2016 Annual Investment Forum

# Navigating Divergent Global Markets

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*The notes below are a summary of the remarks and views expressed by the speakers at the 2016 Annual Investment Forum and do not necessarily reflect the views of Canterbury. A full transcript of the speaker's remarks is available on our website www.canterburyconsulting.com.*

## MACRO DIVERSIFICATION: BRIAN SINGER, WILLIAM BLAIR & COMPANY

### Introduction

Markets are often quite serene as they build themselves to a critical state that makes them vulnerable to turbulence. Then, the snowflakes turn into an avalanche and everything comes crashing down quickly. The "avalanche" of market turbulence came halfway down the mountain in 2015, and it now appears to have resumed its slide. Two quotes that are appropriate to today's environment are "Buy when there is blood on the streets, even if the blood is your own" (Baron Rothschild); and "It is dangerous to be right when the government is wrong" (Voltaire). There is certainly blood on the streets, but investors should be cautious due to the massive misallocation of capital by governments around the world.

### The Modern Era

— The three historic flat periods for real returns of the S&P 500—1910-1925, 1930-1945, 1970-1982—were all periods when resources were misallocated due to world wars and errant Fed policy.

— Today, the Fed and central banks have once again misallocated resources by massively expanding their balance sheets.

— The S&P 500's real return chart shows an upward climbing slope from 1950 to 2000, benefiting from reduced barriers to capital flow among developed nations and an increasing labor force thanks to the baby boom.

— Today, the world is geopolitically unstable, and there is no baby boom in the developed world.

— Given the current misallocation of resources, 15% of the developed world's wealth needs to be destroyed, because that wealth is a wasted asset.

— However, this is not as bad of a problem as it sounds because of the benefit of globalization—the world is a complex adaptive system that can absorb and dissipate shocks, much like a 350-gallon aquarium. The increase in free trade agreements and immigration reform will allow for re-allocation of capital over time.

— Finally, the digital information technology revolution is doing for human capital what the industrial revolution did for physical capital.

   a. An example is block-chain open-ledger technology (bitcoin). This technology allows the transfer of property across untrusted networks, which can be observed by anyone, but not modified. If individuals in developing countries are given property rights via this technology, they will begin to be productive, and this has the ability to lift 83% of the world's population out of poverty.

### 2016 Expected Returns

- U.S. equities do not look attractive, with annual expected returns over an eight-year horizon at only 4%.
- Non-U.S. equities are attractive (8% expected return), especially emerging markets equities (11% expected return).
- Fixed income expected returns are unattractive: 1.5% for U.S. bonds, 2.5% for non-U.S. bonds, 5.5% for U.S. high yield, and 1% for emerging market debt.
- The equilibrium price of oil is around $45/barrel, but high inventories are keeping prices low and could add to the short-term downward pressure.
- Mining facilities coming online around the world will also put downward pressure on industrial commodities in the short run.

### Conclusion

- A successful macro investment strategy involves:

    a. Riding the long-term tides—buying when price decreases below fundamental value and letting the markets play out over the long run.

    b. Navigating the short-term waves—utilize risk controls in order to avoid getting capsized by near-term volatility.

    c. Ignoring the media ripples—avoid listening to the talking heads on CNBC who are mainly concerned with day-to-day movements.

## POLITICAL ENVIRONMENT: GREG VALLIERE, HORIZON INVESTMENTS

### 2016 Election:

- The upcoming election is shaping up to be a disappointment because of the lack of compelling candidates from both the Republican and Democratic sides, and the cathartic and optimistic period that typically follows an election will not materialize this time around.
- With Donald Trump polling at 42% and the next competitor, Ted Cruz, at 14%, it is clear Trump has no real competitor at this time, and it is unclear if anyone in the flanks will be a threat to him anytime soon. There is a real chance (risk) Trump could be our next president.
- Trump is severely disliked by his party, as is his next closest competitor, Cruz, who is Canadian born, and the party at this point seems willing to endorse almost anyone who could unseat both of them.
- No matter who or what group Donald Trump insults, he manages to maintain his lead in the polls. The GOP is certainly fearful of the impact of this on the party's image and what it could mean for the congressional elections coming up.
- The best and most qualified candidates (and, importantly, well-liked by the GOP) are Marco Rubio and Paul Ryan, but both are so far back in the polls it is difficult to imagine them as serious competitors to Trump.
- On the Democrat side, Hillary is the clear candidate that will represent the party in the elections because Bernie Sanders, the next clear competitor, is too old and too much of a socialist.

