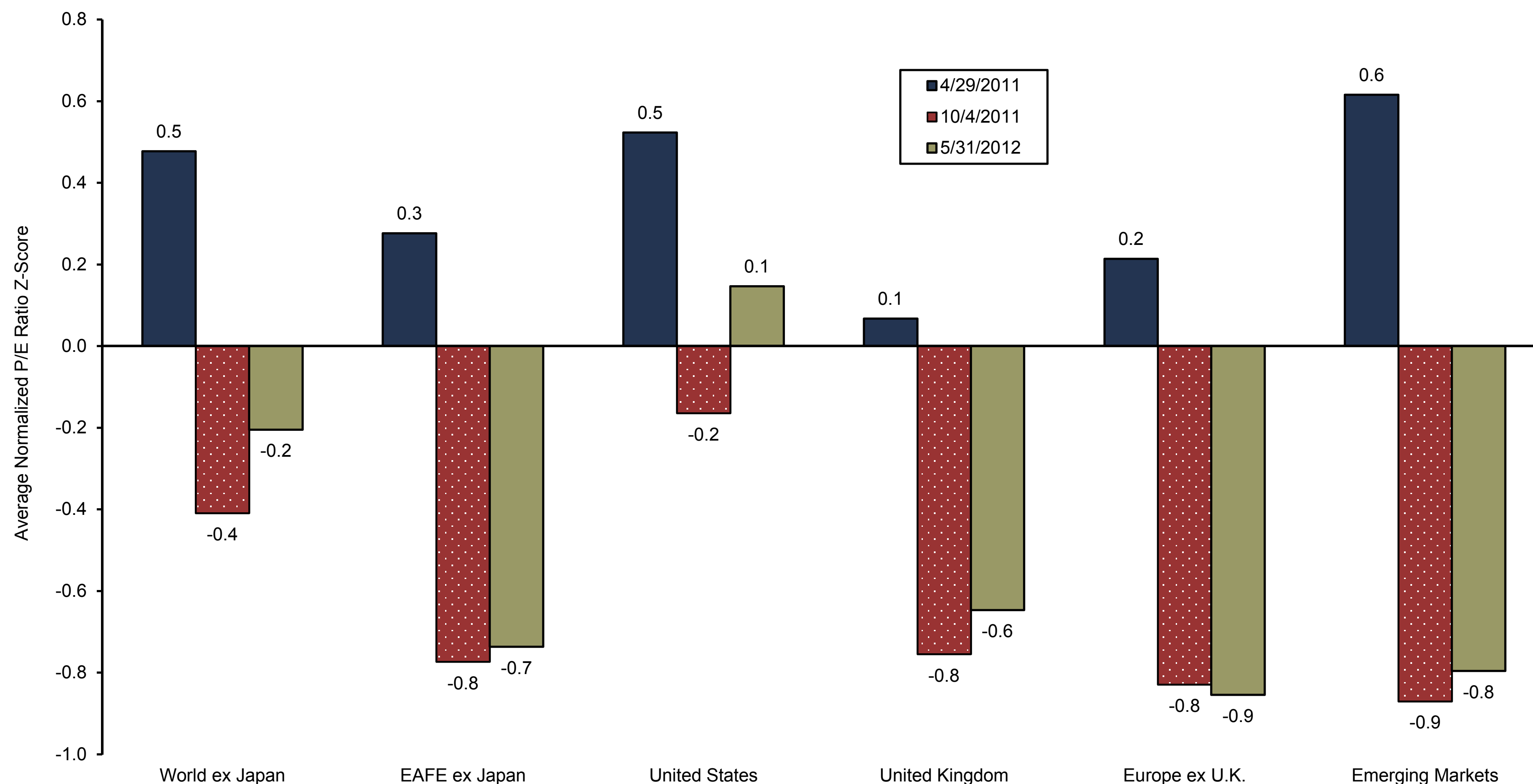




Sources: Deutsche Bank, Goldman Sachs, and Thomson Reuters Datastream.
Notes: Home prices are represented by the S&P/Case-Shiller 10-City Composite Home Price Index. Rent/mortgage ratio compares the approximate after-tax costs of renting versus owning a home across approximately 50 U.S. metro areas each quarter; assumed marginal tax rates are 25%. Rent yield represents annual rent divided by current home price; levered yield assumes a 5% borrowing cost and 50% loan-to-value ratio.

Exhibit 9

MSCI P/E Ratio Deviation From Historical Average Based on Composite Normalized Earnings

