

November 2011

Global Market Outlook:

*The Current Existential Crises of Contemporary
Capitalism — Implications for Future Market Returns*

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Introduction:

The global market is in its third crisis episode since the peak of the tech bubble in early 2000. This third bear market follows closely on the heels of the global financial crisis of 2008, and in some ways echoes lingering concerns of unfinished business associated with that event. There are now concerns that many of the tacit assumptions made about the functioning of the world economy are not as accurate as expected.

For example, when Japan was hit by an earthquake in March, the world suddenly realized that the global supply chain that underpins globalization is vulnerable to interruption. A growth scare resulted when multi-layered ceramic capacitors, a common component in electronics worldwide, were no longer available. Assumptions about China are also being questioned. Just as investors were getting used to the idea that China can drive global growth for the next 50 years, there is the possibility that the Chinese investment-driven growth model might be obsolete before its time and may make the rest of the world vulnerable to a growth slowdown.

In the United States, there has been discussion of the possibility of a double dip recession since the recovery began almost three years ago. An increasing degree of malaise had developed about

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the political process, the budget process, the state of public finance, the sustainability of the U.S. financial system, as well as the size of the U.S. debt. This financial/political nexus has significantly eroded confidence in what many believed was a fairly fixed ideology and consensus. An obvious example is the complete collapse in confidence in the European convergence model, where different states are integrated under a common currency. Investors no longer trust in the sustainability of that currency, bond market or even the entire social model that underlies Europe.

Each major player in this global economy is in some degree of distress. It is the existential crisis of contemporary global capitalism. Why are the markets proving to be more resilient than expected considering the dire tone of headlines and the pessimism of the public?

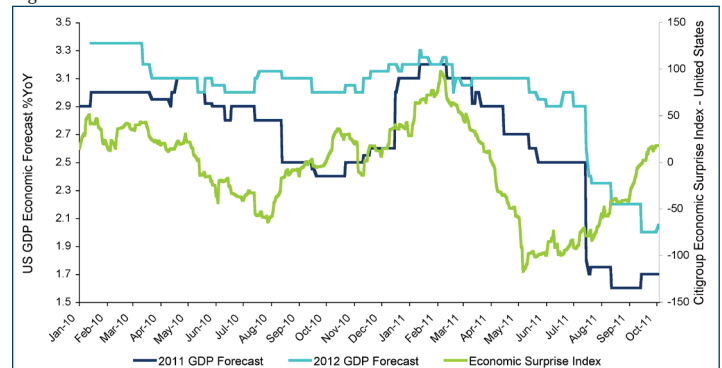
United States – Stable to Improving Outlook

In the U.S., evidence of slowing in the economy coupled with lingering high unemployment has led many to focus on the

specter of a double dip recession. Those individuals and institutions who believed they were on the verge of restoring asset values in pension funds and 401ks saw these assets fall 20%. The result was a significant erosion of confidence.

The other side of the coin is that some of the healing forces in the economy continued to remain active throughout this period. The consensus for U.S. economic recovery and expansion collapsed in the third quarter amidst some evidence of a slowing economy, lingering high unemployment, the S&P U.S. debt downgrade, and contentious developments in Washington (figure 1). However, at the same time the

Fig. 1

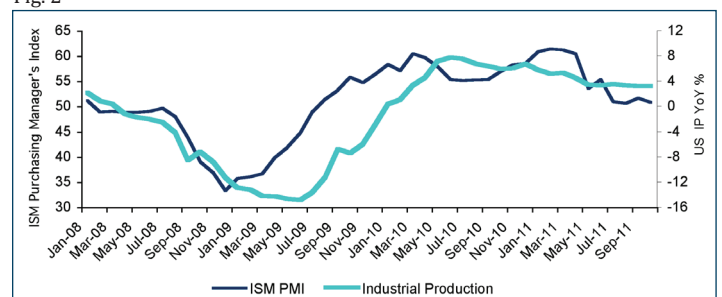


As of October 2011. Source: Bloomberg

incremental bad news appears to be getting better. In fact, in October, which was a recovery month in the stock market, U.S. economic releases were skewed to the positive side. It is my observation that more of the positive surprises relate to actual activity and more of the negative surprises relate to sentiment and confidence. This pattern reinforces the idea that investors are, in effect, trying to talk themselves into a recession simply because it seems like the right thing to do. Evidence, however, contradicts this impulse.

