2017 Annual Investment Forum

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Bob Cluck: I guess it's time. Can you believe it two years back-to-back it never rains in Southern California and two years, 2015 and 2016 we get rain. But anyway good morning ladies and gentleman and welcome to Canterbury's 2017 Annual Investment Forum. I welcome you back if you are a returning guest and for those of you attending for the first time I hope this won't be your last visit to Newport in early January even though it does rain. I think you're going to have a great time. Today we have a great program planned for you.

So I went back over last year's opening remarks and I told you that in 2015 that was a tough year to make any real money in the stock market. The S&P 500 was up a percent and small cap stocks were actually down 4 percent in 2015. The performance came largely from a handful of names, FANG, Facebook, Amazon, Netflix, and Google. Nobody on the planet last year had hopes for emerging markets. They were down 15 percent in 2015. And commodities and commodity stocks were pummeled by 25 percent at least and bonds broke even.

Janet Yellen had just raised the funds rate by a quarter point and our luncheon speaker, Jeffrey Gundlach, the newly appointed bond king, put up a picture of Pete Carroll next to Janet Yellen on the screen as the two vying for calling the worst play of 2015.

2016 ushered in not just a new financial market year, but the highly anticipated presidential primary season with 17 Republicans and 4 Democrats all vying to be their party's nominee. Who would have predicted this would become truly a reality TV show? Greg Valliere one year ago stood on this stage and said I quote, "Don't shoot the messenger, but what I've got to talk to you about this morning I think is becoming an increasing concern for the financial markets Donald Trump is the likely Republican nominee and he has the chance to become the next President of the United States."

Well he was spot-on with his election outcome prediction, but the market reaction has been anything but concerning. But let's not get ahead of ourselves right yet.

As I recall last year a lot of us wanted to go straight to the bar after last year's conference. I know I did. Not much optimism was leaving this room or this stage and as it played out literally from that day through February 11th concerns over Q4 earnings, China, China's growth, commodities, oil, the Fed all pointed to the possibility that we could truly have an economic slowdown or even a global recession and that that set off the stage for a 15 percent correction in the market. The market got whacked.

And guess what the market discounted something that actually didn't happen, because we didn't go into recession, we didn't have a global meltdown. In fact stocks rallied off that bottom through the spring and into June. The 10-year Treasury touched 1.36 percent at the low in February and markets started to price in rates staying lower for longer.

This fueled sectors with yield, utilities, telecoms, REITs, high-yield, corporate, even emerging market's debt playing havoc to fundamentally invested long-only US equity managers as they struggled to keep up with their benchmarks because they frankly either were underweight many of these sectors or were just out of these sectors. Utilities traded at 25-times earnings, last time I checked they're not growth stocks.

The rally continued with a brief interruption after the surprise Brexit vote, but the selloff was sharp, but brief. Clearly the Brexit vote has significant ramifications, but the markets have a way of not fretting over something until they have too or wish too. Yes financial markets are often very fickle. Europe and the Euro face enormous challenges both economic and social, but nobody truly knows the outcome or the global repercussions.

Today we live in a world of soundbites, instant feedback, and instant gratification, even fake news. We're told what we want, what we like, even what's going to happen. And if we don't have an opinion there are plenty of pundits out there to give you theirs. Greg Valliere last year, Jeff Gundlach he actually picked Trump. Turn on CNBC, turn on Bloomberg, every day, all day predictions, cable news, network news. For the nine months leading to the election nobody got it right. It's a tough business forecasting.

That's why we here at Canterbury, plug, don't have opinions and views. All of our positions are reflected in valuation and analysis based upon what we see being realistic at the time and that's why we stick to long-term asset allocation targets.

Look at the markets since the election. Financials, industrials, materials have rallied in anticipation of lower regulations, higher interest rates, and infrastructure spending. Selling in December was postponed until 2017 with the expectation of lower tax rates. Trump hasn't even been sworn into office yet.

So right now I'd like to set the stage for our speakers this morning by giving you a frame of reference for the financial markets starting in 2017. Let me first give a quick recap of the global markets for the year just ended. US stocks advanced 12 percent in 2016, measured by the S&P 500. Small cap stocks had a bounce in the fourth quarter that was significant. Small cap stocks returned over 20 percent for 2016. Non-US equities were up 150 basis points basically flat and the emerging market equities were up over 11 percent. So another year check for the US stock market. Global bounds were up marginally, but US high-yield outperformed the stock market; US high-yield up 17 percent. The bond market here in the United States was up a little bit over 2 percent, while investment-grade corporates were up over 5-1/2 percent, not bad given their starting coupon rates. Natural Resources, commodities stocks, MLPs were all up between 10 and 30 percent in '16, oil was up 45, gold up 7. And volatility throughout the year remained relatively low. I think the VIX remained somewhere between 12 and 14 percent.

So moving onto 2017 this is what we know. President-elect Trump's philosophy and fiscal agenda will a significant change from that of either the Obama Administration or what would have been Clinton presidency. Philosophically Trump believes in less regulation, greater focus on fiscal policy, tax reform both at the corporate and individual level, infrastructure spending, and more protectionism. Any of these polices if and when they're enacted will most certainly have impacts on our deficits, interest rates, Fed policy, and inflation.

Geopolitics which markets have yet to get neuroses over will have investment implications as well, North Korea, China, and certainly the Mid-East. You can be confident something, somewhere, somehow will test the newly elected President. Yesterday I just read in Bryon Wien's Ten Surprises he thinks it will be North Korea doing something in the Pacific. I should add he got one to three of those right though in last year's ten predictions.

But for the US stock market as we begin 2017 it will be the ninth consecutive year that US stocks would post a positive return if in fact we're up in 2017. Our markets today, the US stock markets sell at roughly 17 times the consensus estimates for 2017 earnings. If you look at the Cyclically Adjusted PE, the CAP PE, which smoothes out earnings on an inflation-adjusted basis, the multiple on the US stock market is about 27 times, which is high by any measure, but actually traded into the 40s at the turn of the century in 2000.

The rest of the world's a lot cheaper than the US, especially emerging markets whose shares trade somewhere between 11 and 12 times earnings, but we all know conventional wisdom tells us rates are going to rise, the dollar will strengthen, and that's going to pose deterrents for significant capital flows in these markets. You saw that this morning with a significant reduction in flows into emerging markets last year.

You know but things change in life. Just take a look at 2016. Up until the election emerging markets both with equities and debt were the strongest performing asset classes around the planet. It's also worth pointing out that the spread between the 10-year annualized return between US equities and non-US equities is over 500 basis points. The US has been on a global performance terror in relative terms for a long time. That performance spread historically is statistically significant and should narrow. Not suggesting 2017 is the year for non-US, but I'll tell you here on this stage somehow, somewhere that gap's going to get narrowed.

So as we kickoff another year we know from experience there are going to be twists, there are going to be turns, curveballs, fastballs, surprises, shocks, and of course the natural tendency to second guess ourselves. Being underinvested on the way up or overinvested on the way down and that ladies and gentlemen is why we have asset allocation targets to keep up from often acting on emotion to question typically in retrospect our decisions, "It was so obvious. Why didn't I see it coming?" That's what so fascinating about the financial services business the stock market, the intersection of capitalism, economics, financial analysis, politics, geopolitics, psychology, and human behavior, it's fabulous.

As for today we have a fabulous program planned for you. Four terrific professionals to share their thoughts on the markets and opportunities they see in 2017 and beyond, as well as three breakouts sessions. Early this afternoon we're going to go into a deep dive into three asset classes, global equities, private equity, and fixed income.

Our global equities session is going to be led by Mike Laven and will be in Salon E and F and that will either be there or there. The private capital session will be in Salon A and B, led by Stuart Blair. And Loren Asmus, Chad Bollenbach, and myself will be leading the fixed income discussion. I think we had a very small count signup for fixed income so any of you that want to do a last-minute pivot come see us, that's our pitch.

So anyway before I introduce our first guest speaker one housekeeping item. After the speakers give their presentations there are going to be mics in the room and so I know some of you have a tendency to put up your hand and ask the question. If you could kindly just wait until the microphone gets to you so that everybody can hear the question it would be very much appreciated.

Now I'd like to introduce our first speaker, Mihir Worah. He is CIO Asset Allocation and Real Return and a Managing Director of PIMCO. He is a member of their investment committee community and the executive committee and oversees portfolio management for the US. He's a generalist portfolio manager who manages a variety of fixed income, commodity, and multi-asset portfolios. Prior to joining PIMCO in 2001 he was a post-doctoral researcher associate at the University of California-Berkeley and the Stanford Linear Accelerator Center where he built models to explain the difference between, this is great, matter and antimatter. So I don't know if he's going to get into antimatter or matter today, the applicability of making money in the markets. But anyway he's a smart dude. In 2012 he authored *Intelligent Commodity Indexing*, published by McGraw-Hill. He has 15 years of investment experience and holds a Ph.D. in theoretical physics from the University of Chicago.

So it gives me great pleasure to introduce Mihir Worah.

Mihir Worah: Thanks. So thanks a lot everyone for showing up on this rainy Thursday in Southern California, especially this early in the year. So I'm going to spend some time talking about our views on asset allocation and you guys are kind of get to do a preview, because a lot of what I'm going to talk about, some of what I'm going to talk about is actually work in progress.

I put out an annual asset allocation piece for PIMCO. I'm working on it right now and it should be out in a couple of weeks, but you guys get the first look at it before it goes out to everyone else. So if there's anything you don't like lob stones at me or ask me questions in the Q&A session.

About the matter and antimatter I used to – you know it's often a laughing point when I'm introduced and I started at PIMCO working on real assets, commodities, TIPS, inflation and I used to talk about how probably I ported my knowledge on matter and what's antimatter to inflation versus deflation, but now it's probably more Hillary versus Trump is probably more topical, but there's always matter and antimatter and you can pick which one is which. *[Chuckles]* So none of them is – but they're all identical, none is better and none is worse, it's just a frame of reference.

So let me start the presentation. The way I've organized this presentation I wanted to start with a bit of a historical perspective, 30,000 foot view on what got us here. I think it's important because a lot of the things that are changing you need to appreciate what got us here to try and predict what's going to change and what are the changes and how to position for those changes.

The second part is an important diversion into liquid alts, the importance of alt risk premia, smart data, et cetera, especially as one of the conclusions of the first part of what I say is traditional beta returns aren't likely to be that exciting going forward. Then finally and this is where a lot of the changes that I – you know things are very topical and in flux I do a quick overview of all the major global asset classes, stocks, bonds, currencies, credit, real assets, et cetera.

So let's jump into what got us here and where we are. So this chart is a chart of returns across different asset classes over the last five years of post-recession. As you can see great returns on the left from US equities, you know double-digit returns, but 15 percent returns with you know 12 to 15 percent volatility a Sharpe of over one. Similarly if you look at US bonds lower returns, 4 to 5 percent annualized returns from US bonds, but also with lower volatility. The key thing to take away from here is most asset classes gave you great returns over the last five years with very low volatility. You know with high Sharpe's of you know Sharpe's above one.

So you could be invested in the stock market, you could be invested in the bond market and you got about the same risk-adjusted returns. For the amount of risk you were talking in the bond market you made 5 percent, with 5 percent volatility, in the stock market you made 15 percent per year with 15 percent, 12 to 15 percent volatility. So no matter where you invested other than maybe commodities or emerging markets or taper tantrum when you talk about that you had great returns.

So what were the drivers of these returns? The first one was obviously post-recession. Early 2009 we were starting at very cheap valuations but the second one that's less well appreciated is the boost from Central Banks lowering long-term rates. So on the left you've got the standard bond market seesaw, as rates go down and yields go down prices go up. But the fact is and what I try to show on the right is that every asset class the net present value of every cash flow in the world is affected if the risk free rate which is long-term US Treasuries if the long-term risk-free rate is coming down that boosts the net present value of every cash flow, it's not just the bond market that benefits from the Fed dropping rates or long-term rates coming down. You know you can build up the risk spectrum. You can take the Fed funds rate, what we call "The New Neutral," you can add an inflation premium, dump premium. You get the discount rate for government bonds, you add a credit risk and you get the discount rate to value risky cash flows from the corporate or high-yield bond market. You act on that on equity risk premium and you get the discount rate to value cash flows from the stock market.

So the fundamental building block of every discount rate. So anyone who value cash flows from the stock market you start with the risk-free rate, the US Treasury rate and you add an equity risk premium and you get the appropriate discount rate from flows from the stock market.

So the point is that the net present value of every future cash flow has been boosted by what the Fed has done and it's not just the bond market, but this is another reason way we think rates probably don't go up too much, because if the rates go up enough they impact not just the bond market, but they're going to start impacting the stock market and I'll talk about that briefly. So far the stock market has shrugged off the rise in interest rates and there is a reason for that and we talk about that. But certainly you know Treasury bond yields can't keep rising with the stock market not being affected by it.

So we've gotten here because the Central Bank has boosted every – you know the net present value of every cash flow. What this chart shows is we're probably at the end of that run. So this is the Fed funds rate two years out. The bars, the dash bars are the range are what PIMCO has been calling "The New Neutral." So we talked about The New Neutral in 2015 and that was an important part of our risk taking saying that, "Hey guys guess what? Even as the Feds start hiking rates we're in a new world and rates aren't going to go up to 4, 5 percent," which they did in the past. Even as the Fed hikes rates they probably will have to stop at 2 to 3 percent because we're living in the world of high leverage, low inflation, et cetera.

So what we call "The New Neutral," we said the Fed funds rate should be in the 2 to 3 percent range. And obviously as we heard early in 2016 if you look at the line the market went well through what PIMCO calls "The New Neutral" and now it's started rising again. So this boost from every lower Fed funds rate, every lower risk-free rates is probably behind us and we're going to have to deal with asset returns. So the equity market has to perform, it's going to be earnings, it's not going to be this boost from every lower long-term rates is probably behind us and we talk about why we think rates should rise modestly and how we should position in the bond market in this world. But the key thing is this boost to every asset class is gone and now every asset class is going to have to stand on its own two feet.

So given that this is our projection for future returns over the next 10 years across different asset classes. Four to five percent from the stock market and obviously there could be years where you're up more and there could be years where you're down. But over the next 10 years about 4 to 5 percent from stocks and 2 to 3 percent from bonds, so this is the world we're living in.

