CONSUELO MACK | WEALTHTRACK

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On this week's show, a rare interview with two veteran investors who say turbulent and volatile markets are here to stay and require some unusual approaches.
Fort Washington Investment Advisor's Nick Sargen and former mutual fund star, now private investor Bill Wilby share their strategies.

Nicholas Sargen
Chief Economist, Investment Strategist
Fort Washington Investment Advisors

William Wilby
Private Investor

CONSUELO MACK: This week on WEALTHTRACK, potential sea changes for investors. Two lifelong global economists and money managers Nick Sargen and Bill Wilby are on alert for unpredictable geopolitical and financial storms ahead. What they are monitoring and how they are investing is next on Consuelo Mack WEALTHTRACK.

Hello and welcome to this edition of WEALTHTRACK, I'm Consuelo Mack. For inspiration and levity I occasionally turn to Lewis Carroll's classic Alice's Adventures in Wonderland.
As I survey the still unfolding saga of Brexit, spreading negative interest rates around the world and the unsettling political scene in Europe and the U.S. two quotes seem particularly apt.
As the Cheshire Cat told Alice about Wonderland, "We're all mad here."
And as Alice opined, "It would be so nice if something made sense for a change."

This week's guests are trying to make sense of highly unusual and in some cases unprecedented developments. One of those is Brexit. After decades of opting into the European Union, albeit on some of its own terms such as keeping the pound sterling as its currency, the United Kingdom opted out. The pressing question is will Britain be the lone exception, or the first of many to do so?

A recent Pew poll found the EU was unpopular among substantial numbers of citizens in many countries. 71% of Greeks view the EU unfavorably…61% of the French do…
49% of Spaniards and 48% of Germans agree.

Since the financial crisis there has been talk of Grexit, Greece's possible exit from the Eurozone. The latest candidate is Italy with "Quitaly" envisioned as its struggling banking industry reels under pressure from EU regulators.

Then there is the impact of the unprecedented easing policies of central banks in major developed countries. This chart from Evercore ISI tells the story of the quote "Incredible Balance Sheet Expansion" of the big three.

"Since 2009, Federal Reserve, European Central Bank and Bank of Japan balance sheets have increased a cumulative +$8 trillion! Among other things, this helps explain why bond yields have plunged." And plunge they have, as illustrated by the line representing the average 10-year bond yield of the U.S., Germany and Japan.

The yield on the benchmark U.S. Treasury 10-year note has hit new lows in recent weeks, while yields on German and Japanese bonds are trading below zero in negative territory.

In the week after the Brexit vote, Evercore ISI counted 18 more easing moves by central banks. How do these developments affect global economies and markets? Two experienced global investors are going to tell us.

Nicholas Sargen, Chief Economist and Investment Strategist at Fort Washington Investment

Advisors, the asset management arm of Western & Southern Financial Group joins us for a rare television interview.

A PhD in Economics, Sargen has been international economist, global money manager and Chief Investment Officer for several major financial firms as well as an official at the Federal Reserve Bank of San Francisco.

William Wilby is with us as a WEALTHTRACK exclusive. One of our Great Investors, now a private investor, actively managing his own retirement account, Wilby was the portfolio manager of the award winning Oppenheimer Global Fund which was ranked number one in its category for the 12 years he ran it. A graduate of West Point, Wilby has a PhD in International Monetary Economics and has held various international finance and investment positions at several top financial institutions including The Federal Reserve Bank of Chicago.

Both Sargen and Wilby believe the Brexit effect is far from over. I asked them why it is still so significant.

BILL WILBY: Well I think, Consuelo, it kind of reinforces the kind of budding trend away from globalization and towards nationalism which is not a positive for the global economy long term.

CONSUELO MACK: Explain why it isn't because what's wrong with nationalism? What's wrong with looking out for your own interests? What's wrong with loving your country and wanting to do what's best for your country?