Business confidence has also weakened despite the fact that industrial production has remained stable at about 4% growth year over year (figure 2). This is a pre-recession reading and does not indicate a collapse in activity in the near term.

Fig. 2

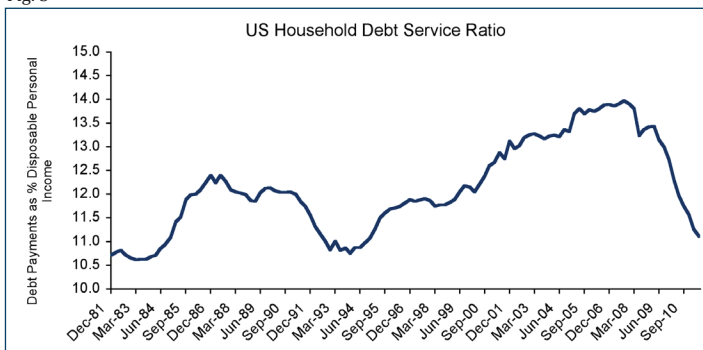


As of September 2011. Source: Bloomberg

Corporate earnings reflect a similar trend. Expectations for U.S. listed company aggregate corporate earnings approximate \$1 trillion USD. There has not been a collapse in near term expectations, although next year's earnings expectations have been moderated, more on sentiment issues than actual changes in expected profitability.

Several areas where the U.S. economy has improved are not getting much investor or media attention. On the eve of the global financial crisis five years ago, investors were worried about U.S. consumers' debt service ratios. At that time, mortgage debt and consumer credit were out of control. One dollar out of every seven was going to debt service. Now the household debt service ratio is down to a little over 10% (figure 3).

Fig. 3



As of September 2011. Source: Bloomberg

This represents almost 3.5% of income that used to go to debt service and is now free for spending or saving. In other words, for any given level of overall disposable income, spending and output can be higher. Growth is more sustainable and less cyclical than it would have been when those debt service ratios were more burdensome. This is a significant change at the household sector level.

At the same time, the corporate sector has generated steady profits, strong cash flow, above average returns, and a strong buildup of cash and cash equivalents on the balance sheets of industrial companies (financial companies have also built up a big store of liquidity). The corporate sector is holding at least 2% of assets in cash in excess of current needs. The distribution