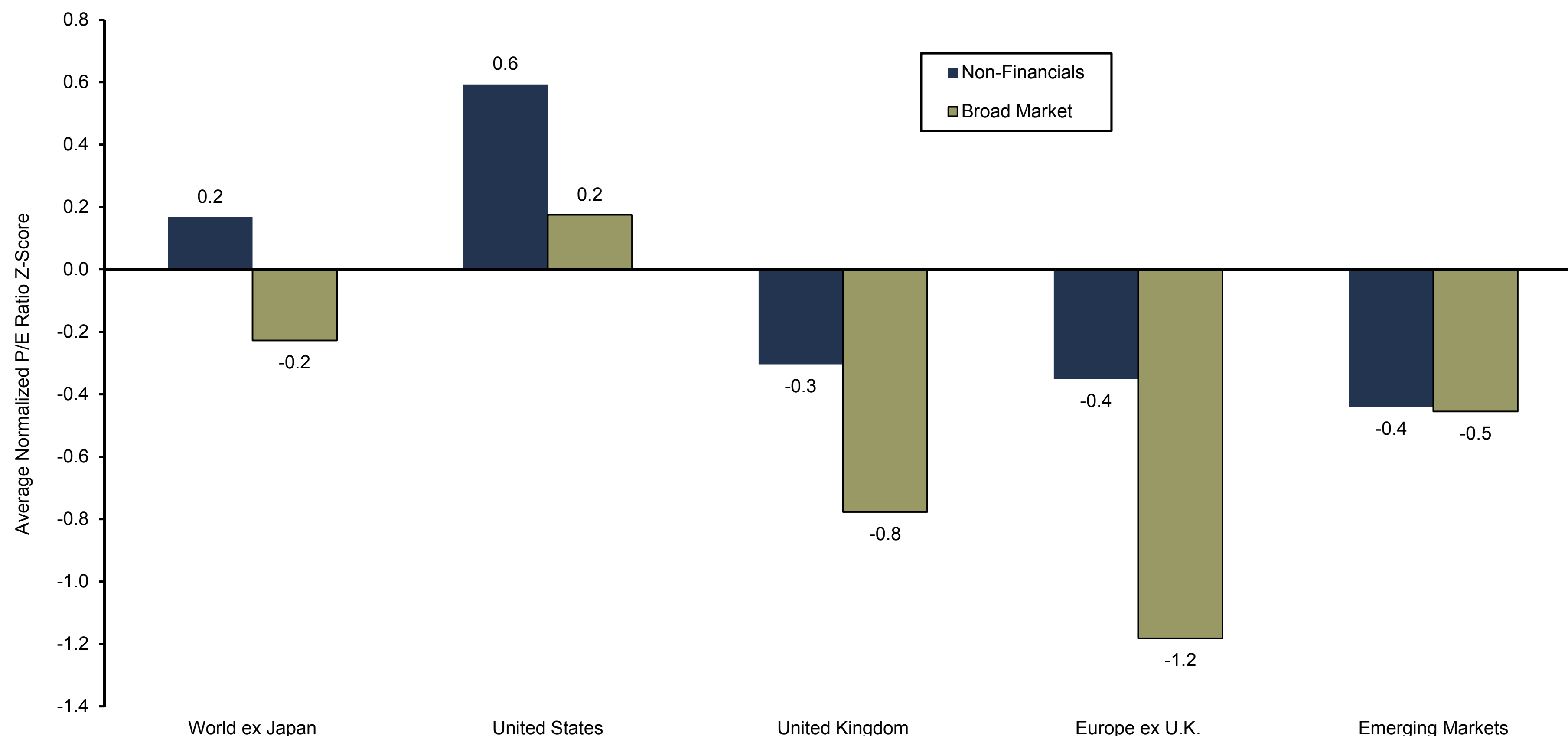


Sources: MSCI Inc. and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties.
Notes: The composite normalized price-earnings (P/E) ratio is calculated by dividing the inflation-adjusted index price by the simple average of three normalized earnings metrics: ten-year average real earnings (i.e., Shiller earnings), trend-line earnings, and ROE-adjusted earningsThe ROE-adjusted P/E ratio is the current trailing P/E ratio multiplied by the ratio of the current level of ROE to its historical norm. Shiller P/E is calculated by dividing the current price level by the ten-year average of inflation-adjusted earnings per share. Trend-line P/E ratios compare current stock prices to the level of earnings predicted by long-term real earnings growth based on a simple linear regression. To minimize the impact of bubble periods on valuations, we have excluded the years 1998–2000 from our historical average and standard deviation calculations for World ex Japan, EAFE ex Japan, Europe ex U.K., the United Kingdom, and the United States. No adjustments have been made for emerging markets equities. Z-scores represent the number of standard deviations away from the historical mean.

Exhibit 10

Relative Valuation of Non-Financials Versus Broad Market: P/E Ratio Deviation From Historical Average Based on Composite Normalized Earnings

As of May 31, 2012



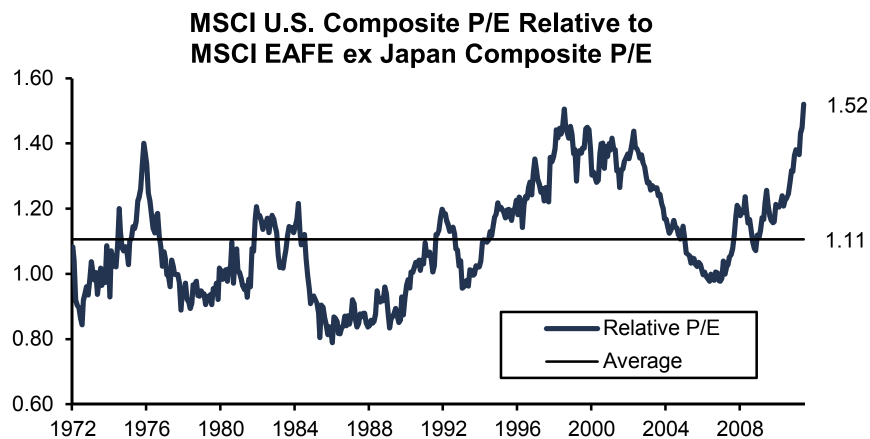
Source: Thomson Reuters Datastream.

