



# FOUR ECONOMIES AND THE ROAD TO PROSPERITY

BY STEVE ORISTAGLIO, PRESIDENT & CO-CHIEF INVESTMENT OFFICER

**Overview:** We are in the eighth year of the recovery from the Great Recession of 2008. Our base case is that we are well past the mid-point but not yet at the end of the current economic cycle, and expect modest economic growth and equity gains ahead of us. There are downside risks to this scenario, much of it dependent on whether the major players – the US, Europe, Japan and China – are able to continue to make economic progress in addressing some of their key challenges. In evaluating each economy, our research focuses on two types of analyses: 1) long-term structural considerations, and 2) current conditions against market expectations. While economic research encompasses an exhaustive data set, we prioritize three types of variables within each of these considerations.

Today our assessment leads us to a top-down allocation with the highest weighting to the US, which scores the best overall across both structural and current variables. We also maintain meaningful exposures in Europe, which has more structural issues but is attractive on valuation grounds and has seen an improvement relative to expectations in several economic considerations. Japan faces both structural and current economic challenges, but has the cheapest valuations, especially in certain targeted areas of the market, and has seen improvements in government and corporate policies over the past several years. Finally, while China continues to hold enormous potential over the long term, it still needs to make structural improvements in governance, and faces challenges tied to increasing levels of debt. It also must navigate a transition from an industrial to a consumer-based economy and modernize an over-controlled, yet underdeveloped economy and stock market. Below we provide a high-level snapshot of how we evaluate countries on six variables in total, as well as the implications for investing and asset allocation.

## Exhibit 1: A Scorecard of Economic Health

Positive (+), neutral (0) or negative (-)

	Long-Term Structural Considerations			Current Conditions Against Market Expectations		
	Debt	Productive Capacity	Governance	Gov't and Central Bank Policy	State of the Economy (vs. expectations)	Equity Valuations (vs. expectations)
	Absolute debt	Demographics	Bureaucracy	Fiscal policy	Productivity	Free cash flow yield
	Debt-GDP	Education	Corruption	Monetary policy	GDP growth	Price-earnings
	Interest coverage	Industrial base	Rule of Law	Trade policy	Employment	Price-book
	Asset coverage	Tech innovation	Political stability	Tax policy	Inflation	Balance sheet strength
				Currency	Cap. Utilization	Earnings/Bond yield
<b>US</b>	0	+	+	0	0	0
<b>Europe</b>	-	0	+	-	+	+
<b>Japan</b>	-	0	+	0	0	+
<b>China</b>	-	+	-	+	-	-

**Defining the Road to Prosperity:** Our scorecard of economic health draws from both quantitative and qualitative assessments, market expectations and our views on the risk/reward tradeoff. We score them on three possible “grades”: a plus denotes a positive contribution, a neutral indicates some good features and some challenges; and a minus indicates a potential impediment for growth or significant downside risk. This allows us to create a level playing field on which to judge multiple economies where comparisons across markets and sectors can be difficult. As with many things it is part judgment, part science.

Among structural variables, we look at the levels and trends with a country’s debt to determine whether its credit can help or hurt future growth. (See our previous piece, [Solving for the Global Debt Overhang](#)). The second category encompasses a nation’s people and productive capacity. We believe a society reaches its full potential when it has the benefits of favorable demographics, higher education, industrial diversity and technological innovation. An economy needs young blood and an educated workforce to thrive and sustain growth across market cycles. Third, good governance that mitigates or prevents the toxic drags of bureaucracy and corruption is critical to help create an optimal backdrop for growth. The rule of law, dating back to the time of Aristotle, says a society should be ruled “by law, not men.”<sup>1</sup>

Within current considerations, we make an assessment based on actual data, what is priced into the market, and what we see in the potential upside or downside. First, we evaluate government and central bank policies, which can help or hinder a nation to move in an efficient and upward path, and determine how it will navigate through crises. These span interest rates, fiscal spending, trade and tax policy and their impact on currency levels, which have a meaningful influence on international returns. Second, a country’s economic health, as defined by traditional measures, allows it to stand out on the global stage. These include productivity, GDP growth, employment, capacity utilization, inflation, and trade and current account balances. Finally, equity valuations as measured by asset prices relative to earnings power, book value, balance sheet strength, revenues, and enterprise value are all key to whether a country’s overall investment potential is attractive or expensive. Next we explain our thinking on each economy and how we arrive at a US/Europe/Japan/China hierarchy in our current investment outlook and portfolio construction.