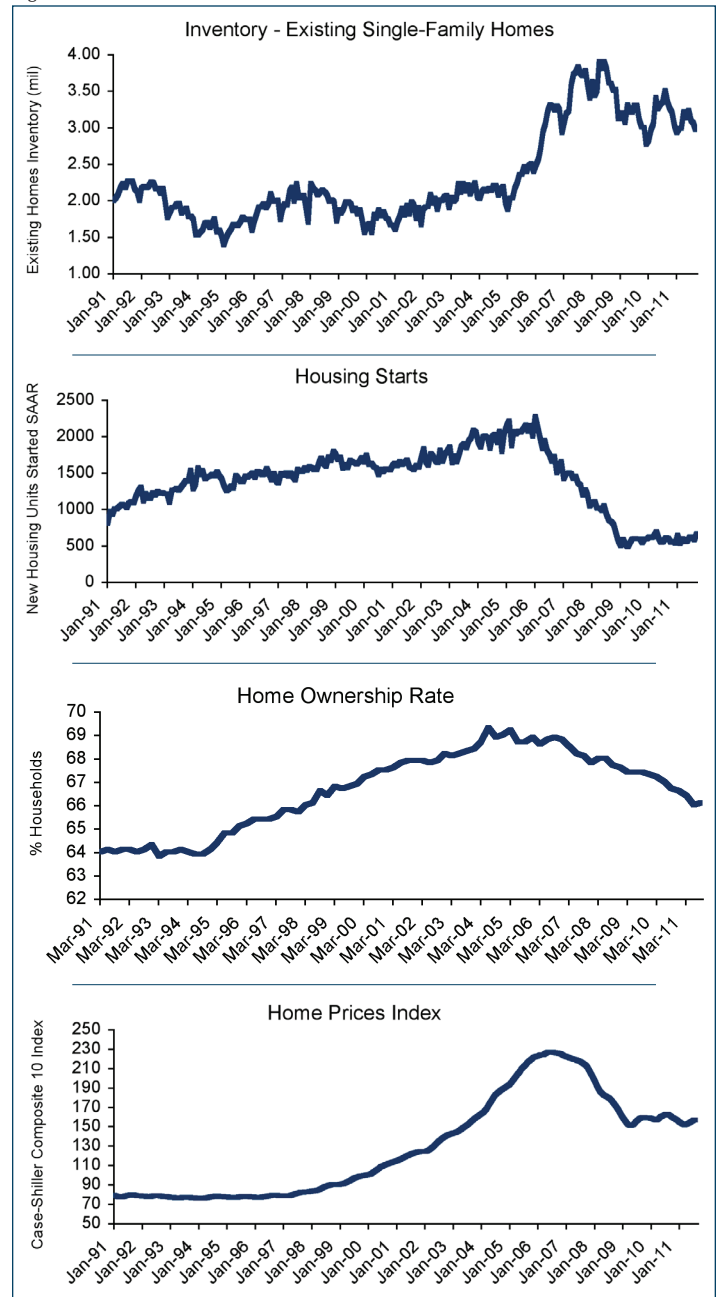
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of these assets has the potential to be additive to the returns on corporate investments, which are already fairly strong. For instance, corporate free cash flow measures both in the U.S. and globally reflect corporate performance consistent with return expectations well in excess of global GDP expectations. As a result, investors can find comfort in the fact that the potential for realizing returns from corporate-focused investments is stronger than what might be expected solely from the growth

performance of the global economy as a whole.

The U.S. housing market performance remains the biggest question mark in employment and income growth, as well as confidence in household sector assets. Housing starts, home prices and non-distressed sales are all in the process of normalizing and stabilizing at below sustainable levels (figure 4). Another housing boom cannot occur until current

Fig. 4



As of September 2011. Source: Bloomberg

inventory is worked off and distressed housing stock is diminished. The good news is that housing prices for non-distressed transactions are stable. Today, the average non-distressed homeowner has much less concern about future price declines in this important asset base; as a result confidence is restored in this part of the economy as well.

The U.S. employment picture is also a bit more encouraging. There have been a few months of fairly good job creation; stronger private sector gains have been offset by weak public sector job creation. There are signs that weekly hours are rising to the point where payroll activity would normally be expected to follow. Productivity gains will be harder to maintain in the future because so many companies are acting like they are already in a recession. When recovery signals start to come in stronger, they will be followed by hiring much more quickly than experienced in the 2009-2010 recovery.

When you consider all of the current pent up demand and caution as well as the strong conservative corporate and household management practices in place, the U.S. really has a healthier economic background than is reported in daily headlines.

China – Concerns About the Durability of the Fixed Asset Investment Model

Opinions about China being the growth engine of the global economy are not new. Certainly, China’s potential in terms of its future size and income generation potential is still substantial, but there are a number of cracks in this façade.

Fixed asset investment, as a component both of the total Chinese economy and of Chinese growth, has reached proportions never seen in any other development cycle in any other major economy in the past one hundred years. The U.S. economy is 65% - 70% consumption and 15% - 20% investment, China is about 35% - 40% consumption and about 55% investment. This is simply not a sustainable long-term position for any economy. China, in effect, has grown as it has built itself as an advanced economy for the first time. The problem with this model is that it only has to happen once. Once the infrastructure is in place, there is a point where the growth rate becomes unsustainable. Economists in China maintain the country still needs a tremendous amount of infrastructure, housing stock is still substandard and there continues to be a

