

An update on the route and destination

Ronald Temple | Lazard Asset Management | 03 October 2014

[At PortfolioConstruction Forum Markets Summit 2014] In February, I made a few key points about investing globally. Fast forward six months and we continue to see quite a few good opportunities around the world.

Edited transcript It's great to be back with you.

[At PortfolioConstruction Forum Markets Summit 2014] In February, I made a few key points about investing globally. Number one, I noted that we've never been in an environment like the one today. There's more complexity, integration and interconnectedness through the global economy than we've ever seen. I made a second point related to that – that we can't simply rely on historical references, playbooks, guides to figure out how we need to invest. We have to think nimbly on our feet in terms of how the world is changing and where we want to be invested. I also made a point about the US and emerging markets and economic growth prospects in those two regions. I said that the US was unlikely to surprise on the upside and my conviction in that case has been reaffirmed. In emerging markets, I focused on China and the risk that the Chinese economy could face a substantial slowdown in the years ahead. I remain convinced of that view as well. I'll follow up on both of those in the next few minutes.

First of all, the US. I noted that there are three key themes in the US economy. Number one – deleveraging; number two – re-regulation; and, number three – widening gaps in society. I want to touch on each of the three.

In terms of deleveraging, the US economy has continued to make progress. Peak debt to GDP in the private sector in 2009 was 295%. As of the first quarter 2014, that leverage has come down to 239%. We've made a 56 percentage point decline in leverage in only five years, which is tremendous progress. So that's a positive.

In terms of re-regulation, which I'll come back to in a minute, it's particularly important for the middle class. The new rules of Basel III and the Dodd-Frank financial reforms in the US have changed the ability of

the middle class to access cash related to the value of their home through borrowing from a bank.

Which then leads me to item number three, which is the widening gaps in society which is obviously to some degree interconnected with the other two points. In particular in terms of gaps in wealth and income in US households, we've seen over the last number of years going into this crisis and coming out of it is a divergence in wealth that's been quite extreme. In fact, every three years, the US Federal Reserve does a deep dive survey of consumer finances and they've just recently released some of the incremental data for 2013. Unfortunately, we don't have the full data set for 2013 yet so I'll reference 2010 figures right now just to give you a sense of the context.

In the US in 2010, there were about 114 million households. If we looked at just the top 10% of households as gauged by net worth, the average household in that cohort had a net worth of around US\$3.7 million. On average, they had about 43% of their assets in financial assets and an additional 24% of their assets were owning businesses. Only 18% of their assets were their house.

But with the middle 57 million American households as gauged by net worth, 62% of their average assets was their house. Their dominant single asset was their house. Financial assets were only 21% of their assets – a very small amount.

The reason I care about these numbers is if we look at the US in the last five years, household net worth has actually gone up by \$26 trillion to around \$82 trillion. Some \$21 trillion of that \$26 trillion increase has been due to an increase in financial asset values. Now look at who owns financial assets in the US. The top 25% of households by net worth own over 90% of all financial assets. If we think about the recovery and balance sheet values we've seen in the US in the last five years, almost the entire amount of that recovery has gone to the top 25% of households.

Meanwhile, the middle 50% of households – sadly, they're saddled with housing assets. The good news is home values have turned in the US and they've increased pretty substantially since the end of 2011 when we reached a bottom in terms of homeowners' equity. Unfortunately, the middle class still remains underwater relative to where they stood before the crisis or even probably 10 years ago.

The widening gaps matter to me because if you think about the growth potential of the US economy – the middle class engine – that mass

market for many products and services offered by companies in the US is still in a worse condition than it has been in years. The middle class remains in a balance sheet recession. I believe that will likely constrain real GDP growth in the US to something in the order of 2% for several more years to come.

Balance sheets aren't the only part of the story. The other part is the income statement and this is a key point of debate at the Federal Reserve. If you think about monetary policy and when the Fed should start raising interest rates, they have a mandate to maintain price stability and to maximise employment. The debate at the Federal Reserve right now is around how much slack there is in the labour market. Is there an excess supply of labour relative to demand?

