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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: global growth is accelerating! That's the headline in this week's exclusive 2017 outlook with wall street's number one economist Ed Hyman, and five star fund manager Matthew McLennan. The global economy and markets are next on Consuelo Mack WEALTHTRACK.

CONSUELO MACK: Hello and welcome to this edition of WEALTHTRACK, I'm Consuelo Mack. Every year on WEALTHTRACK, we bring you an exclusive interview with legendary economist Ed Hyman, founder and chairman of Evercore ISI. Hyman has been voted Wall Street's number one economist for an astonishing 36 years by institutional investors.
We always pair Hyman with a top ranked money manager. In this case we are delighted to have Matthew McLennan, head of the global value team at First Eagle investment management and portfolio manager of the five star rated First Eagle global fund which he has run since 2008.

The two know and respect each other and bring different perspectives to the table.
Last week we covered the outlook for the U.S. in 2017. In a nutshell, Hyman is encouraged by the pickup in strength and confidence in the economy and markets, and believes a recession is years away. Value manager McLennan is focused more on the risks he sees developing, particularly excessive fiscal stimulus and the high levels of debt and stock prices.

This week we are broadening the discussion to include the rest of the world as well.
As a recent headline from Hyman and his research team at Evercore ISI emphatically put it: "Global Growth Accelerating." I began the interview by asking Hyman, what is driving global growth.

ED HYMAN: So we had a lot of fiscal stimulus, a lot of monetary stimulus, China in particular, and then last year ECB stepped it up.

CONSUELO MACK: European Central Bank.

ED HYMAN: The European Central Bank. Mario Draghi. Whatever it takes. China is on a "whatever it takes." My China partner, Don Straszheim, told me that this morning, whatever it takes in China. They're still doing a lot of infrastructure spending, and in Japan they've been on a complete "whatever it takes." It hasn't produced much, and so you have that. Then the price of oil came back, and so that was a real drag on the economy last year. Now that's coming back.

CONSUELO MACK: Just because the energy sector was a drag on the economy.

ED HYMAN: It was decimated.

CONSUELO MACK: But lower oil prices are supposed to be a stimulus.

ED HYMAN: A lift effect, but it looks as though you've got the hurt a lot more and, as Matt I think eloquently put it, you're still at a moderate price on energy, and I get the feeling that there's a little bit of positive feedback, what you would like in expansion where employment gains, wage increases lead to consumer spending. So car sales come out for December. They were stronger than expected, over 18 million. Bank loans Matt mentioned are now positive.

CONSUELO MACK: Last week.

ED HYMAN: So I get the feeling there's a little bit of a positive feedback loop going on and Europe. The data is getting better. I just spent a week in France. New cars. It felt good even before I had a bottle of wine. Then in China, I've been watching nominal GDP, not the real part, but the real and the price, which I think is the more important measure. Without much notice, it's come from six percent in 2015 to over nine percent currently.

CONSUELO MACK: So that's GDP, real GDP plus inflation.

ED HYMAN: For everybody, inflation sounds bad. It has a negative connotation, but if you can raise the price of a car or raise airfares or if an asset manager could raise the fees that you charge, assets under management; Starbucks could raise the price, that's great.

CONSUELO MACK: You make more money and you can...

ED HYMAN: If people get a pay increase, they feel better. So nominal GDP has accelerated significantly in China, and Japan is doing a little bit better, but it's the least clear to me. This morning there was an upward revision in their Purchasing Manager's Index. You can look and see if it was really something, and the Nikkei was up two and a half percent. So it looks like it's picking up a little bit, and they have enormous monetary stimulus in Japan.

CONSUELO MACK: You're talking about stimulus and you're seeing evidence of it finally kicking in, and that's my question to Matt. Finally kicking in record amounts of stimulus all over the world. How much more? We're getting very little bang for all of those bucks it strikes me, and it's a concern of yours, that we've got all this money that's been created right? And debt.

