

January 25, 2012

The New Dawn: A Long-Term Equity Outlook

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2012-2015 Outlook

- Developed economies lose market share
- Debt problems, secular bear market fade
- Fiscal solutions are slow to implement
- Equity bull market emerges

"It's always darkest before the dawn."

Thomas Fuller, English historian, 1650

Over the past year, the world has seen many dramatic and emotional displays that illustrate an increased global desire to fix things: sovereign debt burdens, labor market weakness, income and trade inequality, regulatory largess and a perceived lack of civility, balance and restraint in civic and economic life, to name a few.

For investors, the resulting rollercoaster of market volatility since 2008 has been tough to bear. Earlier this month (*The Long Hard Slog Continues, Jan. 18*), we came to the conclusion that we can expect more of the same risks in 2012 as global economic growth remains sluggish and a nearly 40-year debt supercycle continues to unwind.

In this piece, we look further ahead, and discuss why we believe that the next secular bull market in stocks may begin to unfold in next one to three years. To us, the lessons of history suggest that a new road of opportunity awaits if we can both understand what has happened and be prepared to navigate the conditions we are likely to face.

The Debt Structure Roadmap

As GDP (gross domestic product) growth has stagnated, debt levels compared to the size of most economies have risen in developed countries. The composition of debt and how it is evolving may surprise some, as shown below:

Domestic Debt as % of GDP

	9/30/11	Recent High	13-Yr Average
United States	343%	386%	305%
Eurozone	444%	449%	367%
Japan	622%	622%	575%

Source: International Monetary Fund

As can be seen from the data above, the U.S. has made reasonably significant strides in improving its debt structure, but still has a long way to go. Within the U.S. it is important to break down the different strides made between government, business and consumer debt levels.

Debt as % of U.S. GDP

	<u>9/30/11</u>	<u>Recent High</u>	<u>60-Yr Average</u>
Government	117%	117%	76%
Corporate*	50%	52%	36%
Consumer	87%	99%	59%

*Ex-financial sector

Source: International Monetary Fund

As can be seen from the data, U.S. consumers have paid down/defaulted on a significant portion of their outstanding debt. Consumers have lowered the amount of debt on their balance sheets by 12% as compared to the size of the economy since 2007. Given this as a roadmap, consumer debt-to-GDP rates may not reach normalized levels for another eight to nine years. We are not calling for the deleveraging process to last this long, but as compared to the U.S. government, U.S. consumers have been outright frugal.

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The Developed World is Losing Market Share

The developed world continues to lose market share of the world's income statement. Emerging markets continue to out-grow and out-invest the developed world, which is resulting in a "loss" of market share by the developed countries of the world's income statement. Other, younger areas of the world are systemically outgrowing the developed world. The shift in the world's GDP pie has been monumental. According to the IMF, the world's productive economic pie has shifted as follows:

**Growth Rate of Various Economic Groups
Nominal GDP 2000-2011**

	<u>Total Growth</u>	<u>Average Annual</u>	<u>Percent Market Share</u>
Advanced Economies	74%	5.1%	64%
Emerging & Developing	284%	13.0%	36%
Total Worldwide	117%	7.3%	100%

Source: International Monetary Fund

The productive power of the emerging and developing economies has increased by 284% since 2000. The advanced economies have grown by 74% in productive power over the same period. All data is nominal in nature. If market share had held constant over the last 11 years, the productive capacity of the advanced economies would currently be \$11 trillion greater than presently. To put this in perspective, the GDP of the U.S. in total is \$14 trillion annually. Consequently, as a percent of the economic pie, a massive economic shift has occurred from the advanced economies (primarily Europe, U. S. and Japan) to the rest of the world over the last 11 years, and indeed over the last 25 years. With this, a relative wealth shift has also advanced.

Over the last 25 years, the world's developed economies have answered this shift in economic power by leveraging balance sheets, and consuming a portion of that leverage. This debt supercycle has become an unsustainable economic model as the world's investors react proverbially riot when leverage gets out of hand. Sooner or later, those who are lending capital to the spenders will balk, demand higher interest rates, or simply refuse to continue playing the game. When the game ends (as has been the case in Greece) the outcome is ugly. As the world's savers go on strike, the real losers will be the borrowers. As the old saying goes – the jig is up.

Now, many segments of the world's advanced economies have started to address this unsustainable business model. U.S. consumers in particular and businesses in general have made major inroads to debt reduction through a slowing in discretionary spending, leading to what many in the press are calling "austerity". We view this as healthy, and necessary, in most cases. Governmental systems are now joining the "austerity" parade. Pressure for austerity measures are currently being applied in Europe as the world's investors are demanding a solution to the imbalances the Euro has unleashed on the continent.

