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Investment Update

FOURTH QUARTER 2012

A NEW YEAR'S RESOLUTION: "START ME UP!"

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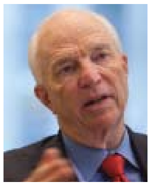
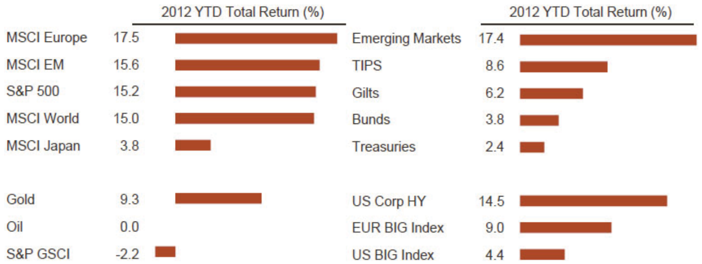


The title to a well-known song by the Rolling Stones? Yes. But it is also summarizes the desire within developed economies for policies to induce growth, and provides a fitting theme song for central banks in their aggressive efforts stoke demand in the face of fiscal policies moving in the opposite direction.

In the years following the global financial crisis, poor global growth has resulted in a world burdened by debt, idle capacity, and excess labor. Central banks of developed countries have tried to do their part via quantitative easing, a policy designed to bring about an acceleration of real economic growth. And based on the double-digit gains in the global equity markets for 2012, their "Start Me Up" policies appear to be working (Figure 1).

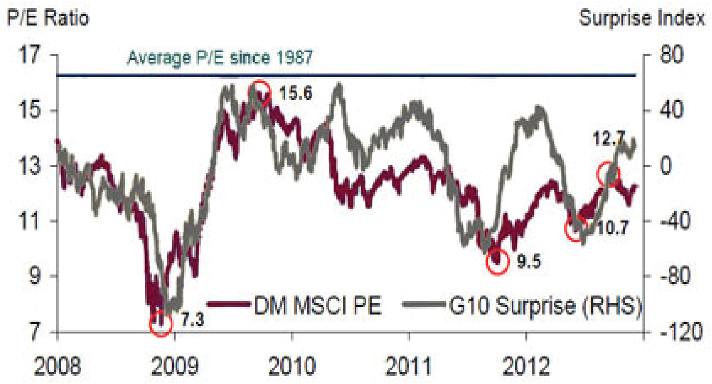
FIGURE 1: QUANTITIVE EASING LIFTED ALL ASSET CLASSES IN 2012 (IN USD)



Source: Bloomberg, The Yield Book, Morgan Stanley Research (December 2012)

Before we get too excited by these results, however, it's important to note their underlying causes. Real growth last year was modest at best: the entire gain in the stock market from October 2011 through September 2012 can be explained by an increase in P/E ratios and by the removal of tail risk by the central banks (Figure 2). This period also saw a resolution of the liquidity risk problem that began in the summer of 2007 and peaked with the bankruptcy of AIG and Lehman Brothers. As shown in Figure 3 (following page), the Bloomberg Financial Conditions Indices for Europe and the U.S. strongly suggest liquidity risks have dissipated as a result of the actions of central banks.

FIGURE 2: EXPANDING VALUATIONS EXPLAIN MARKET GAINS

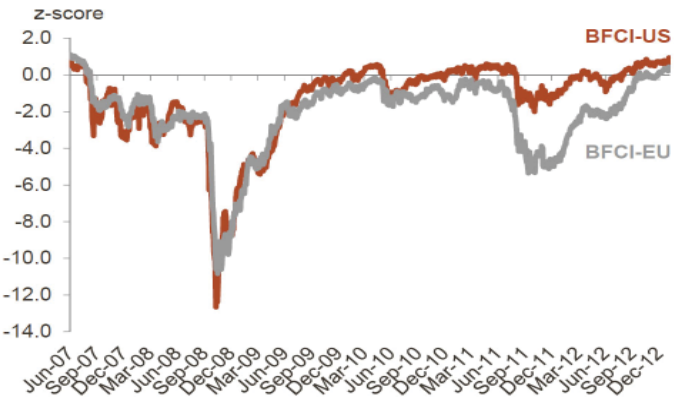


Source: IBES, MSCI, Datastream, Bloomberg, Morgan Stanley Research (December 2012)