### The US – In the Best Shape

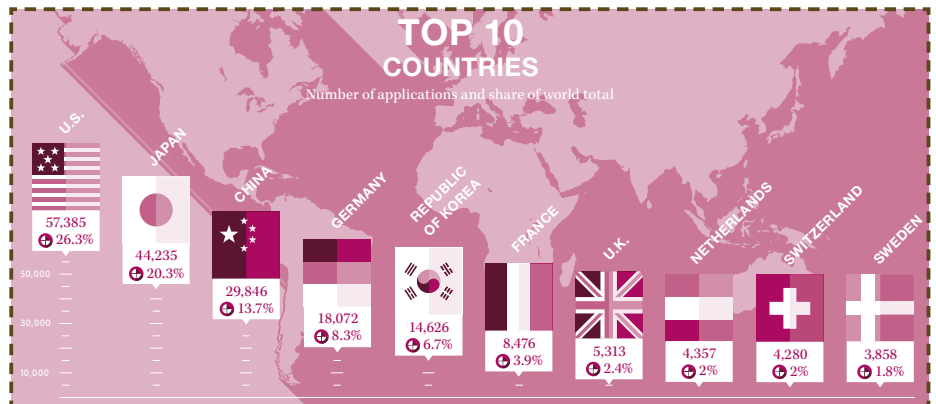
Structural (+), current (0)

The US has been a leader on many of the hallmarks of a thriving workforce that fuel economic growth and market gains. It has been able to offset an aging population through favorable immigration policies that have sustained a vibrant workforce. While it has lost some ground against Europe and Asia on education, it remains one of the most educated countries in the world. Technology continues to thrive in cities across the country, as evidenced by a venture capital market that has continued to break new ground in the areas of software, media and drug therapies, among others.

In addition, as outlined in Exhibit 2, the US continues to lead the world on total patent applications. Its governance, while not perfect, provides a benchmark standard for countries worldwide.

We are neutral on the US for current considerations, mostly because it is ahead of the other economies in the business cycle. Productivity has significantly lagged given a meaningful slowdown in capital spending since the crisis. The Federal Reserve is the only central bank engaged in tightening, though it is proceeding cautiously. Equity valuations are above long-term median values based on a variety of metrics, leaving modest potential upside and more room for a downside

### Exhibit 2: The US Continues to Lead the Way in Patent Applications, as it Has for Years



Source: World Intellectual Property Organization, 2015.

surprise. The Fed's aggressive moves post crisis propelled US markets ahead of other regions, which is reflected in today's valuation levels and our future expectations.

### Europe—Many Issues but Making Progress

*Structural (-), current (+)*

Europe's economy is formidable in size and influence, but it has faced inherent challenges from unifying policies and regulations that can sometimes supersede the best interests of individual countries. Thus we rate them a negative on structural factors. Progressive immigration policies (notwithstanding the refugee crisis, which we will discuss later in this series) have supported a diversified workforce as they have in the US. The region also benefits from an educated populace, diversified industries and strong infrastructure. However, the business environments can vary widely: easier in the UK, much harder in France, due to bureaucracy and overprotective labor laws that hinder productivity and innovation. For example, a former trader at Societe Generale SA recently won \$517,000 in compensation by a French court for his firing due to a record \$5.6 billion trading loss.<sup>2</sup> The UK's vote to exit the European Union illustrates cracks in the façade that we will discuss later in this series.

On current conditions, we see an improving overall picture. Governments are still deeply divided on fiscal policy, while a unified central bank has also created challenges given that countries each have varying monetary and currency needs. Europe has a significant opportunity to surprise on the upside with economic and valuation metrics. The European Central Bank recently reiterated the need to "act by using all instruments available" to restore Europe's growth to healthy levels. Thanks to the ECB's efforts thus far, the euro area economy is growing above trend, and unemployment has fallen from its record high of 12% to about 10.2%, according to BCA Research. Valuations remain attractive relative to other markets, with an equity risk premium (the earnings yield minus the local sovereign 10-year) of 6.1%, almost twice that of the US. European companies are trading at low valuations and generating plenty of free cash flow relative to the rest of the world (*Exhibit 3*).

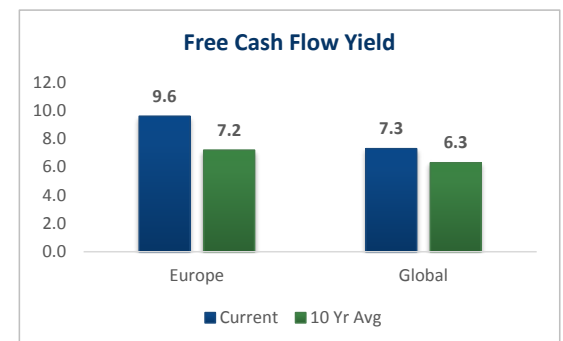
### Japan—Structural Problems, Cheap Valuations

*Structural (0), current (+)*

Japan has the highest debt-to-GDP ratio of any major country in the world, and the country has faced the demons of deflationary forces for more than 20 years, leaving consumers and corporations loath to spend or invest. Japan also faces a serious headwind from its aging workforce that could stunt its growth and competitive edge. The country faces a demographic challenge of historic proportion in the coming decade with a shrinking workforce and a soaring dependency ratio (a measure of those caring for aging relatives).<sup>3</sup> Demographics are offset by other positive influences from a highly educated workforce, diversified industrial base and technology advances. Japan has made progress in corporate governance, reducing the size of bloated corporate boards and initiating reforms but more needs to be done to modernize its workforce.