What I want to talk about in the next few slides for the rest of this presentation is these returns are probably these traditional beta returns are probably too low for most investors, for most investors thinking of retirement, for most endowments, foundations, individuals. So how do you get ahead of just being passively invested in the market is going to give you 5 percent from the stock market and 2 percent from the bond market, how do you do better than that; that is what I want to focus on.

So that was all maybe kind of depressing that if you know you're going to get 5 percent from the stock market on average over the next 10 years, 2 percent from the bond market low yields. The question is are we and we talked about that with a CAPE or a Shiller PE of 25 to 27, are we in a bubble in the stock market? Are we in a bubble in the corporate bond market with corporate bond yields around 3, 3-1/2 percent? And my answer to that is "No." You still stay invested in the markets. We're not in a bubble, it's just that returns are going to be low.

Here's why we think you should continue to stay invested in the market. There's three times you want to be out of the market, you want to be in a negative carrying portfolio, out of stocks, out of bonds in cash and obviously tactically there's always as active managers we try to find those times, those fears like a month or two where you want to reduce your risk and this happens to be one of those times at PIMCO where they're holding a risk posture is pretty low. But long-term over the next one year, two years, three years we think you should still be invested in the market, because like I said there's basically two reasons when you should be out of the market.

One is if you're expecting a recession. This is you know – so this shows the average length of US expansions in the US business cycle. So on average the US business cycle lasts for seven or eight years. The blue one is the current expansion and you can see it's getting pretty long. But as you know Jan Yellen, Ben Bernanke, others have told us expansions don't die of old age, they die for a reason. You see some overheating, you see over-leverage, you see a commodity price shock, you see inflation. And while there's chances of that and we should talk about, there's certainly factors on the horizon with the new administration. Currently we don't see elevated signs of recession, so we're not seeing an elevated sign of recession.

When we talk about the future I will say that tiers have grown fatter, while there's a good chance the market is romancing this immaculate growth surprise, immaculate growth in earnings from deregulation, at the same time let's not get carried away and face the fact that you're getting this fiscal boost and this deregulation at a time when inflation is starting to recover and you're running at 4.7 percent unemployment rate, so there's not a lot of spare capacity in the US economy. So you could get that overheating. No signs of it yet, but watch out for it.

You know a lot of this deregulation, fiscal tax cuts, infrastructure spending might be great in the short-term, but may lead to overheating in an economy that's already operating at pretty close to full capacity. That's it. Right now we don't see elevated signs of recession given what we know.

So what's the second reason why you should be out of markets? The second reason is if valuations are rich. We don't see extremely rich valuations. Valuations are not cheap for sure, but we don't see valuations that are rich enough to give us cause for alarm.

This chart is a chart of the equity risk premium. That's how I and that's how we at PIMCO like to look at equity valuations. You need to compare your returns that you expect from an asset class for the amount of risk that you're taking. And what the equity risk premium does is compare the expected returns from the stock market to the expected returns from a risk-free government bond or 10-year TIPS. So this is how we try to normalize what's happening in the stock market.

You know a lot of folks and equity analysts will tell you the Shiller PE or the CAPE of 25 is probably amongst the richest it's been and we're in a bubble and we're likely to get a recession or a stock market correction. Our view is a Shiller PE of 25 is probably a bubble for the stock market when 10-year Treasuries yield 6 percent. When 10-year Treasuries are giving you 2 to 2-1/2 percent maybe a Shiller PE of 25 is not that rich and what this equity risk premium does is exactly quantify where we are.

So the blue line is the equity risk premium. Basically the way we look at equity risk premium it's a simple long-term version is the inverse of the CAPE, so the cyclically adjusted earnings yield, so if you have a CAPE of 25, you turn it around and you get a cyclically adjusted earnings yield of 4 percent, 1 over 25 is about 4 percent. So the stock market has a cyclically adjusted earnings yield of 4 percent and you compare it to what you get in 10-year TIPS. We think of stocks as real assets so rather than compare it to 10-year Treasuries we compare it to 10-year TIPS.

This chart is a little dated because we update it about once a quarter, but today the yield on 10-year TIPS is about 1/2 of a percent, up from zero percent when we did this chart. So when we did this chart the equity risk premium was 4 percent, 4 percent earnings yield from the stock market and zero percent yield rates, 10-year yield rates and you find that the stock market is exactly fair compared to its long-term history.

So when you're below that orange line the stock market is rich as you were in '99 and 2000. When you're above the orange line the stock market is cheap as you were in the early '90s and the late '80s. Today the market is efficient, the stock market is exactly fair. It's trading in an equity risk premium of around 4 percent which is right at its long-term history. So what this tells you is in a yield of 2 to 2-1/2 percent 10-year Treasuries a CAPE of 25 is not rich, because the options, you don't that many options. It's not like the bond market is going to give you 6 or 7 percent.

Since the election and we update it bond yields have gone up and equities have rallied too. The equity risk premium today it's tightened by about 50 basis points. So if you update this chart to today you'd find an equity risk premium up around 3-1/2 percent. So now you're getting below that long-term average, that orange line, but it's still somewhat above where the equity risk premium gets to in the second half of an expansion where people get very optimistic and equity risk premium compresses to 2.7 percent. Today we have 3-1/2 percent, so we're below long-term averages, we're getting rich, but you know we're not in bubble territory yet.

And just mathematically let me just turn this into what the market is saying about earnings growth. So the market obviously got very excited. So as bond yields rise if earnings growth, if earnings expectations don't rise then like we said the net present value of future cash flows goes down; as bond yields rise the net present value of future cash flows goes down and so equity valuations have to go down. The fact that equity valuations have gone up even as bond yields have risen means people have changed their earnings growth expectations. And just to quantify since the elections people are pricing the S&P permanently grows earnings of 10 percent per year faster than they had before. That's one way of squaring.

A compression in the equity risk premium of 30 or 40 basis points, points to about a 10 percent earnings growth. Now you can that from you know from tax reform, animal spirits, infrastructure, more deregulations, but this is what to quantify what the stock market has done post-elections given the rise in10-year yields you say that it's basically the stock market is pricing about a permanent 10 percent per year growth in US earnings. If you buy that then that's fine. If you think that's too optimistic then you want to be a little bit cautious on the US stock market.

Same point for corporate bonds. This is a long-term history of investment-grade corporate bonds. Again you look at investment-grade corporate bonds as a spread to US Treasuries. It's the same story as with equities. When corporate bond yields are low that doesn't mean they're in a bubble, corporate bonds spread, which is the compensation you're getting for taking risk from moving from the Treasury market and the corporate bond market isn't particularly low.

So again the orange line is the long-term investment-grade OAS at around 120, 130 basis points and the blue line is right around at its long-term average. Again, once again post-elections has gone through a little bit, but not by a lot. So again even though corporate bond yields are low, the spread which is the compensation you're taking for default risk is not particularly rich yet.

The one thing I'll say and I'll talk about when I get into the tour of asset classes, given that equities have gone through – the equity risk premium has gone through it's fair value and corporate bond yields, the investment-grade OAS spread has also gone through it's fair value why not rich? They both certainly you know a little bit better than, you know richer than fair value, the stock market today is a little bit cheaper than an investment-grade bond market. So that's a change in our views in asset allocation use compared to the last couple of years. In the last couple of years we have said that investment-grade corporate bonds give you better risk adjusted, you know expectation of better risk adjusted returns than the S&P; that's switched around.

So the IG bond market has gone a little bit richer than the S&P. Both are a little bit richer as to long-term histories, but investment-grade has gotten a little bit richer. So that's something to keep in mind as you're building your – and that's something I'm expressing. You know there's still a lot of room, there's still a lot of very attractive bonds out there and I talk about, but on average over the next two or three years on a risk-adjusted basis I think the S&P is a little bit better than the cash IG market.

So let's move on from here to you know okay so we don't expect a recession unless some of the policies that we see lead to overheating, lead to an inflation shock, all this geopolitics, you know there's a trade war with China, there's something in the Middle East those kinds of shocks could lead you to recession. But you got to keep your recession – you know everything we do we say, "What is the probability of a recession in the next couple of years?" On average like we said the US, the average US business cycle is seven-years long. So once in seven years we have a recession, which means in any given year you have about a 15 percent probability of a recession. So you've got to construct your portfolios with that in mind. In any given year you've got a 15 percent probability of recession.

You don't want to get blown out of the water if there's a recession. You may have a view that things are going to be fantastic, that's great, so take bullish positions. But you could be wrong, there's a 15 percent probability that you're wrong. Right now we don't see it. So we still construct a portfolio with about a 15 percent probability of a recession over the next 12 months, but that's not elevated rather to history, so no elevated probability of recession.

Valuations getting a little bit richer post-elections, but still not rich enough where you want to sell all your stocks, sell all your bonds, and go to cash. You're returns are not going to be that exciting. So let's talk about how to boost those returns.

So here's some of the things we recommend for boosting those returns. Broaden your betas. You know move away from traditional developed markets stocks and bonds, commodities, emerging markets. I have some views on emerging markets. They had a strong 2016 and at PIMCO we take some credit for calling that based primarily on a view on what the Fed would do and what oil prices would do. So in January when most people saw when oil prices were in the low $30.00s and most people thought they'd go to zero, we've got a great oil analyst at PIMCO who helps me run the commodity return fund and our commodity hedge fund and his call was that oil prices would end 2016 in the $50.00s. And based on that we kind of had an optimistic view on commodities and on emerging markets and that played out.

But clearly with some of the policies that we might see and with the stranding dollar that might be in question, so I'll talk about that when we do the overview. But emerging markets, commodities, alternative assets, real assets stick all of that into your toolkit to try and you know outperform the 4 to 5 percent returns you're going to get from traditional assets.

Diversify your alphas and I talk about that structure alpha, all at-risk premia, very important source of returns. Diversify your portfolio, as well as generate – you know in this low-returning world every bit of alpha matters. Liquidity and complexity premia. Those of you who have been invested in PIMCO funds, you know non-agency mortgaged-backed securities, bank capital, you know these are complicated securities.

You know PIMCO's not the only asset manager in the world that can analyze them, but there's only a handful. So if you can't analyze something well the average investor will ask for a risk premium or additional spread, additional returns to invest in there. So if you can analyze them well and you can pick the good ones and avoid the bad ones not only do you make returns, but you also make that additional return which is a complexity premium that the average investor charges basically when investing in an opaque asset class. So again eek out additional returns by harvesting some of those complexity and liquidity premium.

Then again portfolio construction. I'm sure all of Canterbury's clients and I'm sure Canterbury focuses a lot on portfolio construction, diversification, risk management. This is like I said this is the world of fat tiers. PIMCO has a base case that we're going to muddle along in a new recession over the next 12 months, you know a 2 percent-ish growth. But we recognize five tiers, the Republican sweep, the deregulation, the infrastructure, tax reform, you know it could lead to an immaculate recovery, but there's also you know there's also all that uncertainty around geopolitics, overheating, et cetera. So we don't think while we recognize that there's an optimistic story that wasn't in place before the elections. Let's be clear there's an optimistic story about global growth, US growth, asset prices, earnings growth that certainly wasn't there if you'd had a Hillary Clinton administration. So there's certainly a positive story, but the negative story has also gotten more likely because of inexperience, geopolitics, overheating, et cetera. So both tiers have gotten fatter, so managing risk gets super important.

A few words on smart beta or orchestrating it. So this is how we look at it. At the bottom is beta. So you can pick your beta, traditional beta, stock, bonds, or nontraditional betas, some of which are becoming more traditional, now emerging markets, commodities, real assets, et cetera. So you pick your beta, diversify and then you can pick your alpha. There's two kinds of alpha, one is skill alpha that is basically you know doing your bottoms-up analysis, finding the winners, avoiding the losers. Then the second one is structure alpha. Alpha that exists because of inefficiencies in the market or behavioral, you know small caps, liquidity premia. People don’t like to buy illiquid stocks or illiquid bonds.

So if you were a long-term horizon and at PIMCO we do that, we put two or three percent of the portfolio in what we think are high quality, but illiquid assets and earn the additional returns that other investors will pay, because hedge funds and individual investors only want to be in the most liquid assets, they don't want to be in the illiquid assets. So there's these structural source of returns that are there to be earned for the patient long-term investor and that becomes even more important in this world of lower traditional returns.

Some of the standard alt-risk premia, factors, value, carry, momentum, volatility you know super important. PIMCO has been harvesting these in the portfolios that we manage for clients for awhile, but recognizing the importance of these we are now actually starting to put these out as separate products for our clients who want to invest only in alt-risk premia.

Here's a chart that we ran on the importance of alt-risk premia and the reason why PIMCO's – the big reason or the secret weapon those out-perform consistently over the last 30 or 40 years is structural alpha of these alt-risk premia factors. This is the Total Return Fund. This is the alpha in the Total Return Fund broken down into skill and structure level. So as you can see the Total Return Fund and I just picked that because we've got the longest history managing the Total Return Fund a full 20 to 30 percent of the alpha in the Total Return Fund are these structural or alt-risk premia strategies.

You know we recognize them 30 or 40 years ago that there were benefits to be earned in a sell volatility, people overpay for insurance, sell liquidity, stay bulleted. You know people again people avoid the long end of the curve because it's so volatile. But if you stay bulleted in the 5- or 7-year sector of the curve there's times when you analyze dynamics and you move around the yield curve, but on average staying in the 5- to 7-year part of the curve you know yields returns.

So these are some of the kinds of structural recurring source of alpha that we've utilized at PIMCO for a number of years. And I think it becomes important and this is for clients is you can either allocate like we said to these alt-risk premia strategies, which basically take these structural alpha and isolate them, take away the market beta, take away your duration, take away your S&P 500 beta and focus solely on these alt-risk premia factors you can do that. But if you want a manager that's consistently outperforming and this is why we said a lot of active equity managers, a lot of the studies that have been done about active equity mangers so I think that's part of the reason.

At PMCO we combine you know the macro, the bottoms-up stock picking, with these structural alpha strategies. A lot of equity managers are great at stock picking but there's time when it doesn't work. When one factor like what the Central Bank is doing is dominating everything else and stock picking doesn't work and you find yourself underperforming. What we do at PIMCO is sometimes we get our calls wrong, but our dependence on these smart betas or structural source of alpha means we tend to do well even we get some of our macro calls wrong or our picks wrong. So super important to diversify and make sure that your managers are identifying and trying to use these smart sources of returns.

So let me move from that kind of theoretical discussion into like I said a whirlwind tour of global asset classes. So what we have on top is our overall risk taking stance. Like I said valuations are where you don't want to be massively bullish, but you don't want to be you know valuations are not so rich that you want to be in cash. So overall risk stance is to be modestly – have a modest risk on posture.