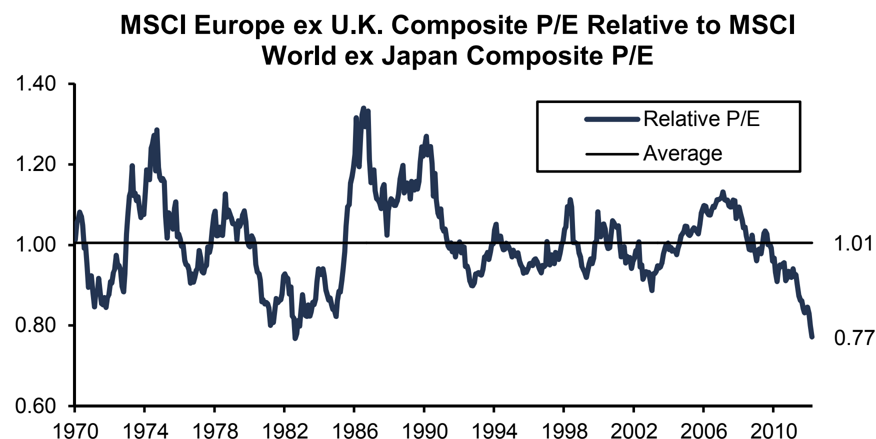
Notes: Datastream indices exclude negative earnings. The composite normalized price-earnings (P/E) ratio is calculated by dividing the inflation-adjusted index price by the simple average of three normalized earnings metrics: ten-year average real earnings (i.e., Shiller earnings), trend-line earnings, and return on equity (ROE)–adjusted earnings. The ROE-adjusted P/E ratio is the current trailing P/E ratio multiplied by the ratio of the current level of ROE to its historical norm. Shiller P/E is calculated by dividing the current price level by the ten-year average of inflation-adjusted earnings per share. Trend-line P/E ratios compare current stock prices to the level of earnings predicted by long-term real earnings growth based on a simple linear regression. To minimize the impact of bubble periods on valuations, we have excluded the years 1998–2000 from our historical average and standard deviation calculations for World ex Japan, Europe ex U.K., the United Kingdom, and the United States. No adjustments have been made for emerging markets equities. Z-scores represent the number of standard deviations away from the historical mean.

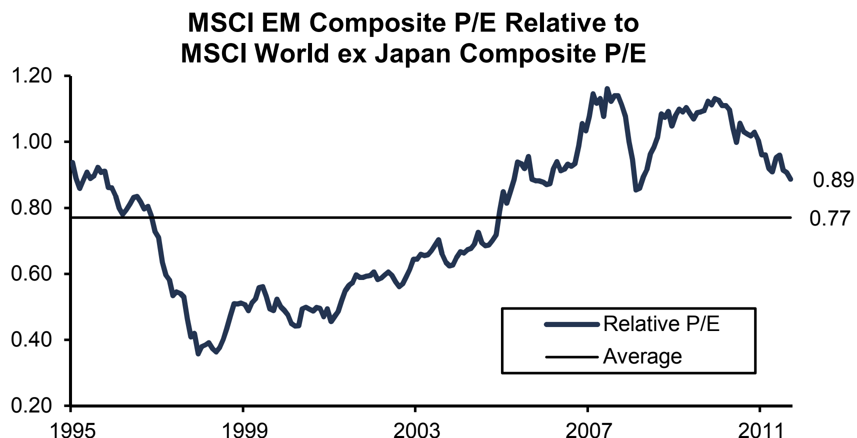
Exhibit 11

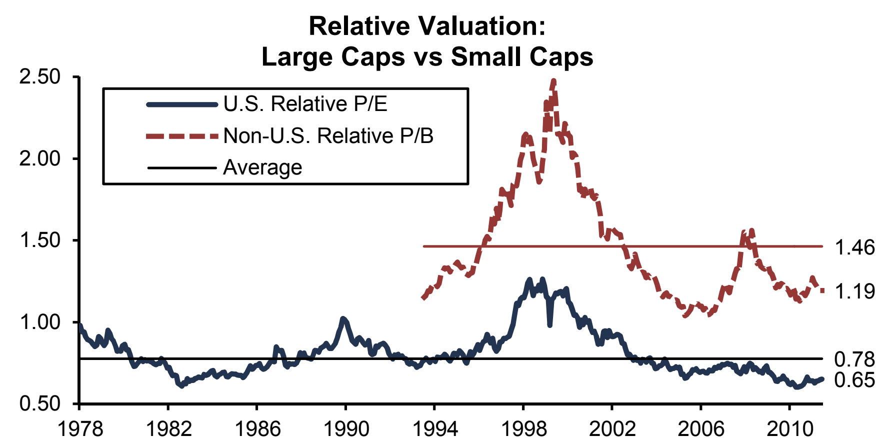
Relative Composite Normalized Price-Earnings Ratios

