September 2011

Strategy Review

W. George Greig, Principal,
Global Strategist and
Portfolio Manager

Moderated by
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William Blair

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Stephanie Braming:

Welcome to the William Blair global strategy conference call with George Greig, Principal, Portfolio Manager and Global Strategist for Investment Management. I am Stephanie Braming, Principal and Equity Specialist for International and Global strategies.

Global markets have continued their decline in September as confidence has eroded regarding the political will of European and US leaders to address macroeconomic issues. Is this concern warranted? What is the way forward for global equity markets? George will update his early August strategic viewpoints and discuss his outlook for the global equity market.

George Greig:

Our investing focus, which is on corporate fundamental and financial variables driving return and risk potential, has been recently pushed aside by a broader set of macroeconomic and political concerns. These are the primary issues influencing short-term market dynamics, which may be subject to reversal over the remainder of this year. Stock valuations are relatively attractive as prospective equity returns by a number of measures look to be at or above long-term averages. Clearly, valuations have been held back by systemic financial risk scenarios, by concerns that the financial crisis of 2008 will repeat itself, and by concerns that growth may be impaired either severely in the short term or moderately on a chronic long-term basis. These concerns derive from geo-political and geo-strategic issues, which tend to create angst in financial markets.

The focus of this review is to address these issues and put them into context. This does not reflect a Brussels, Frankfurt, Washington, or Tokyo point of view as an insider, but a point of view from a market observer and consumer of strategic and political research.

The Eurozone has been the primary focus of headline concerns, which have intensified over recent weeks. There is a great deal of concern that potential sovereign insolvency at the periphery will spread into larger countries with high debt and debt service obligations, as well as into the banking sector because of its extensive sovereign bond holdings. As a result of risks associated with those bond holdings, banking sector funding costs are rising, threatening profitability and ultimately banking system solvency and the Eurozone's viability. The financiers of the Eurozone are not in a position to unilaterally support the sovereign debt obligations of both the entire Eurozone and the banking system.

Extrapolating a worst case scenario is not too difficult to imagine, which would incorporate a European financial meltdown, coupled with some kind of Eurozone breakup. However, it is important to be careful of the ideology of those who promote European doom scenarios, because a lot of the doom mongering about the single currency and European political institutions comes from sources who believe that the Euro was a failed experiment from the outset. That ideology colors expectations that arise during a crisis and makes the anticipation of failure more of a foregone conclusion than it should be. The key issue to bear in mind about the Eurozone and the way that EU and EU institutions are managed from a national perspective is that it is not wise to underestimate survival instincts and the will to make European institutions work when the chips are down. The French and German establishment is more inclined to pull together at times of crisis than they are to split apart. There is a degree of cooperation and communication between the business community and the political establishment both within individual countries and across borders in Europe that is not apparent in normal times, that is not analogous to the US political process and that may cause investors to be misled in terms of the resolvability of some of these European political disputes.

There are significant behind-the-scenes negotiations on austerity plans, bond holder treatment, fiscal enforcement of reform programs, and potentially about fiscal consolidation and consideration both at the bond issuance and taxation levels. I do not expect a resolution of all of these issues in the short term. However, there should be evidence of progress and cooperation in these areas that will lead markets to conclude that it is much less likely than the *a priori* probability assigned that there will be a Euro breakup or significant insolvency risk in the banking system. As a result, the outlook for key risks in the Eurozone is for significant upside over the remainder of 2011.

The US is on the threshold of significant fiscal initiatives and potential monetary policy initiatives from the September 20-21 monetary policy meeting. The market has been in a state of debate about whether or not to expect anything from these events, ranging from the optimistic viewpoint – do not fight the Fed – to the pessimistic viewpoint – quantitative easing is going to be ineffective, counterproductive, and nonexistent. The President's fiscal initiatives are either going to be trampled on by Congress and stillborn or else will be so minor as to be severely diluted and ineffective. Obviously, as with Europe but in a different way, policy will not be perfect or as quickly executed as hoped. It will only occur under pressure of the market. A significant infrastructure initiative would be timely, well supported, and could get bipartisan support, particularly if there was private sector involvement. There could be limited downside with such a measure and potential job growth gains. Housing initiatives that are being developed, or new ones that may be forthcoming from Government Sponsored Enterprises (GSEs) or the US Treasury, could create a degree of psychological and real support for markets in general. Housing, infrastructure, and non-residential construction are depressed enough that they will not need much stimulus to begin to show meaningful growth. At the same time, these initiatives come into play on the threshold of an election year. No one in any branch of government from either party is going to want to see anything but stimulus for the economy so that they can claim credit for it in a campaign. If some stimulus is applied to an economy that has not responded to it up to this point, and the market has a high degree of skepticism about its potential efficacy, it creates the circumstance in which some progress can go a long way from a market perspective.

