July 2012

Investment Publications Highlights

CAMBRIDGE ASSOCIATES LLC

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"The American Dream and the Fiscal Nightmare"

Francisco Blanch et al., Bank of America Merrill Lynch, April 2, 2012

Following a decade of disappointing equity returns, the case for investing in the United States is stronger, particularly when considering other alternatives. There are various reasons for this, but a significant one is that the United States enjoys an abundance of all three factors of production—capital, labor, and natural resources—unlike developed markets peers such as Europe and Japan. However, short- and long-term fiscal challenges, and the likelihood that equities will be unable to stage a large rally until global macro pressures ease, somewhat offset these positives.

Following a decade of disappointing equity returns, the case for investing in the United States is stronger, particularly when considering other alternatives. There are various reasons for this, but a significant one is that the United States enjoys an abundance of all three factors of production—capital, labor, and natural resources—unlike many developed and emerging markets peers. This makes a decade of Japan-style stagnation unlikely. However, short- and long-term fiscal challenges, and the likelihood that equities will be unable to stage a large rally until global macro pressures ease, somewhat offset these positives.

The case for investing in the United States begins with high wealth levels that support consumption. Household wealth in the United States is above $70 trillion, compared with around $20 trillion for the next wealthiest, Japan, and far above levels seen for European countries. Financial assets ($50 trillion) contribute the bulk of this wealth and have recovered in value by around 20% over the last three years thanks to higher equity and debt markets. Wealth stored in housing, which has dropped around one-third since 2006 to $15 trillion, also should rebound. Home prices have dipped below fair market values, and a shortage in some areas means housing starts are growing from multi-decade lows. Lower debt levels will also be relatively supportive of consumption as debt/GDP for U.S. households has fallen 15% to roughly 115%—around 30 percentage points below their U.K. peers.

The United States continues to see greater productivity growth than developed markets peers, also a sign that stagnation is unlikely. While emerging markets productivity growth has been stronger, it has been highly reliant on drivers like globalization and IT adoption. In the United States, productivity has been fuelled by more efficient labor, while the share of productivity growth attributable to technology has actually been declining since the early 1990s. The flipside of greater labor productivity is that unemployment remains elevated, although corporations could alleviate some of the pressure if they stopped hoarding cash.

Aside from higher labor productivity, U.S. manufacturing competitiveness has also been boosted by easing weaker currency. Inflationary pressures in emerging markets have led to increasing labor costs. For example, since 2007, real wages in China have grown by around 80%, while they have actually declined in the United States. Limited productivity gains have meant that developed markets peers have also fallen behind; for example, hourly manufacturing costs in many European countries grew 25% to 50% faster than those in the United States during 2000–10.

Natural resources are the final tailwind for the U.S. economy in upcoming years; here, again, peer comparisons are very favorable. The United States is the top holder of arable land and one of the top producers of natural resources in the world. It is the top holder of non-conventional oil and, outside OPEC, among the four largest holders of conventional oil. Currently, the United States ranks in the top six producers of natural gas and thermal coal—a ranking that will increase given new discoveries. The net result is that prices of many natural resources, especially natural gas, are significantly cheaper in the United States, giving U.S. corporates an advantage.

While these three factors can be used to paint a benign picture of the United States' future, investors should not ignore some significant challenges. On the domestic front, consumers must become less reliant on the government, as transfer payments have soared since the crisis and now contribute around 10% of disposable income. This is not sustainable given the bloated government budget deficit, but political consensus is lacking on how to make cuts. If further brinkmanship ensues, especially considering the upcoming "fiscal cliff," markets could become unglued. Doing nothing is unthinkable; the automatic cuts would force a contraction of around 4.6% of GDP, tipping the economy into recession.

Outside of the United States, improvement needs to be seen in Europe. The Long-Term Refinancing Operations did succeed in lowering peripheral borrowing costs during the first quarter, but without growth, lower financing costs are just a temporary bandaid. In fact, some investors have already written Europe off as the next Japan, given the combination of debt levels, demographics, dysfunctional politics, and limited natural resources. The good news is that some of Europe's problem is political and thus can be fixed, though popular resistance to austerity and German intransigence threatens pan-European cohesiveness. In this context, growth in emerging markets becomes ever more important, and falling inflationary pressures led by lower oil prices might provide some support.

Looking ahead, investors are probably going to want to see more evidence of macro repair, both at home and abroad, before significantly increasing equity exposure. Valuations are not challenging, but questions about earnings and certain sectors like financials remain. A final wildcard is bond yields—if these rise and investors start to see negative returns in fixed income portfolios, it could be the final push that is needed to get investors to make larger commitments to U.S. equities.

"Fiscal Cliff Diving"

Michael Zezas and Julie Powers, Morgan Stanley, May 2012

The structural difficulties that many state and local governments face—namely, rising pension liabilities and operating imbalances—are unlikely to reverse anytime soon. While many of these governments managed to increase their revenues on the back of the recent economic recovery and their overall drag on U.S. GDP growth has decreased, it is likely that the credit quality of many state and local borrowers will decrease should the fiscal cliff go through as planned in 2013. Holders of certain municipal bonds should closely follow this developing situation.

Under the current law, the federal government is set to implement a combination of spending

cuts and tax increases of unprecedented severity at the beginning of 2013. The so-called fiscal cliff is predicted to have a significant impact on state and local governments that are dependent on federal government support. While many state and local governments managed to increase their revenues on the back of the recent economic recovery and their overall drag on U.S. GDP growth has decreased, it is likely that the credit quality of many state and local borrowers will decrease should the fiscal cliff go through as planned in 2013. Holders of certain municipal bonds should closely follow this developing situation.

Leading up to the financial crisis in 2008 and continuing through the subsequent economic downturn, state and local governments routinely spent more than they were taking in. In addition to the excess spending, state and local governments underfunded their pensions and other liabilities while operating on budgets that based spending estimates on future lofty revenue expectations. Following the economic downturn, as tax revenue decreased, many state and local governments continued to spend at rates well above revenue growth. This led to a substantial degradation in credit quality of many municipal borrowers. During a normal, cyclical downturn in the economy, state and local governments have traditionally relied on support from the federal government. However, following the most recent downturn, the challenges many local and state governments face appear to be more of a structural nature.

These structural difficulties—namely, rising pension liabilities and operating imbalances—are unlikely to reverse anytime soon. During the boom years, rising costs embedded in budgets were masked by higher revenues, mainly from increased property and sales tax receipts due to the housing bubble. As the recent recovery in the United States has been one of the weakest on record, it is unlikely that any cyclical factors such as growth-led increases in tax revenues will help improve the credit quality of municipal borrowers in the near future.

Aware of the issues they face, state and local governments have been slowly addressing their spending problems at the same time that economic growth in the United States has contributed to an uptick in tax receipts. However, if enacted as planned, the fiscal cliff would likely hurt state and local governments' credits. Even if the credit quality of many state and local borrowers decreases, the stress on the governments may actually be a positive in the long run if it forces them to deal with their spending issues. General obligations credits are likely to face the most pressure under the fiscal cliff scenario, with state-level issuers likely holding up better than local borrowers. A recent string of municipal bankruptcies in California and elsewhere has served as a reminder that the fiscal pressure due to excessive spending has very real consequences.

While the fiscal cliff is still many months away—with a presidential election taking place before year end—the reality is that state and local governments will remain under significant stress. Estimates vary as to the actual impact of the fiscal cliff, with some estimating it will be drastically scaled back as the end of the year approaches. However, the case remains that the problems facing many municipal borrowers are structural, and further deterioration in municipal credit quality is likely to occur. ■