As of May 31, 2012







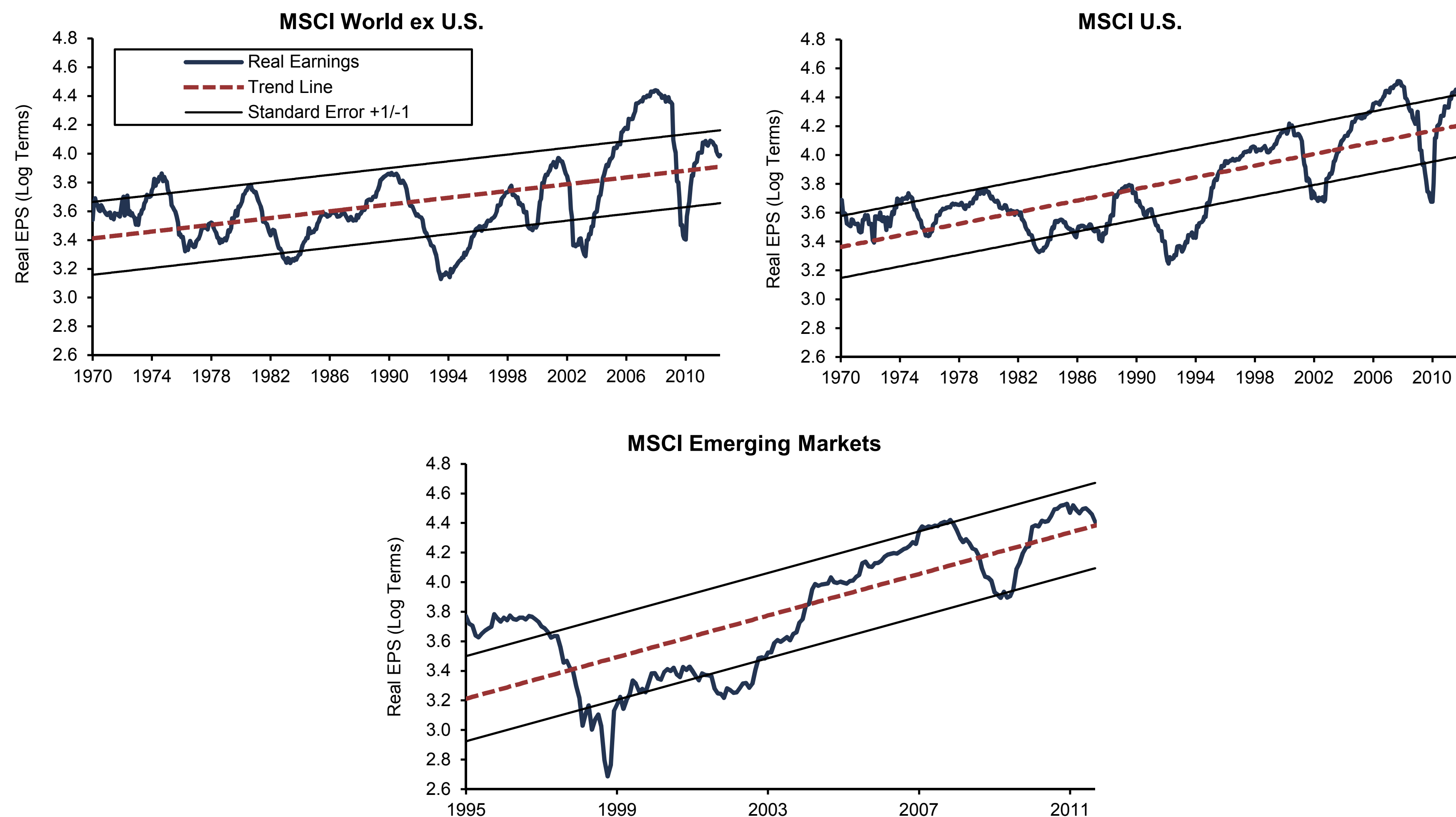


Sources: Frank Russell Company, MSCI Inc., and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties.
Notes: U.S. large caps and U.S. small caps are represented by the Russell 1000® Index and the Russell 2000® Index, respectively. Non-U.S. large caps represented by the MSCI EAFE Large-Cap Index and non-U.S. small caps represented by the MSCI EAFE Small-Cap Index. Non-U.S. relative calculations reflect price-to-book data. All other relative valuations reflect composite normalized price-earnings (P/E) ratios. The composite normalized P/E is calculated by dividing the inflation-adjusted index price by the simple average of three normalized earnings metrics: ten-year average real earnings (i.e., Shiller earnings), trend-line earnings, and return on equity–adjusted earnings. Performance data are in local currency terms. All data are monthly. CPI and Russell valuation data are as of April 30, 2012.

