CONWAY• JARVIS LLC
Investment Outlook

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Should You Be a Global Investor?

That's the question on the minds of many investors these days. They're feeling that investing in US companies is proving to be more hospitable than the foreign markets. A day doesn't go by that we're not reminded of Europe's seemingly interminable saga of financial recklessness and instability and the peril it presents for the global economy. In addition to that, concerns regarding China's economy and its effect on the Emerging Markets ("EEM") are on the rise. And, even though the US is hurtling headlong toward the edge of its own "fiscal cliff", its markets are attracting capital at the expense of its foreign counterparts. 2012 marks the third consecutive year where a "Fear on/Risk off" trade has proved especially harsh for foreign stocks. We've witnessed a distinct change of leadership in the global equity markets in the aftermath of the 2008 Crash. The question for us isn't *whether* we should invest globally but *when* will we be rewarded for it once again.

One of the most enduring tenets of investing is that valuation of a securitized entity generally reflects its internal growth rate. Higher growth rates beget higher stock prices. This has proved to be true throughout the global economy. For most of the 20th century the US held the top spot in the world both for growth *and* stock market performance. That ended with the bursting of the Tech Bubble in 2000 and the emergence of China as the world's fastest-growing economic power. For decades, investment and manufacturing output migrated from the developed countries to sources of cheap labor found in the Emerging Markets. That trend has continued into the new century with China gaining ground and now holding the #2 spot behind the US in the hierarchy of the world's economies.

As Globalization gained momentum, China, India, and other emerging market economies grew at rates higher than those of the larger, developed countries. Understandably, this was reflected in the equity valuations of those Emerging Markets. During the recovery that followed the 2000 recession, the EEM dramatically out-performed the large-cap indices representing the developed economies of the US and Europe. That index led all major stock categories for four consecutive years (2004-2007). At the time, it became apparent to all that any blueprint for successful investing in the 21st century had to include a connection to the world's fastest-growing economies and their companies. To do otherwise would not only ignore the basic tenet of the growth/valuation correlation but would have you assume the risk that your portfolio wouldn't be all that it could be in terms of performance. This made sense and, more importantly, it produced results. Then, everything changed in 2008.

The "New Normal"

That's a term that's thrown around today to describe the current economic and market conditions that were previously unseen in our lifetime and are viewed to be persistent in the future. It's used most often to rationalize the tepid pace of the US recovery and the stagnation of the global stock market. It also comes in handy when assuaging investors' impatience for a robust recovery and the return of a better stock market. *We don't subscribe to the concept of the New Normal.* We view the current conditions as being unfamiliar and, more importantly, temporary. They are the natural result flowing from the collapse of the 21st century "something for nothing" economy that emerged in the developed world. Intoxicated by easy credit, governments, banks, and private citizens colluded to leverage and inflate any number of asset classes. As we know, the Grand Illusion ended in 2008 and the Great De-leveraging soon followed. It left banks, homeowners, and governments in the developed economies feeling the pinch.

Investors are feeling it too. Lacking confidence in their leaders, the financial system, and the markets, many retail investors retreated from the stock market to bonds. Those individuals and professionals that held their ground in the stock market moved capital from the foreign markets to the safety of the US in search of the return *of* their money to go with a return *on* their money. Since 2009's recovery rally where EEM returned 74%to investors, it has trailed the US indices by a wide margin despite laying claim to the highest economic growth rates in the global economy. These days the growth rate premium hasn't translated to higher stock prices in the EEM and investors are questioning the value of investing capital directly in foreign markets. Many are finding it more comfortable to connect to global growth through US-based companies.

Returning To the "Old Normal"

So, should US investors abandon their pursuit of opportunities around the world and simply deploy their investment capital at home? The answer for them hinges on where they see the global economy five years from now and beyond. Many still suffer from what is termed "recency bias", thinking that the current macro-level concerns are sure to propel the markets back to the dark days of 2008. *We harbor no such illusion and remain firmly in the camp of those who see the return to the "Old Normal" and out-performance by the EEM once again*. We see a return to the days when sound, consistent fiscal policy instills confidence in the private sector to invest in their businesses and expand the economy beyond the next election cycle. A contagion of confidence would spread to the public and private equity markets, taking stock prices higher. Growth rates would matter again. That's why we expect a return to the growth = valuation principle that will reward investors who diversify their portfolios into the EEM and developing economies.

When and what will have to happen for that to occur? The US; Europe; and China/EEM are the three stages in the theater of the global economy. The US is currently the only one of the three economies that is expanding, albeit slowly. Europe is in recession. China's growth rate is slowing as a result but it still reigns as the world's fastest growing economic power. The US is gridlocked, unable to craft a budget or fiscal policy and looking at "Taxageddon" at the end of 2012. Its problems won't likely be addressed until well into 2013. The cyclical risks emanating from the US and China are unlikely to generate the level of "Risk/off" fear that has investors heading for safety at the expense of growth. The focus remains on systemic risk in Europe.

Europe on the Big Stage

The Euro-Union is currently front and center, wrestling with how to resolve the insolvency of a number of its members, all with very distinct cultural-based views of money and government. The major challenge is solving the problem while maintaining the Union and a common currency. It's no easy task but we're confident there will be a resolution. The Euro-dollar will survive but the Union itself might look a bit different in the future. You'll find no one who'll argue that the original concept of the Euro-Union was a good idea. Economist Milton Freidman warned that binding distinctly different countries and economies under a single currency in the absence of a central fiscal authority predestined the concept to failure. For a glimpse of just how deep the cultural differences run, read Michael Lewis' *Boomerang*. It's a quick and easy read that illuminates the structural and historical impediments to the Union maintaining its current structure. That said, we expect a blueprint for Euro 2.0 to be in place about this time next year.

We expect Greece to eventually exit the Euro-zone sometime before the end of 2013 and perhaps as early as this year. Unlike Greece, Spain and Italy matter greatly to the global financial system and we have *no doubt* that the ECB and other central banks will lend, guarantee, and print whatever amount of currency is needed to support those sovereigns. This won't happen quickly but it will be done following a good amount of posturing by the decision-makers in the ECB. Make that decision-maker: Germany. They stand alone as the one member deciding the fate of the Union. They will have to write the check, increase their borrowing costs, and pretend that France hasn't just veered down the same political and economic path as Greece. They'll do this in exchange for a central fiscal authority formed with the power to oversee the fiscal practices of the members receiving aid.

While we think it would make sense for Germany to simply exit the Union themselves and print Deutschemarks, it's unlikely. The better path for Europe would be a redo of the Euro-Union concept with enforceable standards, sanctions for offenders like Greece, and a blueprint for expulsion of non-compliant members. We see that blueprint for going forward as the eventual outcome of the current process. Italy and France will have their turn but the systemic risk to Europe's sovereigns and banks will be abated. This will be a significant first step in the direction of returning to the "Old Normal" and one that should open the door for investors to venture back into risk assets in pursuit of the return premiums available in the foreign markets. Investors will want to be there ahead of time when that happens.

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