CONSUELO MACK | WEALTHTRACK

Program #1329
Broadcast: January 6th, 2017

On this week's Consuelo Mack WEALTHTRACK: in an exclusive interview, Ed Hyman, Wall Street's # 1 ranked economist for a record 36 years describes how much the financial world has changed in the last year. He and top investor, Matthew McLennan describe what it means for the U.S. economy and markets.

Ed Hyman
Chairman, Founder
Evercore ISI

Matthew McLennan
Head of Global Value Team
Portfolio Manager
First Eagle Investment Management

CONSUELO MACK: This week on WEALTHTRACK, in our exclusive annual outlook with Wall Street's king of economists Ed Hyman, he describes how much the world has changed. He and top portfolio manager Matthew McLennan tell us what it means for investors next on Consuelo Mack WEALTHTRACK.

CONSUELO MACK: Hello and welcome to our annual WEALTHTRACK tradition, an exclusive two part interview with Wall Street's king of economists, Ed Hyman. Hyman who is the founder and chairman of Evercore ISI has been voted the street's number one economist for an unprecedented and probably unassailable 36 years by *Institutional Investors* for a reason.

In an era of information overload and complexity he and his ISI team pioneered a research product that is brief, accessible, comprehensible and comprehensive. It is a daily must read for institutional investors all over the country if not the world.

So, every year on WEALTHTRACK, Ed is joined by a top investment pro to put the macroeconomic outlook into investment perspective. For 2017 we asked first eagle's Matthew McLennan to join us. McLennan, another WEALTHTRACK regular over the years is head of the global value team at First Eagle investment management, where he is also a portfolio manager for several funds, including the flagship First Eagle global fund, which he took over from legendary value investor Jean Marie Eveillard in 2008. Rated five-star by Morningstar, the global fund is in the top decile or higher in its world allocation category for the past one, three, five and ten year periods and is known for its above average risk adjusted returns.

This week our primary focus will be the outlook for the U.S. economy and markets. Next week we will concentrate more on international conditions, although we recognize they are all interrelated. Hyman's team expects the U.S. economy to pick up steam this year, forecasting real GDP - that's excluding inflation - of 2.5% in 2017 versus an estimated 2% in 2016. They expect inflation to pick up as well, with the Fed's favored GDP deflator measure rising from 1.5% last year to 2.5%.

As for theFed funds rate, they are looking for a sizable increase from around 0.60% to 1.35% by year end. The yield on the benchmark treasury should rise half a percentage point, from 2.5% in December 2016, to 3% by December of this year. And finally they expect profits to improve, estimating that the combined earnings per share of the S&P 500 companies will rise about 10% year over year. A lot can change between now and then, but eight years into the post crisis recovery, Hyman believes economic growth is picking up and that a recession in the U.S. is years away! I asked him to give us the evidence behind the improving numbers.

ED HYMAN: It’s not strong right now. I mean the evidence is not strong, so it’s really a forecast, and I feel a little insecure about it because we’ve had seven years where every now and then it looks like it’s picking up and it’s not. But the Trump pro-growth policies are sort of the main motor, plus it looks like the world economy is picking up some. Europe’s a little bit better. China’s a little bit better, and here in the States I would say the main thing that looks like more growth: our wages are accelerating and you still have strong employment, and I think that combination of employment and wages will get consumer spending up, and that’s the beginning of it. But as you know from our previous visits, we survey companies every week, and that has not picked up, what they tell us, business conditions. We do zero to a hundred, and they’re still 50, and back in 2014 when growth was three percent, they were 55. So I’m waiting on pins and needles to see things pick up a little bit.

CONSUELO MACK: Yet when I look at the earnings estimates, you are expecting about a ten percent increase in the kind of composite S&P earnings per share. So where does that come from?

ED HYMAN: Well, so far that is one space that has picked up. So the earnings that I look at in the first quarter were $105, and a year and a half before that they were almost 120. So the U.S. S&P earnings had a big fall, and now they’re basically back up to 120. So there’s been a big rebound in earnings, and looking forward you should have in particular big gains in earnings for oil companies and for banks.

CONSUELO MACK: So that could make a big difference.

ED HYMAN: Plus, it looks like the world economy is picking up some after slowing a lot and almost going into a recession early this past year. Now it’s picking up.

CONSUELO MACK: So I know, Matt, that you read Ed’s research, and you don’t make your investment decisions based on the macro outlook. You basically make your investment decisions from the bottom up, and you look at individual companies. What’s your assessment of this pickup in growth that we’re seeing in the U.S.?