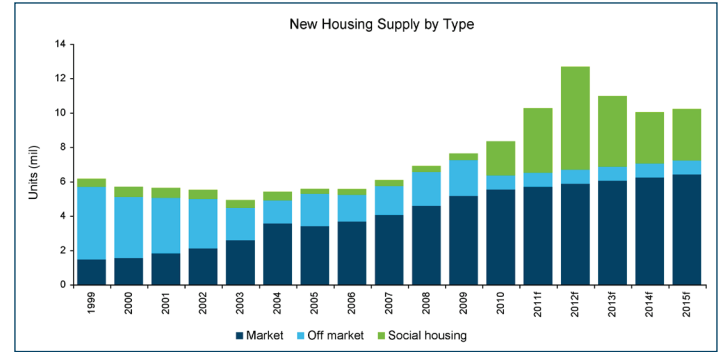
[T]he growth rate of the incremental inputs is no longer sustainable at the same rate as over the past decade.

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great deal of capacity to add. Capital intensity is less than it is in a developed economy. The problem is the growth rate of the incremental inputs is no longer sustainable at the same rate as over the past decade. The result is the Chinese economy will eventually be headed for a downside growth shock. I contend this growth shock will be related to construction. Construction, the building of housing stock, infrastructure and industrial capacity has been the lynchpin of investment and economic growth and it is about to peak.

With the big push toward social housing construction in 2011 and 2012, the input into the housing stock is going to peak, level off, and decline over the course of the next five years at a very high level. The peak for housing starts in China next year is expected to be 12 million units (figure 5). By comparison,

Fig. 5



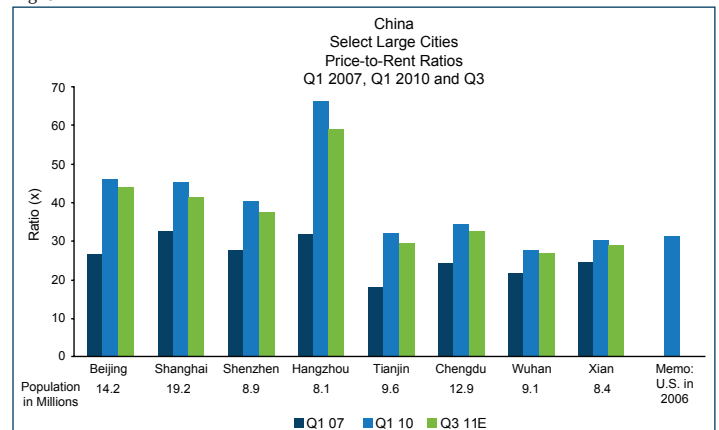
Source: GK Dragonomics Estimates

new housing construction in the U.S. is going to 500,000 units or 4% as much construction for one quarter as many people. That means the U.S. is not building enough, China is building too much, or both.

If Chinese housing construction levels off at an annual rate of 10-12 million units, the growth rates for construction, consumption of building materials, and consumption of other resources will all fall significantly. Whether or not that growth transition can occur without an accompanying financial debt and asset value crisis is an open question that is debated by our research team as well as economists around the world. The precedent is, however, that when there is a significant growth correction in a long-term development cycle, some significant financial stress is associated with it. Strengthening momentum in the U.S. and relief in Europe may lead to recovery in the global economy next year, but there may also be a return to a stressed environment sometime late next year or in 2013 on the basis of these issues in China.

An examination of the current Chinese property market is also troubling (figure 6). Inventories of Chinese homes for

Fig. 6



Source: Wu, J., Gyourko, J., and Yongheng Deng, 2010. "Evaluating Conditions in Major Chinese Housing Markets," NBRE Working Paper Np. 16189, CEIC, Davis, Morris A., University of Wisconsin, Empirical Research Partners Estimates.

sale resemble the U.S. in 2006. Figure 6 reflects price as a proportion of rent. (The story remains the same for price as a proportion of household income.) Housing is unaffordable and also fails to provide a strong return on a rental basis. This relationship does not bode well for the future of housing prices, especially in the context of excess inventory for sale and excessive construction relative to household formation. It is a recipe for a Chinese housing and construction problem in the future.