Again in December and January at PIMCO we've dialed down our risk taking, but we still have, you know we still have a modest risk on posture. We think that you know given the factors out there we think that the opportunities to reengage in the markets in an aggressive fashion, but right now we're running pretty low risk. Then our views across the different asset classes, equities, rates, credit, real assets, currency.

Maybe I'll just go into the slides on each of these asset classes and make what I think what I was talking to you guys about our current thinking. Stuff that's new, that's a change from last year and that's going to make it way into this asset allocation, annual allocation piece that we put out in a couple of weeks.

The first one I've already talked about. That's the risk adjusted, relative risk adjusted returns between equities and corporate bonds. We think today on the margin the scale is tilted a little bit in the favor – you know you've got to pick the equities you want. I'm just talking about the S&P 500 versus US IG corporate bonds, probably the scale is tilted a little bit in the favor of the S&P. The reason for that is like I said both of those are slightly rich to – it's basically because of better convexity in the stock market. Both equities and investment-grade corporate bonds are slightly rich to valuations. We don't think they're going to do much. If you get the right deal which is the growth recovery in a tax reform, earnings growth, a fantastic, immaculate recovery in the US economy that a lot of people are romancing stocks are going to do fantastic, corporate bonds are going to do okay partly because userizing and partly because you know their bonds after all. So stocks will be up a lot and corporate bonds will be up a little bit.

On the bad side where we get overheating and we get inflation and possible recession stocks will do poorly and corporate bonds will also do poorly. So the bad side both do poorly. On the good side stocks do much better than corporate bonds. The convexity profile of stocks even though we don't expect great returns the convexity profile if you get either of the fat tiers is still a little bit in the field of stocks. So we've done a lot of analysis on that and that's something we want to write about.

So let's move into where we like, how we invest in the equity market. Given valuations are pretty full we don’t want to have a big overweight to the equity market. We want to have about a neutral position, that's to whatever your benchmark or your neutral position is. Talking about the global recovery today the stock market we like the best is European Equities. Manufacturing PMI is coming in strong, earnings growth is coming in strong. We think European Equities are kind of where the S&P was six to nine months ago. So if we had to put our money in the asset allocation portfolio that I manage I have a neutral equities stance, but a big overweight of European Equities over the S&P for example.

So we think – you know this is European Equities you know on a fundamental basis if you look at the equity risk premia, if you look at the CAPE or the Shiller PEs have traded cheap to the S&P for awhile and they have been kind of a value trap, like emerging markets were a value trap. Emerging markets trade super cheap. If you look at MSCI EM its CAPE is around 11, compared to the S&P's CAPE at 25. So emerging markets have been cheap, but you know they've been a value trap post the taper tantrum, there's reasons they were cheap. Commodity prices were correcting, the dollar was going up, earnings growth was horrible, inflation was high in countries like Brazil and Russia. So emerging markets while they were cheap they were value inflated or value trap for a number of years.

They turned around in 2016 like I said because we thought that the commodity correction was done. In early 2016 after what happened the Fed finally realized that it couldn't hike rates and couldn't continue to spend on the dollar. So when the Fed going dovish early 2016 and the commodity correction behind us in our view we got bullish in emerging markets and emerging markets burst out of the value trap.

I think today you've got to be cautious on the emerging markets again. While there's pockets of opportunity once again we've the dollar strengthening, you've got rates going up, and you've got a big secular trend that's likely to come in from the Trump administration, which is tariffs, deglobalization. Emerging markets have been a big beneficiary of globalization as you can manufacture things cheaper and so employment goes up and growth goes up in the emerging markets.

If they're forced to export less to the US and import more from the US, meanwhile the dollar is strengthening that's certainly a drag on emerging markets. So while there's pockets, you know there's pockets of value in the emerging markets and in fact the way we like to participate in emerging markets today is through some of the currencies. I think rather than being the illiquid equity markets we rather be on the high carry from the emerging markets through the currency, the ruble, the BRL, Mex peso, INR. So we're kind of cautious. We don't need to be short, but you know we've moved from an overweight position in the emerging market equities in 2016 to a flat position today in 2017, keeping exposure in the emerging market currencies.

The stock market we like best is certainly the European Market. We think that's been kind of a value trap for the last couple of years and it's going to bust out of it. You're getting the earnings, growth, you're getting the currency weakness.

So here's the difference between developed markets and emerging markets. In the developed markets like Japan, like Europe, like the US to some extent as the currency weakens it's positive for earnings it's positive for the stock market. You know especially countries like Europe and Japan that export a lot. So the currency weakens, the exports get cheaper, and the exports grow. So given the cheapening you've seen in the Euro, given the cheapening you've seen in the Yen it's no surprise that post-elections the Nikkei has been one of the top performing markets.

You get the opposite impact in the emerging markets. In the emerging markets when currencies weaken emerging markets, Central Banks need to protect the currency, they need to hike interest rates, inflation goes up, they need to hike interest rates and you get into this bad cycle. So in the emerging markets weaker currencies probably means weaker stock markets. In the developed markets legal currencies lead to stronger stock markets. So that's another reason we like European equities versus US equities the dollar has been strengthening which makes it harder for US exports. Obviously you can regulations and tariffs and what that does, but as of today the strengthening dollar and the weakening Euro is another factor, in addition to earnings, growth, cheap valuations why we like European equities. So we have a neutral view on equities with a positive view on European equities.

In rates I'm going to combine two of the sections I have because this is very important too. I've got a section on – I've got a slide on rates and I've got a slide on real assets. So it's important to have bonds in your portfolio obviously. Like I said there's always a 15 to 20 percent probability of a recession. What that chart on the left shows is the negative correlation between stocks and bonds. While not that strong we think it will continue to hold. Bond yields may go up. Today the Fannie Treasury is at 2-1/2 percent. We think by the end of the year it's likely to be around 3 percent, but the forwards are already pricing 2.8 percent. So Fannie Treasuries go up 30 basis points from here over the next 12 months you haven't lost any money. You made some capital losses, but you're getting your coupon, you're getting your 2-1/2 percent coupon from Fannie Treasuries and net-net you're flat, but you've got a lot of protection against geopolitics, trade war with China, war in the Middle East, overheating, a recession. So you still even if you think bond use is going to go up modestly you still need government bonds in your portfolio, that's your defensive diversifier in your portfolio.

What's changed today and this is something that's very different from the taper tantrum days of the last two or three years what's changed is today the government bonds you want in your portfolios are TIPS. So this is very important rather than regular government bonds. The market has been pricing deflation or low inflation for a number of years. Today the market is pricing inflation of the US over the next 10 years at 2 percent per year in the TIPS market. This is up, TIPS have done well post-elections as the market is pricing more growth, more inflation.

TIPS have certainly done well, but we think there's a lot more room to run. There's a small picture aspect to TIPS and there's a big picture aspect to TIPS. The small picture aspect is just as an alpha trade and we have it across many of our portfolios. Basically you know six months ago the TIPS market was pricing 1-1/2 percent inflation per year for the next 10 years. We thought that was cheap especially with oil price, our view that oil prices would go up. Today's pricing 2 percent per year for the next 10 years, so TIPS has done well.

We think by the end of 2017 the TIPS market will be pricing somewhere closer to 2-1/2 percent per year for the next 10 years. So there's still room for TIPS to outperform Treasuries. So that's the small view it's just an alpha trade. TIPS has outperformed Treasuries over the last 6 months and we think they'll continue to outperform Treasuries over the next 6 to 12 months.

The bigger picture view is your defensive bond in your portfolio when higher inflation is more likely than lower inflation over the next 1, 3, 5 years the defensive bonds in your portfolio should be TIPS. When lower inflation is more likely than high inflation, as was the case post-2013 commodity price correction, dollar strength, global economic weakness, the right position in your portfolio from 2013 to 2016 was not to have TIPS, but to have regular Treasuries. Today that's flipped around, it's a big picture view, it's not just about generating a little bit of alpha in the Total Return Fund or in the income fund where we have TIPS versus US Treasuries, it's a big thing for asset allocators. Your government bonds, the government bonds that you own in your portfolios today should be TIPS.

Especially and I talked about it earlier on there the one things, there's two things that the Trump administration that people are excited about, right, growth and inflation. We're not so sure about growth, yes fiscal stimulus and tax reform could give you a 6 to 12 month boost in growth, but unless you get productivity, unless you get a productivity miracle long-term growth isn't really going to grow. What's quite certain is everything that the Trump administration is talking about is going to lead higher inflation.

So we're not so sure it leads to higher growth, maybe it does, maybe it doesn’t. But we are sure that everything they're talking about at a time when the US economy is running at a 4.7 percent unemployment rate is going to lead to higher inflation. Fiscal stimulus, import tariffs, all of a sudden the iPhone you get from China or the Ford that you by that's made in Mexico is 20 percent more expensive than it was. Inflation is going up.

If immigration goes down you got to pay more to American workers to make them work. Your labor force shrinks. So everything we're hearing from the Trump administration whether you know like some of the policies will be implemented, some won't, but everything we're hearing leads us to expect higher inflation. Growth we're not so sure about, but inflation we're pretty sure about.

So in this world a very important shift in asset allocation portfolios compared to the last 3 or 4 years is that the government bonds you own in your portfolio should be TIPS.

Let's turn to credit. Our favorite sector of the credit markets is still securitized up in the capital structure and non-Agency mortgaged-backed securities. We like investment-grade corporate bonds. They're going to give you 3 to 4 percent returns. I was just talking about relative to stocks probably the risk-adjusted returns is better in the S&P 500.

Our favorite sector we're still taking credit risk in investment-grade corporate in high yield, but what we like and what we feel the most comfortable with is securitized bonds. You're securitized, there's a home behind it. You know our analysts expect US home prices to continue to rise, even with these higher mortgage rates we expect you know modest, 3 to 4 percent appreciation in home prices over the year and then you know the other thing you can be sure that Donald Trump is going to make sure your real estate prices don't go down. So that's one more reason to be optimistic on home prices. Again real assets, real estate, even with mortgage prices modestly higher we think real estate is definitely going to be, (a) we expected real estate prices to be going up anyway and secondly with this administration I think it's going to be a favored sector of the market. We like securitized mortgages, non-Agency mortgages.

As you know PIMCO owns these across, you know in small amounts across different funds, but in particular the income fund is you know with Dan's expertise in this area has quite a large allocation to non-Agencies and other high-quality income generating assets.

You know real assets I won't – you know we're bullish on real assets. If you think inflation is going to go up you've got to be bullish on real assets. I already talked about TIPS.

Maybe a couple of words on REITs, because we talked about how with long-term interest rates coming down bond-like sectors got a boost, utilities, REITs, et cetera over 2016 and these have underperformed since the elections. Banks and small caps have done really well and utilities and REITs haven't done well to the point where today, just yesterday I was starting to buy back REITs into my multi-asset portfolio. I think they've underperformed enough.

Again REITs have two aspects to them. One is the interest rates sensitivity, as interest rates go up REITs get hurt short-term. But the second one is their exposure to real asset prices. At the end of the day you're buying real estate and like we said we've kind of got a bullish view on real estate. So when you balance both of those out and you take the 4 to 5 percent dividend yields you're getting from REITs, again in the world of you know 2-1/2 percent Treasuries we think that REITs you know since the elections REITs have underperformed by about 10 to 12 percent. We think this underperformance is probably where it should be and I'm starting to slowly buy back REITs in the portfolio.

There's something in terms of portfolio construction for people to bear in mine. Just yes so remember that REITs are interest rate sensitive. So if you buy REITs, you like the 5 percent yield, you've got a positive view on real estate and you buy REITs in your portfolio just decrease your long-term government bonds in your portfolio and then you've got a well-balanced portfolio.

If you buy long-term government bonds and you buy REITs yes you're doubling up, but if you think REITs are going to give you – you know so that's what I do. Today I reduced some long-term government bonds, I have TIPS and I'm buying REITs. I think REITs have gotten – even though there's a lot of talk about these bond substitute equities and how they've done well and how they're going to underperform I think REITs have cheapened up enough that it's time to start buying them again.

And finally currencies. I already talked about it so I won't spend a lot of time on currencies. Our big currency positions you know so again with the US economy relatively well, with the Fed hiking and likely to hike at two or three more times in 2017 and I'm happy to answer any questions you folks might have about the Fed, we think the dollar – you know I think the strong dollar, the dollar remains strong. Obviously it can't keep strengthening without impacting the US stock market and without impacting the US economy. But generally you've got to have a strong dollar buy, but it's not going to strengthen much more than it did.

So rather than long dollar we're staying neutral to the dollar and we're making most of our currency positions in the emerging markets. Basically it's long, the commodity currencies, the high-yield and commodity currencies, worse is short the Asian currencies. If there's a trade war where we get in fact if it China, Asia, those are the countries that have benefited the most from globalization and exporting to the US. You know Mexico, Brazil, Russia, Mexico you know a lot of people talk about Mexico because it's close, but the countries that have really benefited from globalization are the Asian currencies and they don't yield that much.

So in currencies our current position is long Brazil. You know Brazil's yield is 12 percent, Russia yield's 12 to 15 percent, Mexico yields is 5 to 6 percent, India yield's is 5 to 6 percent. Mostly short China, Taiwan, Korea all of these currencies that yield 2 to 3 percent. So not a big view in currency. While we continue to expect the dollar to stay strong it probably can't strengthen significantly from here. So rather than trade in the dollar we've taking currency positions in some of the emerging markets.

Then I'll skip this, I'm happy to talk about it, but I'll end with this slide which shows our positioning across the different asset classes again. Thanks for your patience and I'm open for questions now.

Audience: So we've always been hearing that you know the Fed wants to get out of this quagmire by inflate out of the mess that we've got ourselves in with this enormous amount of debt. So do you think if inflation starts accelerating that the Fed is likely to be more measured in rate hikes or at what point do you think they'll want to put the brakes on inflation?

Mihir Worah: Right.

Audience: Easy question.

