MID-CONTINENT CAPITAL

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*advice; judgment; resolution; wisdom

# A World of Opportunity

A summer of rampant pessimism about the outlook for the US economy and financial markets is drawing to a close. Media fixation on the prospects for a "double dip" in the economy, accompanied by a drop in government bond yields to their lowest levels in over 50 years, created a palpable sense among many market participants that the best opportunities for investors were long past, and that meager returns from all financial assets, not just equities, represented the "new normal" investment environment. However, persistently negative sentiment and a string of disappointing reports on housing and employment did not prevent the S&P 500 equity index from generating a solid 11% gain for the quarter, and bringing the index back to where it began the year.

There is a very, very strong consensus among economists and market strategists that the US economy faces a long period of sub-par growth, with only gradual improvement in employment and incomes, as the effects of the housing and financial crises of the last two years dissipate. This may or may not turn out to have been correct, but for equity investors, it is far less relevant than commonly believed. Company earnings, dividends, the growth rates thereof, and the valuations placed by investors on those earnings and dividends, are the critical determinants of stock market returns, not macroeconomic data.

*The overlooked good news for investors is that these factors are overwhelmingly favorable at the present time.* Corporate profits are poised to set new records next year, driven especially by a strong comeback in the banking industry and amazing private sector productivity gains. Dividend payouts are rising as corporate boards are under increasing pressure to deploy huge cash balances that are generating minuscule returns. But most importantly, valuations are at their most attractive level in decades. Many high quality companies offer dividend yields in excess of their own bond yields for the first time since the 1950s. Moreover, the gap between the "earnings yield" (the inverse of a stock's price/earnings ratio) available in the equity market and the yield on long-term bonds is very wide, arguing for much better returns from stocks, and potentially even with less risk.

Among the explanations for these robust corporate earnings is that US companies have much more exposure to international growth opportunities than ever before. According to Merrill Lynch research, nearly half of the profit from the companies comprising the S&P 500 equity index emanates from outside the US, up sharply from a decade or two ago. For this reason alone, narrowly focusing on the weak US economy would increasingly lead investors to incorrect conclusions.

Of particular note is the rising share of US companies' profits being derived from emerging markets. Indeed, a growing middle class worldwide offers some breathtaking prospects for properly positioned global companies.

An estimated one to two billion people will achieve middle class status over the next 20 years, according to various estimates. The emerging markets' share of world GDP has risen from 29% to 39% since 1990, and will likely reach 50% by 2030. Thus, not only are these countries growing more rapidly than the developed economies, the number of middle class citizens within them is also rising rapidly; by 2030, the emerging economies could be home to over 90% of the world's middle class citizens. With rising populations, and rising per capita incomes, total income and spending growth by middle income consumers in these markets could be in excess of 10% per year for many years – far faster than the expected spending growth in the developed markets of North America, Europe and Japan, where aging/retiring baby boomers are likely to sharply limit the growth in their outlays. This shift in the "center" of worldwide consumer spending is truly a megatrend that multinational companies, and their investors, dare not miss.

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The investment conclusions to be drawn from this observation are not entirely obvious. First, it is not clear that the only way to participate in this opportunity is to invest in the emerging markets' stock markets. For example, it is unlikely that any local, publicly-traded, emerging market competitor in the soft drink or athletic shoe business will find success competing against the likes of Coca-Cola or Nike. Second, the way incomes will be spent in these markets is likely to change dramatically as incomes rise. Spending on basic foods will certainly rise in absolute terms, but decline as a share of total income in favor of spending on convenience foods. Entire categories of discretionary outlays – ranging from life insurance, to personal care products, to clothing – can be expected to surge from very low levels in these markets.

We believe that potential emerging market exposure, or the lack thereof, must be an important consideration on our part in the selection of individual stocks for client portfolios, and we actively incorporate this factor into our research and decision-making processes.

The US is no longer the locomotive of world economic growth, but it should be clear that this is not entirely negative, as new sources of growth abroad are clearly in evidence. As opposed to continued focus on the frustrating pace of recovery domestically, we may be drawing closer to the time when these positive global factors could draw more attention and sentiment could turn more upbeat, leading to higher valuations being placed on already high and rising corporate profits, and generating strong stock market returns in the next year.

Sources: Baseline, CFA Magazine, Goldman Sachs, Merrill Lynch



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