BILL WILBY: Obviously globalization produces winners and losers, and the losers get injured by it, and everyone feels their pain, but the question for economics is, where is the maximum good and where do you end up with the largest share of the pie? I think globalization has resulted in the lifting of six billion people out of poverty around the world. Now people in the developed world like those in America may not have seen the spoils of that process nearly like those in some of the emerging markets or other countries.

CONSUELO MACK: Asia for instance.

BILL WILBY: Asia for instance, but the overall global pie has grown. I think the primary thing with Brexit is it's a political development. The economic part of Brexit is too early to tell, and it depends on how many things play their way out. I mean I think even the impact on the UK is highly uncertain right now.

CONSUELO MACK: Nick, you were one of the few people that I know of who actually connected the dots pre Brexit that this was going to be a significant market-moving event. What is your view now?

NICK SARGEN: Well, first my view was – and it's somewhat similar to Bill's – is that I viewed this primarily as a political event and not so much an economic event, meaning most Brits if they realized the consequences for their economy and voted self-interest would vote to stay.

CONSUELO MACK: To remain.

NICK SARGEN: But they said, "We're mad as hell with bureaucrats. We want our sovereignty back," and that's what just made it close, and I didn't understand why the smart money thought everybody was going to vote with the economics. But why is it important to Europe? Here, Consuelo, the whole post war order in Europe was we are tired of fighting each other, World Wars, so basically economic union was viewed as a way to end warfare in Europe as well as economic integration. So to me the significance is this is the first move in the opposite direction. If I was confident it stopped at Britain's borders, maybe the consequences would be limited, but there's a whole series of events unfolding including a French election next year, and the real questions ...

CONSUELO MACK: There are nationalists who could become even more popular than they are now.

NICK SARGEN: That's it. So right now if it was contained at the UK's borders, maybe the damage will be contained, but I think politics is going to rule the roost over the coming 12 months.

CONSUELO MACK: Nick, I know you told me on the phone a couple of days ago that this was the first time that you can remember in your long career on Wall Street where politics mattered as much as they do to the markets and to the economy. Just explain what's changed.

NICK SARGEN: Well first, often people will talk about elections, and I say, "Listen. It really depends on whether policies get changed." So what were the transformational elections positive? I'd say Thatcher, Ronald Reagan. They made a difference. A lot of other times it doesn't matter. What I think is so concerning to me, and it comes back to Bill's theme of globalization giving way to nationalism, when did we last see this? Folks, study the 1930s where people were mad because of the Great Depression, and we went nationalistic and, by the way, tariff barriers went up around the world, and that's what took a recession into a Great Depression. So my fear is not that we repeat history, but my fear is that the politics are reminiscent of what was taking place in the '30s.

CONSUELO MACK: Another sea change that we've seen since the financial crisis is the unprecedented easing that we've seen in central banks around the world and especially in the developed countries but also the interference in the capital markets that we've seen. Bill, I know you are critical of the Fed's current low interest rates for longer policy. Tell me about your view on the Fed policy and then we'll go to other central banks as well.

BILL WILBY: Well, I think, and I think this applies across the board because the ECB has adopted effectively the Fed's policy as has the Bank of Japan, so we have a large swath of global GDP that has adopted these policies. I think there's an argument to be made that the Fed is creating the deflation it's trying to prevent.

CONSUELO MACK: Explain what the argument is.

BILL WILBY: I think you have to look at both the supply and the demand side. Any price movement affects both supply and demand, and interest rates affect both the supply of capital as well as the demand, and I think these low interest rates have aggravated an excess supply of real capital around the world which is part of a deflationary environment. Monetary policy works through encouraging more debt accumulation as does fiscal policy, one private debt, the other public debt, but we're glutted with debt, and people don't want to borrow. Banks don't want to lend, individuals. The issuers are full. They don't want any more debt. In addition, the Fed influences consumer demand. Low interest rates hit the largest demographic cohort, largest and fastest growing demographic cohort ...

CONSUELO MACK: The baby boomers.

