RGA INVESTMENT ADVISORS, LLC

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July 2012 Commentary

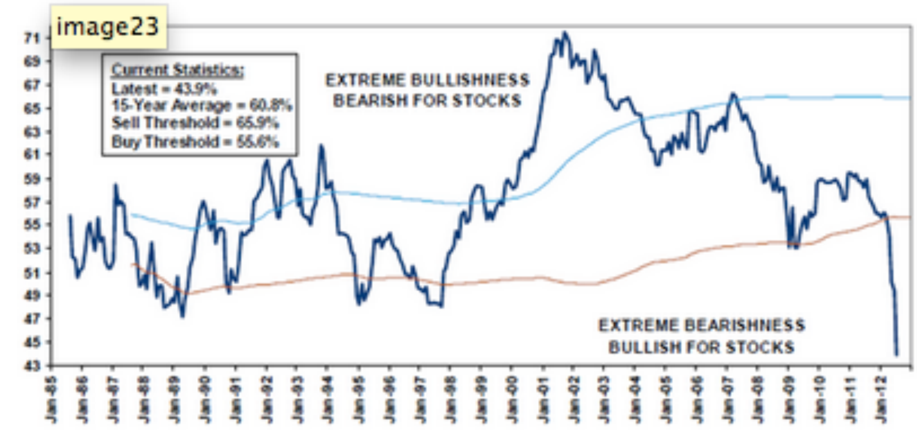
Bulls and Bears

The Month of July

The month of July saw the Bulls and Bears engaged in a brutal bout of tug-of-war on two crucial battlegrounds: the global macroeconomic and the US earnings landscapes. Each battleground saw neither side gain a crucial edge, although we believe there was a crucial qualifier that deserves attention. From April to May, expectations amongst analysts and investors alike took a beating. The prophets of doom and gloom (like Nouriel Roubini) once again plugged their microphones into the mainstream presses, leading to financial commentary with a decisively negative tone around the globe.

As of the end of July, according to a survey by analysts at Bank of America Merrill Lynch, strategists held the most decisively negative tone on equities in their recorded history, which goes back to 1985. This includes events like the 1987 Crash, the Savings and Loan Crisis, the Gulf War, the Dot.com bubble and bust, the Great Recession and the Flash Crash. Never has it been more negative than today, and that is something that we view as highly constructive.

Chart 1: Sell Side Consensus Indicator (as of 31 July 2012)



Source: BofA Merrill Lynch Global Research US Equity & Quant Strategy

There is a reason why we view such gloomy predictions through a contrarian lens: first off, contrarianism is well documented to work in capital markets over time, second, and perhaps most importantly is the role of markets generally speaking. Markets are a discounting mechanism. They are supposed to discount the known, and herein lies the essence of the efficient market theory (please note: we are not subscribers to the EMH, but we do acknowledge some of its merits). When all information is known and available, markets price things relatively fairly compared to their value (this statement cuts at the distinction between price and value, a very important distinction which we will elaborate on over time).

Whenever something is well known by market participants, understood, and foreseen, it will not move a market. For this reason, we have sayings like "it's priced in" and happenings like "buy the rumor, sell the news." What moves markets then? Well, it's the unknown, it's the unforeseen. This is precisely why today the doom and gloom is inescapable, whereas in 2007 economic pundits were slinging around terms like "the goldilocks economy?" In 2007, no one knew what was about to hit them. Today there are thousands of pontificators with well-articulated negatives.

Again, we reiterate that this is not to say that all is well in the global economy and that stocks can only go up. Rather, we are merely pointing out that known negatives are not the problem, it is the unknown negatives that keep us awake at night. Moreover, when expectations skew so strongly in one direction (i.e. the negative), it is only natural that the next surprising moment will swing the pendulum in the opposite direction of what the crowd expects. This is how it almost always works. Surprises, by and large, run counter to the general tone.

The Tug-of-War:

Let's turn our attention on the battlefields of July. On the global macro front, we had one of the worst months on record of economic activity throughout much of Europe, including England, and persistent weakness in Asia, albeit with signs of improvement. Further, we had the U.S. economy itself show continued signs of deceleration, driven primarily by events from abroad. What does this all mean? Well things are about as bad as they can be on a global level. It's as simple as that. And typically when things deteriorate like this globally, we get coordinated action from both governments and central banks. The problem at this juncture is that the Europeans are incapable of navigating through what we continue to describe as a Constitutional crisis.

The entire continent is handicapped by the fact that the bodies, which should have the capacity to counteract the pervasive weakness, simply don't have the necessary authority to take action. Towards the end of the month, Mario Draghi, the President of the European Central Bank, through muttering a few words, sent global markets higher by more than 2%. And you know what they say: "actions speak louder than words." One can simply deduce that with the capacity for action to back up his words, Draghi could reverse a serious coefficient of the problem that is plaguing Europe right now. Herein lies the predicament of the asset allocator: how much faith should be instilled in the European leaders to do the right thing at the end of the day? There are countless competing constituencies in Europe, and while U.S. politics are messy with just two competing parties, imagine a continent of competing countries with their own chaotically messy competing parties.

How does it ever end? We think the end looks a bit like the month of July. We are most likely not quite there yet in Europe, but what's happening takes us substantially closer to the end game—cementing the "irreversibility of the Euro," to borrow a phrase from Draghi. The end, in our opinion, involves the core countries (those that are relatively ok economically and low cost of government borrowing) joining in on the pain and this is happening on several levels. First, with the decline in the price of the Euro, the core countries are losing much of their purchasing power. Second, and most importantly, with the continued collapse of the periphery in Europe, the core countries are losing one of their primary sources of demand, thus driving the strongest economies into the ground with the bad. Once the strongest economies experience this pain, they realize precisely what is at stake, and are induced towards action. Inaction thus will be broken.

Looping into Earnings

This negative feedback loop rippling through the Eurozone has made its way to the US through two global channels. First is the obvious: Europeans do buy plenty of goods and services from the U.S. and there is a notable drag on earnings here both from the lack of demand, and from the falling value of the Euro. As the Euro moves lower, the value of U.S. exports declines apace, and this was one of the more cited reasons amongst U.S. companies for lackluster revenue growth.

The second substantial factor is Europe's role in emerging markets. Europe is a major end market for China in particular, and further, European banks are some of the primary financiers to the emerging world. European banks are far more global than our American institutions and with market dislocations plaguing the Eurozone, banks are reigning in on their activities outside of their home domiciles. Some of this is pure risk management, while some is mandated action at the hand of concerned regulators. With Europe slumping, many of these emerging markets have stagnated in growth due to the drop in demand.

Meanwhile, earnings out of the domestic markets for US based companies remain fairly good. As we have been hammering home lately, the housing market has registered notable improvements in recent months, and this has a serious multiplier through the economy. Indicators ranging from home prices, to rail traffic paint a far more optimistic view of the U.S., and were it not for the global woes, earnings would look quite good hear. While the global woes are inescapable right now, such a drastic fall-off in economic activity leads to growing pent up demand for when activity reaches the right side of a trough. In the meantime, multinational firms have lagged the market immensely, but when pent up demand inevitably returns, there will be a slingshot effect that drives global earnings for U.S. multinational back upward.

Early in the recovery, U.S. manufacturing roared ahead, actually surpassing the pre-Great Recession peak, and emerging markets grew at a rapid pace, while housing continued to drag. Today that scenario is reversed, with housing starting to recover, while manufacturing and emerging markets cool off. Perhaps for once in this recovery from the Great Recession we can get all economic engines pointing in the same direction.

Warm personal regards,

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