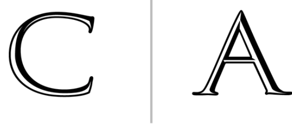

CAMBRIDGE ASSOCIATES LLC

GLOBAL MARKET COMMENT: THE GLOBAL INVESTMENT OUTLOOK: CONFRONTING THE WALL OF WORRIES

January 2003

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THE GLOBAL INVESTMENT OUTLOOK
CONFRONTING THE WALL OF WORRIES

Worry Number 1: The U.S.A.

The U.S. economy could be heading for a double dip and may slip into deflation. The manufacturing sector is already suffering price deflation of about 1.3% annualized, and yet equity market valuations discount a strong earnings recovery, which is nowhere in sight. Consumer savings are rising in response to rising job insecurity and diminished household wealth, and the flip side of rising savings is diminished consumption—bad for corporate sales and profits. Meanwhile, excess capacity persists and corporate capital expenditures are minimal with free cash flow used to pare down debt and mend frayed balance sheets. The specter of malign deflation (i.e., not just declining prices, but shrinking demand and increased inability to service consumer and corporate debt) lurks in the shadows like latent cancer, poised to spread throughout the economy's vital organs. And in the background the drums of war beat. The market rallied when the 1991 Gulf War proved a cake walk; perhaps as a result, however, anything more prolonged than a brief, deadly strike will disappoint today's expectations, and so there's plenty of downside potential from the impending conflict.

Yes...but. Is there really any *news* in this litany of prospective woe? Anything we haven't known for months and read about every day in the papers?

Deflation is unlikely—not impossible, but unlikely. There is always price deflation somewhere—in computers, for example, for the past 20 years—and so anecdotal evidence of declining prices is not in itself evidence of a general diminution in demand or impending debt crisis. While remaining well hedged against the possibility of deflation, investors should not, therefore, predicate their general asset allocation mix on the presumption that this is a likely outcome.

The United States is predominantly (70%+) a service economy, and service sector prices are not declining (look at health care). Unemployment and personal bankruptcies have both risen, as one would expect during a period of economic weakness, but consumer loan delinquency rates are currently much lower than during previous periods of economic weakness and personal incomes have, in aggregate, continued to rise. As a result of the bear market, household net worth has dropped from six times income to five times income—but six times income was a record high and five times income is very healthy by historical standards. Despite the fact that the U.S. consumer seems to hog the headlines, consumer debt/income ratios are in fact higher in the United Kingdom, Germany, and Japan. In short, although U.S. consumers are spending more carefully, they are still spending, and rumors of their demise are generally overstated.

Similarly, although corporate debt rose sharply in the late 1990s, declining interest rates meant that debt service costs remained well within historical ranges. Like consumers, corporations are now using some cash flow to reduce their indebtedness, and this also contributes to lower growth, since they are not investing in new plant and equipment. This may soon change, however—one of the positive surprises of 2003 may be a pick-up in capital expenditures, which the market does not now seem to expect.

So, yes, it would be naïve to assume turbo-growth for the U.S. economy in 2003 and, yes, valuations already discount expectations of reasonably robust profit recovery. There is certainly room for disappointment on that score, although almost all the commentary we read assumes earnings estimates will drop as the year progresses, which makes it difficult to know just what the market *really* expects. Finally, the prospect of war has been with us for so many months now, capturing the lead story on almost every evening newscast, that the markets have surely had time to weigh the probability of various outcomes and to price them accordingly.

On balance, then, we are more optimistic about U.S. equities than the litany of worries might suggest, but this may be attributed in part to our not having subscribed to the notion that the secular bear market had run its course and so we expected rallies to be followed by retreats. Consumer confidence and market sentiment are poor, and despite the lowest yields in decades (zero or negative real rates of return) money market funds are bursting with $2.7 trillion of buying power. It may be hard to make a strong case for U.S. equities on the basis of current valuations (dividend discount models excepted), profits growth, or geopolitical stability, but we spot glimmers of contrarian opportunity in the prevailing gloom.

We regard the United States as Worry Number 1 because in the short run we agree with the consensus view that the world needs a reasonably healthy United States as the key to global economic recovery. Beyond the short run, both Europe and Asia—but particularly Asia—may prove less correlated with the United States than in the past decade, but not until the world economy is in better shape than today.

Worry Number 2: Continental Europe

Europe is limping, with Germany in particular looking economically dysfunctional and politically in denial of its obvious structural problems. European share prices have slumped to a six-year low and the euro's 20% rise against the US$ hurts European competitiveness.

