

Q&A

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Perspectives on the year ahead



Jim Rothenberg



Rob Lovelace



Shaw Wagener



Wesley Phoa

Jim and Rob are portfolio managers with Capital Research and Management Company. Shaw is a portfolio manager with Capital International, Inc. Wesley is a portfolio manager with Capital Research Company.

Macro events were unusually important to markets in 2011, contributing to greater volatility in asset prices globally. And while 2011 has come and gone, many of these events, like the European sovereign debt crisis, continue to influence the direction of markets.

To provide perspective into the current market environment, we recently sat down with four of our most experienced portfolio managers from across the Capital Group organisation: Jim Rothenberg, Rob Lovelace, Shaw Wagener, and Wesley Phoa, to get their perspective on the events of 2011 and how that might influence markets in the year ahead.

The markets in 2011 were driven in part by large macro events. Do you expect that environment to continue in 2012 and, if so, what do you think the implications are for investors?

Wesley Phoa: I see a continued focus on macro-economic and political developments as major economies in the world go through a period of significant transition. There are a lot of reforms that either are occurring or have to occur. Those reforms always come with a cost. And the size of those costs and the implications for investment returns depend a lot on the policy decisions that are made and what kind of unexpected economic developments occur. This period of transition makes asset returns unusually sensitive. I believe this situation will likely persist for a couple more years.

Rob Lovelace: At its core, this is about deleveraging. It's been with us for four years, and it will be with us for a few years more. The equity markets, to a great extent, are spectators in this. So, as governments and individuals deal with deleveraging, it is going to cause a lot of uncertainty and noise, which will affect markets, economies and even political election cycles.

We're in a very different situation than we've ever been in, as this is the first time in history that we're deleveraging on a global scale with fairly flexible monetary and labour structures. So, the past is not necessarily going to be indicative of what's going to happen this time, which is reinforcing the uncertainty.

Wesley Phoa: The deleveraging process has been a drag on growth, but if you try to accelerate that process too much, the outcome could be catastrophic. For various reasons, the global financial system has been able to spread the deleveraging out over some period of time. Perhaps we are halfway through already. That's been a delicate balance that policy-makers, company managements and individuals have tried to strike, and I think it's playing out okay right now.

Outside of these macro factors, what else is driving market volatility?

Wesley Phoa: There are three broad factors which I think have been making financial markets more volatile than they need to be. The first is the uncertainty created by the number of decisions that turn on politics and policy. Investors don't feel as comfortable making judgments about politics, so we're seeing a large risk premium come into being, particularly in the United States and in Europe.

The second major factor is the financial systems in Europe and the United States are going through a very large regulatory transition right now. Furthermore, company managements are working out how to fund their balance sheets and there's lots of deleveraging and de-risking going on. And that has created volatility in markets and it has also reduced liquidity, which in turn increases volatility.

Finally, the underlying microstructure of markets has changed. We've seen in the past couple of years a dramatic rise in high-frequency trading in equities, being driven by hedge fund activity and ETF market making, which can create some very high and strange correlations. We've seen periods of excessive volatility hit the markets, such as the flash crash in 2010.

Rob Lovelace: As investors become increasingly uncomfortable with volatility, they seek strategies to minimise it. Ironically, they are often using ETFs, futures trading structures or other perceived hedging instruments, which will sometimes accentuate market volatility. So the very instruments designed to dampen volatility, oftentimes when used in large volume, drive the markets in one direction or another.

In some ways, it does create opportunities for us as long-term, research driven investors, because as these markets move valuations on a company that we've known for a long period of time and like, that's great. But it means that looking at short-term results can often be disappointing because of the volatility that is created around it. The important thing to remember is to keep a longer term horizon and have patience.

The macro environment and volatility in the market have overshadowed corporate fundamentals. What are we seeing at the individual company level?

Jim Rothenberg: In many cases, companies are doing reasonably well. The underlying growth rates aren't necessarily fast, but they're solid, especially among companies that are more global in scope, and who have exposure to the developing world, where growth rates, while slowing, are pretty good.

