September 16, 2011

Dear clients and colleagues,

It looks as if the 'Fear Factor' has gripped investors in the last few weeks. Many markets are now officially in bear market territory (down 20% from the previous peak). You may recall from previous comments that we had a cautious view of the market given global macro risks as well as the end of QE2.

We are now upgrading our view of the market as our outlook for a gradual economic recovery as well as attractive valuations make us a lot more positive.

We attended a few conferences in the US last week supporting our view that the economy is still growing. Companies are cautious, but are unanimously saying that the current situation is not at all like 2008. Economic data has been mixed but still indicates growth. A lot of data from the "real" economy such as mileage driven by trucks, airport passenger numbers, etc. are still positive.

Macroeconomic risks won't go away anytime soon, but valuations are reflecting the worst.

Economies in the developed world are facing a prolonged period of adjustment. Baby boomers are reaching retirement age, with very little savings. Governments promised free healthcare and generous pensions, but do not have the means to honor those promises. We only see one solution for boomers, spend less and save more. And they are. Since consumption is the largest part of the economy, growth will be lower for many years to come. And governments also have to reduce spending and play a lesser role in the economy.

We believe emerging markets have reached that tipping point where internal demand is creating sustainable growth. However, they have to deal with a lot of imbalances and the main risk is inflation.

We believe central bankers in the developed world have got it wrong. They are maintaining artificially low rates, penalizing savers by trying to foster consumption. It won't work and the result will be inflation.

So we'd better get ready for slower growth and higher inflation; in other words, stagflation.

How does one invest in an era of stagflation?

Companies that will benefit from the emerging market consumer;
Companies that can still grow domestically because they are addressing a large and fragmented market;
Companies that generate strong cash flows and do not need to access capital markets;

Looking at the 70's, we want to remind you that if you invested $100 in US large cap stocks in January 1973, you would have had $143 in December 1982, less than inflation. The same $100 in US small cap stocks would have grown to $417, or around 14.5% annual return.

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Some investors are suggesting hard assets such as commodities as inflation protected assets. In the case of commodities, we would suggest that returns have exceeded inflation now for many years and that the world can't deal with $100 oil. When oil reaches that level, growth stalls. Oil goes back down, the economy resumes growth. Therefore, we believe that commodities will provide low returns going forward. We do not include gold as we have no view on gold.

Have a good week.

The team at Global Alpha.

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