MATT MCLENNAN: I think there’s no doubt that we’ve seen sort of a steady improvement in the U.S. economy over the last handful of years, not just this recent couple of months. I mean we’ve seen unemployment go from ten percent to five percent. We’ve seen bank loans go from shrinking to growing. Even though energy prices have picked up somewhat here, they’re still a lot lower than they were on average over the last decade, and that’s a source of stimulus for the economy as a whole and, as Ed referenced, there are some signs of corporate earnings improving at the margin here, and then layer on top of all of that the proposed stimulus that Trump is talking about, and I think you have a range of different reasons why the market is reflecting better fundamentals and why people are feeling better about the economy. In fact, consumer confidence and expectations are quite high relative to history at this point in time. My only concern as an investor – and it's difficult for me to foresee the future and to have the same kind of granularity that Ed does when he's looking at all these different variables of the economy – is that much of this may be priced.

CONSUELO MACK: Into the market.

MATT MCLENNAN: Into the market, so I mean it's an environment where valuations have improved a lot bottom up when we look security-by-security. With the backup in the bond market here, we've seen that largely absorbed by riskier credit markets which implies that credit spreads have come down as well, and if you look at other measures of risk perception such as implied volatility, they're very low relative to history. Hedge assets like gold are quite cheap relative to risk assets like equities. So when we look at financial markets, they're telling us that they're already confident, and so that makes our task difficult as investors.

CONSUELO MACK: And what difference? You mentioned the Trump expansionary policies, Ed. How much of a difference can a President Trump?

ED HYMAN: Well first, keep things on the right path. Last year was a good reminder of how different things can turn out to be, like the Brexit vote or Trump being elected, or the market crashing early in the year. So there's a lot of uncertainty out there.

CONSUELO MACK: Recognize. Yes.

ED HYMAN: With that said, there are three channels that this works through. One are just the fiscal policies, the tax cuts, the spending, more defense spending, and then the second channel is through deregulation. The first part you can put a pencil to. Deregulation, what that does (Laughs) and you don't. And the third channel is through increased animal spirits. So the president of Ford Motor Company announced they're going to build a billion and a half dollar plant here as opposed to Mexico, and he said because he felt better about Trump's pro-growth policies. I'm thinking, well, that's just animal spirits. Maybe he's being nudged a little bit too, so that third channel is impossible to measure. The second one, deregulation, is difficult, and the first one is also pretty difficult when you get the tax cuts and repatriation of profits working through the system. So it's difficult, but I think that Trump will get, unless something really unusual happens, which is frankly pretty possible (Laughter), an errant tweet here or there, but I would guess that we'll probably see a good part of the tax cuts come through, both a corporate tax cut as well as individual tax cuts, and the deregulation looks as though it's pretty much going to happen early on, and the animal spirits seem as though they are increasing much, much more than I thought possible after the election.

CONSUELO MACK: Right. And Matt, you always strike a more cautious note, because at First Eagle your first job is to avoid the permanent impairment of capital, so you don't want to lose your clients' money. You want to preserve their capital, and in the Global Fund you've got about 30 some-odd percent of the portfolio in U.S. equities. So clearly you're finding some opportunities here. Right?

MATT MCLENNAN: Well, let me strike a cautious tone first.

CONSUELO MACK: Yes, please.

MATT MCLENNAN: We reference the improvement that's happened in the U.S. economy thus far, and part of that is indeed due to the resilience of the U.S. economy, but part of that is reflective of years of cumulative stimulus. We had dramatic fiscal stimulus, very easy monetary policy. We've had QE, and now we're talking about fiscal stimulus at close to the peak of the cycle, as opposed to the trough of the cycle. Unemployment's below five percent, not ten percent. This is not usually the time that you'd expect to see fiscal stimulus, and so it raises the risk of a more inflationary dynamic evolving, and I think that we've seen a move up in long-term interest rates which have started to price that to a very small extent.

But the fact is, the recovery in oil prices from their troughs, the move up in interest rates from where we've seen and the dramatic appreciation of the dollar reflecting that move up in interest rates, prospective headwinds to the economy. And I think if you have that stimulus and you have the emergence of labor cost pressures, not necessarily a great thing for corporate profit margins at some point into the future. I guess the other thing I would sort of worry about in broad brushstrokes is that there are factors that work against the stimulus. The currency appreciation that I referenced before could lead to a meaningful deterioration in the current account position of the U.S. That savings investment imbalance has...

CONSUELO MACK: So our exports will be much more expensive and, therefore, they could decline.