Exhibit 12

Real Earnings

January 31, 1970 – May 31, 2012



Sources: MSCI Inc. and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties.
Notes: All earnings per share (EPS) data are in local currency terms except MSCI Emerging Markets EPS, which are in US$ terms. MSCI World ex U.S. EPS deflated by G7-CPI. MSCI U.S. and MSCI Emerging Markets EPS deflated by CPI-U. Trend-line earnings based on simple linear regression. Data are monthly. MSCI Emerging Markets earnings data begin September 30, 1995.

Exhibit 13

What Can We Expect From Commodities Futures, in the Absence of an Inflationary Shock?

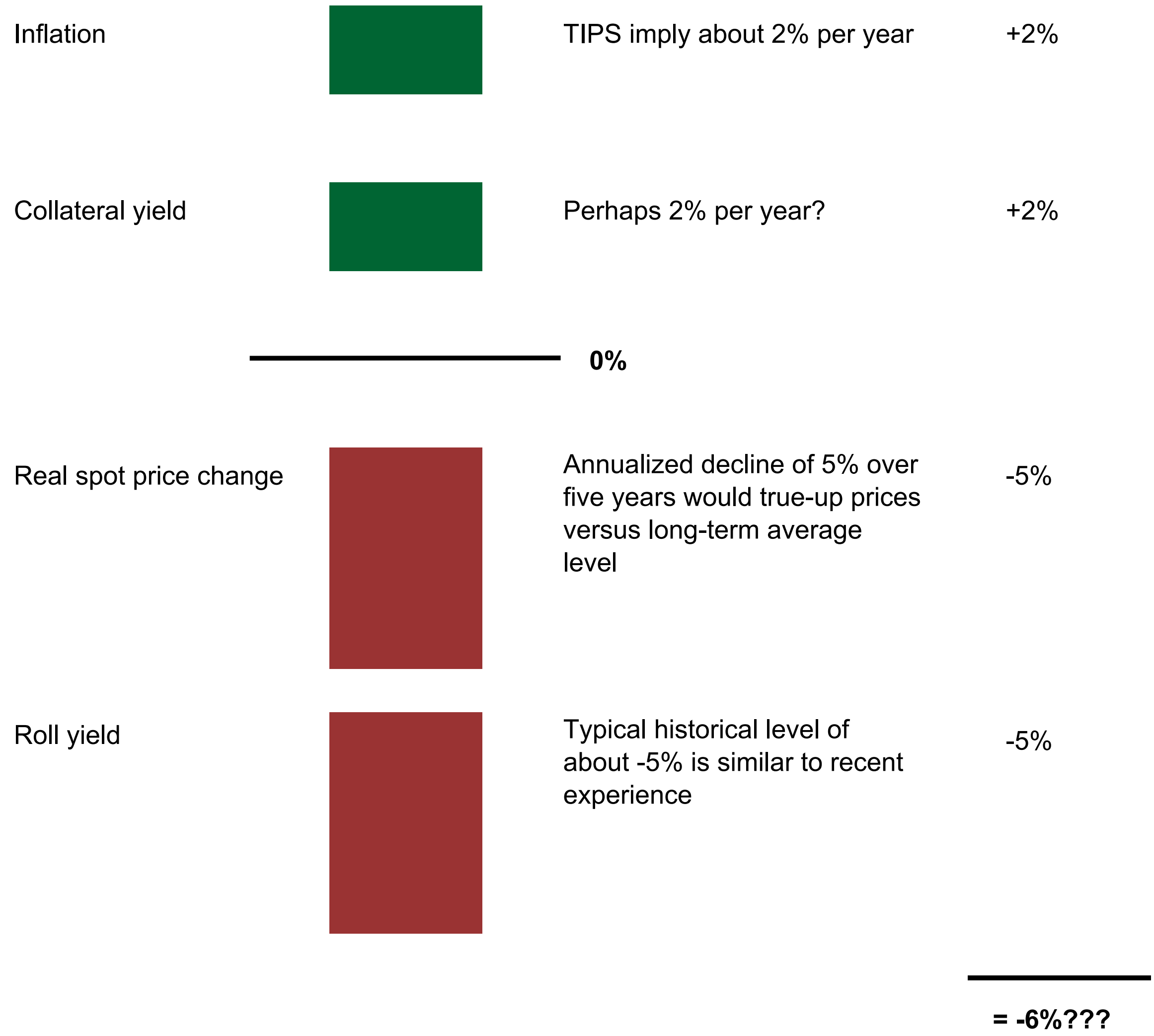
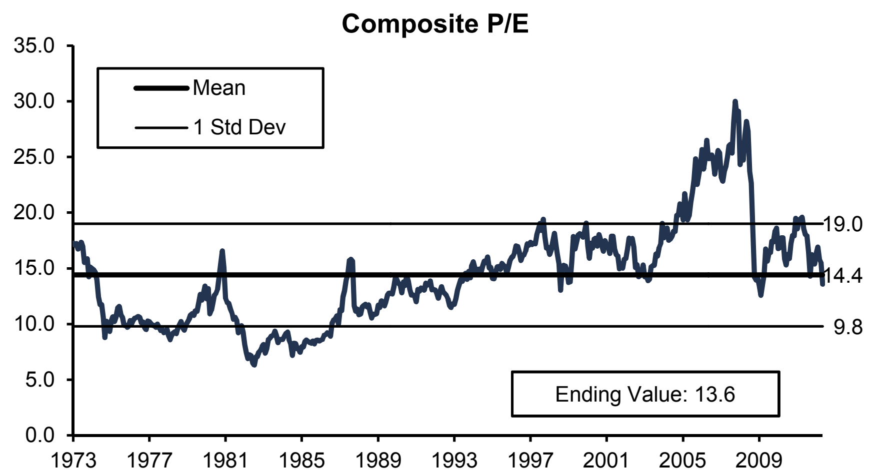
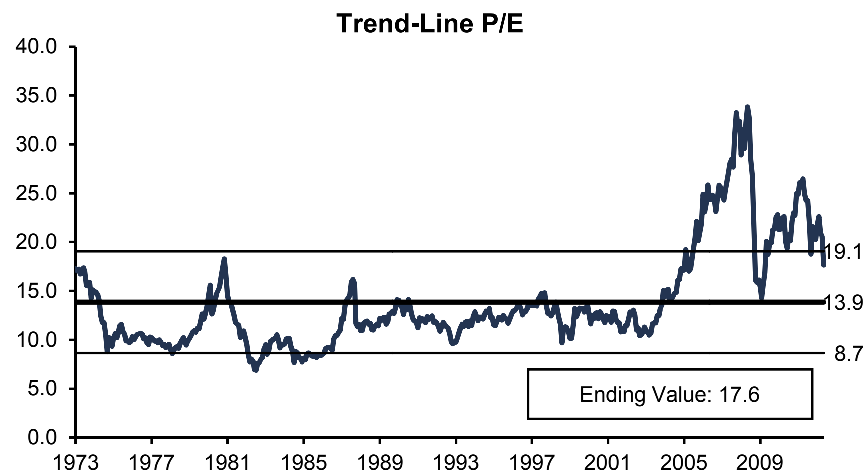