Mihir Worah: Hard question. *[Chuckles]* Because so pre-elections inflation was starting to pick up just indigenously with commodity prices, with cap closing, you know unemployment rate close to – the you know the US economy operating close to capacity and the Fed had told us repeatedly that they would like to run the economy hot, which is as inflation up 2, 2-1/2 percent they tolerate it just because we had such an undershooter over the last 3 or 4 years that they tolerate an overshoot. So I think they tolerate an overshoot to 2-1/2 percent or so. But I think the Fed is getting very worried about fiscal policy and we read that in the minutes just yesterday that part of the reason you know when the Fed hiked in December and you read their minutes you know one of the things that took the market by surprise is one of the dots for 2017 moved up. That's the first time a dot has moved up in a Fed economic projection the last 2 or 3 years. They're always constantly moving down.

So while the Fed will tolerate somewhat above target inflation, you know 2-1/2 percent or so, when inflation starts getting above 3 percent then that's when they'll certainly start putting the brakes and that's one of our risks. You know one of the risks that people have to watch out for is again I've said repeatedly a lot of the policies that we're hearing about yes they may or may not be implemented, are pro-growth, that's good, but these are pro-growth policies at a time in the US doesn't really need pro-growth policies, save them for when we're about to go into a recession.

So when you do all of these pro-growth policies at a time when the economy is doing pretty well and there's no slack in the economy it could lead to higher inflation and the Fed could worry about it.

So the reason why I say it's a hard question is this is one of the things that has changed, the Fed's reaction function we think has changed from pre-election to post-election too. So if inflation is just going up without any fiscal policy they tolerate it and they try again inflating away debt is certainly something the Fed and the fiscal policy makers should think about. But if they think inflation is going up because you're getting infrastructure spending and you're getting – so they look through tariffs.

If inflation goes up because of tariffs they'll ignore it. That's a one time, that's a one-time shock, that's actually a negative for the economy. But if inflation is going up because they're getting a lot of spending and a lot of job creation when there aren't that many people who want to work and so you've got to take wages up significant the Fed will probably try to slow the economy down.

Audience: Your final remarks were sort of bullish on REITs. Back in your early chart that showed 2009 to 2016 it looked like REITs were among the best performing class.

Mihir Worah: Right. So big discussion around REITs the fact that from 2009 to 2016 REITs have so significantly outperformed S&P, that there's some catch-up, just like we talked about there's some catch-up of global equities because they have underperformed the S&P. If you breakdown that 2009 to 2016 performance for REITs you find that a lot of it came in the early 2009-2010, that's because the 2008 crisis was centered around the real estate market. So REITs just got absolutely destroyed in 2008 and then they made that up.

So if you do 2011 to 2016, five years, you find that REITs haven't outperformed the S&P, they're about in line with the S&P. It's just that 2009-2010 they did really, really well because they were coming out from very depressed prices. So if you do a five-year history you'll find REITs have performed about in line with the S&P.

That said they are interest rate sensitive. If long-term rates go up and just you know rule of thumb REITs have about a 20-year interest rate duration. So you know they're like a high-yield or a corporate bond with 20 years of duration and a 5 to 6 percent coupon. So rule of thumb if interest rates go up REITs will underperform, but given the backup that we've seen so far we don't see interest rates – yes they will go up a little bit more, but we don't see them going up significantly. And we think the post-election 10 percent underperformance means it's okay to have some of these inflation sensitive assets in your portfolio.

At the end of the day REITs are sensitive to real interest rates like TIPS. So it's a question of why interest rates are going up. If interest rates are going up because inflation is going up then you find while the 10-year Treasury moves, 10-year TIPS don't move, because all that's going up is inflation expectations. And if the 10-year TIPS – so REITs are sensitive to 10-year TIPS, they're not that sensitive to 10-year regular Treasuries. So if rates are going up because inflation is going up REITs will do fine. If rates are going up because growth is going up then you find much more opportunities in growth stocks, et cetera, et cetera and REITs may not do that well.

So they're just a diversify. Again, part of what Canterbury preaches and what we preach in our is diversifying, you're not going to get every call right. So REITs are something that have underperformed that will do well if inflation goes up and pay you a 5 to 6 percent AFFO dividend yield. So I think it's okay to have a small position in REITs over here. Again like I said if you look at a 5-year history they haven't really outperformed the S&P.

Audience: When I look at the growth rates, 2, 2-1/2, 3 percent range that are predicted I start to look at and I was told this a couple of weeks ago that today in the United States for every skilled worker there's two skilled jobs available, so that tells me your 4.6 percent unemployment rate or whatever it is is untrained for the jobs that come out. So now we're going to see a big infrastructure spend, we're seeing new growth rates and we're seeing a closing of immigration of people. Who is going to drive this growth rate? Is it all productivity gains? Because if you don't have people coming into the marketplace how do you drive the sustainable growth over the long term?

Mihir Worah: That's right. So which is why we think that we are confident in a 6- to 12-month boost in growth, we're not that confident over a permanent or a 3 year, or a 5-year boots in growth, which is what a lot of the optimists are – and again there's something to be said, yes the US economy was over regulated and maybe over taxed and there's something to be said for that, but again certainly 6- to 12-month boost in growth, but yeah without productivity you're not going to get, you're not going to get which is training, education, yeah.

Again generally forcing manufacturing in the US which is not which is not the efficient place to manufacture, again I don't want to be political, but we'll see what happens right? But a lot of this forcing of manufacturing in the US, this fighting against the auto companies that's Michigan, Ohio, Wisconsin is what got Trump elected and so that's localized to that small boost localized to that area, it's not a national boost so we'll see.

Audience: What is PIMCO's corporate profit forecast for this year?

Mihir Worah: We think again this is work in progress, we're working on our annual piece. We think again starting from a depressed base because you know you got the low corporate profits and low CAPEX because of the oil correction last year and we're recovering from that, probably 10 percent.

Audience: You raised issues about Trump's policies leading to higher inflation versus growth, but what about lower taxes and less regulation as growth factors?

Mihir Worah: So lower taxes and lower regulations are definite growth factors in the short term. It's a question of how you know again if it's lower taxes, if it's low taxes across – you know so low corporate taxes definitely help, but if it's lower personal you know again that's further down the plans, but lower personal income taxes that primarily benefit you and me aren't definitely, you know aren't necessarily a positive for growth.

So again while we see the upside, the potential, well you see the potential for growth so let me put it this way. So lower corporate taxes and deregulation is definitely positive for growth, but at the same time we've equally got tariffs which are negative for growth, trade wars which are negative for growth, so you've got this balance. Maybe you come out on this side and the positive factors win, maybe the negative factors balance and maybe the negative factors win, which is geopolitics, trade wars, tariffs, et cetera. So on growth it's not clear. You've got deregulation and you've got lower taxes which is positive, but you've got these things that are negative as well and we don't know what will win. Maybe the good side wins.

On inflation everything we see points to higher inflation partly because the US economy is running at full employment today. So a lot of people talk about and here's the key difference, again I don't want to be negative, what I'm saying is the right side can win, but there's equal left side to growth that you've got to be aware of. While tariffs are negative for growth but they're positive for inflation. No immigration is negative for growth, but it's positive for inflation, you know we've got to pay, you know wages will go up. Infrastructure spending will boost growth short term, does nothing for productivity, it's positive for inflation. Tax cuts and deregulation is very positive for growth, but with that growth at an economy that's at full capacity you'll also get inflation.

So what I'm saying everything we see points to higher inflation, while growth is more balanced. Maybe you get stronger growth, maybe you don't. If the policies are enacted without accident you certainly get stronger growth, but there's a big chance of accidents which could lead to lower growth. But some of those accidents will also lead to higher – if there's a war in the Middle East and oil prices go up there's higher inflation, low growth. So there's a lot more factors pointing to higher inflation than to higher growth, that's all.

Audience: So to your earlier point about the difference in valuation between US and emerging markets, what will it take for that valuation to close and maybe not for EM markets as a whole but maybe for a specific EM country?

Mihir Worah: So the first thing is it will never close completely, because there's a risk premium so like we talked about. Again long-term investors can earn that risk premia. Emerging markets you know the laws aren't that clean, the liquidity isn't that good so you've got to have – even if my earning expectations were the same I'd want to buy emerging markets at a cheaper price because I'm not sure I can my money out, my money could be trapped. Laws, you know the government could just take over. There could be nationalization, there could be taxes, tax changes. So there has to be a risk premium to invest in the emerging markets. So you know so you want to earn those high returns you're taking more risk, nothing's free. So expected – so valuations will always be cheaper.

And if you look at the historical gap it's an extreme. So emerging markets will always be cheaper as the developed markets, but today they are – there weren't an extreme coming into 2016, they've corrected somewhat not right to the US, because as we heard S&P is up 12 percent and the emerging markets is up 11 percent. So that gap stays the same relative to the US, but relative say Europe, et cetera, emerging markets have closed the gap. So on the margin they're less attractive to me especially until I get clarity on what the administration policies are likely to be in terms of emerging markets depend heavily on exporting to the US.

Korea, Taiwan, China they need to export to the US. If they can't export to the US all of their exports to the US are suddenly 30 percent more expensive they're not going to do that well so I want to clarity on that before I – you know yes the valuations are cheap, but you know I think you've got to be a little bit patient to get some clarity.

Thank you.

Poorvi Parekh: Good morning. My name is Poorvi Parekh and I'm honored to introduce our next speaker, Harry Segalas, CIO and Portfolio Manager at HS Management, a firm that he founded in 2007 and now manages about $3.5 billion in assets. The firm will complete 10 years in business this coming year, but Harry will mark his 35th year in the industry.

After graduating from Tufts University in 1982 he returned to New York to spend eight years on the sell side as a research analyst, before joining W.P. Stewart, a concentrated quality-growth manager. He spent the next 17 years there making his way up to the role of Chief Investment Officer, overseeing $8 billion in assets at the firm and being directly responsible for managing $4 billion of that amount.

Canterbury has worked with Harry Segalas for over 20 years and he epitomizes the astuteness and vigilance of a classic stock picker. Even with instantaneous dissemination of public information on his universe of large US companies he develops an edge through ciphering through company details, recognizing new industry dynamics, and keeping a disciplined focus on valuation. In a segment of the market that has challenges many active managers his firm's track record has shown that over longer periods good stock picking can trump the efficient market hypothesis.

For Harry this emphasis on discipline goes beyond work. He has a habit of walking to work every day and maybe some of his best thinking occurs during this time and that's a couple of miles walking to work.

In 2007 when Harry left W.P. Stewart to setup HS Management hedge funds were all the rage in New York, but Harry remained true to his core competence of managing long-only equity portfolio of high-quality, large US companies that were growing ahead of their peers and had strong fundamentals. After all he had grown up hearing and thinking about these companies. His father, Sig Segalas founded Jennison Associates, another prominent growth equity firm back in 1969 when Harry was just nine years old.

Over the years each man has successfully built his own track record. I would love to be a fly on the wall at the Segalas' family Thanksgiving dinner table where I'm sure there is at least some friendly banter about the performance of the respective top holdings. And now the family passion spans three generation as Brendan Segalas, Harry's son, has also decided to follow his father and grandfather's footsteps down Midtown Manhattan. I hear that's he played a significant role in putting together today's presentation.

Just as walking does not go out of style regardless of the New York weather and I think Harry has brought some of that for us today here, the firm has shown that persisting perhaps over generations, integrity, and a focus on quality can provide a way to build long-term investment value regardless of different market environments. And as a portfolio manager Harry is also a true advocate for the companies that he invests in. You will likely served Starbucks coffee if you visit his office these days and his report will likely be offered for review on an iPad.

But since you can’t bring Disneyland and Marvel Studio to New York Harry we are happy to welcome you to the land of your top holding, so with that please join me in welcoming Harry Segalas.

Harry Segalas: Thank you Poorvi, very nice introduction, thank you.

Well thank you all, thank you Poorvi for a very nice introduction. I appreciate it and my thanks to Canterbury. I've had a long relationship with Canterbury. It's amazing when I think about myself 35 years in the business and I've known a number of the folks here, Bob since the early '90s and Adele and Matt Lui for a number of years it's really been a very good relationship. I'm also very honored to be here alongside a number of these other very prominent firms. It really is an honor for our firm.

Poorvi gave you a little bit of background on myself. I thought I would actually start with a little bit of history leading up to the creation of our firm before I get into talking about the process briefly and then get into a number of stocks and our thinking about some of the variables that we think are likely to drive the portfolio in the years ahead.

But it mentioned that I had started in the business in '82 and if you think about it – I actually thought the business was very simple because the S&P multiple at that time was 10 times. I actually thought that's how it worked, it was nice 10 times. It was a little dull for a few months, because I started in June and I didn't understand why everyone so upset, but by August things picked up in '82 and we went on quite a bull market.

Obviously '87 was difficult, October of '87 and it was interesting if you think back that was a time where multiples were going up very rapidly at a time that bond yields were going up and that created some of the dislocation. 1990 I had the chance to join W.P. Stewart, contrary to quality growth firm, went through different times there, I think about the first Iraq War leading into a recession, but nonetheless some pretty strong markets.

I can remember actually January of '92 our quality growth portfolio was selling for 25-times earnings, so the multiples were a bit better. Went through a very difficult 30-month period where the earnings grew, but the portfolio didn't and we saw the multiple drop to 16-1/2 time in December of '94. Then of course that embarked on quite a 5-year stretch we had double-digit gains in both earnings and in multiples driving the market and that during the Asia crisis back in last of '98. Of course that all lead to 2000 when multiples really got out of sight and I can remember Warren Buffet quoting I think it was a Fortune article at the time that they asked people what they're expectation of annualized returns in the market was and people said, "17 percent."

I can remember we would have our seminar in New York and we would be criticized for talking about things like price earnings, ratios, so needless to say a very difficult couple of year period there, 2000 through 2002.

I always remember the toughest period was a 3-1/2-month period in the second quarter of '02 when we lost 800 multiple points or 800 BPS in multiple over 3-1/2 months, very difficult. You may be growing your earning stream, but you can't overcome that. And of course overall the 0-0's were a difficult time after a good time in the '90s for gross stock investing, were a difficult time for grow stock investing, but really that was – opened up the opportunity for us. That opened up the opportunity for the creation of our firm in 2007.

I think people thought that or forgot that one could do well in gross stock investing and in our case high-quality gross stock investing. That left room for us to develop what we viewed as an experience and as I we like to call ourselves, "still relatively young investment team." That really led to our reason to being the creation of our firm in 2007.

So with that I'll turn to – make sure I've got the slides going here right. What I'd like to talk about today briefly on the firm, a quick overview in the investment methodology, many of you may know it and spend a lot more time on the portfolio and trying to think about both the last 10 years and what are the variables going forward.