In *Europe After EMU*, published in 1999, we argued that Europe's progress in economic and labor market reform would be three steps forward, two steps back, but that forward progress would nevertheless be made. Germany has been busy taking its two steps back, achieving the dubious distinction of making France appear liberal by comparison, but we still believe (political rhetoric notwithstanding) that both France and Germany will continue to stumble haltingly down the path toward greater economic liberalization, because the alternative routes lead to stagnation. So the political propensity toward redistributive economic policies will be checked by the political propensity toward policies that stimulate growth, produce more jobs, and create more wealth—albeit unevenly distributed. At different times, first one and then the other of these irreconcilable approaches will hold greater sway, but we suspect the latter will win out in the end because the former ultimately poses a greater threat to living standards.

Meanwhile, markets have priced in the expectation that European growth will lag that of the United States, with European equities selling at more attractive valuations than those in the United States. While accepting the conventional wisdom that neither Europe's economies nor its markets are likely to perform well if the United States remains in the doldrums, we see more promise in European equities simply because they have more scope to exceed diminished expectations. In addition, unhedged US$ investors in €-denominated assets might benefit from the continued depreciation of the US$—although we would caution investors against counting this as money in the bank (see currency comment below).

Worry Number 3: The U.K. Housing Bubble Collapses, Taking Consumers With It

Most people buy houses to live in, not as an investment, and so the monthly mortgage is more significant than a property's price. Low interest rates and rising personal incomes have made housing more affordable to more people, and this has fueled the recent boom in both the United States and the United Kingdom. Prices may well fall sharply in some areas of Britain when short-term interest rates next rise, but the notion of a general, impending catastrophe is overblown. The U.K. economy is more flexible and robust than those of the eurozone, and Britain has the added advantage of being able to tailor its monetary policy to domestic conditions.

Worry Number 4: Japan Remains a Basket Case—and Now the Basket is Unraveling

Japan is trapped in a deflationary spiral, a liquidity trap, political paralysis, a slow-motion implosion of the financial sector, and a demographic nightmare.

The tug-of-war between the old guard and the reformers continues, with the reformers recently gaining some ground. Next March, Prime Minister Koizumi gets to appoint a new governor of the Bank

of Japan, which should enable the reformers to advance another few inches. The problem is that Japan may have to get worse before it can get better and that policy mis-steps could result in the cure being worse than the disease, leading to Koizumi's defeat and the return to power of the reactionary wing of the LDP, who would circle the wagons in support of the bankrupt status quo. It would be sensible, therefore, to remain cautious, to remember that many false dawns have come and gone in recent years, and that the insolvency of the financial sector is only one of several related structural problems. On the other hand, although Japan is unlikely to register strong growth in 2003, there is plenty of room for positive surprise.

Worry Number 5: A US$ Crash

Many would argue that this should be ranked as Worry Number 1 since they regard the US$ as another bubble created by a feckless Fed and destined to suffer the same fate as the Nasdaq, but with wider and more devastating consequences. Their scenario is one we have related before, and regard as unlikely, although not implausible. With a huge and growing current account deficit, the United States must suck in over 75% of the world's savings at a rate of $2 billion every day, making the US$ entirely dependent on the kindness of strangers. If foreign investors decide en masse to stop buying US$-denominated assets—or even worse to start selling—the consequent crash in the currency would set off destabilizing shock waves around the world, affecting everything from grain futures in Chicago to the price of petrol in Dubai, to the cost of a hotel room in Shanghai, and of vodka in Vladivostok.

The answer? Buy gold, the only currency providing a hedge against the arrogant folly of central bankers and/or the inflation they will stimulate in their desperate (and ultimately futile) efforts to stave off the deflationary consequences of the dollar's crash.

Like all good conspiracy theories, this scenario is plausible, but unlikely. The dollar's rise in the 1990s was a rational reflection both of the relative strength of the U.S. economy and of the appeal of U.S. equities and bonds to foreign investors. On a trade-weighted basis the US$ did not become as overvalued as in the early 1980s, before the Plaza Accord led to its orderly retreat, and the extent and velocity of its current pull-back are much the same as during previous cyclical declines. In addition, everyone now "knows" that U.S. assets are less attractive to foreign investors and that the US$ is overvalued and will decline. All the pundits say so.