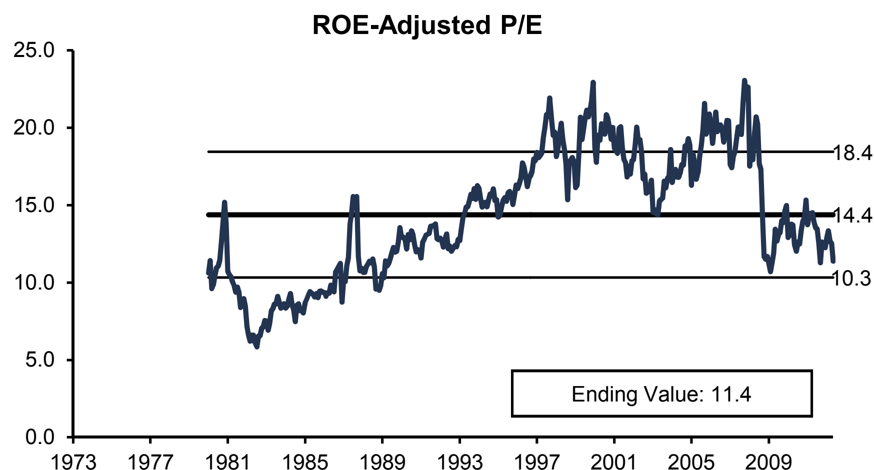
Exhibit 14

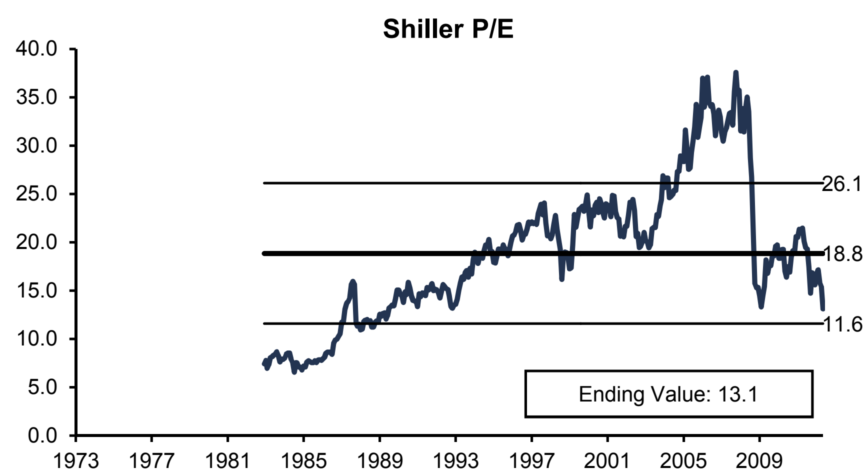
Natural Resources Equities Normalized Price-Earnings Ratios