So as you can see we are a concentrated quality growth manager. We own 20 to 25 stocks, hard cap of 25 companies of what we think are first-class businesses in our clients' portfolio. We think for us there's a real advantage to having that singular focus not just for the investment team, but the entire firm to be focused on this one methodology. Needless to say it's hard enough as is, but we think that there's a benefit to that focus.

An experienced team, this was very important after being in the business for so long you know it was important for us even out of the gates to come out fully formed with strength not just on investments, not just on operations, but as a client service as well. There's been quite a need for this continuous investment in growth, continuous investment in the business. If you think about when we started in 2007 it was before Madoff, the compliance and the regulatory environment has changed dramatically. So there's a constant need for us to invest and we continue to do it. We started a relationship with ACA, an outside firm which will use compliance as well. We just updated our website and there's a constant need to do that.

In our assets under management as Porpy mentioned are about $3.5 billion dollars. Porpy mentioned my father and my oldest son, but a funny story. I can remember back in 2009 we were quite proud when we got to $500 million in assets under management. I was with my then my second son who was then 10 years old, his name is Zane and Zane decided to tell me – I remember we were actually at a hockey game and he decided to tell me that he'd already figured out his future. He figured out that after he went to school and went to college he'd get a bunch of friends together and go into the investment business. Because he said you he figured you know this is what the family knows something about. I said, "That's a very good idea. That's good thinking." He said, "After all papa," which he likes to call his father, he calls his grandfather, "is a great investor and you're a good investor." I said, "What do you mean? Our records is every bit as good." He looked at me at the time and he said, "$100 billion, $500 million get real."

So in any case we're actually quite proud to be where we are and the progress that we've made.

For us it all starts with the business. We're looking for what we think are first-class businesses, strong financials, value-added franchises. We tend to stay away from things that are very commodity oriented, very capital intensive. We're looking for companies that have value-added brands, franchises, various entries, the ability to sell product or services not just here but around the world, run by people who we think are reasonable who take a long-term view. It starts with assembling as I mentioned 20 to 25 of these in our clients' portfolios.

We then look to effectively make our clients the owner of an earnings stream and underlying cash flow stream. Those cash flow streams is every bit as powerful and important as they an extreme that grow each and every year and faster than average in most periods of time. By doing so we're putting effectively upward pressure on the portfolio.

And while we care deeply about the quality of the business and while we care deeply about the growth and earnings and cash flow because I think ultimately that is what drives appreciation in a portfolio, we are not at all momentum investors. We agree with Warren Buffet's comment that growth and valuation are joined at the hip, so we have a strict valuation discipline trying in an effort to help attach our clients to this stream of earnings and cash flow at what we think is a reasonable, what we think is an attractive price.

We like to characterize what we call "multidimensional approach to growth." I'll get into this a little more later, but what I mean by that is that the portfolio has an array of companies with an array of different growth rates. There's the dominant, durable, defensive companies with duration, there's the more rapid growth companies. We move across that spectrum based on fundamentals of valuations. By definition many of these companies are 800-pound gorillas with larger caps, but we're also willing to go down the cap scale below $10 billion, not below $2 billion, but below $10 billion if we find companies a little earlier in the lifecycle.

We're also big believers in active management. Our view is our client's capital is scarce capital. We come to work trying to determine every day what's the best use for that capital. Turnover has been running about 65-75 percent and I put it in the range of 60-90 percent, that's a combination of both new names coming in forcing our decisions as we run up against our hard cap of 25, but also utilizing our valuation system and taking advantage of changes in valuation.

Now it's interesting if you think back when I started in the business back in '82 how has changed on the research side on the investment side. There's just been this enormous commoditization of information. Technology has really led the way there. Also, regulations FD has changed those a lot. I can remember when I was a sell side analyst growing up part of my job was to call up a company, find out how business was and they would tell me, "Oh comps are running pretty good," and I would go tell the whole world about that.

So the world has changed a lot in that regard and we've tried to structure ourselves to focus on what I would consider the value-added activities. For us that really starts with conceptualization. There's so much information out there, but you are going to conceptualize information with your values and your perspective differently, everyone will conceptualize it different. So we spend a lot of time on idea generation and on the conceptualization of those ideas.

From there we then look to immerse ourselves in the research. We have a focus list of 50 names, an analyst is assigned to it, but it's not a siloed approach, everyone pays attention. It's really a matter of immersing ourselves whether it's conference calls, visits, 10-Ks, modeling just trying to get to know the company the best that you can and really trying to think of the proof of concept in terms of the variables that either support or refute what you may think is the investment story.

And finally having evaluation discipline and then making the portfolio decision. We look at a number of things. We look at the forward PE on both an absolute relative basis. We like to look at the free cash flow yield, also an absolute relative basis. We also go through an appraised present value calculation for all of our companies. I think that does a very good job or better job really of looking further out ahead in terms of a company's length of the ride and outlook. We're always mindful of what the market capitalization, what our work has wrought and what the market capitalization is for each company. We are effectively using this evaluation decision to drive portfolio decisions.

Poorvi mentioned Marvel which is probably one of the better examples. It's a while back, it was when we first started Marvel Entertainment, but it's a good example of how you can conceptualize something differently. I remember at the time there was an analyst report that came out and this was pre-Iron Man and basically the comment was that they were already licensed out to good franchises, Fantastic Four, Spider Man and the like and that now they were going to have to get into the manufacturing of movies, because other people didn't want to do it. They were going to go away from a beautiful license model to a more risky manufacturing model.

Now we thought about it a little differently, but clearly franchise or licensing model is a very beautiful model, but in that industry it only represented about

10 percent of the profit pool. Manufacturing was about 70 percent. If you made the movies about 70 percent of the profit pool. They stayed out of the other 30 percent which was distribution. But effectively being able to manufacture really could increase the future earnings power.

Again one of the benefits of being in the business a long time and not just myself, but my colleagues like David Altman, Greg Nejmeh is we have a lot of contacts and we've met a lot of people over the years of known companies. So we actually reached out to a number of the movie companies and asked them, "Is this true that you didn't want to make these movies?" They said, "No, they wanted to make them themselves." So we then proceeded to do work and analysis, but we actually at that time analyzed the superhero genre. So at the time that 19 of the 20 movies at the time that come out had hit over $100 million in the box office, only one *Elektra* had fallen short.

We actually went through this detailed analysis. Now all I really needed to know was that Nicolas Cage rode around on a motorcycle and his head caught on fire and that did $100 million, that's really all I needed to know, but it gave me some idea that *Iron Man* had a shot.

So effectively you know we conceptualize it differently. As opposed to the comic book business being a dead business it was a lucrative R&D business, as opposed to moving away from the licensing side we were looking at profit pools. But again it's a good example of how we try to think of things a little bit differently.

Now here's a look at the current portfolio. Probably the first thing you can see these are all very recognizable names. Interestingly enough two of the names we've actually owned since inception. Google, which is now called "Alphabet," is one of them. Diageo, which is a leading spirits company is another one. I mentioned before about our multidimensional approach and that also will encompass if we find a franchise that has the same characteristic we like as a domestic franchises, the ability to play in both developing and emerging profit pools and they just so happen not to be down a sell here we're willing to own some of those companies as well. There's also two companies we've owned for eight years or more, Time-Warner and Nestle and Disney we've owned for over six years.

So it's a mix of companies that we've had for a long time. The position sizes have changed based on evaluation, but also new names that are cycling as we push hard on new names. The most recent new name we just purchased in just the middle of December was Estee Lauder. At the end of the day Estee Lauder we think is the prestige beauty leader. We think it's a very attractive business model. The stock was under pressure last year for a host of reasons. A particular weakness overseas because the international markets was a factor, the strength of the dollar has also put pressure on them, but fundamentally we think that there's a secular outlook that's positive here.

They have a number of attractive brands and there's an ability the distribution of their leading brands far outpaces the distribution of their newer, smaller brands. There's an ability to increase distribution over time.

They've been battling the longtime department store demise and I don't know for those who saw it today there was some difficult numbers out of Macy's and Kohl's. They've been battling this for a long time, but they're benefiting from growth in the Travel Channel, the online channel, they're own store channel and you're also seeing the growth of some particular specialty franchises, but there's Ulta, which as I walked around last night happen to see in the mall right here. Sephora which is actually owned by LVMH. So that's the most recent purchase.

Now I highlighted before and it's worth spending a moment on this the multidimensional approach to growth. So on one end of the spectrum there's the dominant, durable, defensive companies, duration and at the other end of the spectrum there's the more rapid top-line growth companies. We're willing to move across that spectrum based on fundamentals and valuation. In some companies earnings are a little more consistent and some may be a little more variable.

But it's interesting, the ability to move across that spectrum we think is not just a matter of increasing opportunity, we think it also lowers risk. A good example if you bump back to '07 the more rapid growth companies did well, the valuations moved up. We were able to redeploy capital in this more defensive names where the valuation has lagged. It became very apparent to us from a bottom-up perspective the world was slowing, we leaned more defensively to keep that earning stream growing.

If there's a recession we're certainly not going to be immune from it, but it's very important for us to keep that earning stream growing as opposed to having that larger 30 percent drop in corporate profits which can do a lot of damage on the portfolio. So the ability to move across the spectrum is something we think a lot about.

A good example I think of a stable company would be McDonald's. Now very interesting what's gone on with McDonald's. To us McDonald's is not just about all-day breakfast. That was obviously very important, that helped them a lot, it's creating difficult comparisons in the fourth quarter and the first quarter, but I think that's put some pressure or kept the shares under somewhat of a cloud. But the real story is a real transformation and we're big believers that management matters and leadership matters. We saw what Steve Easterbrook who runs the company did in the UK. It's amazing in the UK, he took over McDonald's a few years back, but in the UK there are over 40 consecutive quarters of comp service sales growth.

Very different business and again this is where technology's becoming handy. I remember watching old YouTube videos of him on certain debate shows in the UK where they were going after McDonald's about food and advertising to children and you could see the changes that they had already made over there, fresh fruit Fridays, antibiotic-free chicken and the like. Effectively he's coming in and trying to change things here. They have already made a number of strides to do that and to try to modernize the experience.

They've also changed the business model. It was always a big franchise business model, but they're moving to more of a franchise business model. They realize where the dollars were coming from. The dollars were really primarily coming from seven countries, United States and six European countries and they started to franchise more countries outside in Asia and the like, which is leading both to greater growth opportunity, but more stability at a lower cost structure of some of those.

So McDonald's is a good example of a company that we think – well the focus today is clearly on the difficult comps. We think there's a more fundamental change going on that should help them. We don't mind the 3.4 percent dividend yield in the meantime.

Marriott, I thought this was apropos, but it's one we've known for a long time. I can remember visiting Marriott in the mid-'90 and if you really know the history of Marriott, it's a fascinating history in terms of how they grew as a company. They actually got themselves in some trouble in the '70s. They got very aggressive, they really are a manager and a franchiser but they got into building hotels and then selling them and the market went out from underneath them. They had a lot of debt. It was a real cultural you know crisis for their company because the senior Mr. Marriott, the founder didn't believe in any debt. They really had to work their way back in terms of creditability and really reestablishing that model as a manager and franchiser.

Tell you an interesting story. I remember visiting Marriott about 1995 and they served me Pepsi. What they had told me at that time was that when they were in that financial crisis Pepsi helped lend them some money. A number of vendors helped lend them some money. So it's interesting if you try to get a Coca-Cola in a Marriott you won't find it, they've continued to stay loyal to Pepsi for all those years.

But it's one we've owned over the past and our valuation system had pushed us out of it a few years back and we think the expectations were getting a little high a few years back. But it's in our focus list, we paid attention to it. Then from the sidelines we saw that they announced the proposed acquisition of Starwood earlier this year. Then what happened was a Chinese company came in and bid up the price and Marriott stock went down in response to that.

Now there's always other things going on too. You may recall the market was weak at the start of the year too, but the stock was under a great deal of pressure. They came up with another bid and while it wasn't as good as the first bid it was still we think a bid that is a good deal for the company and that created an opportunity for us to buy into the shares under that weakness under that pressure. We think this transaction's going to be quite powerful. You're putting together two very powerful franchises not just from a brand standpoint, but from a cash flow standpoint.

There's a lot of synergies with their rewards program, the Marriott program and the Starwood program. Marriott tends to be considered a better operator so that can be good for development for Starwood as the brands people feel better about. There's more power with the so-called OTAs, Online Travel Agencies, they'll have more leverage there. And fundamentally it was done at a time where debt was very reasonable and there's ability with the cash flows to payoff that debt and they've even already gotten back into the marketplace repurchasing shares. They're a manager and franchiser. Starwood had a couple of physical properties, the St. Regis New York, San Francisco and they've sold those which helped pay down the debt. So fundamentally we think this is becoming a more powerful entity over the long run. A good example of the variable grower that we would look at.

Finally more rapid growth companies as well. I think first Lululemon I went to was the one here many, many years ago. You know one thing we see you can often see patterns or live-through patterns and what often happens sometimes is very rapid growth companies on the frontend don't always keep the backend growing as the supply chain you'd like growing as well as it need be and that's something that hurt this company a couple year back. We were early in investing in it. I think the day that we after they've gone through the pants crisis a couple of years ago, the day we invested in it the then chairman made some comments on Bloomberg that further worsened the situation, but fundamentally we've like the people.

Again speaking about being in the business a long time one thing we felt good about was the person who then became one of the cochairman had been the former CFO of Starbucks who we knew from a long time back and knew how to help a young company grow and build the supply chain and the like. So it's a company that we still think has room to grow on the top line and not an easy thing as you know these days and that's both in store development here, store development internationally in particular in Asia, very strong online business, over 20 percent, very strong men's business, over 20 percent. So it's a company right now that we think is turning the corner as it relates to margins as they went through some different margin times and now have the infrastructure in place.

Now I was a political science history major, not a trained economist and we are bottom-up fundamental investors, but we have to be aware of the macro matters and how they may affect things and I just listed a couple. The first one and I heard the prior speaker you know obviously we're now staring at stimulative fiscal policies. The fact that all executive branch and the legislative branch is lined up and the intensions have been announced, we don't know the details, but it's tax reform, it's lower regulation. We are now staring at a much more stimulative fiscal policy which has the potential to goose growth and to raise inflation.

There may be unintended consequences, trade wars and the like that can hurt, but that is something that we're having to evaluate. Obviously that's had a major impact goes hand-in-hand with what we may see out of monetary policy. Again I'm not an economist by training, but looking back over history the thing that I think everyone is always very worried about was deflation. In the Depression here it was really deflation. It's hard to get out of deflation; Japan deflation.