We've done quite a bit of work on this. We've examined the labour market in depth. The percentage of American adults who work today versus the percentage who worked back in 2006, before the crisis hit, has seen a material decline, from 63.4% employment to population ratio to 59% employment to population ratio. That 4.4 percentage point decline actually equates to about 11 million missing jobs. If we were sitting at the Fed, we would say that's an enormous number relative to the workforce of 250 million people.

In our analysis, we've been able to explain part of that 11 million. About four million of the missing jobs relate to demographics. The American population is aging and there are more and more people over the age of 55 where employment rates do decline historically and are declining even today.

Another one million missing jobs can be explained by disability, which happens to be something that occurs in a deep economic crisis. We often find that in the US, as people run out of employment benefits, they need another source of income and so they rely on saying that they have a disability.

So there's four million because of aging, and one million from disability. That still leaves six million unexplained lost jobs. We believe there is a case to be made that there is a substantial amount of slack in the US labour market as represented by that gap in employment.

We believe that also puts a lid on consumption growth. As I mentioned earlier, with households having homes that are worth less than in the past, with income statements that are somewhat stagnant and many jobs that are missing, the US has done quite well in spite of those facts. But, it's unlikely to deliver superior growth in the order of 3% to 4% that many

people have prognosticating for several years. On the US, we remain moderately optimistic, but in our view, realistic about growth prospects.

Turning to the second topic [I discussed at Markets Summit] in February – China – I should say that there's one primary theme in emerging markets and that theme is differentiation. Part of the reason I focused on China is that I believe many investors are a bit too complacent in assuming that China can always grow at a rate well beyond that of many other countries in the world. Much of the debate we often hear is whether China will grow 7% real term or 7.5%. I would suggest that the debate should be whether China should grow 4% instead of 7% over the next three to five years. There are three key points I would make about why I express this concern or skepticism about future growth.

Many of the real competitive advantages that drove China's growth in the past are dissipating or even becoming competitive disadvantages. Just to give you one example – labour costs in China were historically extremely low relative to many other countries but over the last 10 to 15 years we've seen very rapid wage growth in the order of 16% to 17% per annum since 2001. If we compare wages in China to Mexico, in 2001, the average Mexican worker made about \$2.40 per hour. The average Chinese worker made 70c per hour. Fast forward to 2013 and the average Chinese worker was making \$4.50 per hour while that Mexican worker was making \$3.30. It does not mean that jobs in China will all suddenly flow to Mexico – but what it does mean is that if I'm the CEO of General Electric and I'm deciding where to put my next offshore facility, Mexico is a lot more appealing than China.

Another reason I think Chinese growth may well slow is population. Demographics are working against China because of the one child policy and working age population actually declined for the first time last year.

Last – but not least – my final worry on China is leverage. As real competitive advantages have decreased in importance, leverage has been increasing in the Chinese economy. From 2008 to 2013, debt-to-GDP rose from 155% to 238%.

The one statistic I hope you remember is this: the amount of outstanding corporate debt in China rose 50% in two years 2011 to 2013. In my view, the worry for China over the next three to five years is that if China's growth decelerates to reflect the realities of its competitive advantages, and leverage continues to accumulate, we could have a bigger challenge on our hands in China when they finally do go back to a more sustainable economic growth rate in years ahead.

Again, this does not mean that you need to sell all of your emerging market exposure – but it does mean that you need to be very careful about understanding the countries in which you invest and the companies. In my view, you need an expert professional active manager to do that job for you because within emerging markets, as I said before, the theme of differentiation is the theme to know about in the years ahead.

To summarise, we continue to see quite a few good opportunities around the world. In the US, in spite of moderate growth, we find very attractive valuations and returns on capital. In emerging markets, as I mentioned, there's huge differentiation across the board and many markets are undervalued at this point, in our view. In countries even like Japan, we see prospects for significant upside. So there are many good opportunities around.

The key thing to do is to be very careful about recognising that the past does not tell you where we're going in the future. You need to be careful and skeptical about thinking about investment choices and actively manage where your capital is deployed.

I look forward to seeing you at Markets Summit in February 2015, to discuss our views and see how they've evolved and how they might affect your investment opportunities.



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