January 31, 1973 – May 31, 2012







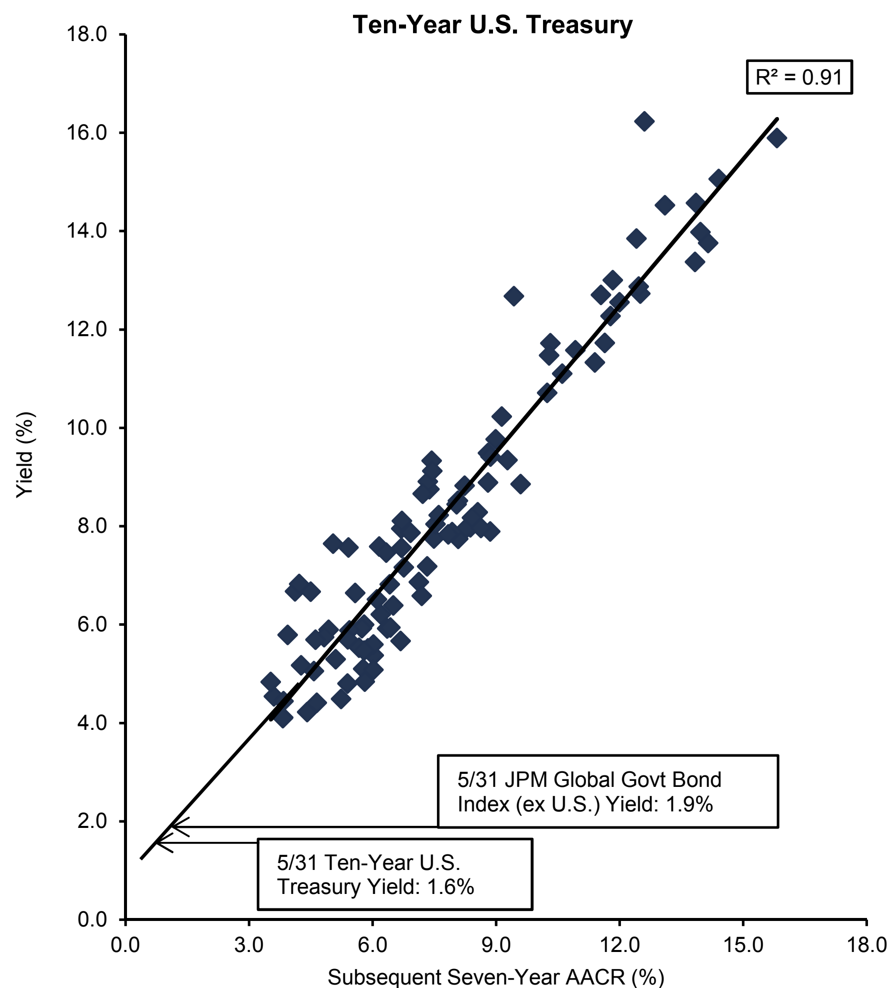


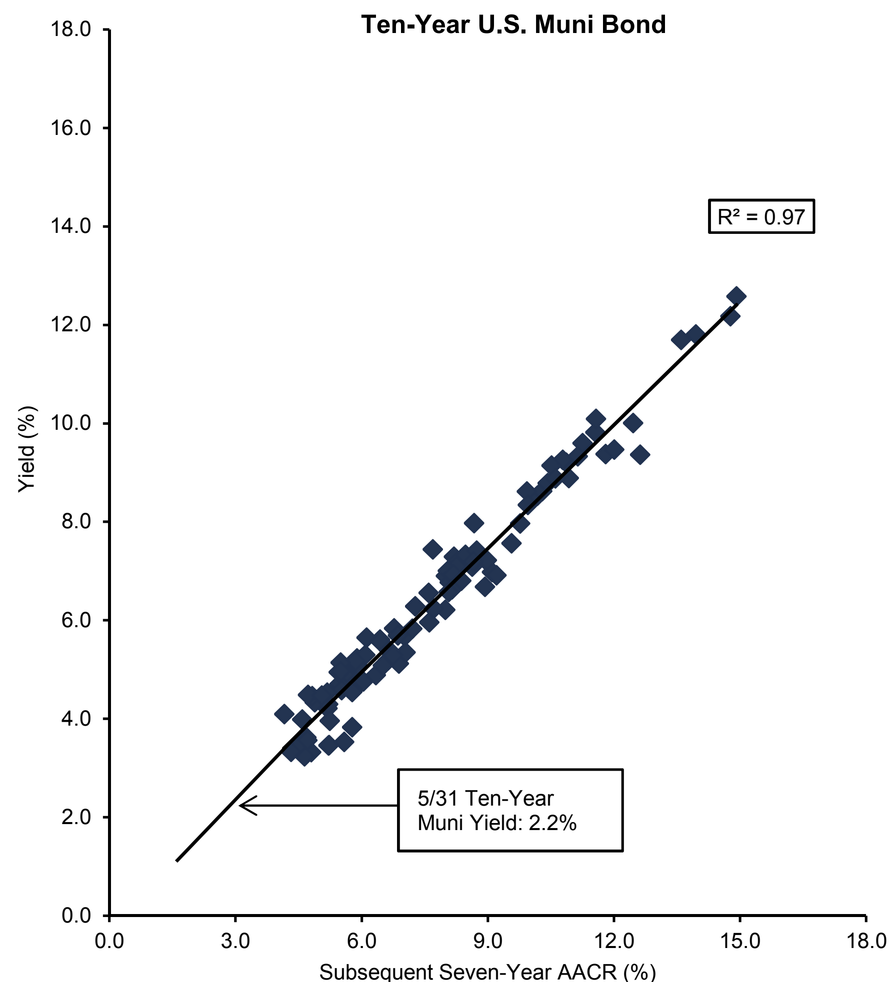
Sources: Thomson Reuters Datastream and U.S. Department of Labor - Bureau of Labor Statistics.
Note: The composite normalized price-earnings ratio is calculated by dividing the inflation-adjusted index price by the simple average of three normalized earnings metrics: ten-year average real earnings (i.e., Shiller earnings), trend-line earnings, and return on equity–adjusted earnings. CPI data are as of April 30, 2012.

