



PLIMSOLL MARK CAPITAL

“Climate is what we expect. Weather is what we get.” Mark Twain.

For the global investor, 2011 was a rough year for stocks. Excluding the US, the global stock market declined 14%, with minus 13% for developed markets and minus 18% for emerging markets. All in all, 2011 was a year which most investors will be happy to consign to history. And it's not just because most equity markets fell (sometimes sharply) but also because the prevailing mood was so gloomy. The only respite was the positive 2% return turned in by the US stock market, making it look like the nicest house on a bad block.

So, standing at the threshold of 2012, what looks different?

Plimsoll Review

Unfortunately, the answer is not very much. To put the current financial environment in perspective, it's worth reviewing how we got here. Over the last 40 years, the expansion of public and private debt has distorted our view of prosperity. During that period, almost all developed nations, and some emerging economies too, became hooked on credit as a substitute for investment in tangible things – plant, equipment and an educated work labour force. The focus was on producing paper and not real things as interest rates were lowered and assets securitized at an accelerating rate until the process could go no further. In 2008, it all came to an abrupt end marked by the collapse of Lehman Brothers. **Now, we are left with interest rates at practically zero and creditors that trust almost no one.**

Prevailing wisdom has it that the real economies and financial markets around the globe are systematically healing themselves through a process of muted growth in the developed world, characterised by high unemployment and relatively orderly deleveraging (meaning paying down the debt). It's too bad but that's not the case. In reality, the way out is neither pleasant nor smooth because we still live in a world where there is too much paper and too little trust. The most likely result will be sluggish growth everywhere, punctuated by frequent periods of economic decline and significant market volatility. It won't look exactly like the 21st Century version of the Great Depression because we have learned how to better manage the economy. The policy tools in the hands of our central bankers and politicians are powerful enough to control the rate of descent, but not avert the fall.

By reducing interest rates to almost zero and initiating a series of “quantitative easings,” where government debt has been substituted for private debt, central banks have temporarily succeeded in keeping the real economies afloat in the US, Europe and even Japan. To get a sense of global debt levels, take a look at the exhibit below from the Boston Consulting Group.

This table summarizes the debt level for ten developed countries by reporting the total borrowing of the government, household and corporate segments of each country's economy expressed as a percentage of GDP. The obvious take away (without getting lost in the torturous detail) is that many countries have borrowings that are at higher levels than they

EXHIBIT 2 | Debt Levels with Negative Impact on Economic Growth



have ever been (at least in peace time) and most are at levels which have subsequently been associated with long and painful economic adjustments.¹ **Moreover, aggregate debt levels have continued to rise modestly since the financial crisis of 2008.** This was the point at which many market commentators and participants incorrectly believe that these ratios began to shrink. The sad truth is that only the deck chairs on the Titanic have been re-arranged - with more liabilities being assumed by sovereigns (categorized in the table as Government Debt). There is still a massive iceberg of debt looming out there.

Plimsoll Outlook

The question now becomes: **Can a debt crisis be solved by putting on even more debt and lowering interest rates to zero?**

Solving the debt problem (recall that it has been 40 years in the making) requires the right combination of three things: (1) growth, (2) inflation and (3) good fortune.

First, let's turn to growth. As Pimco's Bill Gross states: **"Growth is the magic elixir that cures all economic woes.** Is government debt too high? Just grow your way out of it. Is unemployment hitting historic levels? Growth produces jobs. Are the financial markets depressed? A little growth renews the capitalistic spirit." **But growth is something that the world is short of at the moment, especially in the developed world with Euroland slipping into recession.**

It seems like a distant memory that 2011 began with significant optimism that global growth was accelerating and would be strong enough to begin to correct the imbalances we see in the debt table. This was optimistic from the outset and became visibly so by mid-year. And by year end, the pendulum had swung in the opposite direction with forecasts that a recession was right around the corner. As always in a complex world, the reality is even more complicated.