In Japan there is a new government coming into action against a very steep wall of cynicism about the Japanese government and Japanese politics in general which, when viewed in an historical context, is completely justified. There is some reason to believe that fiscal reform may not only be possible but also may prove to be effective policy. The new administration is coming into power with expectations set so low both domestically and globally for any prospects of reform that the market would be prepared to welcome any signs of progress.

In summary, the overall scenario is that over the summer the market has been extremely depressed about global growth prospects in developed markets and reduced valuations as if there will be a recession comparable to 2009, due to similar financial risks. I do not believe this is a similar situation as 2008. First, the financial risks are not at the same scale. Second, the political initiatives that are occurring and may be implemented will diffuse these risk perceptions over the next several months. As a result, there is considerable valuation upside in equities, even as growth expectations are reduced. I believe that reduced growth expectations will be a limited and fairly confined exercise. If this is an environment in which OECD growth is lower on average than it was in the previous decade, the flipside is that growth volatility is probably lower as well. As a result, I believe the worst case scenario fears of financial instability and growth that are in the market today are unlikely to be realized. As confidence builds that the worst case scenario will not be realized, there is the potential for equities to be revalued upwards. Having said that, there are three risks on which investors should be focused. They are not the ones that the market is currently focused on day to day.

The first risk is China. This is the one that keeps us awake at night. How sustainable is China's growth? How will it be managed when the very high rate of growth and investment spending in China slows down and when China's investment and infrastructure assets approach the point where the degree of saturation is such that the growth in new investments has to slow or come to a halt? This is the top economic growth risk in the world today. Obviously, timing the realization of this risk is the most difficult task that any of us in economics or equity management have to face today. Currently, China's growth looks stable. China's institutions look stable. China continues to invest in its infrastructure, capital formation, and in residential and non-residential construction to continue to build out the basics of a modern society. The process is much further along than it was two years, five years, or ten years ago, and there is evidence not only of excessive investment but of mal-investment as well that would normally signify increasing risks of a growth slowdown somewhere down the road. Is that 2012, 2013, 2014? That is the critical question we are going to continue to evaluate form month to month and from quarter to quarter.

The second key risk is that financial system capital requirements and regulatory burdens become excessive just at the time when the financial system is being influenced by de-leveraging and de-risking from within and without. The risk is that the exogenous burdens on the financial system paralyze it just as demand for credit and other financial products are decelerating and that the financial system essentially freezes as a result. This is not a risk of failure. It is a risk that the financial system becomes an impediment to future growth. Using Japan as a precedent, I think this is one of the principal risks that the current financial system has; not that it is going to blow up but that it is going to grind to a slow halt and may remove potential growth from developed economies.

The third risk that is worth contemplating is the security risk posed by the Iranian nuclear program and the idea that after significant setbacks over the course of the last two years, the Iranian nuclear program is now making significant progress again. Considerable efforts will be devoted toward halting that program, which of course means an elevated level of security risk associated with curtailing that progress. It is very difficult to put probabilities or outcomes on that risk, but it is obviously a headline risk that investors should be conscious of in looking ahead to 2012, and the potential impact on the energy markets and overall growth potential.

Our overall conclusion is that the markets are over-reacting to headline political risks in developed economies that should not hold back growth or destabilize the financial system, but there are more significant longer-term and intermediate-term risks that investors have to be conscious of on a one- to five-year basis. These issues could keep the market from emerging into a full-fledged boom market environment in the mid to longer term. In the shorter term, however, there is a relatively favorable return outlook, particularly in developed markets.

Question and Answer Session

Question:
Do you think bondholders of European or US banks may have to take a haircut on their investments?