BILL WILBY: ... which is the baby boom, and they can't get a secure income stream, so all of this puts huge uncertainty about the future in people's minds, not to mention unprecedented monetary experiments has an impact on business' confidence in the future, and so I think for investment purposes as well as consumption purposes the Fed has both increased supply and diminished demand which is what a deflationary impulse is all about.

CONSUELO MACK: Nick, what is your view of what Bill is saying about Fed policy and central bank policy

NICK SARGEN: I basically agree with the whole point about the distortions in the capital markets. The one thing I will give the Fed credit for is at the worst part of the crisis, they made the right move.

CONSUELO MACK: Well, Bill agrees with you there, but it's now.

NICK SARGEN: Yes, and what we're saying exactly is that I think there's diminishing returns to getting rates lower and lower while there's increasing capital market distortions. Then also, Consuelo, as you know, I'm working on why are we seeing so many bubbles, and everybody wants to pin bubbles always on the private sector. Guess what. Often bubbles reside at the central banks when they extend too much credit, and the question then is not just is there a distortion in capital, but are they creating a mispricing of risk assets that can come back to haunt us?

CONSUELO MACK: Where are you seeing the most dramatic mispricings? Or where are you seeing bubbles now?

NICK SARGEN: Well, globally. I would say ironically China is where everybody has their focus. They are now in a situation where they've overextended credit, and so not just the IMF but the Bank for International Settlements are all concerned. I do believe that China, they control their financial institutions. So I'm not calling for a collapse, but I'm basically saying their economy will continue to slow steadily because of poor resource allocation. You pay the price one way or the other.

CONSUELO MACK: As investors, let me ask you one more question along these same lines. Negative interest rates. It's hard to believe the trillions of dollars now of negative interest rates that we're seeing in sovereign debt. Germany, Switzerland, Japan.

NICK SARGEN: Exactly.

CONSUELO MACK: It's spreading. So what's the consequence of negative interest rates?

NICK SARGEN: Well, one of the consequences is, how much lower can you go? Because at some point financial people will say if you're going to tax me to put my money either with a central bank or commercial bank, guess what? I'll hold cash.

CONSUELO MACK: Negative interest rates.

BILL WILBY: Negative interest rates is the best sign there is of exactly what I was talking about earlier which is the glut of credit and debt formation. It's like trying to take a guy who's just won Nathan's Annual Hot Dog Eating Contest and offering him another hot dog. We have enough debt and credit out there. All the ratios around the world are at extremes for the last hundred years that we've seen. People don't want to borrow anymore because it stretches their balance sheet and puts them into more financial harm, and yet the Fed is using incentivizing borrowing as its way to stimulate

CONSUELO MACK: Let's talk about the U.S. and put on your economist hat, Nick, as well. Looking at what's going on around the rest of the world, at least the developed world, I'm thinking the U.S. looks pretty good.

NICK SARGEN: We are a very resilient economy. Two things help. We're a very diversified economy. When everybody was so worried about oil prices, yeah, okay, some oil producers get hurt, but it helps consumers, but the other thing is we are not overly dependent on the external world. Twelve, 13 percent of the U.S. economy is exports, not Britain's 50 percent.

CONSUELO MACK: What's your view as an investor?

BILL WILBY: I totally agree with that. As an investor, I think that the impact of the rest of

the world on the U.S. is generally grossly exaggerated, especially in China. People get all upset about developments in China. China's impact on the U.S. is miniscule. We don't export a lot to China. I think the low interest rates, the negative interest rates, everything we've talked about increases financialization which has social as well as economic impacts, and that's I think one of the reasons why U.S. growth is kind of stuck in the mud, but from a market perspective, I look at kind of a muddle-through environment here. I don't see huge downside to the stock market. I don't see huge upside either because of earnings.
I'm more concerned about the Japan model; that we just pancake for a long period of time, and then it becomes truly one of finding individual companies that can be outside the pancake because there's no revenue growth. If GDP stays in this one to two percent range, there's no revenue growth for companies that's available to companies in the broad market, and margins are pretty close to peaks, so there's no earnings growth and, therefore, the market doesn't go anywhere, but there are exceptional companies out there that are showing exceptional earnings growth. The problem is they're expensive, and the thing to do is to buy those companies when they're down, and we may have come off a period where some of those expensive but companies that are growing at ten to 20 times the market rate of growth may be attractive in here.

