RGA INVESTMENT ADVISORS, LLC

October 4, 2012

September 2012 Commentary

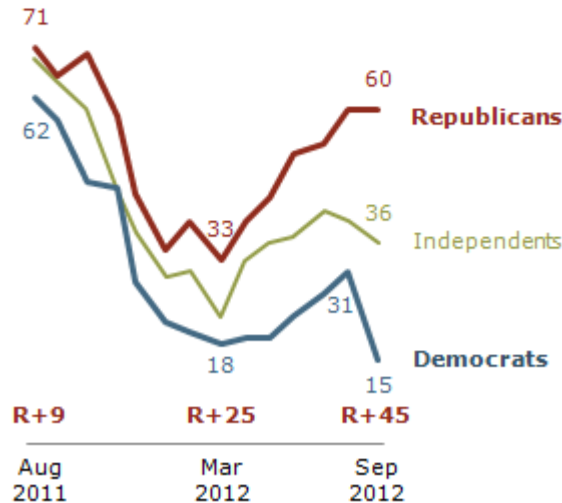
Politics, QE, and more

The 3rd Quarter

The third quarter of 2012 could very well go down in history as a pivotal moment in both Western Democracy and economic theory. As the quarter draws to a close, the world is essentially in the test-tube phase of whether two grand 20th Century experiments inevitably will work. In one petri dish, you have the European Union moving closer towards a "United States of Europe" structure, and in the other you have the continued evolution of monetary policy and the role of a central bank. With both Europe and monetary policy, market participants had been waiting nearly five full years for an impactful and powerful end to the present dual crises. While neither party took what can be deemed a conclusive step towards ending crisis, both took what is far more substantial than a half-step towards resolving crisis.

As is so often true with historical events, there is a substantial amount of misinformation and a seemingly willful lack of understanding about the primary causes and effects driving the course of events. We will take a little time to expound on our understanding of where thing stand today, for it won't be until we are all blessed with the benefit of hindsight that any clear linear narrative could emerge.

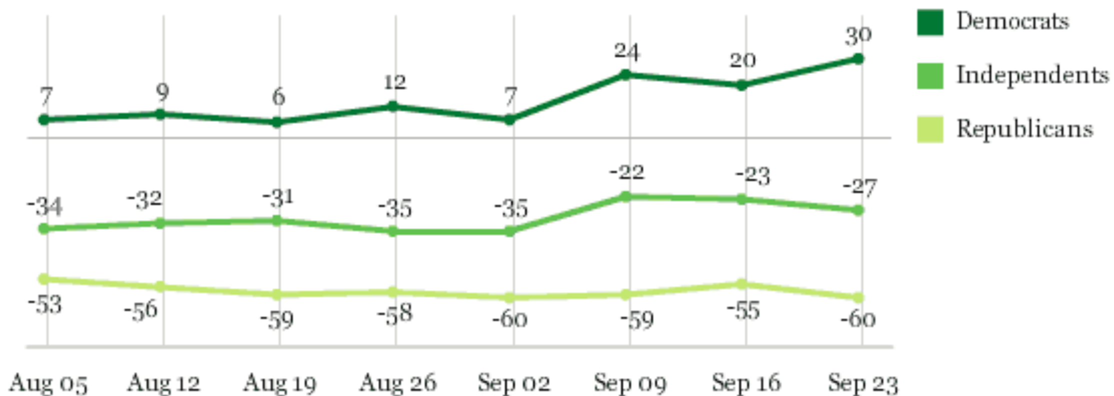
Last month we alluded to the short-termism that frames our political debates. This month we want to explicitly highlight how that effect is playing out, before delving deeper into the impact of the aforementioned historical events. We want to do this, because since we are in the middle of a heated presidential election season, even formerly unbiased investors and commentators are interpreting events through their political lens rather than their analytical. This is pervasively and frustratingly clear whether it be the deca-box screen on CNBC with ten pundits shouting out one-another, or in the business and finance sections of the Main Street news publications. Here is the proof:



This chart is the result of a poll that asks voters by party affiliation whether they are "hearing mostly bad news about the economy." The gap is massive and clearly demonstrative of the impact of partisanship on interpreting the state of the economy. Our next chart to that end is a gauge of consumer confidence broken down by party affiliation. Those who follow markets, or have an interest in behavioral economics know that consumer confidence is a lagging indicator, which in theory should confirm a directional shift in the economy. Considering the influence of election season, we think it's clear that today's consumer confidence number is almost meaningless and reflects little more than the question: "is one a Democrat or Republican"

Gallup Economic Confidence Index -- Recent Weekly Averages by Party ID

Weeks ending Aug. 5, 2012, through Sept. 23, 2012



Gallup Daily tracking

GALLUP

Now that we have effectively established a partisan tint to today's economic analysis, let us offer some of our own interpretation on the historical events of the past quarter. In our commentaries throughout this year, we have continually referred to the European Crisis as a constitutional crisis. This stands in stark contrast to the mainstream interpretation of the European situation as an economic one, with a cause based in economics and a solution coming via economic reform. Considering the failed attempts at economic solutions to the crisis, we believe our thesis has been empirically confirmed by the course of events. Why and how this matters is an important point.

