CAMBRIDGE ASSOCIATES LLC

INVESTMENT PUBLICATIONS HIGHLIGHTS

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Investment Publications Highlights

Summarized by Published Research Team

"Back to the '70s... with a Twist"

by Henry McVey, Morgan Stanley Investment Management, June 2010

Markets will remain volatile in the months ahead, as macro worries such as the threat of increased government intervention and extreme monetary policies dominate. Equity investors should be aware that many of the recent drivers for rebounding earnings are transitory, financials cannot reduce write-downs indefinitely, and commodity prices are stabilizing. However, opportunities do exist, particularly in the case of European equities trading at low valuations. With the risk of deflation rising, investors also may wish to look at higher income generating–securities such as high-yield bonds and emerging markets debt.

Markets will remain volatile in the months ahead, as positive earnings momentum is offset by macro worries such as the threat of increased government intervention/regulation, extreme monetary policies, and slowing growth in emerging countries such as China. This suggests it will not be business as usual for investors for some time, and that the recent shift toward macro investing will continue. The next few years could resemble a period like the 1970s and early 1980s, with higher volatility, periodic crashes, and poor monetary policy. Unlike the 1970s, however, the real risk this time around is deflation.

In terms of the outlook for equities, earnings growth remains solid—despite the handwringing about economic growth—led by energy and financial profits. However, the main earnings drivers are likely transitory (higher commodity prices and lower write-offs for financials), and energy and financials tend to trade at low multiples. In addition, the specter of deflation could put downward pressure on multiples, while the growing risk of sovereign debt crises necessitates higher risk premiums.

Within equities, now may be the time for investors to consider shifting from the United States to Europe. European equities trade at a forward multiple of 10.1 times earnings, as the market has focused on macro concerns. Investors have underestimated the resolve of Eurozone members to find a solution to the sovereign debt crisis, and have over-rewarded strong economic data in the United States. Excessive optimism in the United States is reflected by the performance of sectors such as retailers; since the equity market trough in March 2009 through the end of May 2010, retail stocks have outpaced the S&P 500 Index by more than 30%. Emerging markets equities have also become more attractive, as they have underperformed U.S. equities by 11.2% during the first four months of 2010 due to safe haven concerns, and valuations make sense relative to growth prospects.

Sovereign bond yields remain low despite rising debt burdens and the need for greater issuance. This is due to ongoing deflationary pressures such as high unemployment, excess capacity, and surplus housing. The deleveraging process is also highly deflationary, and its impact on prices has yet to be felt. As of year-end 2009, total debt (excluding financials) stood at roughly 270% of GDP in the United States, 205% in the Eurozone, and 320% in Japan. The prospect of interest rates remaining low for an extended period suggests high-income securities are attractive, especially in

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emerging markets and non-investment-grade credit.

On the currency side, sovereign debt concerns and the ensuing flight to quality have punished emerging markets currencies in recent months, but now may be the time to scale back into this trade, as emerging markets currencies are not only cheap, but supported by better fundamentals than those of developed markets. Emerging markets fiscal discipline remains impressive relative to shortfalls in developed markets, and trade balances are favorable. Finally, emerging financial markets have remained calm in recent months relative to those in developed markets, suggesting the risk of capital flight has receded. Key positive catalysts would include stabilizing equity markets, particularly in China, and a calming of tensions on the Korean peninsula.

"U.K. Fiscal Adjustment Ahead: Implications for Equities" by Sharon Bell, Goldman Sachs, May 13, 2010

Over the last 40 years, there have been three instances in which the United Kingdom has had to reduce the deficit, and on all three occasions it was able to outperform the world market.

In the last 40 years in the United Kingdom, there have been three periods in which the budget deficit has been cut significantly: 1977, 1980–82 and 1995–98. Notably, these periods were matched by periods of outperformance by U.K. equities, driven largely by a rise in U.K. multiples. There are two additional parallels between today's situation and these past periods that should encourage equity holders. First, the price-earnings discount at which U.K. equities trade today is similar to that at the outset of other adjustment periods, and second, sterling's recent sharp depreciation should help cushion any impact of austerity on both the economy and equities. While there was one period during which fiscal austerity was not positive for U.K. equity markets in absolute terms—1980–82, when sterling fell and inflation exceeded 10% per annum—U.K. equities still outperformed other global markets in local currency terms.

Despite the similar results in equity markets, the periods have differed with regard to fundamentals and economic environments. Real earnings, for example, were strong in 1977 (up 13% for the year), mildly positive in the mid-1990s (up 20% over the four-year period), and weak in the early 1980s (down 3% for the period). GDP growth, meanwhile, was also mixed. In 1977, real GDP growth fell through the year, but was still running at about 2% at the end of the period, while in the early 1980s, GDP plunged during a deep and prolonged double-dip recession, but by the end of the fiscal adjustment period had recovered to around 3%. The mid-1990s were the best and most consistent period for growth, with GDP running at around 3%, perhaps a function of the focus on spending cuts rather than on tax increases.

The interest rate and currency backdrop also differed throughout the three periods, with interest rates collapsing in the first two periods—helping to cushion the market from the impact of the fiscal tightening—but rising in the mid-1990s, thanks to the strong global economic backdrop. The pound, not surprisingly, lost value *prior* to each period of fiscal retrenchment, with sterling falling sharply in the 1974–77 and 1992–93 periods (sterling's humiliating exit from the European Exchange Rate Mechanism was in late 1992). This time it also looks like a sharp fall in sterling will precede a period of deficit reduction. With more than 50% of the U.K. equity market's exposure coming outside the United Kingdom, this should more than offset the impact of fiscal tightening on equities.

There is no consistency with regard to economic sector performance during these periods. While there has been a significant amount of speculation about the impact of spending cuts on companies with large exposures to government expenditure, these companies make up only 2% of U.K. market capitalization and have outperformed the market recently. If spending cuts are enacted, this group will become more vulnerable, though heavily weighted sectors such as health care are unlikely to experience severe cuts.

It is axiomatic to believe a need for fiscal prudence would signal weakness for an equity market; however, that has not historically been the case. The U.K. equity market has outperformed during periods of fiscal prudence, and by possessing the luxury to depreciate the sterling, the United Kingdom should be able to contain any impact on the economy or equity markets caused by austerity measures. ■

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