CONSUELO MACK: So I'm going to ask you about those in a minute, Bill, but let me just go to turbulent markets because Nick's just written a new book. It's going to be published in several months, and it's called *Global Shocks: An Investor's Guide for Turbulent Markets*. So you do think the market's going to be turbulent. How turbulent?

NICK SARGEN: Yes, yes. It remains to be seen. Again I don't think Brexit is necessarily going to be the catalyst, but the way I ask it is, where are the risks? I think I see at the beginning of the year I was over at a conference in Europe, and they hit me with the following issue: What happens if there's an external development and Europe goes into recession and interest rates are negative? What do you do? So that's ...

CONSUELO MACK: And ...

NICK SARGEN: The answer is ...

CONSUELO MACK: Who knows?

NICK SARGEN: Who knows? The second more immediate risk is this is the first time in my lifetime both political parties in the U.S. are anti-free trade. Historically we've been a nation that believes in competition. We can out-compete everybody. Now we're afraid of our own shadow, and if we were to get into a situation of potential just talk of trade war, China, Mexico, Canada, believe me the markets would freak out. So I'm not forecasting it will happen, but I'm trying to say, what do I have to have my antennae on the lookout, and that's why I emphasize I usually am not someone who focuses on political developments, but this is unforeseen.

CONSUELO MACK: Everyone I'm sure who's listening to this program is going to say, so what are they doing as investors and, Bill, you especially because you're a private investor now. You're running your own retirement portfolio. How are you investing in this particular environment?

BILL WILBY: Well, I'm fairly defensive.

CONSUELO MACK: For you defensive is ..

BILL WILBY: Yes. I was a professional equity manager, so to me I've got 65 percent in stocks which is at the low end of the range for myself, and with the remainder I'm about half in long-term bonds and half in cash. The reason I like long-term rather than short-term or intermediate bonds is because the bond-equity correlation is negative. So in effect, bonds dampen portfolio volatility much better than short. The longer bonds dampen the volatility in the portfolio much better than short-duration bonds do. So I've been very comfortable with that. It reduces the overall volatility in a portfolio. I think you can get less than hedge fund volatility with simple investments by using stocks and bonds together in an intelligent fashion.

CONSUELO MACK: You are a bottom-up investor. You said that there are companies out there that you want to own for the long term.

BILL WILBY: What I like to do is collect great businesses that I think can grow faster than fairly pedestrian GNP growth and buy those businesses when they're out of favor. So I think there's a lot of opportunity to take advantage of the volatility that Nick's talking about. To the extent that we really do get some downside volatility, there are chances to pick up companies that are growing their revenues at 20 percent plus in a two percent revenue growth world.

CONSUELO MACK: Such as ...

BILL WILBY: Amazon's growing revenues at 25 percent right now. Everybody thinks Amazon's expensive. It's on three times revenues. That's half the multiple of most pharmaceutical companies. So the problem is it keeps reinvesting its capital and it has an extremely high return on that capital, so their cash flow is growing at 20 plus percent, but they're not showing accounting earnings, and so it's an interesting opportunity if you get it ... there's no question that Amazon's expensive on a P/E multiple basis, but I think you can't use traditional P/E multiples as a way to value companies in today's world where there's no capital in companies. It's like we were talking earlier. Companies don't need to borrow money. They're like banks. They generate enormous cash. Facebook, Google. These are phenomenal companies that have huge operating margins, much higher than what the market is. One of the reasons the operating margin of the market is as high as it is, is because a shift in the weighting of companies towards these large companies that have enormous operating margins which has driven overall market margins up.