The European Union started as a common free trade zone in the aftermath of the devastation wrought by World War II. Powerful visionaries, through back channels, orchestrated the framework for a much tighter political union over the course of decades, using economic union as the means for implementation. Implementation happened gradually over the years, commencing with six countries in an alliance to trade coal and steel, and evolving to include 27 member nations, a common currency and central bank, and a supranational governing body. This evolution was no accident, yet the evolution had essentially stalled since the adoption of common currency.

Typically in this world, it requires a crisis in order to effect change. In periods of extended successes, the powers-that-be are lulled into a sense of complacency, during which many take victory laps for achieving a new plateau of prosperity. Those who had been lulled by success have now been shaken by crisis.

It's become painfully clear that the euro currency works very well in the good times, but horribly wrong in the bad times. The nature of these flaws manifest themselves most clearly in the economic arena, thus leading to the misdiagnosis as an economic crisis. Yet in reality, these problems are the reflection of a flawed political design, lacking the requisite institutions to weather a storm. A common currency imposes a unified monetary policy on a region, however, such a structure factually cannot work without

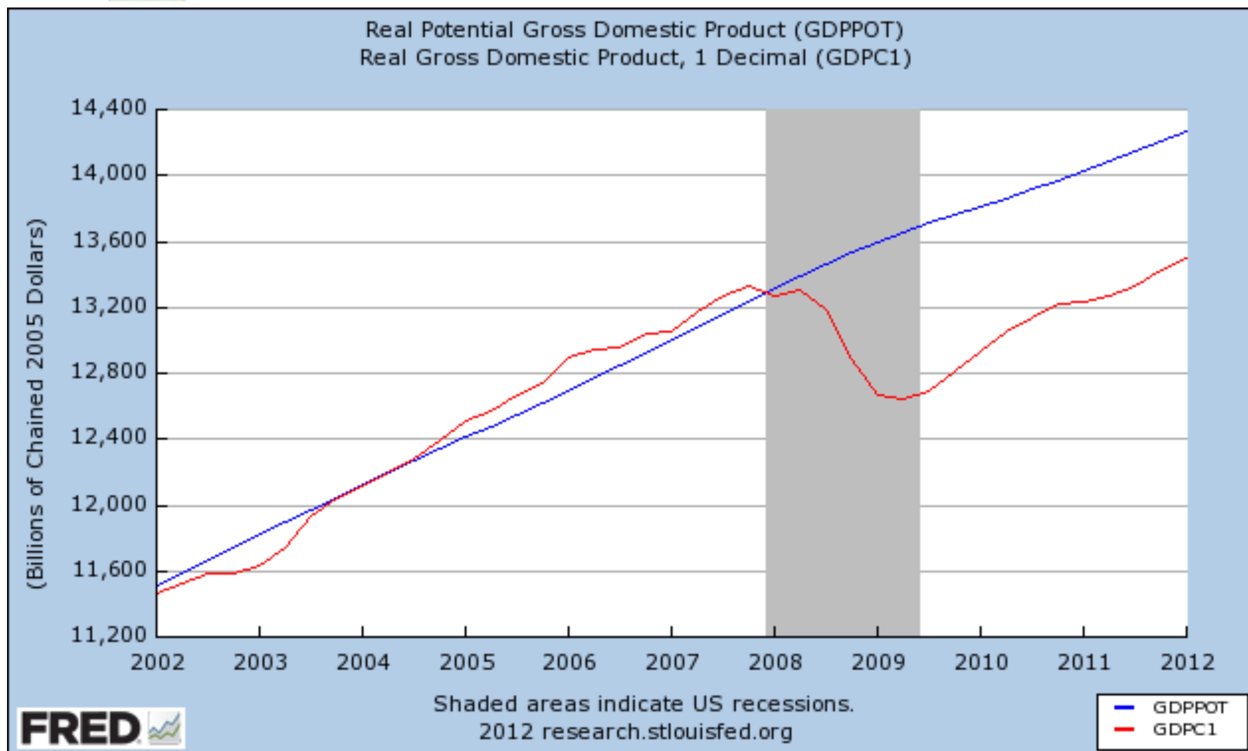
some kind of centralized mechanism to redistribute imbalances within the currency zone. The resistance to a redistributional mechanism is that any such means to redistribute would force certain political constituencies to cede concessions to others via a centralized fund-raising and budgeting body. We all need to be cognizant of the fact that this is a process, not an event, and as such will require a decent amount of time to "finish," but we strongly believe it will inevitably get there. Importantly, during this past quarter, several substantial steps towards an end-game have been taken, and markets have reacted accordingly.

What QE is and is Not

As we all know by now, the Federal Reserve Bank recently announced their latest effort to stimulate the economy—the indefinite open-market purchase of $40 billion per month of mortgage backed securities (MBS) until the labor market improves. Sure enough, the commentary seen about QE has been grossly misleading and tinged with emotional and political bias. Some have asserted that QE3 itself is a political endeavor, some have insisted it will cause hyperinflation, others have said QE is creating a bubble in US Treasuries, and a few have declared it will do nothing whatsoever. Sadly, none of these proclamations are remotely close to the truth. Let's do some mythbusting.

