

Scout Investments

Global Economic and Market Outlook

L' Evenement Principal

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2011 Outlook

GDP GROWTH:
1.8%

UNEMPLOYMENT:
9.0%

INFLATION:
1.75%

FED FUNDS RATE:
0.25%

Many of our regular readers are aware of our “Long, Hard Slog” concept. This theme originated in our pieces in the fourth quarter of 2007. In the original, and following pieces, we outlined our concern about a secular change which, in our opinion, was going to be a main driver to the overall economic, financial, and political environment as we moved forward. The main issue, or imbalance, which we as a country, and eventually many around the world, would face was excessive debt creation backed by a slowing long-term economic growth rate. This obviously has come to pass, and many now recognize the issue as secular and very challenging.

Early in 2008, we developed another piece, “The Main Event.” In this piece, we outlined our thoughts concerning not only real estate debt levels being unsustainable, but also government and total financial system debt being unsustainable. Our current piece, “L' Evenement Principal,” now addresses the same issue in Europe. The title of this piece, roughly translated to English is “The Main Event.” Like a bad recurring nightmare, market activity sentiment and fear resemble what the world witnessed in 2008 to 2009. Are we coming back to “The Main Event?” In our view, we never really left the process of balance sheet justification for both the private and public sectors of the overly indebted segments of the developed world.

At the end of the day, we believe the systemic risks radiating from Europe are the real drivers behind the financial system’s increased level of volatility we have witnessed during the last few weeks. That is where the real “show” is currently being played out, not in Washington or Tokyo. We in the U.S. are still dealing with our own “Main Event.” A new show has opened in Europe. European politicians and central bankers are running out of time to address the authority/responsibility imbalance currently in place. Citizens of various countries around the world are asking the same serious question which we in the U.S. have been asking since 2008 – **what do we as a people want from our government?** As we have said many times before, this is a question that needs to be answered by the people of all countries who are serious “users of other’s capital.”

We have long postulated that as solutions are forthcoming to these very difficult, trying problems, the world's financial system will celebrate, as a main deterrent to sustainable growth is addressed and imbalances which have been building for, literally, decades begin to wane. As this happens, we expect the next major, secular worldwide bull market to ensue. This process (basically a long period of financial deleveraging) could take anywhere from one-to-three years to fully unfold. Do not get us wrong – the unwinding of the world's excessive debt structure will not be over in three years – it may take that long to thoroughly address this very difficult and uncomfortable issue. In the meantime, we expect continued volatility in the world's financial/banking system. These systemic risks have, and will continue to weigh on world asset valuation levels, be it positive or negative.

The world's economic balance is shifting away from the traditional western/developed world. This process will continue at various rates, due to the transferability of productivity and demographics. Consequently, as the developed world continues to lose world economic market share, it is necessary for the developed world to address balance sheet leverage. If we as a people do not address these issues, as we have seen, market forces will address the issues for us. This will not be pretty or comfortable. Market forces are not benign, or kind. Market forces are, however, normally fair.

Recession in the Cards?

Let's cut to the chase on this issue. Currently we are assigning a probability of 35 percent to the chances that the U.S. will start to experience a recession during the next 12 months (measured as two back-to-back negative GDP growth quarters). U.S. GDP data was revised downward last week, with an emphasis placed on the revised first quarter 2011. Unemployment remains high and will probably continue to remain at above average levels.

Consumer and small business sentiment data is troubling. Last week, the University of Michigan Consumer Sentiment Index tumbled 8.8 points to 54.9, a level normally associated with recessions. As a matter of fact, this reading is the lowest we have seen since 1980. Our 35 percent probability of recession is reasonably high. According to *Barron's Magazine*, a consensus of economists currently assign a probability of 28 percent to a recession occurring by the end of next year. Color us slightly "bearish" in our outlook towards the overall economic environment, which on balance has been the case since our "Long, Hard Slog" conceptual piece was released. We believe the probability of the economy flipping into recession has risen during the last week, driven primarily by the negative sentiment/wealth effects of the volatility in the equity market along with the lousy consumer attitudes towards the economy as witnessed in the University of Michigan survey.

Why the U.S. Escapes Recession Over the Next 12 Months

Now, of course, the inverse to our belief in the probability of recession being 35 percent, is that we believe there is a 65 percent probability that the macro economy remains in a positive, albeit weak, growth mode. Our outlook of growth is broken down into two possibilities. One, very slow growth (less than 2.5 percent GDP growth) and the other (growth acceleration) where GDP growth starts to accelerate at a rate in excess of 2.5 percent. Why is 2.5 percent a good operating number of division? If the economy grows nicely above 2.5 percent, there is a chance that the job market will start to improve. Less than 2.5 percent and the employment picture continues to struggle. We believe data will prove that productivity gains in the economy average roughly 1.9 percent over longer periods. Due to population gains, our workforce grows by 0.5- to 0.8 percent annually. Consequently, a decent "rule of thumb" is, the economy should create jobs if real growth is higher than 2.5 percent.