CONSUELO MACK: Nick, briefly how defensive are your portfolios at Fort Washington and what's your portfolio strategy?

NICK SARGEN: Basically on the equity side, our lead portfolio manager has done a marvelous job since the financial crisis. He's basically been fairly bullish and constructive. He turned much more cautious a year ago partly. We are more value-oriented partly for valuation reasons, and then partly it's just the recognition of increased risk globally. On the fixed income side, we're basically saying that again the U.S. is in better shape than other economies. We still see opportunities in corporate and even high-quality, high-yield bonds. So we haven't changed the investment strategy but, Consuelo, I never thought I'd say this in my lifetime. I've never recommended gold, and I'm not today, but I would say the following: Watch again what happens geopolitically.

CONSUELO MACK: Political developments.

NICK SARGEN: If it gets scary, for the first time in my life I would contemplate gold. So I'm not there yet, but I've got it on the hip pocket.

CONSUELO MACK: This is earth-shaking news. One investment for a long-term diversified portfolio, Bill Wilby, what would you have us all own some of ?

BILL WILBY: Well, I just finished talking about Amazon. I might as well put out Amazon as a long-term investment. I have to preface this with it doesn't mean that now is necessarily the appropriate time to buy this for your audience, but I'm looking on a 20-year view and what you have. It's the number one in cloud services in the world. It's Wal-Mart, and it's also Netflix all in one package, and it sells on three times revenues. I think these are great businesses. The returns on capital are very high, and if you project out that revenue growth rate and look at a P/E multiple, all Amazon has to do is stop reinvesting 100 percent of its capital, and its earnings will skyrocket, and its P/E multiple will shrink to single digits.

CONSUELO MACK: All right, and we are actually asking for like a ten or 20-year investment. What would yours be, Nick Sargen?

NICK SARGEN: It's interesting. Here we are talking about Europe, and most people's inclination is stay away. Honestly I really don't know what to do in the public market right now. It's a coin toss, but I was just talking on our private equity funds. Guess what? We've made three European investment approvals. You say, "Are you out of your mind?" The answer is no. We're making a ten-year bet on those, so we think that some of the pressure in Europe is near term. Longer term, there may actually be on the private equity front if you get the right type of fund, there are some opportunities.

CONSUELO MACK: All right. We'll leave it there. So great to have you both. Nick Sargen, thanks so much from Fort Washington Investment Advisors, and it's so lovely, Bill Wilby, to have you on as a private investor.

BILL WILBY: Thank you. Thanks very much, Consuelo.

CONSUELO MACK: Thank you both very much.

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: Hold some safe haven assets – cash, U.S. treasury bonds, gold, or all three.

When Nick Sargen says he is considering holding gold for the first time in his career I definitely take note. Although he is not recommending buying it now, we and many other WEALTHTRACK guests have been long term advocates of always having a modest position in gold as an insurance policy against disaster and traditionally a behavioral opposite to stocks.

One of *Morningstar*'s favorite vehicles to own gold is the iShares Gold Trust ETF.

Bill Wilby holds long-term treasuries in his retirement portfolio as a non-correlated asset to dampen volatility.

A top rated treasury ETF is the SPDR Barclay's Long Term Treasury ETF. And cash which Wilby also holds, is a no brainer because it can be both defensive and opportunistic.

Next week we will discuss how to think about money and invest it wisely with two highly regarded financial journalists. Jonathan Clements, whose latest book is *How to Think About Money* and Spencer Jakab, the author of just published *Heads I Win, Tails I Win: Why Smart Investors Fail and How to Tilt the Odds In Your Favor.*

In the meantime in the extra feature on our website you can find out why after 30 plus years Bill Wilby has unplugged from his Bloomberg machine and Nick Sargen explains the biggest change he has seen in forty years of investing.

Thank you so much for taking the time to visit with us. Have a wonderful weekend and make the week ahead a profitable and a productive one!