MATT MCLENNAN: Well, you know for sure you can't make all people wealthier in real terms by just printing money, and the problem that we have in the world economy is that the imbalance we discussed in the context of the U.S. of having too much debt is not local to the United States. If we look at debt to GDP, household plus corporate plus sovereign, in Europe, in China, in Japan, in each of those regions it's higher than it was in 2007. So it's like a hot air balloon that's gone pretty high. We had a growth slowdown 12 to 18 months ago that Ed referenced, and the central banks of the world and the fiscal authorities responded reflexively to that with easy policy to keep the hot air balloon inflated, but the imbalances remain in place. We have sovereign balance sheets that look like post war balance sheets, yet when we look at the geopolitics of the world today, it almost feels like prewar geopolitics. We've had a total breakdown in the Washington consensus around the world. We have...

CONSUELO MACK: The Washington consensus being about globalization.

MATT MCLENNAN: Globalization.

CONSUELO MACK: Liberal trade, about...

MATT MCLENNAN: Rational economic policy, all of these sorts of things. We've seen a pendulum swing start to move towards populism and nationalism. So it's not just the electoral outcomes that we've heard people talking about in the United States. We talked about Brexit last year, and we see the emergence of more autocratic nationalist regimes around the world, and so I think that the geopolitical backdrop has become much more complicated, and I think that this makes it a very uncertain state of nature to be predicting on a more structural basis. I agree with Ed that what we're seeing short term is an uplift, but as we look out 12, 18, 24 months, five years into the future, the crystal ball gets very foggy because of those structural imbalances. I think about China in particular. China reached a high watermark level of fixed capital investment that was hard to even conceive of. China was consuming half the world's iron ore, and 40 percent of the world's copper for a country that's 20 percent of the world's population. The government's been doing what it takes, to use Ed's term, to keep that in place, but by doing so, by trying to support something at an artificially high level, they risk compromising the sovereign balance sheet in China over the medium term. So these are some of the things that bring us concern.

CONSUELO MACK: Ed, I'm just thinking about this growth acceleration, which is real all over the world. So the stimulus seems to have worked to a certain extent, but also the economies themselves as you're describing it anecdotally initially, they really are improving. Is employment picking up in the rest of the world as well?

ED HYMAN: A little bit.

CONSUELO MACK: Are businesses doing better? All of the things that make an economy work; it's improving. Right?

ED HYMAN: I think it's still early. It's improving. I think maybe I'm overstating it, but I'm say an expert at looking at the tea leaves, and they're looking better. They're picking up a little bit, but I was in France and it's still pretty slow. So I think we're still sort of early, and I do worry that we could get suddenly too much inflation, and you might not have seen it Matt, but I think the World Bank reported global debt to global GDP is 365 percent, much higher than ... just a grim reminder that there are these risks out there, but I think that the problems will occur when inflation is picking up and central banks are tightening. Right now we're so far...

CONSUELO MACK: Are you seeing inflation picking up now in other parts of the world?

ED HYMAN: No.

CONSUELO MACK: You're not. So that's important. So that's going to be a key...

ED HYMAN: I'm not seeing much...

CONSUELO MACK: …indicator for you.

ED HYMAN: I'm not seeing much inflation here either except for wages and so many places it looks like pricing power is so difficult because of intense competition, like in the auto sector, the retailing sector. In the case of health care, education, there's definitely pricing power, and inflation is going up there.

CONSUELO MACK: So the expression: "This time it's different," so it is it possible that there is something else besides central banks raising rates, that this time is different, that could actually give a real body blow to economies, could slow them down rather than the traditional?

ED HYMAN: The things that Matt's talking about. (Laughs)

CONSUELO MACK: So Matt, you tell me what you think could really hurt the global economy.

MATT MCLENNAN: Well, other than some sort of geopolitical dislocation, which we'll put off to one side because it's hard to analyze. It's interesting to think about some of the non U.S. economies and the cycles that they've gone through over the last 30 years. I think of Japan as an interesting case study because this was an economy that got over indebted somewhat ahead of the other sovereign economies of the world.