Ironically, the search for growth is becoming further handicapped by the excessive borrowing that got us here in the first place. High debt levels are choking the developed world economies and constraining stimulus policies. As economists Rogoff & Reinhart point out in their historic text, *This Time It's Different*, sovereign debt levels approaching 80% - 90% of GDP are actually a barrier to growth because an ever increasing percentage of a nation's output must be diverted to creditors who in turn become wary of reinvesting in a slow economy. The result is a vicious circle that feeds on itself.

Further compounding the matter are the structural impediments to growth present in the developed world economies. In his writings, Bill Gross has repeatedly stressed that **the US and Europe are facing three distinct head winds to growth:**

- **Globalization** has diverted hiring to much cheaper alternatives in developing countries. Rock-bottom borrowing costs have little impact on corporate decision makers deciding whether to create jobs in high or low labour cost geographies.
- **Technological innovation** is destroying traditional consumer based business models (70% of the US economy is dependent on consumption). If on-line retailing has effectively destroyed retail book and record stores and seriously comprised the economic viability of shopping malls, then what do low (or zero) borrowing rates mean to Target or Wal-Mart when considering future store expansion?
- **Demographics** are not on our side. With the baby boomers beginning to enter their retirement years, will lower interest rates cause them to spend more? In fact, they may have to save more with bank CD's that used to yield 5% now offering something close to nothing.

¹ For the US, the incredible reality is that the government debt shown in the table does not include the present value of the Treasury's own estimate of unfunded future Social Security, Medicare and Medicaid liabilities at levels that are already on the books.

On the good news side, the US economy appears to be accelerating modestly as optimism builds that house prices have reached a clearing level and consumer spending shows a little resilience. Add to that the likely bias to stimulus that accompanies any presidential election year and it is likely that growth will continue to surprise on the upside. But down the road, the US economy will likely suffer a fiscal drag as stimulus measures fade and a round of automatic spending cuts appear imminent following the failure of the 'Super Committee' to agree to anything sensible on the fiscal horizon. The problems in the US are more likely to become visible in 2013 and beyond. **Of the major world economies, the US looks likely to be the most robust in the year ahead.**

On the other side of the Atlantic, Europe is showing signs of having already entered a recession. Austerity is the course through which this contraction is being delivered and most countries are committed to inflicting fiscal pain on their populations. This is to meet the demands of the bond markets on the one hand and the policy goals of a mercantilist Germany on the other. When you combine Germany's political need to impose moral hazard on what it sees as the badly behaved teenagers in the south and its commitment to an export based economic model with bond market cynicism, you have a mechanism for impoverishing large parts of Europe. While the immediate risk of a credit crisis across the Continent has receded following much more aggressive policy moves by the ECB, the risk of further accidents in Eurozone bond markets and a shuffling towards the precipice of Euro break-up is possible in the year ahead. **Our view remains that the consequences of driving the Euro over the cliff are so serious that disaster will be averted, but it may not be until the last minute.** In the meantime, growth will be no more than a memory.

In the emerging world, eyes are focused on the possibility of a hard landing in China with most investors believing in the magic powers of communist economic management to avoid it. The Chinese economy responds quickly to changes in stimulus and it is indeed likely that the foot has come off the brake in time, but there is still likely to be a round of bad debt pain in the property sector following the huge 2009 lending binge. In the medium term, China, along with other large emerging economies, is in the midst of a shift towards a consumer society where individuals have more power. We are already seeing spiralling wage demands putting manufacturers in Eastern China out of business and factories being moved either to lower cost areas or to countries where productivity is much higher. The outsourcing boom is running out of steam. **The big advantage for the emerging world in the current investment environment is that balance sheets there are in good shape and growth is becoming less reliant on the developed world.** These trends are understood by the market but currently overwhelmed by fear.

All in all, it seems unlikely that growth alone will bail us out.

Second, to sustain a vital economy a modicum of inflation is necessary as an expanding monetary base serves to keep the growth machine well oiled. **A healthy dose of inflation has the knock-on benefit of creating more money to pay back the outstanding debt.** Currently, however, inflation seems to be falling everywhere. In the developed world, it is responding to the lack of demand which means that the huge increase of liquidity caused by quantitative easing may be storing up future inflation problems but lack of confidence and activity today push the risks to the deflationary end of the spectrum. In the emerging world, we have been through a classic monetary cycle which has begun to squeeze inflationary expectations.