If you look at corporate America as a proxy for other companies around the world, you see reasonably good earnings. You see very strong balance sheets. You see profit margins that are at or near peak levels. It is a very profitable time for many businesses.

What you hear when you talk to managements, however, is not inordinate optimism. It's a very cautious views of things, because in many cases, the regulatory environment isn't clear, the political environment is uncertain and the economic forecasts are varied. So there's a great deal of caution. Companies are being very careful about adding labour, trying to do more with less and trying to focus on their key initiatives.

Rob Lovelace: You could say that we're not seeing broad corporate strength rewarded in the market, in part because the market multiple has been contracting. The overall price/earnings ratio has been coming down because of the macroeconomic uncertainty, and companies themselves are projecting an image of uncertainty in terms of their planning.

But when you take out that general compression in valuation multiples, I would say you do see the fundamentals proving themselves in individual stocks which have done very well, such as higher end retail companies, various parts of the food and fast-dining areas and manufacturing in the high-tech chain that have either products people want or components that go in products people want. So there has been a differentiation in the market — it's just been swamped a little bit by the overall compression in valuation multiples.

"This is the first time in history that we're deleveraging on a global scale with fairly flexible monetary and labour structures." -Rob Lovelace

In the developing world, many investors are worried about China's slowing growth. What is your evaluation of China at the moment?

Shaw Wagener: If you look at the way China responded to the Great Financial Crisis, they opened the flood gates in terms of liquidity in their own market, which maintained growth but facilitated a large transfer of wealth to commodity rich countries like Australia and Brazil.

This time around, however, I think what you see in the five-year plan and leading up to this political transition that we're having now, is a very targeted effort on the part of policymakers to encourage a better domestic lifestyle for its citizens. So it includes things that do require a lot of commodities, like public housing, but it also includes things which are directed towards the local citizenry that are more service oriented and driven by locals, like healthcare and pension reform. We can expect that trend to continue.

"Companies are doing reasonably well...Growth rates aren't...fast, but they're solid, especially among companies that...have exposure to the developing world" -Jim Rothenberg

The markets are a little disappointed that China didn't respond to the current crisis by doing exactly what it did in 2008 and '09 by flooding the market with liquidity. The reality is, I think, maybe this time around there's a little bit more thought behind the process of what they're trying to encourage and not encourage, and that could result actually in a much better foundation going forward than the lurch forward of having a lot of liquidity and then pulling that liquidity back.

There are areas to watch, however. Our analysts that spend a lot of time looking at the cyclical areas of the Chinese economy have noticed an increase in accounts receivable, a drop off in orders, and other things like that. We suspect that we're getting closer to the end of that cycle, and so we want to spend time looking at the directional change of those figures.

What are your thoughts on Europe and how that situation unfolds in 2012?

Rob Lovelace: I think the markets are very impatient with the rate of change, though the underlying framework in Europe, at its core, is political. It is a fundamental change in the structure of the European Union both from a monetary standpoint, but also now a fiscal standpoint. It's really creating a federation. To do that takes a lot of time. They didn't do it in the first place because of feelings of national sovereignty. And so they went as far as they could. And now this crisis is presenting the opportunity to take it to the next level of federation. The main driver is Germany, and Germany cannot drive this quickly or

aggressively because of the history that's driving their desire to come together as a federation in the first place. I believe that it will be a collaboration with the French and the other major economies. It will not be done to optimise neither the short-term economics of the situation, nor market returns. It's being done to create a lasting, durable federation that can fund itself through taxation, that can issue bonds, and the political will has to be generated to do that. It's entirely political, and the markets get frustrated and worry about it.

Going into 2012, the progress will be slow, and it will continue to create challenges for the rest of the world because it will create a slower economy, hurt the trading patterns as a result of it, and continue to create liquidity problems the world over.

But they're headed in the right direction. The political will seems to be there. So, I'm an optimist in the long term, though I see continued volatility in the short term.