CONSUELO MACK: In real estate.

MATT MCLENNAN: In real estate they had an investment boom, and then they tried to make up for the slack through easy fiscal policy, and then the government debt to GDP got very high. But what we saw in Japan was something that felt like a nominal ice age for the last generation. GDP in nominal terms went pretty much sideways. The market point to point has gone pretty much sideways. Interest rates have been pretty much zero, and we still had economic cycles despite the central bank not raising interest rates, and what was a catalytic force for some of those economic cycles was outsized exchange rate movements. In a world where interest rates go to close to zero, the perception that one region will raise interest rates is enough to propel its currency up which acts as a brake on its economy. So we saw the Japanese experience some recessions with strong currency. Maybe that's a risk for the United States now.

CONSUELO MACK: With the dollar so strong.

MATT MCLENNAN: In a sense, Ed referenced the fact that in Europe their recovery is early stage. Unemployment is still close to ten percent whereas the U.S. has gone from ten to five. Europe is benefiting from a cheap currency, not an expensive currency. It has a current account surplus. It has lower real interest rates. So it has all those things supporting it. Japan as well has a ten-year bond targeted at zero. If you go back to the U.S. by comparison, the dollar is expensive relative to its 15-year average despite the fact that we have a current account deficit. Why is that? It's because interest rate differentials are supporting portfolio flows.

CONSUELO MACK: So everybody's coming and buying U.S.-denominated assets.

MATT MCLENNAN: The stronger the dollar goes, the more that pressures corporate profit margins in the U.S. and it has its own contractuary effect. You're essentially exporting deflation from Japan and from Europe. Even China's been depreciating against the dollar to the United States, and that's what complicates the whole picture here.

CONSUELO MACK: Ed, one of the things that you've said is that China has stopped exporting deflation to the rest of the world. Can you explain that and why that's significant?

ED HYMAN: Well first, it's showing up everywhere. The U.K. inflation rate has moved up a lot as energy prices move through, but the China Producer Price Index declined for about four years. It was a major... they were exporting deflation like crazy, and the German PPI went down. Our PPI's gone down, and part of that was you had a complete manufacturing recession, because prices are going down. Now the China PPI has been going up for almost a year.

CONSUELO MACK: Wow. That's a change.

ED HYMAN: So as I mentioned, the nominal GDP in China has already accelerated 300 basis points from six to nine percent, and all of that is price. The real GDP has been the same all through this, and so I think it's generally accepted that global deflation is behind us. Mario Draghi in his last press conference said the risk of deflation is greatly diminished, and so that's behind us. What's in front of us (Laughs) is more tricky to figure out.

CONSUELO MACK: So investing in the rest of the world. Are there many more opportunities overseas? Where are you finding them? Where are you finding great companies at cheap prices?

MATT MCLENNAN: It's tricky actually, because even if you look top down at the overall valuation of international markets, they look a little cheaper than the U.S. market, but much of that value discrepancy is concentrated in the financial sector, and in some of those economies where financial repression is more entrenched, it's going to be a long time before those financials can earn attractive ROEs.

CONSUELO MACK: Return on equity.

MATT MCLENNAN: They have lower equity to asset ratios as well, and many are needing to recapitalize. We've seen an Italian bank bailout in the last month, and so when we look at businesses of like quality, I would say that the valuations that we're seeing outside the United States are similarly high to what we're seeing in the United States.

CONSUELO MACK: Oh, interesting.

MATT MCLENNAN: There is no broad brushstroke valuation discount. The one thing that may be cheaper is the currencies. Currencies like the yen and the euro and Mexican peso, et cetera, have all fallen fairly dramatically versus the dollar. I have no idea what's going to happen to them in the next 12 months. It depends how hawkish the Fed is; but looking out over the long term, having some diversity of currency may be beneficial at some point, if the gap between U.S. growth expectations and the rest of world growth expectations moderates a little bit. But for us it's really company by company. Our cash levels in our overseas fund are similar to our U.S. value fund.