Exhibit 15

Relationship Between Starting Yields and Subsequent Returns

March 31, 1980 – March 31, 2012





Sources: Barclays, J.P. Morgan Securities, Inc., and Thomson Reuters Datastream.

Notes: Graph uses quarterly data. Yields are based on the the beginning of the seven-year period. For example, the March 31, 1980, ten-year U.S. Treasury yield of 12.6% is plotted against the seven-year AACR of 16.2% from March 31, 1980, to March 31, 1987. The last full seven-year period was March 31, 2005, to March 31, 2012.

Exhibit 16

Defensive Equity Strategies

Potential Solutions

	Quality	Low Volatility	Equity Income	High-Yield Bonds	Sell OTM Covered Calls	Long/Short
Investment Thesis	• Firms with stable fundamentals re-rate amid uncertainty	• Lower-volatility shares may offer a smoother ride without a return penalty	• Sustainable dividends provide a bit of protection during market downturns	• Near-equity returns, sub-equity volatility, thanks to income cushion	• Capitalize on the gap between implied and realized volatility	• Highly skilled managers can separate good stocks from weak ones
Implementation	• Quasi-passive indices and fully active managers	• Quasi-passive indices and fully active managers	• Quasi-passive indices and fully active managers	• Active management preferred	• Systematic, but various option strikes and tenors	• Manager selection is critical

Considerations for Success

- Tend to limit drawdowns, while participating in most of the upside during broad equity rallies
- Benefits tend to accrue over a full market cycle; requires discipline
- Allocate when volatility is low and recent strategy performance has lagged
- Active managers have a wide range of investment processes and short track records
- Long/short equity considerations include: liquidity, leverage, transparency, key-person, and organizational stability

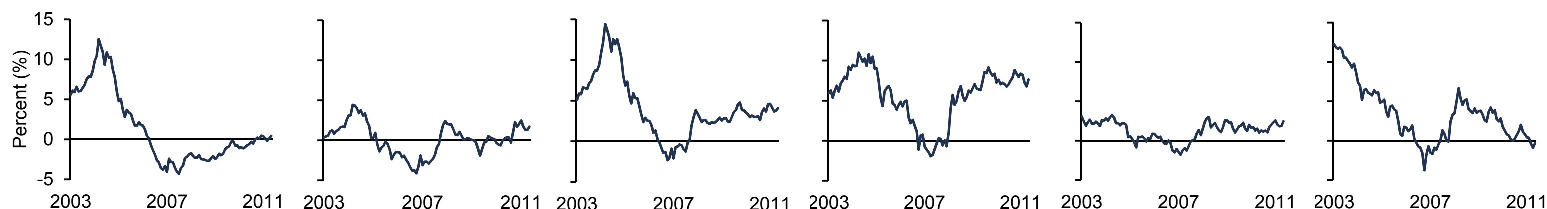
Exhibit 16 (continued)

Defensive Equity Strategies

Potential Solutions

	Quality	Low Volatility	Equity Income	High-Yield Bonds	Sell OTM Covered Calls	Long/Short
Favorable / Unfavorable Environments (vs broad equities)	+ Aging market cycle	+ Aging market cycle	+ Market/earnings cycle	+ Solid fundamentals	+ Expensive beta	+ Expensive beta
	+ Aging earnings cycle	+ Aging earnings cycle	+ Demand for income	+ Available leverage		+ Divergent corporate fundamentals
	- Plentiful liquidity	- Plentiful liquidity	- Plentiful liquidity	- Constrained by call	- Plentiful liquidity	- Low return dispersion
	- Decent macro data	- Strategy momentum	- Strategy momentum	- Consensus bet	- Decent macro data	

Rolling Five-Year Relative Performance (vs Russell 3000® Index)



Sources: Barclays, Chicago Board Options Exchange, Frank Russell Company, Hedge Fund Research, Inc., MSCI Inc., Standard & Poor's, and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties.

Notes: Rolling five-year relative returns are from December 31, 2003, to April 30, 2012. The x-axes are at zero (i.e., the point where performance of the defensive equity strategies matches that of the Russell 3000® Index). Indices used in analysis: S&P 500 High Quality Rankings Index ("Quality"), MSCI U.S. Minimum Volatility Index ("Low Volatility"), S&P 500 Dividend Aristocrats Index ("Equity Income"), Hedge Fund Research Equity Hedge Index ("Long/Short"), CBOE S&P 500 2% OTM BuyWrite Index ("Sell OTM Covered Calls"), and Barclays High Yield Composite Bond Index ("High-Yield Bonds").