Wesley Phoa: Europe needs to work through the political process at its own pace and in a way that produces lasting solutions. In order for change to be really

credible, we have to know that it's going to last beyond the next election, that the people of Europe have signed off on it. And unfortunately, that takes a lot more time than markets are prepared to accept.

The other step that's very important in Europe is to stabilise the banking system, because one of the reasons why the financial markets have been so jittery, and so impatient, is that they know there are a lot of inherent fragilities in the European banking system. You've seen progressive steps over the past year to introduce more stability, but it's difficult to negotiate between the different countries.

As you think about the current market, what expectations do you have for the return environment in 2012?

Shaw Wagener: In equities, I go back to the idea that there are basically three components — dividend yield, earnings growth and what people will pay for it — valuation. Of those three things it feels like dividend yield is relatively straightforward right now. If you're looking at the global markets in 2012, a dividend yield around three percent seems like a fair number.

Earnings growth in the range of five to ten percent seems like a good base case, given what we know about corporate earnings in 2012. Earnings growth coming from Europe, however, could be flat or slightly negative. The question then comes down to valuation and what people are willing to pay for that earnings

In the short term, the case could be made that valuations could go up or down. Valuations are low right now, but investors are still concerned about volatility in the market. So it's unclear what direction we'll go in the short term. When I look at return expectations over the long-run, however, I think the valuation part of that algebra is at unrealistically low levels given what growth prospects and dividend yields should be.

Wesley Phoa: In the short to medium term, we are still going through a deleveraging process, and it is not realistic to expect very high returns on any asset class, certainly not without taking an enormous amount of risk. So it is sensible, I think, to dial back expectations on returns for any risky asset class.

Now if I look at the longer term, there is strong growth happening in large parts of the world, which is going to drive strong asset returns somewhere. Take the United States for example. Despite the political gridlock and deficit problems, there are some very positive tailwinds, including demographics, accelerating technological innovation and a continuing productivity boom that shows no signs of ending. So I think it's possible to be more constructive over the very long term across a lot of markets globally, but I don't see any way to avoid significant volatility and some short- to medium-term disappointments.

"When I look at return expectations over the long-run...I think the valuation part...is at unrealistically low levels given what growth prospects and dividend yields should be." -Shaw Wagener

When you think about the current market environment what advice would you give to investors?

Rob Lovelace: I'm seeing many investors de-risk because of the volatility. The irony of de-risking is that anecdotally investors are actually concentrating their portfolios. They're moving heavily into cash or investing less globally, and move away from anything that is viewed as volatile or anything they own which doesn't do well for a period of time. But at the end of the day, it's concentration.

If I gave you a blank piece of paper and I told you, "Here is the uncertain environment you're in. We don't know if we're going to have inflation or deflation. We don't know if interest rates are going to stay low for 17 years or come back up. What

type of a portfolio would you build?" And I bet it wouldn't be a concentrated portfolio. And, increasingly so, you would say, "I would want, probably, as diverse a portfolio as I can come up with because, who knows? The thing that I thought was de-risking might actually have been increasing my risk depending on the environment."

So the advice I would give in this environment is to have a discipline of saying to yourself, "I really don't know where things are going. I need to stretch my time horizon and be more diversified."

Jim Rothenberg: I agree with what Rob said about stretching your time horizon. I try to remind myself that it's not the first ugly period of time that I've seen in my tenure. This period of time feels a lot like the early 1970s in the United States. There was an impeached president, a lost war in Vietnam, high interest rates, double digit inflation and a rise in the price of oil from \$3 to, at one point, \$36. It was a very ugly period of time.

It also was a period of time, when the solutions weren't very clear. When you roll the tape forward, you discover we found a way out. And it led into, starting in the early 1980s, a period of very strong economic growth, which carried all the way through to the year 2000 - with a couple of bumps along the way.

We've been in difficult times before. The way out is not always very clear, but the resiliency of the system is impressive. The resiliency of the global economy has surprised some people and we'll find a way out. But it's important to keep a long-term perspective. ■

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