So it's interesting when you think about the Fed raising rates recently that was only the second rate hike. It tells you how tenuous, how tentative things have been. As deep as we are in the economic cycle, as deep as we are in the stock market cycle it's only the second rake hike. It does seem with the talk of stimulative fiscal policy that that now is changed. I heard the comments before about the TIPS and what it's pricing to inflation I think that has – what has occurred is that this fear has changed and we have to evaluate what the impact will be.

Now one impact has been the strength of the dollar. The dollar was stronger over the past five years, it was very strong over the past three years. We actually thought we heading to the point where the dollar comparisons and this matters to us because we like on a secular basis we like companies as I said with the ability to play not just here but in an emerging markets, international markets. About 60 percent of the revenues of our portfolio come from domestic markets so we're certainly affected by the strength of the dollar. We were expecting that to moderate some and now that actually doesn’t look to be the case with what we've seen with the strength of the dollar. And there's always unique circumstances of the pound and the like but that's something to evaluate.

I think the other thing sometimes we lose sight of that we're actually approaching the eight-year mark of the bull market. So I thought I heard it was the second long – read it was the second longest bull market. Clearly the economic recovery and the point made earlier we're not at the bottom. Unemployment levels closer to 4-1/2 percent. So we are further along here. One thing that people often don't realize is that there's only been one down quarter – you know we're benchmark agnostic in our approach, but I'll reference the indices at only one down quarter for both the Russell 1000 Growth and the S&P 500 in the last 16 quarters and that really is pretty unusual.

So for us as bottom-up investors what we always ask ourselves, "What does this mean for earnings?" "What does this mean for P/E ratios?" "What may this mean for portfolio prospects?"

So with that this looks at our earnings stream. I heard the question asked earlier about corporate profits and corporate profits as a whole we're under some pressure because of oil and energy, but we're recovering some this year. But for us you know we think that the ability to grow your earnings per share at a 10 percent or better rate on a secular basis, on the basis we're talking not just this year is a very good rate.

I will say that prior to what has occurred with the election our mindset has been very much you better get it from top-line growth. You better get it from real demand. It's very difficult to have demand out there. It has been very difficult to get price. As I mentioned we're deeper into the recovery so margins are at pretty good levels. So for us really that growth is coming from true top-line growth and also the benefit of free cash flow.

As I mentioned the free cash flow is important to us. We look at the free cash flow conversion rate for our companies, which is the what's left of the net earnings after capital spending and working capital requirements, what's left. It really runs about a hundred, it's about a dollar in earnings and almost a dollar of free cash flow. That can go obviously to pay dividends with the yield of the portfolio of about 1.7 percent. But it also can go for things like share repurchases can be accretive or occasionally those closed-in deals like Marriott did.

But I think over time absent this year where you'll get a recovery I think we're still at the point where 10 percent or better growth will be a very good rate of growth. We have not factored in in our forecast at this point yet more pricing. We've not factored in yet any particular benefits of tax reduction. The tax reduction will be felt obviously for domestic companies quite a bit, but we are disproportionate benefit if you're domestic. But the international companies have a lot of cash overseas and I think that will be coming back and beneficial in a positive way.

So those are things that could be pressure to the upside in terms of earnings, but at this point we still think 10 percent would be a good rate of growth in general and it's something that we strive for.

Now here's the current valuation and I highlighted a couple of numbers in the past. We started the business and you can see back there I think that was back in early '08 we were actually a little more than 20-times earnings. Then you can see we started the business in '07, went to the marketplace in '08 and then you can what happened with multiples in '08. I mentioned my second oldest son, Zane and he remember looked and I talked to him about how things had started and he pointed out to me, he said, "You know you started the business at the exact wrong time." *[Chuckles]* Zane's at boarding school now. *[Laughter]*

In any event you could see what happened. It was very interesting the low of the multiple was not at the low of the fair market in early '09, the low of the multiple you may recall was the third quarter on '11, double-digit declines for all indices. We got down to under 12-times earnings. So we certainly have benefited in the last couple of years from that combination of growth and earnings and from that combination of multiples rising.

Things have leveled off a bit and you have to watch out a little bit for mix shift. We bought Amazon which goosed the number. We sold Amazon which lowered the P/E ratio, but fundamentally we've benefited from multiple over time, but it's not at the peak levels we saw back in early '15. Actually that little wiggle up there at the end accounts for what we saw post the election where valuations went up again.

Now this is a chart we've looked at over the year. The earnings yield, bond yields. So the earnings yield is the inverse of the price earnings ratio and we compare it with the bond yield. This is the 10-year bond yield. I can remember at my time W.P. Stewart we used to have a chart with 25-years worth of data. What it showed was that earnings yield on our portfolio generally sold most of the time between 60 and 90 percent of the bond yield. But then obviously we bought a curve with the financial crisis and just a total breakdown of bond yields and the fears of deflation the bond yield just collapsed.

We are at you know a point here where you know I guess when I started in the business yields were over 20 percent or whatnot when I was there, quite high back in '82, inflation was quite high. So we've gone through this very long period of you know certainly lower yields in a bondable market. And you've seen somewhat of a tick-up and it was highlighted earlier and the earnings yield dropped a little bit as the fear ratio went up. But we're still at a point where that relationship is very reasonable.

It's actually we think compelling from the standpoint of we try to think about things as business people. I could take my $100.00 and I could buy a bunch of businesses and we think the earnings will grow 10 percent over time, each and every year over time. Or I could put it out at $2.50 and what would I do as a business person and thinking of reinvestment risks and the like? So we still think it's in favor here. It's very possible that we'll in a period of rising rates maybe it's hard for multiples to go up, but we think there's ample room.

This is very different. I was thinking back when someone mentioned to me last night about 2000 and I referenced it before. In 2000 leading up to that period of time the 10-year bond yield was 6.7 percent. The multiple in the portfolio which is almost hard to believe was close to 30 times. So we were at a point where that earnings yield bond relationship was about 50 percent; so 50 percent, not multiples of the bond yield, you know at 50 percent of the bond yield. That's actually about where it was back in '87 too, it broke a little below 50 percent, very rapid rise in multiples at a time there was a rise in bond yields created what occurred in '87 and lead to the earnings yield, bond yield under 50 percent and we had that quick correction which readjusted things, but we're still at multiples of the bond yield. It's true for our portfolio, but as a general comment it's something to consider.

Now this is one that I think is interesting. This shows the I think this was the first 5-3/4's years of our existence. We use the Russell 1000 Growth, but this chart would look very similar with the S&P 500. What you could see is the quarterly performance of the Russell 1000. I think you had 13 up quarters and 9 down quarters in that time. You also had a good degree of volatility in that time. I think there's 11 quarters here where the market was up or down more than 10 percent.

So starting with '13, so effectively the last 4 years you notice a couple of things. Well there was only 1 down quarter and again this is also true for the S&P. It actually wasn't the first quarter of last year. You may recall last year the tremendous drop in the market we saw January-February, the market actually ended up in that quarter. It was the third quarter of '15 the market dropped. But again only one time when the volatility was greater than 10 percent compared to about 11 times I think if I added up quarterly or remember it correctly in that prior period of time.

So I think we've had as we've gotten deeper in the bull market. There's certainly has been a move to passive, a move to EFTs and it's really been sort of a continuation of the trend and there's been less volatility. That's something that you know as we think about the future it's not something that we would count on we think by definition.

I can remember that one of my mentors in the business back in my old days used to say to me that the market swing from greed to fear and back again. I would say there's probably not been – really there may have been fear in other parts, but in the market that's not a lot of fear over the last several years. I think over time it's important you know it's very hard to know what is going to occur. I think you have to do years of good businesses growing earning stream, valuation, but the reality is I think we're going to go through times that are not only up. And I think actually having a strategy or an ability to move within your strategy a little more defensively, whether that's from a valuation standpoint or whether that's from earnings standpoint if in fact things grew to be not as good on the economy it is very important.

You know we talk about the so-called upside-downside capture ration and I think that ability to preserve capital which has not been as important to markets in the last four years I think over time just by definition I think is likely to be important again.

So just to conclude before we get onto any questions you know our belief continues to be that a focused, fundamental approach creates opportunities. Creates opportunity often because there's dislocation, whether it's the dislocation that Marriott saw earlier this year when they needed the acquisition or even the small dislocation as people worry about the comps from McDonald's we think that creates opportunities for investors who take that approach. And whether it's our methodology or other methodologies we're able to do that.

I think overall earnings gains are likely. There are going to be cross-currents and again I keep getting back to the fact that you know we are deep into the cycle. Employment levels are already low, margins are already high, the dollar is strong, there's always unintended consequences to things. But nonetheless we think overall you'll see growth and corporate profits, maybe a little higher rate this year than on a long-term basis. We think with a bottom-up strategy and a more concentrated focused strategy that one can grow those earnings 10 percent or better.

Clearly as I illustrated the bull market has certainly driven evaluations higher, but we think there's still reasonable. We have not been counting on multiples to drive the portfolio. We've been counting our earnings to drive the portfolio. While we think the evaluations are reasonable I think that continues to be the right way to think about it. I think it's really going to be on the earnings side that we're going to have to look to.

So you know fundamentally we believe that active management adds value and we also think that having an approach that be resilient in tougher times is very important. When I think back to some of the times I talked about in my first 25 years and some of the times I talked in the past 10 years it may not have been so prominent in the last 4 years, but we are sure that by definition we'll go through challenges. We have to think not just about the reward but the risk and that's something that I would encourage everyone to also contemplate.

So with that I'll stop and be happy to take any questions that you may have.

Audience: Of your portfolio talk about cash overseas and what would you expect if cash comes back? Are they just going to buy back stock or are they going to actually do something with it and what are the implications there?

Harry Segalas: When you think about the cash overseas it really is you know we have many multinationals and actually some of the companies that have the most cash overseas are actually the technology companies, the Apples, the Googles, the Facebooks of the world. These companies are not starving themselves for investment in their base businesses, they continue to invest very aggressively. So I think at this point it would be more likely and depending on the situation to see more in the form of share repurchase. Obviously if they're an Apple it can be quite accretive at these multiples.

You may also see companies look for acquisitions as well as they branch into other fields or as they brand into what I would call "more closer fields," but there's clearly a lot of dynamics going on in the technology area, in the media area, play if you think about AT&T, with Time-Warner, if you think about the growth of Netflix, the growth of Comcast. So there will be I think that will go to a fertile ground and perhaps some of the cash coming back we'll have to think about that.

But these companies really by definition the ones we look at they're not capital-intensive businesses to begin with and they're not starving themselves for investment. So I would think it's really more the opportunity to utilize their cash just in a more efficient way than the way it's currently being utilized.

Audience: Question: Since the large majority of companies today are reporting a non-gap earnings, are you calculations in PEs based on gap or non-gap?

Harry Segalas: That's a very good question. What we've just done recently most of our companies we've looked at on a gap basis. There were a few companies that we were looking at on a non-gap basis, but we were also still looking at the free cash flow yield, which was accounting for that. But we've just made the move to have everyone on a gap basis particularly what we're really looking at here is stock compensation and trying to figure out how to factor that in.

As an aside when I just looked at it it took the multiple up about 80 basis points. So instead of 19.2 as we've just made this adjustment on the few remaining ones we hadn't, which I think was Facebook, Google, and the like Apples' been on a gap, Microsoft's been on a gap basis it moved the multiple up there about 20 times. It doesn't change the free cash flow yield, that's already been captured. It doesn't really change our view of the appreciation potential, we do that appraised present value calculation. In some cases there's some leverage on the growth rate or our view of the terminal multiple may be a little different. But for us most of the companies were on a gap basis and we've always been looking at them on a cash flow basis as well, but there is some slightly higher multiples as we made that move.

And I think companies are moving to that. You saw Priceline already moved to that and there was a number of numbers that where the valuations would be really quite high which we do not invest in if you were to look at it on a pure gap basis.

Audience: You seem to have focused around 25 companies. There are others with a similar philosophy to you that have picked 5 or 10 or 15 as a target. So first question is: Is there something magic from your perspective on the 25 and how do you compare with the other numbers? The second is: Would you care to reveal your performance over those years say compared to the S&P 500?

Harry Segalas: Sure on the first question there is no magic to the 25. To me I think there's a magic or a benefit from a process standpoint to have focus. And I think with having a hard cap whether it be 20 or 25 I like this idea that it forces you to also make hard decisions. We want to have enough diversity and diversification of the earnings stream in the portfolio to make sure that – you know things don't always go right and to make sure that when it doesn't go right for one company that other companies are picking up the slack. So we think there's a need to have a certain number of companies that create some diversity in the earnings stream in an effort to help you grow faster than the averages over time and also to grow positively through recessionary periods.

You know when we were at W.P. Stewart it was 15 to 20 and I purposely chose to go to 20 to 25 and there were two primary reasons for that. One, I had noticed that we'd had some success going down the cap scale, finding companies earlier in their lifecycle and whether it was Whole Foods back then or Starbucks back then or believe it or not Apple with an $8 billion cap and $4 billion of cash on the balance sheet was our short-term interest rate play if the iPod didn't work out. And I wanted to make sure that as we created our firm and if we were fortunate to get larger that we had that ability to continue to go down the cap scale and have room for that.

I think the second thing was I did notice, I noticed that sometimes if we ended in a situation that we did well and did relatively – a stock did particularly well, relatively well, it moved up in valuation, it moved down in appreciation potential, relatively looked more expensive and we would be nervous about the impact of a pull-back and we also needed the room. We needed the room for other new names, other ways to allocate our capital. I had noticed, I had looked back that we sometimes got out of those situations entirely and in my mind it's almost like I heard the comment that Ted Williams said, "The single hardest thing to do in sports is hit a baseball," well the single hardest thing to do in the investment business is to come up with a good idea and I felt we were negating that good idea because of that short-term fear of the impact of a pullback or valuation.

And by having room to have 25 you can cut the position back, cut it back, cut it back, fret less about the impact of a pullback, have room for the physical new name, have room from a capital standpoint. And I think over time you know it's helped us. We hung in with Marvel and Disney ultimately bought it. We cut back, cut back, Amazon eventually we get pushed out entirely when the valuation got more expensive, but it helped us stay in longer and longer by having that room.