MATT MCLENNAN: Unless we see some dramatic tax policy targeting imports, I think we could see the reemergence of the jewel deficits discussion with fiscal deficits and the current account deficit which is not really factoring much into the market's thinking at this point in time. So for us, looking at the market as a whole, we don't see it as a market full of bargains. In fact, it's an incredibly different backdrop from say the mid '80s where all you had to do was show up to get an attractive real rate of return. You had double-digit interest rates. You had single-digit P/E ratios. Today you have repressed real interest rates which you need, and you have P/E ratios for most companies that are of quality north of 20 times earnings. So it is not an opportunity-rich environment relative to history. The final thing I'll say is that even though things feel a lot better, we have more debt today relative to GDP than we had in 2007, and we're talking about easing fiscal policy. If we get higher interest rates, that's a real headwind given the stock of debt. So these are sort of some balancing considerations.

CONSUELO MACK: Ed, how do you figure that in to the economy? And how businesses feel?

ED HYMAN: I've been for a long time in the slow and steady wins the race. That's been my sort of touchstone, and it's been a comfortable one. As Matt, you're pointing out, maybe that changes. Maybe it gets a little too fast and inflation picks up which could be one of the big surprises this year. As I study the economy on a different way, I travel around all over the U.S., and every city I go to is just flat booming. I've just been in Salt Lake City. It's booming. I flew up to Portland, Oregon. It's booming. Fort Wayne, Indiana doing great.

CONSUELO MACK: I just have to interrupt you. One of the reasons why your research is – your number one economist for 36 years – is that you keep coming up with these indicators. Your feet are on the ground. You're visiting cities. So you have these 40-some-odd cities that you've noticed conditions are booming, and you did that I remember with the stimulus from the central banks that kind of no one else in the world was putting it all together. I remember this. It's now up to there are 280 stimulus moves across the globe, and we'd be counting them. Now it's up to 315. So you're doing that with cities now, and you're saying that you're seeing on the ground that cities across the country are booming.

ED HYMAN: Now I get into arguments, so Fort Wayne, Indiana doing great. And I work with a guy who's from Buffalo, and he said Buffalo's booming. I said, "We're not putting Buffalo on the list." He kept pushing and pushing and pushing. Finally, I got enough information. Okay, Buffalo is…

CONSUELO MACK: Buffalo is a recent addition.

ED HYMAN: Des Moines, Iowa, et cetera. So I'm very in tune with what Matt was talking about inflation picking up and adding more stimulus to an economy that's already ... I really don't know how a place like Seattle or San Francisco or Miami can do much better than they've done now after seven or eight years, and so that could be a surprise. So in that regard I like the dollar going up because it's a governor. It's a headwind on the economy which I'm sort of now thinking I wouldn't mind having a little pushback on the economy. So far the economy has not taken off from what I can tell, but the things that are driving local economies are health care, higher education, new tech like Facebook, e-commerce and then sports and entertainment.

CONSUELO MACK: But I'm listening to this. So health care or telecommunications, technology, education.

ED HYMAN: Can I just add?

CONSUELO MACK: Yes.

ED HYMAN: Your point on debt is dead on. I mean that's going to be a killer at some point.

CONSUELO MACK: So at some point we'll have to pay that piper if interest rates go up a little bit. I mean something's gotta give. But listening to what Ed was saying, that strikes me as, gee, isn't the U.S. a really good place to invest? Given how the markets have done, should you have been more invested in the U.S.?

MATT MCLENNAN: Well, it depends on price always as an investor.

CONSUELO MACK: Right.

MATT MCLENNAN: I would say that if we look at markets as a whole, prices haven't been super attractive whether you look at the low level of real interest rates or the high levels of valuations overall. If you just naïvely look top-down at the markets and think about what prices imply about the next ten years' returns, they're pretty modest, particularly if you start from a base of having above average debt. Typically, in those scenarios you have fairly constrained growth in the economy, and so if you have low yields and low growth, it's not necessarily opportunity-rich per se. But if you think about what Ed was saying about the pockets of vibrancy and the U.S. economy and the services sector, we do see a number of interesting companies in the U.S. that have dominant market position in certain services, whether it's software, advertising services or other niches of the economy, where those businesses are essentially a royalty on nominal GDP growth. Those businesses grow in line with the economy, and if you can provide or find an opportunity to buy into those businesses at windows of time where they are priced with attractive free cash flow yields – they're not pricing a lot of growth – then you can get sound returns investing in the U.S.

CONSUELO MACK: So would those be, for instance, like an Oracle, which is one of your largest holdings or a Microsoft or ... ?

MATT MCLENNAN: If you think about Oracle for example...

CONSUELO MACK: Give us an example.