CONSUELO MACK: The International Fund.

MATT MCLENNAN: They're around 20 percent and so...

CONSUELO MACK: Repeat what that signifies.

MATT MCLENNAN: Well, again it's not a market timing call for us. We view cash as deferred purchasing power. We like to buy businesses that control a certain niche of the economy that are persistent in nature and free cash flow generative and with prudent managers, but we only like to buy those businesses when we get a margin of safety in price. So the cash flexibility enables us to be patient buyers. The fact that our cash is close to 20 percent means that bargains are harder to come by. Our cash levels were low in 2009 when markets were in distress, and there was a lot to buy. So we're very patient buyers and on average we hold businesses for close to a decade. What enables us to be patient holders is the nature of the businesses that we're buying, and what enables us to be patient sellers is that we have that potential hedge in gold, so that our more mature investments sit across from this potential hedge. So we have a decade cycle time that goes on in our business, but it's very much company by company.

CONSUELO MACK: And Ed does not have a decade cycle time because you're looking at the data coming out every single day. One of the things that you had said in our last program with you about the U.S. economy, that even though the recovery is long in the tooth, that you think that the potential for recession is several years out. What is the feeling that you have about recession potential in Europe for instance?

ED HYMAN: I think it's pretty much painted by the same brush.

CONSUELO MACK: It is.

ED HYMAN: So Matt pointed out that they're really early. Their unemployment rate is ten percent.

CONSUELO MACK: But is it going in the right direction? Is it going down?

ED HYMAN: It's coming down.

CONSUELO MACK: It is.

ED HYMAN: It's definitely. They've turned the corner. That looks pretty good. I'd say Matt is one of the best students of which markets to look at of anybody I know, so you should be asking him. We favored the U.S., and I would share with you and your viewers that right now this is a pretty standard view.

CONSUELO MACK: Does that worry you, Ed?

ED HYMAN: Some.

CONSUELO MACK: If everyone thinks one way, there must be something wrong.

ED HYMAN: I guess my favorite mentor in the business, who is a great timer says, "I've made most of the money in my career being *with* the crowd."

CONSUELO MACK: Interesting.

ED HYMAN: The reason he's done much better than the crowd is he knows at what point to leave.

CONSUELO MACK: Leave.

ED HYMAN: (Laughs) But you can enjoy the crowd for good periods of time, but I'm just saying it worries me some. The whole thing is a little bit overdone right now, and we agree with that being U.S.-centric with the policies here, but we also like Japan and think that's our second favorite space.

CONSUELO MACK: Why is that? What improvement are you seeing in Japan?

ED HYMAN: So the economy is doing a little bit better, and they have so much monetary stimulus in the system, and it looks like it might be starting to work.

CONSUELO MACK: Also, what about the corporate reforms that my understanding was that they were... which they have not been very shareholder-friendly. Is that a function? I'll ask Matt that.

ED HYMAN: You should ask Matt that, but that is an important point.

MATT MCLENNAN: I agree with Ed on that. I think for those of us who have looked at Japan for a long time...

CONSUELO MACK: You've been in and out of Japan.

MATT MCLENNAN: A long time.

CONSUELO MACK: But again, individual companies.

MATT MCLENNAN: Individual companies. We've definitely seen an improvement in shareholder orientation of Japanese companies, and I think sometimes they get mischaracterized. I think many of the businesses we own in Japan are some of the best businesses in the world. They have very strong market position, management teams that are fanatical about extending their lead in the markets in which they operate. What's changed is their willingness to distribute the free cash flow of their business to shareholders.

CONSUELO MACK: Shareholders.