All of which raises an important question: will the benefit to capital markets from monetary policy cross over to real growth in 2013? Our answer is both yes and no. Yes, we will see more real growth than most pundits would have you believe; and no, we will not see as much real growth as the central banks intended. Real growth, after all, is a function of only two variables, employment gains and productivity gains. The latter explains the expansion of profit margins and to some extent the outperformance of large-cap companies, particularly global champions. Today, the environment in which these global champions operate is looking fairly healthy as a result of the deployment of technology and benefits from the evolution of global supply chains.

This is expressed in *Race Against the Machine*, a recent book by Erik Brynjolfsson and Andrew McAfee of MIT. Using the 64 squares on a chessboard as an analogy, they show the cumulative impact from compounding a factor by doubling it 63 times. In this way, they show that exponential increases initially look like linear ones, but are not. Their example is as follows: if we place one grain of rice on square one and double the amount on each subsequent square, we will have 128 grains of rice on square eight, but on square 64 we will have a rice pile the size of Mt. Everest! In terms of technological advancements, the past two generations were on the first half of the chess board, where exponential movements appeared like linear ones. Now, we are on the second half, where real change happens at a staggering and obviously exponential pace.

FIGURE 3: BLOOMBERG FINANCIAL CONDITIONS INDEXES INDICATE NO LIQUIDITY RISKS



Source: Bloomberg (December 2012)

The takeaway that sticks in my mind from reading the book is the following: "Martin Grotschel analyzed the speed with which a standard optimization problem could be solved by computers over a 15 year period ending in 2003. There was a 43 million fold improvement which he broke down into faster processors and better algorithms. Whereas processor speeds improved 1000 times, algorithm improvements gained by 43,000 times."

The several hundred basis points of margin growth among manufacturers that has occurred in the past decade is largely explained by this recent explosion in technological prowess on domestic plant floors combined with the benefits arising from globalizing supply chains.

First, lets look at the productivity of domestic plant floors. Since 2000, the value of output produced by U.S. manufacturing plants is up even though employment has shrunk by more than one-third as a result of two recent recessions. The entire margin improvement at the plant level, a whopping 300 basis points since 2000, can be attributed to better labor cost absorption. Barring a sales decline, which we do not foresee, manufacturing margins will continue to rise as technology works its magic through the production process. And its effects will accelerate.

Second, the globalization of supply chains has kept a lid on costs. Reflecting the Law of Comparative Advantage, the margins of companies in the developed world have benefited from competition among those based in emerging markets. Even though labor costs are rising sharply in portions of the developing world, the ongoing shift in the geography of supply chains has held cost premiums in check. According to Empirical Research, since 2004 prices of manufactured goods are up 4% per year, wages of U.S. manufacturers have increased by 2% and imports from emerging Asia inflated by less than 1%. Throw in a declining dollar, and it is easy to see that U.S. manufacturers have benefitted greatly from this trend.

In sum, we see another positive year for equities, particularly relative to bonds. Bond investors are like the observer who sees a 50-cent piece in the path of a steam roller. He may pick it up in time, but he is more likely to be crushed. Every policy maker in the world is joining in the chorus of "Start Me Up." Woe to the investor who doesn't listen.

In the environment ahead, stocks win and bonds lose. However, the sources of return for equities will be different in 2013 than they were in 2012. The P/E expansion period is largely behind us. It will be earnings and dividends that drive returns this year. There will be less "risk on" and "risk off" than what we experienced last year. And those companies that have world-class supply chains that can put technology to work on their behalf will be the big winners. They are also the companies that generate free cash flow year in and year out and have a history of capital allocation decisions that have resulted in rising shareholder values.

[1] *Empirical Research Partners, Portfolio Strategy (December 2012)*