# Global Equity Markets: Back to Basics

## Manager Call with Canterbury Consulting and Vaughan Nelson's Chris Wallis

*On December 15, 2015, Chris Wallis, CEO and CIO of Vaughan Nelson Investment Management, addressed today's investment landscape and the opportunity set that investors now face. He discussed the history of credit markets, the current state of the market, and his outlook on various sectors and asset classes. With decreased efficiency and increased volatility in equity markets, Chris believes that security selection will be paramount in driving excess returns going forward. The notes below are a summary of Chris's presentation and do not necessarily represent the views of Canterbury Consulting.*

### HISTORY OF CREDIT MARKETS

- Pension return requirements and asset allocation decisions cause market bubbles and busts
- When interest rates are low and pensions have difficulty meeting their 7% return requirements, Wall Street creates securities with high yields and AAA ratings that become broadly consumed by pension allocators
- The resulting boom and bust cycle has been repeated several times in history: off-balance sheet financing leading to the telecom bubble, sub-prime loans leading to the housing crisis, and most recently, leveraged commodity notes leading to the commodity bust
- The bust in commodities has also caused a bust in emerging markets
- Oil capacity can be tightened quickly, but emerging markets may take longer to recover
- QE's long-term impact will likely increase volatility in currencies. A significant amount of U.S. dollars created by QE rotated into dollar-denominated emerging market debt because of the low interest rates in the U.S.

### STATE OF THE MARKET

- Quantitative Easing and Central Bank policy tools can no longer lift the prices of all risk asset categories or equity sectors—fiscal policy is the only remaining option
- The "third industrial revolution" is rapidly impacting sectors and industries. The competitive dynamic between online and brick-and-mortar (Amazon vs. Wal-Mart) is an example. In the future, whole industries will be taken out by technology (driverless cars, etc.)
- The global macro environment (declining commodities) and government policy choices (raising interest rates) are inherently deflationary, so owning the proper nominal assets (e.g. stocks) is essential to preserving wealth

### OUTLOOK ON SECTORS AND ASSET CLASSES

- Consumer discretionary—the value of brick and mortar assets are declining as online sales become more important, even for traditional retailers like Wal-Mart
- Commodities—don't invest in anything that's not related to crude oil
- Industrials—are heavily exposed to energy

- Consumer staples—investors have flocked to this sector for its relative safety, causing it to become very expensive
- Utilities—are expensive and have limited growth with prospects limited by regulation
- Emerging markets—have very challenging demographics. Success will take multiple years, not quarters
- Foreign developed—is cheaper than the U.S. market currently. The valuation gap could close if these countries can put their unemployed population to work, but beyond the 15%-20% relative move, there is little upside

## CONCLUSIONS

- There are no material opportunities at the sector or asset class level
- Don't fear higher rates as they cannot rise further on a real basis
- This Federal Reserve interest rate cycle is completely different from the past (the rate increase is not occurring during a booming economy), so ignore the market history of prior cycles
- The bull market in risk assets ended in the summer of 2014
- The next five years will not be like any five year period in recent history
- U.S. demographics while not great are far superior to the rest of the world
- GDP growth and asset returns are not as correlated as many market participants assume
- Public markets do not reflect the structure and make-up of the domestic economy
- In a lower return environment, must own nominal assets, rely less on asset class diversification, and focus on security selection

## Q&A WITH CHRIS WALLIS

When will global equity markets start improving?

- The rising U.S. dollar (which has been positive for global equities) appears played out and will struggle to move higher
- We will be in a low return environment in the near term

What role is our national debt playing in inhibiting or competing with the equities market?

- The national debt has played a minimal role
- Government debt will not crowd out private credit because the supply of dollars grossly exceeds the supply of debt
- U.S. demographic trends will lead to an acceleration in the velocity of money and inflation in the next decade

Which developed and emerging markets countries do you see the most potential in for the next five years?

- Now's not a good time to think in terms of countries or sectors—it's all about security selection
- Increase in passive investing, which is built around asset allocation, has made the market less efficient

- Active investing, which is built around valuation, is more important when dispersion among countries is low

**What does the end of the commodity super cycle mean for inflation, corporate profits, and commodity-based industries?**

- The commodity bust has set the stage for comfortable, normalized inflation between 2%-3%
- The industries and countries that have been built around commodities will be hurt the most
- "A barrel of oil is the cheapest asset on earth" and expected to recover in price to $60-$80 over the next two years. However, it is very difficult to express this view in the equity market because of all the current excess supply and the bankruptcies in the space, particularly in off-shore drillers

**What is the long-term impact of a zero or near-zero rate policy?**

- There won't be a significant longer-term impact, but it will require a lot of fiscal adjustment in the next five years

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**Chris Wallis, CFA, CPA**

*Vaughan Nelson, CEO/CIO*

Chris Wallis is the CEO and CIO of Vaughan Nelson Investment Management. His responsibilities at Vaughan Nelson include portfolio management and equity research. He has 23 years of investment management, financial analysis, and accounting experience. Prior to joining Vaughan Nelson in 1999, Chris was an associate at Simmons & Company International and a manager at Coopers & Lybrand, LLP. Chris received his B.B.A. in accounting from Baylor University in 1991 and his M.B.A. from Harvard Business School in 1998. Chris is a Certified Public Accountant in the State of Texas and is a CFA charterholder.

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## About Canterbury

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