So to me I think the magic is not in a particular number, the magic is in the discipline in making hard decisions. And over time you know we've lagged the indices over the last three years or so, but on a 5- and 10-year basis the absolute and relative are above whether it be S&P 500 or the Russell 1000 Growth. Again, we're benchmark agnostic, but we know ultimately we have to do better than the indices over time.

Audience: In listening to your presentation I didn't hear once the impact of disruptive technology on your existing portfolio or the opportunities that disruption might make as you look forward. How do you address it?

Harry Segalas: Well I think actually we try to consider that obviously a great degree. We have such an I guess it would be a Schumpeterian economy, just this disruption that goes on in changes things. So we try to be very mindful of it. A good example would be in the media space. There's been tremendous disruption and that has made us emphasize certain businesses and deemphasize some other businesses. We still think intellectual property wins. We think there's the opportunity to effectively sell that intellectual property not just really existing channels, but new channels that are being developed such as streaming, internationals another area that new channels are being developed.

I think it certainly made us more favorable to a name like Comcast, which at one time we were concerned about the capital intensivity but at some point they grew out to such a point or they spent so much capital that the free cash flow was very strong and that they actually – the one thing people were going to need was broadband, but they've also invested a lot of technology with XFINITY and are finding ways to incorporate things like Netflix with their XFINITY platform and they've also gotten into the content business.

So we have to think about it. Certainly if you think about advertising overall Facebook and Google are capturing the very lion share of digital advertising dollars and they're actually capturing overall advertising dollars. So we try to think about it from the standpoint of what it means to their earnings and what it means to their valuations. So it is something – I know I didn't mention it but it is something we try to be very mindful of.

We don't want to just go after disruption if we didn't think it was a good business model. You know that's always the challenge. You have to go back and say, "Is it s good business model?" There's some things that could be very disruptive but actually don't prove to be things that monetize well or prove to be in the end very good business models. So that's where we have to spend our time trying to break that down.

Audience: To your early points on the top-line growth based on the companies that you are seeing and the work you're doing where do you see top-line growth coming from predominately in the marketplace?

Harry Segalas: You know when we look overall it's a combination of you know there's particular areas, it depends on a company-by-company basis, but certainly companies that are involved in e-commerce, mobile, international, those are some of the areas that we're seeing some of the better top-line growth. There's no question in some of the more mature industries that may have attractive oligopolies in them there's not a lot of top-line growth. So the food industry is an area that we used to do more in, but fundamentally – we owned General Mills last year and we had sold it at some point. Fundamentally it's very hard to get a lot of top-line growth.

One reason we tend to favor in the consumer nondurable area – we tend to favor companies that aren't just in developed markets but are in developing markets because that is another area. If you look at the data on the demographics, the sheer population growth, the sheer growth of consumer spending you may have ups-and-downs over the short run, but over the long run it's a very powerful trend. There's a powerful trend to urbanization going on too. So companies that can serve that are getting top-line growth and we're seeing that in the multinationals. We like that idea of healthy developed profitable that produce cash flow but having places to put it to grow and in the consumer nondurables that tends to be the area.

Harry Segalas: All right, thank you.

Jaylene Howard: Good morning, I'm Jaylene Howard with Canterbury Consulting. I'm pleased to introduce Dr. Sonal Desai, Senior Vice President, Portfolio Manager, and Director of Research at Franklin Templeton Investments. Dr. Desai holds a Ph.D. in economics from Northwestern University and a B.A. in economics from Delhi University. In her time, prior to joining Templeton, she was an academic, a former professor. She spent six years at the IMF and really, well, she's a globetrotter. She spent time in many different continents during her career. So I think you'll agree that there is no better person to walk us through the imbalances and the opportunities that exist now in the global fixed income space. So please join me in introducing Dr. Sonal Desai.

[Applause]

Dr. Sonal Desai: Hi. Good morning, and thank you all for inviting me here and giving me the opportunity to speak to you. I thought that what I would do is actually talk a little bit about what happened last year, 'cause wow, what a year. Between the economics and the politics, the global changes that happened last year, we are in a remarkable point in time, and the year itself, from an economic perspective, was absolutely fascinating. At this point in time last year, take yourself back to where we were. We were at a point where every single day what you would read in the newspapers, in the *Wall Street Journal, Financial Times*, any newspaper you care to speak about, recession risks are rising.

The concern was overwhelmingly that we were getting ready for a deflation here in the US, a recession, a deflation, oil prices collapsed. We were looking at oil at sub $30.00 levels, and of course it's probably rude to call them learnings, but the entire street gave us the rationalization for why not only was this what was happening but it was a portent of what the rest of the year was going to be like. It was going to be terrible.

Now from our perspective, we at our team, we didn't see this. We didn't see this in the data. In particular, definitely inflation had come down a lot, headline inflation in particular, but I go back to the issue of oil prices which had collapsed starting in the tail end of 2015 and continuing into January of 2016, but this was largely base effects. When oil prices fall, they can fall for two reasons which have two distinct impacts and two distinct signs.

One of course is a lack of demand. If there is no demand as in the aftermath of the global financial crisis, oil prices collapse, and yes, that's a very negative outlook for the global economy, or oil prices can go down for the other reason and that is supply has gone up. Now this is actually positive in any way, shape, or form. It's positive. There are a lot more importers and users of oil in the world than exporters, so yeah, when oil prices collapse, it's really bad for the Saudi Arabias, for the Russias, for the Nigerias, the Venezuelas of the world. The rest of the world, the Chinas, Indias, Europe, the US, a lot less so. Okay, the US, it's a little bit more nuanced because we produce and import oil here, a bit more nuanced, but overwhelmingly for consumers around the world, it is positive and there is more than 85 percent of global GDP that is concentrated in the hands of oil consumers as opposed to exporters.

This is something that's very important to keep in mind, that every time you hear about a collapse of oil prices being a bad thing, it's not. It really isn't. It's only a bad thing for specific countries.

So this is where we were. Things were looking very bad. We started the year with US Treasuries at 230 in December of 2015, the US Fed had said they would raise interest rates four times during 2016. Very rapidly, the market price fell to those rate hikes because clearly the economy was in such bad shape. So we start the year 230 on US Treasuries. We get to a point in the year when we have Brexit and essentially the bottom drops out of the US Treasury market and treasuries drop to levels which were not seen in 1933 when unemployment in the US was in the 20s. We dropped to around sub 140, and today, we dropped to 135 on US treasuries, almost 100 basis point decline from the start of the year.

Let's talk just briefly about Brexit. The due apologies to anybody who's from the UK here. Midsize global economy with zero global impact. It's a trade agreement. Yes, it's bad for the UK over the longer term. Even that, it's not clear how bad it's going to be, and really for the euro area, not that bad at all. The UK is not more than ten percent of the euro area of the economy. So it gives more rationale for the huge stepwise moves that we were seeing.

What were we thinking about? Well, even at the start of the year, we thought that the markets were actually pretty tight. We thought wages were getting ready to go up. I have slides here but I'm not gonna go through a whole bunch of slides. I just want to tell you a story here. Wages had started building up and we saw a neighbor market was stronger. In a country where consumption is pretty much the driver of the economy, we looked at this and we didn't understand the panic that markets need to be going through, so this was one very key feature of the start of last year and we tried to understand why are markets behaving this way? And the answer is a little odd.

All of us in this room know we're not supposed to look at headline information. We're not supposed to look at oil prices. Oil prices, we know, have headline impact. They're not an indicator of underlying inflationary pressure. That's the wages and that's the labor market, a whole bunch of other things. However the market looks at that headline number and clearly sentiment is influenced by that headline number, and that is what we think was responsible for the spiral of expectations into deflation and a poor outlook and we saw that as a crisis for a large part of the year. I'm gonna come back to that in a bit when we talk about the outlook for this year.

Let me touch upon what was happening in the rest of the world at the same time. Here in US, we have probably and arguably the most dovish Fed we have seen since the Fed of Arthur Burns, and this of course presaged the great inflation of the 1970s. Now I know whenever anyone talks about the 1970s, we talk about OPEC, oil price shock, et cetera, et cetera. It's not consistent with the facts. The facts are that it was loose monetary policy which predated the OPEC cartel price increases and what was responsible for that loose monetary policy was the very politically driven Fed which essentially financed the Vietnam War for a couple of presidents. Now that led and embedded inflationary expectations.

A little bit of economic history. Then we had Paul Volcker come in. He raised rates all the way into the teens, really squeezed inflation out of the US economy and growth for a while, but it was necessary and he bought prepared 30 years of credibility. That's what happened in the sense of that we have 30 years of inflation and inflation expectations declining and hand in hand, US Treasury yields coming down, a secular bull market for fixed income, and it was driven initially by squeezing inflation out of the system and that was Volcker's gift to the Fed.

Let's talk about what was happening in the rest of the world. This dovish Fed did not raise rates four times clearly last year. That didn't happen. It raised them once at the end of the year, but what was going on at the same time in the euro area and what was happening in Japan? Let me just take a look at, first of all, Japan. We had Japan, which was doing QE. In the case of Japan, there's a reason to do QE. Japan is the only country in the world which has embedded deflation, 30 years of deflation. They can do QE and they're probably gonna continue doing some version of QE and very, very easy monetary policy for an extended period of time.

The way they want to achieve that is essentially via a depreciation of the yen. It is the only tool they have. Once you have deflation embedded in the system, you need to decrease the AP yen. Instead, for the first nine, ten months of the year, the yen appreciated. The yen started at 120 and went all the way to 100, so you had a 20 percent appreciation of the yen instead of a depreciation of the yen, and the reason for this was actually the interplay of monetary policy, the US monetary policy and Japanese monetary policy.

The BLJEs, in January of last year, by 10 basis points, cut rates to negative, and the Fed had just said that they were going to raise rates by 100 basis points, so there was a nice new differential which built up. Typically when that kind of yield differential builds up, the yen depreciates. Instead, the yen appreciated. Well, the reason is by February, against the background that I just painted of calamity basically here in the US, a recession, a massive recession, the market priced out those rate hikes, so effectively, you have market-driven easing at the short end of the US rate curve of close to 75 or 80 basis points.

The BOJ was effectively out-eased by the Fed. That's what happened. It was out-eased by the Fed without the Fed having moved as essentially via the market and via talking, the established Fed talked rates down and there's nothing the Bank of Japan could do, so we saw that appreciation. That's in Japan and what Japan needs is a continuation of yen depreciation to basically break this country out of these deflationary expectations, and the bottom line is they really need deflation. That's the dirty little secret.

Every country has built up debt in the last eight, nine years, massive amounts of government debt. There are few ways governments can deal with this debt. Well, first of all, there's the good way, right? There's the good way of dealing with debt which is what every country should be doing, lots of nice growth, productivity growth, GDP growth, and the debt deflates. Then there are the various other ways which are a little bit more murky.

One, of course, you could do it very blatantly. There are defaults of different kinds, like Argentina or Greece, you could default. That's one way of cutting your debt stock, probably not the way which would appeal to Japan, or the US, or the euro area, or you could allow your currency to depreciate, which effectively allows you to default to foreigners in the sense that foreigners who bought your debt are now getting back less than they expected because the currency has depreciated.

And finally, of course, you can inflate, and if you look at the US, yes, the debt stock went from 35 to close to 70 percent of GDP. Guess what? It increased a lot less than other countries and that's because nominal GDP growth in the US and in this entire period, in the post global financial crisis period, has been pretty healthy, so the debt has been increasing but being deflated by nominal GDP growth. Japan, on the other hand, has actually had negative nominal GDP growth, and unsurprisingly, their debt is exploding. That's on Japan.

And finally, about the euro area. Let's talk briefly about the euro area. The euro area, we don't think that deflation is as embedded in the euro area as it is in Japan, however it is definitely a part of the world that easily can take advantage of slightly lower inflation to keep policy loose for longer. Why does it need to keep it loose? Well, there are parts of the euro area, the southern periphery, if I can call Italy a part of the periphery, and increasingly France, a part of the euro area which has done no structural reforms, they need some way to grow, and the way they grow is via exports.

The euro area has pretty moribund domestic demand. The US stands out as being a country which is domestic demand driven. The rest of the world, these areas are few and far between. You have certainly some emerging markets, but in the developed world, it's less common to see a domestic demand=driven economy like the US.

So while the euro is weak, countries like Italy and France continue to export, and then of course you have countries like Germany which exported when the euro was at 140 and will continue to export with greater profitability when the euro's at 104. But the ECB will take advantage of this time to try and buy these countries time before inflation really takes off to do the structural reform which might encourage a certain amount of growth. More on euro area and the populism there later.

But let me now bring the story back to where we stand right now with the US. Where we are today relative to how I started this talk, it is the mirror image. We are looking at the mirror image of the start of the year. Oil prices, the base effects will drop out. Relative to being at sub-$30.00 in January of last year, we're in the $45.00, $55.00 range right now. Whether it's $45.00 or $55.00, base effects, even if oil was at sub-$30.00, the base effects would drop out and headline inflation gets forged towards core inflation, which is running about three percent.

Now you actually get a little bit of tailwind coming from oil prices actually having risen, so you're gonna get headline impact on inflation the first several months of this year, which is gonna look pretty scary relative to what the Fed has told us, but again, here we are in this room. We're not supposed to look at headline inflation, are we? Except that last year we did and that's why we'll assume that the market will continue to look at headline inflation and we don't think it's going to look very pretty.

So we're looking at a country which is even closer to full employment. You're gonna get tailwinds as noted coming from oil prices, and at this stage, what is pretty apparent is you're gonna have loose fiscal policy. Now we were saying this prior to the elections it didn't matter whether it was going to be a Clinton presidency or a Trump presidency, it was very clear. The one factor which was abundantly clear was we were gonna get either loose or extremely loose fiscal policy, so we are in the world of extremely loose fiscal policy. We have overly loose monetary policy. We're getting ready for extremely loose fiscal policy. |

We're looking at headline inflation with tailwinds coming from oil prices in a country which is at full employment and looks like the labor market is tightening even further. The stars are all aligned. You're getting ready for a little bit of inflation here, and therefore, when you look at markets which are now pricing in around 50 basis points of rate hikes this year here in the US, we think that they are underpricing enormously and they're depending on the dovish Fed. Well, the Fed can be dovish, but if headline inflation, yes, headline inflation, starts creeping up towards three percent or more, it's going to be a little higher to do, especially against a background of full employment and growth.