Within current considerations, the government and Bank of Japan must continue fiscal stimulus, monetary easing and structural reforms. "Abenomics" has not gone far enough and more needs to be done. We believe these efforts will unfold in 2016 and provide a boost to asset prices. Policy makers must encourage a generation of entrenched savers to change their ways, so households and businesses will increase much-needed spending and investment. QE can be an uncomfortable

### Exhibit 3: European Companies Offer Attractive Valuations



Source: Bloomberg, data as of 6/13/16. Global data reflects companies in the MSCI ACWI Index.

path and it is a little like taking antibiotics: you need to keep taking the medication even after you start feeling a little better. Expectations for growth and inflation are so low that a surprise to the upside would be a significant shot in the arm. As outlined in Exhibit 4, Japan is the clear winner on equity valuations, which will translate into significant gains if the economy can beat very low expectations going forward.

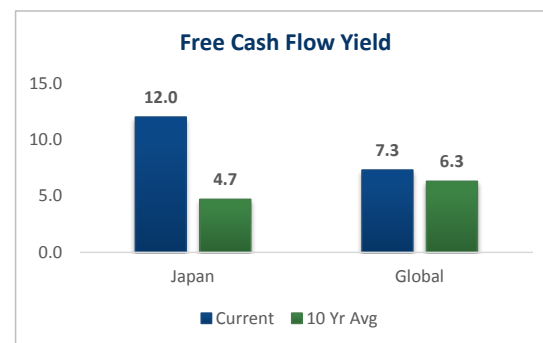
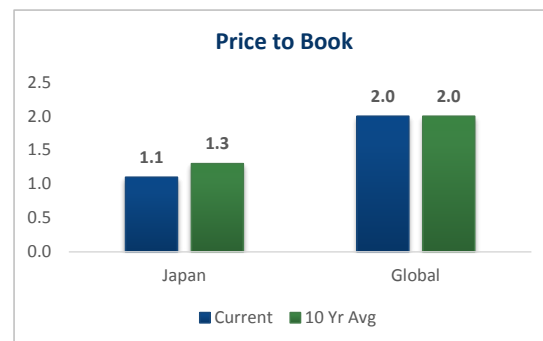
### China—A Bumpy Path

Structural (-), current (-)

China has initiated significant policies that have fueled a burgeoning workforce amid robust credit, market and real estate expansions over the past decade. Recently growth has slowed from a double-digit pace as it has navigated a soft landing in its transition to a consumer-based economy. The country has made great advances in education as millions have moved out of poverty into the middle class. It also began to phase out its one-child policy in 2015 to remove what had become a demographic roadblock. On innovation and diversity, one global innovation study found it to be outpacing its economic peers in developing markets, with the numbers of patents rising rapidly.<sup>4</sup> Chinese provinces that depend heavily on “smokestack” industries have lagged those with more diverse business bases, although the growth of private companies is providing a counterbalance to state-owned enterprises (SOE). With governance, however, China has work to do. China ranks 71<sup>st</sup> out of 100 nations in the WJP Rule of Law Index (2015), but the report noted that the country has made improvements in regulatory enforcement and civil justice.<sup>5</sup>