- While it seems Hillary is likely to succeed against Donald Trump, the win will not be straightforward or without significant negative headlines. There is the email server debacle, which has the potential to lead to an indictment (though not very likely); historically a party has seldom managed to win the presidency more than twice in a row, and when it has, it has been when the incumbent president had a high approval rating (something Obama does not have at present); and it is just a matter of time before Bill Clinton makes a political gaff.
- The best opponent to go toe-to-toe with Hillary in the election is Rubio, but again he will have a difficult time unseating Trump.
- California will play a pivotal role in this election, but there is a chance Ohio will once again be a major swing state.
- It is clear the Obama administration has not been successful in global politics. Hillary is capable of doing a better job, and it is quite clear that Trump will be antagonistic (evidenced by his comments re: starting a trade war with China).

### Markets:

- Trump's positions and views, which are volatile and provocative—taking on Janet Yellen, tax cuts that would cost billions, and openly bashing Wall Street—will create uncertainty for the markets. The markets would probably prefer to live through a Hillary presidency—they managed to do quite well under Obama.
- We are in good hands with Janet Yellen—she has her finger on the pulse of the economy and markets, and will be thoughtful when it comes to raising rates.
- The consumer should begin to feel and enjoy the effects of the gasoline "tax break" caused by the massive drop in oil prices over the past year, while Texas is now starting to feel the effects of a revenue shortfall.

## PRIVATE CAPITAL: HOWARD MARKS, OAKTREE CAPITAL MANAGEMENT

### The Cycle in Investor Behavior

- Since 2009, recovery across various regions has been gradual, with mixed results. The United States has led in terms of the recovery and is at a point in which asset pricing is between "the high side of fair" and "the beginning of rich".
    - In geopolitical terms, the world is more uncertain today than at any point in Mr. Marks' life, with many open-ended questions remaining about growth, leverage, developed-world competitiveness, and the dearth of political leadership, among other issues.
    - Uncertainty is high, and the market abhors uncertainty.
- Until recently, investment markets had swung in favor of euphoric behavior, characterized by high prices, lower risk aversion, many buyers, and few bargains to be found. All of these have negative implications for both prospective returns and safety. Only in the past year have these pressures begun to abate, with somewhat lower prices (and somewhat better values) prevailing.

### Conclusion

- In constructing portfolios today, the most important concern is whether to play offense or defense. This is the key determinant of performance in the next one to five years.
    - Key questions in reaching a conclusion here include the following:
        - Should we prepare for prosperity or not?
        - Should we worry more about losing money or missing opportunity?

        - What holds the key: capital and nerve, or discernment, discipline, risk control, and selectivity?
    - Oaktree's guiding motto today is to "move forward, but with caution."

### Q&A

- *Where are we in the distressed cycle?* Oaktree's view on the distressed opportunity is matched by the target size of its funds. Since 2008, the distressed opportunity has been limited, due to the low-interest-rate environment, which has allowed companies to "kick the can down the road" and work through credit issues through improved operations.
    - Because of recent "pro-risk behavior" and a recovery that is "long in the tooth," Oaktree is in the process of closing a larger fund in excess of $10 billion.
    - Oaktree believes that the opportunity for distressed is forthcoming, due to volatility in credit markets, adjustment in investor expectations, and subsequent downward adjustment in valuations.
- *As a distressed debt investor over the past few years, what has been your biggest surprise, if any?* Recently, Oaktree has been focused on European non-performing loans, real estate, and shipping. It has found solid opportunities across the board.
    - The firm's biggest lesson learned was around dry bulk shipping, a subsector that was adversely impacted by the slowdown in China. It was difficult for them to exit these investments when they needed to do so.
- *Compare the use of leverage in the market from 2008 to now.* Mr. Marks is not concerned about a repeat of the last recession, which was driven not by the regular economy but by the financial community. Banks today are much less leveraged and are restricted from engaging in the same activities. Given that there has been "no boom, [there is] no reason to have a bust."