Consequently, what we call *The Long, Hard Slog* continues and will do so over the foreseeable future. We see slower than normal economic growth continuing due to ever-aging population bases and unsustainably high levels of debt hampering growth opportunities in the developed world. Does this mean the world in total will see slower-than-normal growth rates over the long term?

In a word, “no”.

But, over the short term, the world will continue to focus its attention on those “balance sheet” items, primarily in Europe and the U.S. as the peoples of those areas continue to decide what they want/need from their governmental systems. Now, it has become apparent in Europe that the world’s investors have at times, had enough. We believe the European leaders understand this, and cannot economically survive without the capital markets’ support. We in the U.S. are in the same boat. However, we sense many politicians in the U.S. haven’t received the same message from the market as those in Europe. Why? Because the world’s investors have not sent the same message to the U.S. as Europe. Will this message be delivered if there is not a credible “plan” brought forward in Washington to deal with ever-rising deficits?

In a word, “yes”.

As in Europe, we believe the world’s investors will “riot” if the U.S. does not eventually show the discipline and decision-making ability to deal with our own problems. When will this “riot” take place? We of course, do not know as events will drive the answer to this question. We speculate that the markets will probably show patience for another 1-2 years. Why this period of time? First, the U.S. election. The markets probably don’t expect much to occur on this issue in the U.S. until after the Presidential election. Then, the markets will “allow” the President a year or so to get something done. If nothing happens over that period of time, risks will be rising, along with interest rates, in our view.

All of this being said, we are gaining the sense that while much acrimony and anxiety is currently surrounding these “decisions”, much progress has been made in both the U.S. and in Europe over the last two years as the “developed” societies discover their own answers to these important structural questions. *In the U.S. a national debate has surfaced regarding this question – what is the role society wishes for its governmental systems.* This question has been and is currently being played out through national elections. Europe, we sense, is behind the U.S. in this decision “process”. However, we take heart in the fact that European leaders are now asking the right questions rather than simply trying to “paper” over their

currency/banking/debt problems. *There is a long, hard slog in front of not only the U.S. economy, but the European economy as well.* Indeed, we believe Europe’s economy is now in recession. But the world has come a long way over the last year in asking the extremely important question: what do we as a people want from our governmental systems?

Investment Portfolio Risk Ramifications

What does all of this mean for investors? We believe we will see very “dark” periods in 2012 – periods where the world is focused on the “balance sheet” items mentioned above, as has been the case at times over the last 5 years. We expect volatility, due to this focus, to remain very high by historical standards. So all of that being said, one would assume we are suggesting a very low-beta, defensive stance in investment decisions. Is this correct?

In a word, “no”.

Anatomy of a Bear Market

Many in the investment business believe bear markets can be defined as an investment market where assets decline by 20% in value from a peak. This is the “classical” Dow Theory definition of a bear market. I agree with this definition, but add the caveat that this definition applies to “cyclical” bear markets, rather than “secular” bear markets.

The anatomy of a “secular” bear market tends to be extremely vicious, and long-term in nature. It is not a bear market which ends easily, and is a bear market which lasts years. Typically “cyclical” bear markets are accompanied by recessions, or other shorter term “cyclical” issues. “Secular” bear markets are long-lasting affairs accompanied by economic and/or political problems which seem at the time to be unsolvable, and replete with systemic risks (consequently, the name “secular”).

According to Ned Davis Research, the U.S. has experienced 4 “secular” bear markets since 1900. These bear markets tend to share a number of common traits: They

- are long-lasting.
- destroy wealth (after inflation).

- Accompany or are caused by grinding, fundamental economic or political risks and flaws.

Let's take a look at the four secular bear markets which have occurred over the last 112 years:

Bear Market Facts

Date, Duration and Reason for Existence

3/1906 – 8/1921 15.4 Years

Panic of 1907, World War I and reparations, economies in Europe in debt. The gold standard was questioned.

9/1929 – 4/1942 12.5 Years

Great Depression leads to authoritarianism/militarism
Leads to World War II.

2/1966 – 8/1982 16.5 Years

Guns and butter diplomacy; leads to ever-higher inflation pressures. Build-up of Cold War conflict. OPEC takes over as arbiter of oil pricing.

Average 14.8 Years

1/2000 – 12/2011? 11.9 Years

Debt creation occurred due to shift in economic growth on a world-wide scale. Debt level is unsustainable.