MATT MCLENNAN: ...which is a large holding in our funds, here's a business that controls 40 percent of the relational database market and is also quite dominant in all the applications that attach to databases. The majority of their income comes from recurring maintenance fees on the installed base of databases, and that grows gradually over time, but it's all free cash flow to us as shareholders, and the company itself, if it grows in line with nominal GDP and has a seven percent free cash flow yield, offers a nominal GDP plus type of return, whereas bonds in the U.S. are offering nominal GDP minus returns. The reason for that is with high levels of debt in the economy, it takes low interest rates on the debt relative to economic growth to deleverage the economy over time. So in a world where real returns are scarce top down, you have to look for individual situations where you've identified a company that offers the prospect of sound real returns.

CONSUELO MACK: As you said, at a proper price with a big margin of safety. One of the things – I'm just looking down at my notes – that you said in a recent report was that I think the odds of a U.S. recession are like way out, I mean several years away. I mean eight years in a recovery, why isn't the danger of recession, why is it not closer, and why is it way out?

ED HYMAN: Well, the first reason before I get to the timing is I think that we'll get a recession when inflation goes up like you're warning me it might happen, and if it happens quick then I'll change my view, but that's the first thing. Then the Fed responds to that and rates go up. I'm sort of expecting inflation to go to five or six percent at some point in the future, like years in the future.

CONSUELO MACK: But years, but not this year or next year.

ED HYMAN: Fed funds to be five or six percent, but getting back earlier, there are maybe a half dozen different indictors that tell you where you are in the business cycle. They're sort of like rings on a tree that tells you how old the tree is. One of them is when the Fed tightens, and here we are eight years into an expansion, and the Fed tightened a year ago, waited, and then they did another tightening just a few weeks ago, and now we're up to a big 60 basis points. So that tells me we're old chronologically but about middle of the road economically. Housing starts are still worse or lower than most recessions. The U.S. leading economic indicator which does move up from lower left to upper right over years, it has not yet moved above its '07 peak, and in the past once it makes a new high, you start the clock and the recession is about five years out on average.

CONSUELO MACK: I see.

ED HYMAN: This is also getting to be a pretty standard view. I'm very sensitive to when I'm stating the obvious with the thrill of discovery, and most people now think the recession is about three years out, when I survey investors. So three years out is more or less infinity (Laughs) for me, but I don't expect a recession this year or next year, and probably not in '19, '20. (Laughs)

CONSUELO MACK: Well, the clock is running here, too, and so I have to ask each of you my one investment question: the one investment for a long-term diversified portfolio in the U.S. Matt, do you have one that you would recommend?

MATT MCLENNAN: Well, I think we spoke about Oracle as an example before of a business with a high free cash flow yield and a stable growth profile. Another example of one of our larger holdings in the U.S. would be a company like Omnicom which is the leader in marketing services, whether it's advertising, creative production or affinity marketing programs. They're essentially a services company, where their earnings over time grow in line with the economy, and they generate around about a six percent free cash flow yield. It's businesses like this that make up our portfolio one at a time with a hedge in our portfolio in gold. The final thing I'll say is that our portfolios have above average cash at the moment. This is not because we have a negative market timing call but because the kinds of businesses we talked about have been hard to find at the right price, and so we're probably a little more conservatively positioned than we have been on average for the last five or six years.

CONSUELO MACK: Ed, what would yours be, U.S.-based?

ED HYMAN: So we have a collaborative research effort. We have our analysts. We have our strategists. I do the economy, the technical analysis, and we are all coming to one space, which are financials. So we're leading with financials. They also happen to not be particularly expensive which is...

CONSUELO MACK: They've had a big run-up in the last ...

ED HYMAN: They had a big run-up, but they're not quite to nosebleed.

CONSUELO MACK: So you two have to stay right here because we are going to continue the conversation which is going to air next week on the outlook for the global economy, everything else kind of ex U.S. So Ed Hyman and Matt McLennan, thanks so much, and we'll continue our discussion in just a minute.

ED HYMAN: Thank you.

CONSUELO MACK: At the close of every WEALTHTRACK, we try to give you one suggestion to help you build and protect your wealth over the long term. This week's action point is about what I said this time last year: Review your risk tolerance for the U.S. stock portion of your portfolio. The U.S. market has had an impressive multi-year bull run, which accelerated after the election. It is expensive by just about any historical measure. That means it is more risky than it was last year, or the year before that. Take some profits, raise some cash, take a breather and start making a list of some beaten down assets, industries or regions which might be of interest in a correction.

I hope you can join us next week for part two of our exclusive global outlook with Ed Hyman and Matt McLennan. Hyman's headline is "Global Growth Accelerating." We'll find out by how much and how to take advantage of it.

In the meantime, please visit our website Wealthtrack.com for this show and others. And keep reaching out to us on Facebook and Twitter. Thank you so much for watching!

Have a great weekend and make the week ahead a profitable and a productive one.