Why don't we rate the probability of recession higher? Currently, we can count five reasons.

- Six-month rate-of-change of the Leading Economic Indicators.
- Shape of the yield curve (partially reflecting easy Fed policies).
- Oil prices, drop in mortgage rates, "high beta" segments of economy not showing new weakness (housing, autos, business inventories).
- Corporate profit growth is strong – latest quarter S&P 500 +9 percent. Normally, corporate profit growth is not this strong on the cusp of a true economic contraction.
- Quality spreads have not spiked within the bond market, which is a reflection of investor preference still being drawn towards riskier asset classes.

What to do?

Our bottom line advice is to **not get too aggressive in investment posture at this time**. The "Main Event" in Europe is still building, and the encore and finalization of this problem are a ways off. Until progress is made on this issue, we believe the markets will continue to punish lethargic attitudes, and poorly designed action. On the other hand, the U.S. stock market fell to an intra-day low of 1101 (S&P 500) on August 9, down from a high of 1370 on May 2. This represents a "correction" of 19.6 percent, a little shy of the traditional definition of a bear market. The market closed at 1178 last Friday, up 7.0 percent from the low witnessed earlier in the week.

With this decline from the highs in mind, what are our views toward putting capital to work? Much of the answer to this question resides on where an investor stood coming into this "correction." If an investor was aggressively positioned coming into this correction, we would advise moving towards a "neutral" position on strength, as we expect the markets to remain in a very volatile state over the next number of months as "L' Evenement Principal" continues to unfold. On the other hand, **if an investor entered this period in a basic defensive posture, again we would suggest moving towards a "neutral" stance**. Our perception of valuation, highlighted in our recent "Reading the Roadmap" piece, outlines our longer-term secular thoughts concerning justifiable P/E ratio and equity market valuation ranges going forward.

Based on the data highlighted in "Reading the Roadmap," we suggest the market will be bound by a wide valuation range of eight times earnings (during periods of economic stress and uncertainty) and 16 times earnings (periods of economic strength and investor euphoria). We won't go into the details behind these thoughts in this piece – please see "Reading the Roadmap." Now, if those valuation levels are reasonable, the "midpoint" of longer-term justifiable valuation levels should be 12 times earnings. Currently, the market is priced at 12.3 times earnings – at the midpoint of our projected longer-term valuation bands. What could make the market move to the bottom of these bands? A recession, and continued unaddressed systemic problems in Europe or the U.S. based on the "Main Event" concepts. If these actions were to take place, and a true bear market were to ensue, we believe a justifiable valuation level of eight times earnings may indeed be in the cards. If, on the other hand, we stay out of recession and the "Main Event" issues are affectively addressed both in Europe and the U.S. (a probability which we believe will take one-to-three years to materialize), then the market could justifiably trade up to 16 times earnings, representing a nice premium to today's valuation level. We believe the likelihood of this occurring to be nil currently, but reasonable longer-term.

Where in the World?

Given this broad background, what is our Global Equity strategy dictating? We are moving more capital into the U.S. – as we are looking for a "safer" haven for capital during this time of building financial, banking, currency and political stress. We are overweight U.S. exposure, and are adding to that exposure. We believe in adding to U.S. large-capitalization exposure to be of particular interest.

Additionally, we favor South America, Asia (excluding Japan) and certain other resource-rich economies. In other words, this call is not particularly "pro-dollar," rather, it is a "pro-growth" call. We see continued above-average growth in many parts of the world outside of the U.S. and desire to structure portfolios to reflect these "pro-growth" biases.

Why equities? Along with our developed thesis of the end of the longer-term bear market (which we all have been suffering since the year 2000), we believe dividend yields, P/E ratios and other valuation metrics lead us to the conclusion that many investors will favor equities over bonds in active allocation decisions. This process will take time to unfold, and volatility will be high as we go through the rest of this year.

Final Word

Market risks have intensified recently, driven by a new awareness of structural problems in Europe, structural political/economic problems in the U.S. and heightened chances of the world slipping into an outright economic contraction. The U.S. stock market has sold off by almost 20 percent during this period. We believe the chances are reasonably high that we will escape an outright economic contraction (and a full-fledged bear market) at this time. However, due to the structural deficiencies in Europe and the U.S., volatility will remain high, and at times, owning stocks may be uncomfortable.

As the old saying goes – this too shall pass. The question of “What do we want from our governments” is being actively asked. The question needs to be asked prior to an answer being forthcoming. We are well-along the way of the developed world’s people answering this question. During this period of high-anxiety, valuations and opportunities will present themselves. We are looking for “pro-growth” investments, worldwide, to take advantage of these opportunities.



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