MATT MCLENNAN: So we've seen dividend payout ratios move up. I mean a decade or two ago it wasn't uncommon to see many companies pay no dividends or have 15 percent payout ratios. We have companies in our portfolios now, Japanese companies, where the management teams are returning 60 to 80 percent of their earnings, and that's a really big shift in corporate governance. We're seeing higher presence of independent directors. We're starting to see a little bit more valuation sensitivity in the M&A that's being done in Japan. So, on the whole we've seen the pendulum swing in the right direction there.

CONSUELO MACK: Rise in populism, Brexit. How big a deal has that been to the euro zone economy, to the U.K. economy?

ED HYMAN: So far I thought the wheels would fall off, and I remember right after the Brexit we were getting ready to hire somebody, and we stopped. We said, "Well, let's wait."

CONSUELO MACK: Right. It was like Y2K but...

ED HYMAN: Then we went ahead, and it's still a risk, but it looks as though Brexit really hasn't impacted the U.K. economy.

MATT MCLENNAN: It'll be interesting to see what happens in the French and German elections this year. I think we'll get another read on whether that pendulum shift to populism is becoming more broad-based and what that could mean. The reality is that the U.K. is yet to file Article 50 and formally leave.

CONSUELO MACK: The vote happened, but the actual Brexit has not occurred.

MATT MCLENNAN: We don't really know who the political players will be that will be negotiating this on the European side of the equation. So I think there is a little bit of uncertainty there.

CONSUELO MACK: Final question for each of you, and I'll start with Ed this time for the one investment for a long-term diversified portfolio kind of ex-U.S. What would you have us invest in?

ED HYMAN: The **Nikkei**.

CONSUELO MACK: The Nikkei.

ED HYMAN: Outside the U.S. I would favor the U.S., but that's our first choice. I do think, if I may add on to what we're talking about, these votes coming up this year are a good reason to hold your cash, because it could be an opportunity. If there's not a problem... the market's acting as though there's not a problem. So if there wasn't a problem that might not work, but our favorite investment outside the U.S. is Japan.

CONSUELO MACK: Matt.

MATT MCLENNAN: I think within the context of Japan, an example of an interesting business that we like a lot in Japan is **Fanuc** which is ...

CONSUELO MACK: Remind me what Fanuc is again.

MATT MCLENNAN: Fanuc is the company that no one's ever heard of that is responsible for a lot of the cars that you would drive, for example. They're the world's leading provider of servo motors and computer numeric control systems for robotics. In fact, they control about 60 percent of the world's market for servo motors, and they're vertically integrated into robotics. What's interesting about that 60 percent market share position is that no matter what car you drive in the United States, the vast majority of them are going to be painted by a Fanuc robot or welded or assembled in some way or another. One of the deflationary forces that's been going on in the world is the trend towards factory automation. Fanuc is a beneficiary of that trend.

CONSUELO MACK: So thank you both very much for joining us on WEALTHTRACK for two sessions, one in the U.S. last week and on the rest of the world this week, and of course always to have Ed Hyman on is a WEALTHTRACK exclusive.

ED HYMAN: My pleasure.

CONSUELO MACK: What a treat for us and being joined by Matt, a wonderful mutual fund manager or portfolio manager as well. So thank you both very much for being with us.

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: **Consider Matt McLennan's Philosophy of Patient Capital.** McLennan and his first eagle team are willing to hold cash if they are not finding the right opportunities in the market. As McLennan told us price matters and most stocks look overpriced to them at the moment. Consequently they are holding cash positions of around 20% in their portfolios, waiting for better prices and those higher margins of safety they insist upon. Until they find them, they are willing to be patient with their own and their shareholders' capital. Next week we will be joined by another value investor, who is even more cautious about the market. International value advisers' co-founder and portfolio manager, Charles de Vaulx will explain his 40% cash holdings! In the meantime, in this week's extra feature on wealthtrack.com, Ed Hyman and Matt McLennan, who are both avid and eclectic readers, share some of their favorite books with us. We also look forward to hearing your comments and recommendations. Please continue to reach out to us on Facebook and Twitter. Thank you for watching. Have a great weekend, and make the week ahead a profitable and a productive one.