Europe – Addressing the Debt Crisis

With Europe, the critical question is: How can you stabilize risk tolerance in an economy and a market that is so fraught with uncertainty and psychological vulnerability? Italy is currently the key locus of this concern. Italy is the third largest bond market in the world and is by far the biggest bond market in Europe. If Italy were perceived to be in a debt trap (where debt and debt service grow faster than the economy is capable of growing so that debt becomes an even bigger part of total income), a major crisis would result.

Meanwhile the European banking system is completely intertwined with the sovereign debt markets. European banks underwrite, fund, and risk manage a considerable portion of European public sector debt. If Italian debt and European debt is not sustainable, the banking system is not sustainable either. If Italian debt and the banking system are not sustainable, then the whole edifice is not sustainable, including French debt and ultimately the rest of the European structure. It is a nightmare scenario hawked by doomsayers.

The question becomes: How is this situation resolved from an administrative, political, financial, and psychological point of view? It is a difficult and complex environment with no clear solutions. The political element alone causes a great deal of angst among pure capitalist thinkers. My view is that Europe is a cultural, financial, and political entity designed to move forward toward greater integration through a process that

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involves crises. It has happened before and it will probably happen again. To get a resolution to the crisis, the crisis has to be so dire that there is no alternative to reform. This seems to be the key dynamic in Europe today. In Italy, the government is being pushed out in favor of what is essentially a technocratically appointed government capable of enacting necessary, but unpalatable, reforms. This new government entity is able to act without electoral consequences. Ask a European Union bureaucrat or an academic from France if European institutions are really meant to function this way (lurching from crisis to resolution using an undemocratic and apolitical administrative process of reform that only works under the most dire of exigencies) their response would be,

“yes.” They would contend that this is a perfectly rational and functional design. If the same question was asked to a free market ideologue academic in the U.S. or elsewhere, they would say it is the craziest thing they had ever heard.

European institutions, in my opinion, are structured to function a little differently from what we consider normal. I have a fair degree of confidence that the mechanism is workable in the long-term.

Conclusion

Forget the headlines. Headlines do not earn return on equity for companies. Look instead to the evidence presented on a day-to-day basis. There is good, strong profitability and corporate performance globally. Corporate governance is improving almost everywhere.

There are attractive valuations for both equity and credit. Returns on equity, price to book, earnings yields, price/earnings ratios, and yields on credit products reflect attractive valuations and good prospective returns. The returns and premiums gulf between low risk assets and mid-high risk assets is not rational. A deep-seated crisis mentality contributes to this valuation disparity, but also could represent a buying opportunity.

Attractive valuations, however, do not necessarily mean there will be a bull market any time soon. Too many people are convinced the market is in a permanent state of crisis. This is a similar point as during the recurring crises of the 1970s and 1980s. Today, as it was then, the prevailing conventional wisdom is pro-crisis and cynical equals smart. Once in that mindset, it is difficult to move quickly or easily to a bullish position. A crisis by its nature creates displacement in psychology, fear and concerns about loss and risk. The good news for today’s investors is that valuations are attractive. The bad news is that these valuations may persist for some time.

A strong, sustained and growing gap between the return on investable assets and the cost of capital continues to be the prevailing success factor in investing. That is where the market is now. This value creation will lead the way into the next cycle.

The data in the following table showing earnings and dividend yields against risk-free bond rates reflects this reality (figure 7). In the U.S. the earnings yield is 8.2% corresponding to a price/earnings ratio of about 11% against a bond yield