Maybe. We have no argument with the fundamental case against the US$, only with the prevailing notion that it must therefore, inevitably, decline steadily from now on. When "everyone and their mother is saying the dollar will decline in the next 12 months" (Marc Chandler of HSBC, quoted in *The Wall Street Journal*, January 20, 2002) we suspect the trade may be past its sell-by date. In short, the US$ may

be vulnerable, but we would not bet the farm on its imminent demise. Moreover, we would guess that any decline over the next year or two will be punctuated by vicious counter-trend rallies.

Gold we regard as a hedge against the perfidy of central bankers, especially the U.S. Federal Reserve, appropriate only for those who believe that Greenspan spends his days systematically debasing the currency. The only other reason to buy gold is because it has gone up, and might keep going up as it attracts more momentum investors. This, of course, is entirely speculative.

Asset Allocation Implications

Public Equities

Despite the bear market, U.S. equity valuations still seem relatively high by historical standards and forward earnings estimates are unrealistically optimistic, given the intense pressures on corporate profits. In addition, the dramatic excesses of the equity market bubble have yet to dissipate entirely. For these reasons, the secular bear market probably has further to run, although prices may not drop below the lows of last July and October.

Nevertheless, the skies are clearing, albeit slowly and inconsistently, and there is a considerable danger in hibernating with the bears too long.

We would therefore advise *against* aggressively underweighting equities and would buy on weakness. Cautious investors might explore low-beta ways to implement their equity allocations (e.g., long/short equity hedge funds, underweight aggressive growth, allocating some assets to equity managers who raise cash when they can't find stocks that meet their investment criteria), but a bet on bonds or cash and against equities strikes us as a risky proposition.

However, since corporations are using cash flow to pay down debt rather than invest in higher earnings, credit spreads should continue to narrow, which suggests that high-yield corporate bonds could be seen as a viable substitute for low-quality, value-oriented equity exposure—at least with the bonds you get paid to wait if the markets go nowhere.

Although the London stock market will follow where New York leads, it now sells at a lower valuation, as do the eurozone markets. As in the United States, we would advise against underweighting U.K. or eurozone equities.

More generally, we continue to suggest that U.S. investors increase their modest allocations to non-dollar equities in both Europe and Asia, partly on the basis of relative valuations, but partly also as a means of profiting from any depreciation in the US$.

A wary pessimism about Japan is reasonably well reflected in the market price, which is why the Japanese equity market now sells at the same level as 20 years ago (based on Nikkei monthly price levels). We continue to advocate a market weighting in Japanese equities, but to recommend that investors implement this through active, research-driven, value-oriented managers (including long/short strategies).

Hedge Funds

Hedge funds number in the thousands; hedge funds-of-funds number in the hundreds; and careful due diligence would suggest that the number of hedge fund managers worth considering number three or four dozen. Under these circumstances, something has to give, sooner or later.

Generically, hedge funds held out the promise of good returns unrelated to the performance of the capital markets, but have largely failed to deliver—at best they have been among the least bad of many unappetizing choices. There is imminent risk of disillusionment, especially with funds-of-funds, whose numbers have exploded in recent years. If the equity markets were to stage a sustained rally, hedge funds would lag, and large quantities of capital be withdrawn from funds-of-funds, causing havoc in the hedge fund world and increased volatility in the capital markets.

Even good funds not held by funds-of-funds would be exposed to collateral damage. For these reasons we would argue that investors need to know as much as possible about their hedge funds managers—including whom they have as clients—and should exercise unusual caution in manager selection. After all, there is no fundamental basis of return for most hedge fund strategies, just manager skill (sometimes amplified, for better or worse, by the use of leverage). Manager selection is everything.

Property

The U.K. property market is far too rich. For historical reasons, European property markets don't yield enough to attract tax-exempt investors. A substantial quantity of Asian property is still distressed. U.S. real estate is suffering from declining rents and rising vacancies.

We would avoid the U.K. and European markets, preferring to buy U.S. real estate through value-added funds (rather than prime properties favored by pension funds), and selected Asian distressed funds.

Bonds

With developed markets sovereign bond yields at 40-year lows, many investors are questioning the risk implicit in these low yields.

However, investors still need high-quality bonds as protection against the low probability, high catastrophe possibility of malign deflation. Just because rates are at 4% doesn't mean they can't go to 2%, although we fervently hope this does not occur. Buying credit or mortgage-backed issues in order to extract more yield nullifies the hedge and defeats what we regard as the primary purpose of the bond allocation.

So, we would advise investors to maintain a sufficient allocation to sovereign bonds to hedge the total portfolio against deflation, and pray that the value of these holdings declines.