Answer:
What the market is waiting to hear about is the negotiations between the governments, the ECB, the EU and the banks about the legal and financial ramifications of either formally marking bonds down to market or not marking them to market but marking them down in another way. Sovereign bonds impact banks, bank solvency impacts bank bonds, bank bonds impact money market funds and insurance companies. That is the linkage through which this process is perceived to threaten the financial stability of the European financial sector. Part of the market's fear is that the resolution is

opaque because of the complexities of legal standing and the debates about market pricing mechanism reliability, which is complicated by the multiple jurisdictions that are involved. I do not have specific answers as to what is going to happen or which proposals will be favored by whom and resolved in what way. There is a tremendous amount of effort to resolve these issues, as complicated as they are. These values have been compromised, and the question is how the answer is parceled out among all of the parties involved in a way that enables the whole system to retain its stability. My bet is that there is an answer to that question probably within a timeframe of a few months. It is not going to take years.

There may be risks for bank bondholders in Continental Europe but not in the US or the UK. The risk is to banking equity in Continental European sovereign debt. It is spread all over the world, but that is where the banks are going to take the most significant writedowns.

Question:
How is your outlook being positioned in portfolios now? What factors are you evaluating in contemplating changes in positioning?

Answer:
Our portfolio positioning is relatively conservative in the sense that there are no massive overweighted or underweighted positions either geographically or by sector. We are fairly diversified. We do have on a relative basis a significant exposure to companies and industries that benefit from a continuation of global growth and a sustained global growth environment and we have not altered that positioning. The tactical question that we need to wrestle with on a short-term basis is if we see a higher probability of a favorable resolution to the financial crisis in Europe, how does that alter our tactical view on the Financials sector. That is a question we will be discussing as a team over the course of the next several weeks and the rest of the year.

Question:
What will the implication be for developed versus emerging markets positioning in that scenario?

Answer:
The question of developed versus emerging markets hinges to some extent on what happens in emerging markets' short-term policy making. What will happen to reported inflation rates in the emerging markets and what does that mean for monetary policy? Official interest rates were recently cut in Brazil. If there are declining emerging market inflation rates reported in the next two months, which seems likely, and some movement away from tightening in the significant emerging markets, the valuation pressure on emerging markets could ease and emerging markets could start to perform a little better in the global context as that unfolds. Inflation has been much more stubborn and persistent in emerging markets than what was expected at the beginning of the year, so that is not a foregone conclusion. As a result, we are maintaining a status quo allocation between emerging and developed markets currently.

Question:
The Swiss National Bank intervened in the currency market given the strength of the Swiss Franc. Do you foresee any additional moves by governments? What is the impact from a currency perspective?

Answer:
The Swiss intervention was a significantly favorable development for global growth and global equities, because it indicated policy activism could be forthcoming when market pressures require it. The market took that intervention favorably. It is a minor precedent for policy around the world but is a significant benefit for Swiss corporates and it is a significant step toward restoring some degree of equilibrium in global currency markets in which valuations have become extremely distorted. The other logical intervention candidate is Japan where the currency is not quite as overvalued as it is in Switzerland but where it is well outside of the bounds of exchange rate parity either on a purchasing power or real effective exchange rate basis. Japan may follow the Swiss precedent when the new leadership gets better organized.

In terms of questions of effectiveness of intervention that occur in the market, the key point to remember is that any central bank or treasury has unlimited means at its disposal to weaken its own domestic currency. There are severe limitations on the ability of any government to strengthen its currency in the face of selling, but any government can sell as much of its own currency as it wants in order to intervene to hold back appreciation of its own domestic exchange rate.

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As William Blair & Company's Global Strategist for Investment Management, Mr. Greig has headed the firm's international investment management team since 1996. His hands-on, bottom-up approach takes Mr. Greig and his team around the world. As of 12/31/2010, the team manages $26.6 billion in non-US assets. He has more than 30 years of experience in domestic and international research and portfolio management. Before joining our firm, Mr. Greig headed international equities for PNC Bank in Philadelphia and previously served as investment director, as well as managing global and emerging markets funds, at London-based Framlington Group. Mr. Greig received his B.S. from the Massachusetts Institute of Technology and his M.B.A. from the Wharton School of the University of Pennsylvania. Mr. Greig has been featured in numerous publications, including *The Wall Street Journal* and *Barron's.* In addition, he is a frequent guest on CNBC's Kudlow and Company and was a panelist on *SmartMoney's* Annual Investor Roundtable in 2006 and 2007.

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