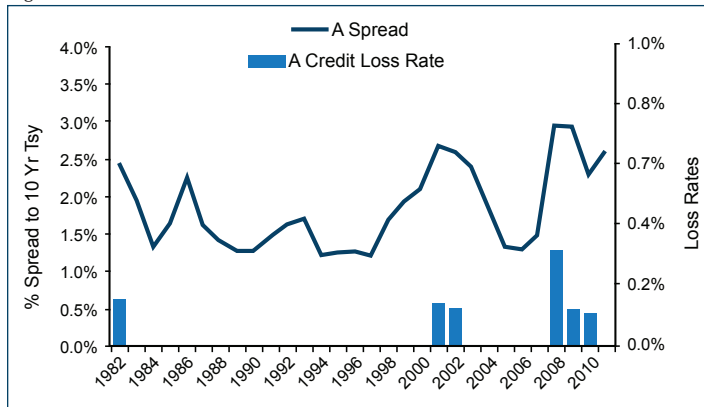
Fig. 7

	US	Euro Zone	UK	Japan	Emerging Markets
Government Bonds					
10 Year	2.13	3.48	2.37	1.01	5.96
Corporate Bonds					
AAA	1.37	3.11	2.86	0.74	na
AA	2.91	3.24	4.87	0.83	na
A	3.64	4.31	5.82	0.69	3.40
BBB	4.25	5.32	6.49	0.91	4.62
High Yield	7.86	8.91	na	na	9.91
Equities					
Dividend Yield	1.98	3.74	3.41	2.38	2.53
Earnings Yield	8.21	11.12	10.75	8.87	10.71

As of October 2011. Source: Bloomberg, FactSet

of 2.1%. This earnings and dividend yield gap is normally about 3%. When the gap is over 6%, as it is currently, it means the odds are in favor of investing in any kind of risky assets. The same is true for high yield and investment grade corporate bonds. Odds are also improved for other risky assets such as REITs, real estate and other types of real asset investments. This is true globally. For the first time in over 50 years, government bond yields are lower than equity dividend yields in every major developed market in the world. The credit side is also worthy of attention. The spreads of various investment grade credits over risk free rates, compared to credit/loss ratios are shown in the following chart (figure 8). The "A" rating in this illustration reflects the average

Fig. 8



As of September 2011. Source: Bloomberg

company rating in the S&P 500. On average there has been a 2% spread of A-rated bonds over the risk free (though it is now approximately 2.5%) case. The chart shows that the loss experience for A-rated bonds is generally less than 0.2% and occurred in six different years over a 30 year period. Yet during that time, investors were paid a 2%-3% premium annually for an average loss of less than 0.1%. With these returns more elevated than usual, the return prospects are very favorable under almost any reasonable and realistic set of assumptions.

Where is the market today? When evaluating long periods of returns in equity and bond markets, it is clear that most of the time market returns are not average. Returns are usually worse than average in a bear market or better than average in a bull market. The return expectations depend on where action

Forget the headlines.

Headlines do not earn returns on
equity for companies.

is taken in which part of the cycle. We are currently very late into the third down leg of a flat to down cycle. The market peak in March 2000 was followed by a two year bear market, which was then followed by one in 2008-2009. This year's third bear market has been experienced to a lesser extent because the market started from a lower base. The last time the market had a similar cycle was in the 1966-1982 period, when there were also three major down markets. Each time the psychology got worse and more deeply embedded. However, the closer to the end of this type of cycle, the better the prospect for improved long-term returns.

There are three key messages we can apply to investment strategy today. First, look for return seeking strategies. In other words, seek out risky assets and think about how to make money, not how to avoid losing money. Second, think about what the best opportunities are and be selective about investing in them. Tactically shifting allocations and trying to game the market in various ways will not work. The best way to take advantage of current market conditions is to select effectively from among the return opportunities available. Finally, the best way to do that is to prioritize the fundamentals: value creation, governance, quality, and the fundamental characteristics that create the returns on assets that translate into the returns that investors earn.

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As William Blair & Company's Global Strategist for Investment Management, Mr. Greig has headed the firm's international investment management team since 1996. His hands-on, bottom-up approach takes Mr. Greig and his team around the world. As of 9/30/11, the team manages \$21.9 billion in non-US assets. He has more than 30 years of experience in domestic and international research and portfolio management. Before joining our firm, Mr. Greig headed international equities for PNC Bank in Philadelphia and previously served as investment director, as well as managing global and emerging markets funds, at London-based Framlington Group. Mr. Greig received his B.S. from the Massachusetts Institute of Technology and his M.B.A. from the Wharton School of the University of Pennsylvania. Mr. Greig has been featured in numerous publications, including *The Wall Street Journal* and *Barron's*. In addition, he is a frequent guest on CNBC's *Kudlow and Company* and was a panelist on *SmartMoney's* Annual Investor Roundtable in 2006 and 2007.