## GLOBAL FIXED INCOME MARKETS: JEFFREY GUNDLACH, DOUBLELINE CAPITAL

### The Fed

- Central banks around the world have undergone prior instances of raising rates, only to then cut those rates as a result of economic turmoil or changing macroeconomic data. Gundlach doesn't believe that this will happen in the United States, but the Fed needs to dial back the rhetoric in order to maintain credibility. Fed officials have refused to change their rhetoric and have continued to communicate four rate hikes in 2016.

- The market believes that rates will hike by 60 basis points (bps) in 2016. Coincidently, the difference in GDP between the United States and eurozone is 60 bps. Therefore, the following question is raised: The difference between tightening (United States) and easing (eurozone) is only 60 bps?

- High yield spreads are at their widest margin (currently 700 bps) relative to past rate hike cycles. These wide spreads are normally associated with an easing cycle, not a tightening cycle. The Fed needs to focus its attention on the high yield market because corporate stresses will become more pronounced in a low-commodity-priced environment.

- The United States currently has low inflation metrics when compared with emerging markets and non-U.S. developed markets. Why is the United States tightening when other developed nations are easing, when core inflation is trending in the same direction?

- The bond market is pricing inflation at 1.75% for the next 25 years. This defies the efficient-market hypothesis. Shelter (i.e. rent equivalents) is the only true inflation metric included in the Consumer Price Index (CPI). Why is the Fed concerned with average hourly earnings increasing when rent prices are doing the same?

- The Atlanta Fed GDP forecast (GDPNow) updates GDP growth projections when incremental data points are released. This projection is currently at 0.7%. GDPNow has historically been a good predictor of actual GDP growth. If the projection holds true, the Fed's 2.2% U.S. target growth rate will not come to fruition.

- Nominal GDP is falling and is currently at 3.1%. Moreover, the ISM Manufacturing Index is below 50 and has continued to decline for months. This has historically indicated a potential recession and lower GDP projections. Again, these figures lend more credence to monetary easing, not monetary tightening. The ISM Manufacturing Index is historically a good indicator as it closely follows nominal GDP.

### Global Economy

- Emerging market equity valuations still have a sizable spread with commodity valuations. There could be further downside pressure if commodity prices don't recover in the near term.

- Chinese equities have technically "broken down." Chinese demographics now mirror that of Japan's immediately preceding the Japanese "lost decade." Even after recent devaluations of the currency, the Chinese yuan's relative strength will continue to be a headwind for exports.

- While there will be further volatility in emerging markets, India is the best long-term play. The country has favorable demographics, political reform, and business growth.

### Interest Rates

- Do not be locked into an interest rate idea for 2016. It is prudent to take a "wait and see" approach and observe how the market will interpret the U.S. tightening cycle.

- The two-year Treasury currently is indicating that the Fed is less likely to raise short-term rates to the extent that it has communicated.

- The five-year Treasury has been range bound since 2011. If the rate rises above 1.8%, it would likely signal that the Fed is not backing down from its tightening plan.

- The 10-year Treasury is coiled and situated in a narrow range. If it moves in significantly in either direction, it will continue to have momentum.

### Energy

- High-yield bonds have almost always exhibited negative returns during tightening cycles. The gating of Third Avenue will likely create more redemptions in the first quarter. This could cause potential liquidity constraints in the space.

- High-yield spreads have historically been a leading indicator for the S&P 500. Ultimately, the S&P has to decline or credit has to rally.

- GDP has been propelled by junk bond issuance. High-yield issuance can stimulate GDP in an expansionary period. This boost may disappear and would be another indicator of declining GDP.

- Leverage in the high-yield market is at an all-time high in all sectors.

## Conclusion

The Fed’s decision to raise rates for the first time in 10 years may assist in creating a negative macroeconomic backdrop for 2016. Unfavorable metrics in nominal GDP, commodities, global growth, and high-yield debt point to accommodative monetary policy. Portfolios should be tilted towards capital preservation and should be positioned as such for the rest of the year.