Each of the above bear markets were awful, wealth destroying events (returns after inflation). Secular bear markets have ended when the investing world believes an end will occur to the dislocation – or the reason the bear markets exist in the first place. Let us take each case in point.

1906 – 1921 Bear Market. At the beginning of WWI, the world's major economies were dominated by monarchy rule. WWI brought this to an end. Additionally, war debts were huge – France, Britain and Germany were all three deeply in debt – without the forecast of economic growth. What was going to happen to the gold standard? Was it going to be abandoned?

A series of central bank decisions started taking place following the end of the war, and leading up to the Dawes plan of 1922. Late in 1921, investors sensed a solution to the war debt problem was at hand.

1929 – 1942 Bear Market. During the 1930's and into the early 1940's, many in the world believed capitalism was at some degree of risk of being overtaken by socialist/communistic and other totalitarian forces. The Great Depression was one thing, but until 1942 it appeared the Axis powers could win the war.

In April of 1942, Col. Jim Doolittle and his B-25 forces bombed Tokyo. While limited damage occurred, the stage was set for the naval Battle of Midway (June 1942). This led many to shift their thinking that the Allied powers could be victorious, and that democracy and capitalism would be the dominant global forces going forward.

1966 – 1982 Bear Market. Inflation is an ugly animal. It destroys wealth, and at the very least it provides an insidious hidden "tax" to entire economic systems. Inflation roared in the U.S. during this period, eroding purchasing power of the dollar and increasing prices in general by a total of 197%! There seemed to be no end in sight of ever-higher prices.

August 1982. It became clear that Paul Volker, then head of the Federal Reserve, was going to take action to squeeze the economy by raising interest rates and choking inflation. The world's investors became convinced this was going to work.

In all three examples above, secular bear markets didn't end when the problem at hand was over. Indeed, inflation continued to be a problem well into the 1980's. WWII was not over until the late summer of 1945. After WWI, European war debt problems were not resolved until well into the 1920's. However, in each case the world sensed a solution was at hand to the systemic problems which accompanied each secular bear market.

Anatomy of a Bull Market

As mentioned, bear markets are defined at 20% price declines from peaks in asset values. The same can be said about the classic definition of bull markets – markets where asset values increase by 20% from troughs. This again is a definition of a cyclical bull market. There are secular bull markets in which, after

inflation, real wealth has been created. Following the end of each historical bear market, a secular bull market has begun. Each of these bull markets has had periods where asset values decline, and sometimes significantly. However, the characteristics of these bull markets are as follows:

Bull Market Facts

Date , Duration and Magnitude

8/1921 – 9/1929	8.1 Years	310.1%
4/1942 – 2/1966	23.8 Years	435.2%
8/1982 – 1/2000	17.3 Years	722.9%
Average	16.4 Years	489.4%

Long-term secular bull markets are wealth-creating animals. If an investor was fortunate enough to put \$100,000 to work in the U.S. equity market (in this case, the Dow Jones Industrial Average) at the beginning of the “average” secular bull market, that \$100,000 would have been worth \$589,400 by the end of the bull market. This is significantly more when dividends are reinvested.

When May This Start Happening?

That, of course, is the real question – not if the next major secular bull market will occur – but when. We believe there are three stages to economic “shock” processes. These three stages can be outlined as:

1. **Shock.** The very existence and magnitude of the problem surprises the economic system. Extreme price volatility occurs within the financial system. Risk-taking stops. Business investment slows dramatically. Personal investment (housing, for example) slows to a crawl. Financial markets riot. This is what happened in the United States from 2008 – 2009.

2. **What Happened?** After the initial shock passes, a long-drawn-out process starts in a society as what happened. Why did this problem occur? What truly is the problem? All of these questions are answered through societal introspection. This is the process we in the United States went through from 2009 – 2011.
3. **What are we going to do about it?** This may be the longest stage of the process. This is the stage of when society comes to grips with how to solve the problem. Be it inflation, debt structure or the very existence of a capitalistic system, the solution to a problem of this magnitude is not ever easily agreed upon. It is our view this is the stage we in the United States find ourselves.

The lessons of history show that economic and political darkness can be overcome, even when the odds are great. The task is never easy or quick. However, the rewards are potentially great.

To us, it is no mere coincidence that we have just been through the first 30-year period since 1861, the dawn of the American Civil War, when fixed income investments outperformed equities. The financial and moral issues, as well as the climate of uncertainty, that the developed world and our nation are grappling with are no less profound than the issues our country wrestled with on the fields of Gettysburg.



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