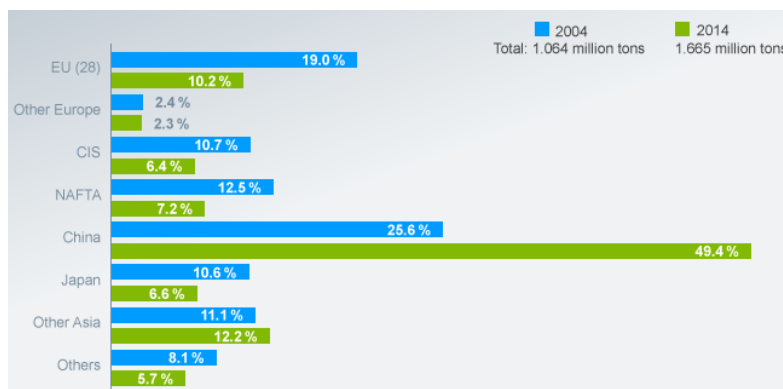
The strong arm of China’s leaders has allowed it to take decisive action on fiscal, monetary and trade policy. The country has several trillions in reserves for fiscal stimulus and room for lower rates. It has also taken steps to reform its Byzantine system of direct and indirect taxation and is starting its biggest overhaul in more than two decades to reduce the burden on services companies and encourage factories to upgrade and innovate.<sup>6</sup> All of this has fueled among the highest productivity rates in the world. The economist Paul Krugman famously wrote that “productivity isn’t everything, but in the long run it is almost everything.”<sup>7</sup> While there are many excesses in China, the country seems to understand its mission and has the economic potential, the tools, the reserves and the will to execute its evolution. The path will be complex and volatile, likely with some trial and error. For example, it has severe overcapacity problems affecting dozens of industries that are hurting economic reform and trading relations, according to a new report by the EU Chamber of Commerce in China.<sup>8</sup> China produced as much cement in 2011 and 2012 as the US did during the entire 20<sup>th</sup> century, while its steel production dwarfs that of other leading world producers, as outlined in Exhibit 5. Finally, China also gets a negative score on valuations amid concerns about potential bubbles in its real estate and stock markets.

### Exhibit 4: Japan’s Valuations are Among the Developed World’s Most Attractive



Source: Bloomberg, data as of 6/13/16.

### Exhibit 5: China’s Overcapacity Glut as Illustrated by Steel Production



Source: Deutsche Welle, World Steel Association

## Investment Implications: The Global Economy's Fine Balance

The outlook for global growth has begun to pick up, according to a report from the International Monetary Fund (IMF).<sup>9</sup> The global economy is expected to grow at a rate of 3.4% in 2016 as stronger consumption modestly outweighs sluggish corporate investment, the IMF found. The US is benefiting from favorable financial conditions and strengthening labor and housing markets, while the euro area is seeing stronger consumption supported by lower oil and easy financial conditions despite weakening net exports. China's construction growth will be a powerful counterbalance to the drag of overcapacity. In Japan, growth is expected to strengthen due to fiscal support, lower oil, accommodative financial conditions and rising incomes.

Our base case for the global economy is that we are in the late stages of the global debt cycle but we do not see the makings of a recession. We expect debt deleveraging will be a drag on growth and asset prices, with more muted equity and credit returns, for the next 5-10 years. In this landscape we see the best opportunities in private markets, value stocks, distressed debt and asset-backed securities, as outlined in Exhibit 6 below.

### SERIES OVERVIEW

*This is the second piece in a series where SCS explores what it considers to be some of the essential questions facing world capital markets today.*

- *The global debt super cycle (May 2016)*
- *Top challenges facing the global economy's major players (June 2016)*
- *Geopolitical considerations (our next piece)*
- *Global equity and fixed income valuations*
- *Investment and asset class considerations*

## Exhibit 6: Investment Opportunities Across the Four Economies – Select Examples

		US	Europe	Japan	China
Credit	Public Credit	Mispriced mortgages and asset-backed loans	Short-duration direct lending		
	Private Credit	Direct lending for the middle market	Direct lending combined distressed situations		
Hedge Funds	Credit, Long/Short & Event-Driven	Complex structured credit	Non-performing loans and bank debt	Short Japanese regional banks	Select consumer products, web services
Equities	Public Equities	Specialty financials with good business models	Undervalued multinationals (pharma, insurers)	Small-cap specific opportunities	E-commerce
	Private Equity	Lower middle market; Disruptive technologies	Family-owned and entrepreneur-led businesses		
Private Real Assets	Real Estate and Natural Resources	Operations-focused small cap upstream oil & gas	Undervalued real estate in constrained growth markets		

<sup>1</sup> Lawrence Solum, "Equity and the Rule of Law." *Nomos* 36 (1994): 120-47. Web.

<sup>2</sup> <http://www.bloomberg.com/news/articles/2016-06-07/kerviel-wins-over-400-000-euros-in-socgen-dismissal-lawsuit>

<sup>3</sup> McKinsey & Co., "The Future of Japan: Reigniting Productivity and Growth." March 2015.

<sup>4</sup> *The Global Innovation Index, "Effective Innovation Policies for Development,"* 2015.

<sup>5</sup> *World Justice Project Rule of Law Index, 2015.*

<sup>6</sup> *Bloomberg, April 21, 2016. "China's About to Start its Biggest Tax Overhaul in Two Decades."*

<sup>7</sup> *Paul Krugman, "The Age of Diminished Expectations."*

<sup>8</sup> *European Union Chamber of Commerce, "Overcapacity in China: An Impediment to the Party's Reform Agenda." February 2016.*

<sup>9</sup> *International Monetary Fund, World Economic Outlook, January 2016.*

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