The inflationary route to government solvency remains a paradox much like Schrodinger's cat – simultaneously possible and impossible.

Third, **in the western world, we have come to expect good fortune. The problem is that we have used up a large store of it.** In two particular areas, the developed world has benefited from a serendipitous underpinning of prosperity delivered to us from the previous generation: (1) we have been the recipients of a demographic dividend with the baby boom greatly expanding the labour force; and, (2) we have experienced a productivity revolution brought on by the dissemination of information technology. The first of these is in the process of reversing - building liabilities for a shrinking workforce. As far as the second... who knows? Technologists point to breakthroughs in nanotech, bio-engineering, energy, and 3D printing of manufacturing products. While new technologies will have a favorable impact over time, it appears unlikely that they can contribute to resolving the debt crisis in the near term.

In short, it appears that we are going to have to create our own luck.

It is not all gloom, however. The dynamics playing out in the background are indeed poor, but prices of many assets already reflect a lot of this. If you had known, at the end of 2010 what would happen in 2011 – a significant deterioration of the Euroland crisis, a much weaker US economy and a slowdown in the emerging world, you would perhaps have predicted that markets would have fallen by more than they did. There are many reasons why this didn't happen, but the most important may be that there is a lot of cash on the sidelines and returns are hard to come by. That has not changed.

The long term, secular resolution to our debt induced tragedy is like a five act play and we are currently just approaching intermission. We see a 'muddle through' process, where some yet-to-be-determined combination of growth, inflation and good fortune with a bit of restructuring or forgiveness (in the highly indebted countries such as Greece) puts us back on the straight and narrow. There will be intervals where economic activity looks to be improving and sovereign debt worries recede which will cause financial markets to react favourably. On the other hand, there will be times when it will appear as if there is nothing but trouble ahead and asset prices will be cheap. The tension between risk and lack of return opportunities seems likely to lead to more of what we have had - continued uncertainty and high anxiety resulting in significant market volatility without necessarily experiencing a full-on crisis.

Plimsoll Policy Response

In this environment, we think it makes sense to have a balanced portfolio with exposure to all the geographic regions.

The US equity market has fared relatively well and was, in fact, the best performing major market of 2011. This reflects levels of corporate profits which have surprised forecasters with their resilience having held near record levels. Those of a cyclical mind-set believe that this cannot be sustained. We believe the profitability of corporate America reflects a favourable shift toward high margin, world leading businesses which generate vast free cash flow proving that America's free enterprise spirit is still intact and seeking profitable opportunities around the globe. Valuations are seen by most commentators as low, but we tend to the view that they are in the fair value camp, neither high nor low. **With the US economy looking a little better over the short term and the developing world offering growth opportunities for corporations operating globally, high quality US businesses and global franchise companies that pay generous dividends should have the most significant weighting and form the core of your portfolio.**

For non-US equities, we favour a strategic allocation to Asian markets where we believe that the fundamental growth story is strong but we are focused on balance sheet strength and defensive business characteristics. To hedge against deflation, we continue to hold an opportunistic bond fund where the manager has the capability to adjust the duration and the credit quality of the portfolio as dictated by economic conditions. We are relatively light in government bonds. We still have a position in commodities and gold as a sensible means of insuring against the risk of an inflation flare-up, however distant that may be. It is possible that the commodity position will be reduced should economic weakness come to dominate markets.

In summary, this is not a buy-and-hold-on-forever market. Accordingly, in most portfolios, we hold a significant strategic position in cash reflecting an environment that can be best described as delevering, dispersionary, disruptive and deflationary. Holding a ready store of cash provides the flexibility to act when uncertainty and volatility combine to make asset prices cheap. Hang onto your hats, the bumpy ride continues!

Our very best,

The Plimsoll Mark Capital Team