QE in reality has no influence on politics and no influence on the capacity of the US government to issue debt. This is important. Many have used QE as a launching point for declaring US Treasuries the "next" bubble, and again, this analysis could not be more wrong. In bubbles people are buying assets seriously detached from their intrinsic value, with the permanent impairment of capital (i.e. substantial losses) being the ultimate outcome. With Treasury bonds, while its possible (and in our opinion highly likely) that long-term Treasuries will not out-earn the pace of inflation, the odds of an impairment of capital are effectively nil. The distinction that we make here is between the permanent impairment of capital and an inadequate return. One situation is clearly far worse.

How does this tie into QE? The Federal Reserve Bank added a new wrinkle to this latest round of quantitative easing—in addition to expanding their balance sheet they have declared that such action will be done indefinitely, until the job market improves. This is akin to what some economists call nominal GDP (NGDP) targeting and in or opinion as professional investors and amateur economists is a bold, constructive, and historic event in central bank history. Think of the rate of change in NGDP as the rate of real GDP growth (or contraction) plus the rate of inflation. Therefore there are two ways to increase NGDP: either via higher growth or higher inflation (or a little bit of both). The implicit embrace of NGDP targeting is a statement by the Fed that they will accept a higher rate of inflation until the economy returns to its trend rate of growth. The following chart highlights the gap created by the Great Recession, also known as an "output gap":



The blue line represents the long-term trend of US GDP growth that traces back centuries, and demonstrates where GDP would be today had we not entered the Great Recession and maintained trend. The red line shows us where GDP is actually at right now. Ever since the Great Depression we have had recessionary periods where the red line drops beneath the blueline; however, not since the Great Depression have we experienced a substantial output gap that does not close within the first couple years out of recession. What the Fed's latest action says is that we will accept higher inflation in order to close that gap between the blue and red lines, and only then will the Fed focus on keeping inflation in check.

Let's leave the debate aside as to whether nominal GDP growth ultimately translates to real GDP growth and talk about how this impacts your investment portfolios. The message is clearly that we all must accept higher levels of inflation, and in this context, we insist that the aim be to understand inflation rather than to fear it. We want to caution that higher inflation does not mean a repeat of the 1970s, and further, we want to make clear that the chances of hyperinflation are non-existent. These are two points we will elaborate on in the future, but for now, let us assert that the Fed has far more tools at its disposition to fight inflation than they do to prevent deflation.

As far as investments go, we believe there is one outstanding way to take advantage of the present economic landscape. Two of our purchases during the last quarter are most reflective of this—**Walgreen Co. (WAG)** and **Siemens AG (SI)**. Both companies recently issued a blend of short, medium and long-term debt in order to fund different corporate initiatives. For Walgreen, the debt issue

allowed the company to acquire Alliance-Boots, with a present cash flow yield over 9% at a long-term cost of capital of 3%. Walgreen very conservative balance sheet affords the chance to constructively take on more long-term debt in order to immediately benefit from a 6% arbitrage opportunity. This is a situation where even if Alliance-Boots' impressive growth slows, and no synergies are realized, the company makes the spread in the capital structure arbitrage.

As for Siemens, the company similarly issued a blend of short, medium and long-term debt. Instead of making an external acquisition, Siemens will use the proceeds to buyback nearly 5% of their outstanding shares. Considering the companies weighted average cost of capital is well above ther cost of debt, this should drive down the cost of capital and greatly increase the value of their shares over time.

Many in the value investing camp believe that the macroeconomy is not all that important to investment analysis, but we would beg to differ. We believe it's extremely important to both understand the prevailing forces driving the economy, and to be intimately familiar with the framework within which policymakers are operating. It's not our job to ascertain the best policies in any given situation, but it is our job to anticipate the most likely course of action and its implications. Both Siemens and Walgreens highlight an area where the macro-catalysts (in the form of lower corporate debt interest rates) is driving increased value in an already attractive value investing opportunity. Beyond the investment front, we think it's increasingly important to discuss these historic events as they unfold, because we are in an environment where media commentary is framed by the prevailing bias of the news source, rather than a serious interpretation of the consequences of policy initiative. As always, feel free to reach out to us if you would like to discuss these events in any more depth, as we welcome the opportunity to help further elaborate on our thoughts.

The Portfolio Strategist

In recent quarters, many of you have come to us to inquire about our research and investment process. We pride ourselves on our ability to identify sustainable, scalable, and defensible GARP investments, and we're always eager to discuss the specifics of our process with you. To that end, we recently launched a research service that leverages our proprietary insight. We've coined this service "The Portfolio Strategist" and it can be found online at www.theportfoliostrategist.com . As a valued client, we will be including you in our research report distribution list. We believe that many of you will appreciate the added context around the investments that we source and actively manage within your portfolio(s). Of course, please let us know if you'd prefer to stop receiving these reports.

This service will be available as a paid subscription to outside individuals. If you know of anyone who might benefit from our investment selections, please send them our way; we will be happy to extend them a free one-month trial subscription.

Warm personal regards,

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