Now we can talk a little bit more about different factors such as infrastructure, would this be good or bad. You can talk about deregulation, tax cuts. You can put a bunch of economists in a room, you'd have the Larry Summers of the world who would say that what you need is infrastructure. I guess he said infrastructure when it was going to be a Clinton presidency but now he's not a great fan of infrastructure anymore, but basically infrastructure, if you came from the Keynesian school, or you could look at John Cochrane or John Taylor, and given that I got my Ph.D. at Northwestern, I tend to be more in that direction where you talk about deregulation and corporate tax cuts and the idea is this is what you need to get growth to take off.

But one thing I think you would not get either school of thought saying is what is the problem with the US economy's growth? Productivity is low. Productivity growth is running at around half a percent. It would be difficult to find an economist who would tell you that the way to get productivity growth up in this country is to have overly loose monetary policy. It doesn't compute. It's not monetary. We can argue about whether it's fiscal policy or deregulation infrastructure.

We can argue about this, and economists, we can argue forever, but one thing I think you'd have a very difficult time convincing any economist is that the correct policy response is to keep monetary policy extremely loose in the hope of encouraging real GDP growth which is stronger than underlying potential. Potential growth in the US that way is probably running anywhere from 1.6 to 1.7 percent. They're kind of growing above potential. It's not what I would consider exciting growth. The Fed would like the country to grow between 3 and 4.

The point is there is a limit to how much monetary policy can deliver. It cannot deliver that growth and potential is 1.7. The answer is to raise potential growth and that's where the arguments start.

Now you cannot lean on monetary policy for this, so what I'm saying here is actually something quite simple. I think that the Fed is behind the curve. It is already quite far behind the curve. Having said that, what is the result of that? I am not suggesting that getting ready for another period in which inflation in the US is in double digits, not at all, however this is a country where we have an entire generation which has never experienced inflation.

So stop and think for a second. You've got an entire generation of traders, somebody who was a trader right before the Niemen crisis who was an entry-level trader before the Niemen crisis today is probably a senior trader who's still got his job at JP Morgan or Morgan Stanley. He's got the same rates which have been really non-zero. This is a very unusual time and therefore you don't want inflation to be double digits. Inflation of 4, 5 percent, which is definitely within the realms of possibility, is something which should come with an enormous sticker price shock for any person here in the US.

So I would say that it is probably enormously premature to assume that inflation is dead, that rates, despite having falled off 50 basis points after the elections, are in any way close to being done, let's say. Where should rates in the US be? Well, historically they kind of hung around where nominal GDP growth is. I look at where real GDP growth is and I'm thinking about inflation, nominal GDP growth could easily have come in anywhere in the five to six percent range.

We don't think that US rates are going all the way up to five or six percent because after all, we do have peculi that I talked about around the world and you will have some suppression of long-end yields here in the US, but could you really get US treasuries up to that three and a half, four percent range? I think very easily and that suppression, that last 150, 200 basis points below what I would consider fair value, that's coming because of the ECB and BOJ, so you have around 200 basis points taken out of the long end.

I've talked about the G3. Let me touch upon China, and let me talk a little bit about emerging markets, and then I want to leave it open to questions and we can really talk about pretty much any country or you can argue with me as much as you want, 'cause I know that we, as a team, and our friends, have had a dramatically out of consensus view for basically the whole of last year.

Towards the end of the year, our views started playing out. I think there was a point at the end of September, our funds were actually underperforming by close to 15 percent. The turnaround was that by the end of the year, we were outperforming by over 500 basis points, so essentially, we had a close to 16, 17 percent out performance in a matter of two or three months.

And that was not based on anything other than our call on fundamentals. We didn't see what the market was panicking about and we think that essentially the market was buying into a bubble. When you have a bubble, it's very difficult to call the end of a bubble but it's very risky to keep buying an asset because you think everybody else is going to keep buying it, and treasuries were fundamentally in bubble territory when they were at 1.4 and still enormously overvalued territory when US treasuries are running at around 2.4 to 2.5, and I think this, in a nutshell, is what we think about the US.

And China. We have for a long time said that we expect China to moderate. We're not looking at a hard landing. I will say this. Over the last year, our concerns about China have actually increased, not in the near term. I call that near term for a year to 18 months, I don't expect anything catastrophic out of China. The problem is with the big politburo change which is coming up this year over China, the concern we have is that the structural reforms that China had started doing in 2015 are in the process of being unwound, so they are once again using fixed asset investment and credit-fueled building to fuel the growth that they're seeing.

Now it's not as bad as 2009, when we were looking at close to 20 percent of GDP in fixed asset investment. That was the largest fiscal package any country had in the post-GFC world. That's what country did. Today, we're looking at something which is close to three or four percent of GDP, but the problem is that it is being done in a similar fashion. We don't see an immediate crisis of china, but certainly if you look at the year to 18-month period, the risks are increasing, so that's our call on China. We're looking at six or seven percent growth. It is about enough, and I can certainly talk in terms of the issues of trade war and so on and so forth, if there is interest.

Emerging markets more broadly. It's very difficult to talk about them more broadly. There are emerging markets which are as different from each other as Australia is from Sweden, and therefore when the Australia RBA raised rates, there's no reason for me to expect that the Riksbank is going to do it the next day. I don't think that you can really look at emerging markets in this fashion. Markets broadly tend to look at EN just as an asset class. I think it's not that easy anymore. Turkey is really different from an Indonesia which is enormously different from a Mexico or an Argentina.

Each country is unique and individual, and the countries which have been running good policies unsurprisingly we think are in a much better position to actually face a Fed that is raising rates, and there are countries like Turkey which we think are going to have continued pressure because you see countries where monetary policy is too loose and that's the worst situation you want to find yourself in when the Fed is going to embark on a rate hike cycle and the country has actually absorbed a lot of foreign corporate influence.

Mexico I should touch upon briefly just because it is a country which we see a lot of value in and clearly it's very much in the news with everything we're hearing about from Trump. The Mexican peso continues to depreciate. It is the favorite hedge against a trade war of any kind, the tearing up of NAFTA, et cetera, et cetera. The baseline continues to be that NAFTA will not be torn up but it will be adjusted in various ways, but certainly you get headlines like Ford abandoning a $1.6 billion investment and Mexico is so in lock step, will depreciate by two percent. So this is pretty much par for the course.

I think it's important, again, to take a step back and try to understand what are we actually saying? Let's take the worst-case scenario. On January 21st, President Trump walks into office and he shreds NAFTA and throws into the wastepaper basket. What happens on January 22nd? Does trade with Mexico stop? Well, no. How many countries in the world does the US have free trade agreements with? It's a handful. It's not as if the US doesn't buy anything from the euro area. It's not as if the US doesn't buy anything from the UK. There are no free trade agreements there.

The US has a far fewer number of free trade agreements than regular WTO-governed relationships. You revert to WTO and you're looking at three to five percent tariffs on Mexico's major exports to the US, that's cars and manufactured goods. Then you start talking about unilateral tariffs 20 percent, whatever you want to talk about. Yeah, that would be negative, a 20 percent tariff.

The one thing, again, to keep in mind here, a 20 percent tariff would imply a depreciation of the Mex peso from fair value. It would not mean that you go from 21, in the assumption that it's been 30, 40 percent, to 23, 25. Fair value for the Mex peso is between 13 and 14. These are our calculations and the IMF's calculations, fair value between 13 and 14, so I give you 16. You don't get to 22. The Mex peso has depreciated close to 55 percent from fair value. There is so much built in here that it is completely inconceivable to assume unless you literally think that trade with Mexico grinds to a halt.

That isn't going to happen because there's no reason for it to, and quite frankly, if you grind that trade to a halt, it's not just Mexican exports that suffer. Something to keep in mind is that the US exports a lot to Mexico. You're going to see a lot of unhappy corn farmers, and tomato exporters, and vegetable exporters, and farmers in general across the US who are going to be screaming blue murder if you try to impose, and that is what would happen, by the way. A 20 percent tax in one direction will be met with a 20 percent tax in the other. That's how trade wars get fought.

So I think it is premature to look at Mexico today and say that the economy is going to collapse. We are looking at a country which has one of the most conservative and orthodox central banks. It is doing everything which the Fed is not doing. It is ahead of the curve looking at the depreciation of its currency saying it will eventually feed through to inflation, raising rates preemptively, in advance. It's taking all the right steps. Fiscal policy is moving in the right direction. They're consolidating. This is a country which has done structural reforms. We don't see Mexico collapsing on the back of what's happening with Trump.

We do sentiment towards Mexico being very negatively affected, but we think it's really premature to assume that the next outcome is the Mex peso at 25. I mean you can do the type of models which we do and which the IMF does to try and figure out what fair value for the Mex peso is. We had an offsite in Mexico and our entire team went out to dinner and it was $7.00 a head, so you can take a look out of the window attitude for figuring out is the Mex peso over or under valued or you can do the models. Anything you do will give you this result. This is an undervalued currency.

I think I'm going to stop over here and open it up for questions.

Audience: So on inflation, what are you seeing that the rest of the market is not seeing. You touched a little bit on your remarks on 2006, but going forward, what do you see that the market's not seeing?

Dr. Sonal Desai: So I think actually the market has started seeing it. I think the market tends to move incrementally and we tend to be able to stick our necks out and really talk about our conviction level. I already see just from casually inspecting, looking at people's forecast, that typically I think CPI forecasts for this year have gone up to 2.2 from what used to be 1.8, and for the following year, I'm looking at 2.4, which used to be under 2.0, still. Now so the market's forecast are drifting upwards. If I look for the year as a whole, I'm not suggesting that you will necessarily see 3 or 4 percent. I'm saying that as the base effects from oil drop out, you could easily get there.

Now of course this is the point where I repeat that of course we take base effect seriously and we're not gonna say 3 percent, 4 percent implies that's what US inflation is. I'm just pointing out that last year, when we had headline inflation collapse on the back of oil prices while intellectually everyone realized it was oil prices, how the markets moved was as if this was a real deflationary risk and that is all I'm suggesting, that if you see surprising, you will get sticker price shock. That's what I'm suggesting. You see that sticker price shock and inflation and inflation expectations move up, and then yes, they would move down.

If inflation runs at around 2, 2.5 percent, GDP runs at 2, 2 2.5 percent. Nominal GDP, you're at 5, so I don't need inflation at 6. I'm just pointing out that if I have to look at a risk scenario, my risk scenario, given monetary policy, fiscal policy, oil crisis, consumption, wages, full employment, all the risks seem to be on one side of the scale, so I would say the risk is to higher rather than lower inflation, at this point.

Yes?

Audience: To follow that up, in this environment, how do you see inflation impacting on the stock, the equity markets?

Dr. Sonal Desai: So I'm not an equity expert, so I'm going to caveat everything I say by it could be anybody who's giving you this answer, but I would say that in the first part, I think some inflation is not bad because it's pricing power for companies and I do think that companies may start taking advantage of this pricing power because they will be forced to. As wages go up, in the first part, you see companies using their profit margins but ultimately you start seeing prices go up, and indeed, especially if we start seeing something dramatic on the tariff front, you will see prices go up.

Within the stock market as always, there are probably gonna be winners and losers, if you have some form of a border tax which actually has an impact on oil importers, which we have here in the US, you might see negative impact, but I'm not going to go too much further than that. I would just point out that any chart that you would have seen over the last several years shows that with each round of QE, we saw the S&P basically move hand in hand with that round of QE. So more than inflation, I'd say that the equity market and equity valuations currently do reflect a little bit at least of the easy money that we've been seeing for a very long time, so just as a macroeconomist, I'd say as that monetary policy starts tightening, that it's going to have a slightly negative impact on those equity prices.

Yeah?

Audience: Your inflation forecast is relatively benign, but what happens to that forecast after President-Elect Trump is the president and he opens up all of the federal land and offshore for drilling? What's to keep the price of oil from dropping back into the $30.00s and then what does that do to your forecast?

Dr. Sonal Desai: So I'd say that the drop of oil into the $30.00s, that's a good point. The things that should argue against it, and it could work, it could not work, by the way, I would repeat that while oil is a tailwind, oil is not a main supporter of inflation. The main supporter of inflation is gonna be the labor market and wages which we are seeing go up, however oil is the headline impact and the sticker price shock that comes from oil.

Now one thing which is different from the last time, which was in 2015, the global economy is a lot more robust this time around then it was in 2015. We see increased amount coming from China. We see increased amount coming from India. The euro area, despite its very weak growth, is also actually growing above potential, and we see growth in the US has been fairly strong.

So I'm not an oil expert. I do think that increased production is going to tap how far oil prices can go up. I don't see them being significantly above where they currently are. Could we get enough production to actually collapse them into the $30.00s? I don't know. That's the truth. I think that actual demand is stronger today than it was the last time when we had this big oil development, and that, other things being equal, would argue for oil prices being higher than they are, unless we get a significantly greater production very quickly.

Yeah.

Audience: I was fascinated by your comment of extremely loose fiscal policy. I'm trying to grasp that. The only way I can see that certainly reducing regulation and compliance burden is it would be productive but not necessarily loose like the Fed financial repression. The only thing that might be loose about fiscal policy would be if we went to huge deficits. Is that what you're essentially saying?

Dr. Sonal Desai: Yeah, I'm talking about the deficits. So here's the thing. The regulatory reform, A1 okay, fantastic for GDP growth, really good stuff. Tax cuts? Yes, they are good, but they increase the size of the deficit unless you get an enormous change in GDP growth again and it's not clear. Infrastructure, and here I'll just throw my hands up and point out one thing. Infrastructure's a great thing. It depends on what infrastructure you're gonna do.

I will point out that you change 101 in San Francisco, which is what I know, from being five lanes to six lanes, that's gonna be a huge production to go five to six. The impact on productivity is going to be tiny and barely noticeable. What you're basically going to do is to pay a whole bunch of people to build and that's almost like consumption. Fine, but it doesn't do anything for long-term growth.

You talk about a village in the middle of India which has no roads and you build a road from that village to a town which then takes stuff to be exported, your increase in productivity is going to be five, six, ten times. It's almost immeasurable the change you have to GDP growth.

A country that is as developed as the US is, the additional growth impact from infrastructure is almost all what I would consider consumption. It's another version of what China does where you build a third high-speed train next to the other two high-speed trains which aren't being used anyway. You've just given a whole bunch of people employment. That's what you've done.

There is some intelligent infrastructure which could change the GDP trajectory of the country. I don't think anyone's talking about that. I'm talking about Korean-level high-speed Internet across the country, the whole Midwest. We don't even have it on the West Coast. But you do something like that, and potentially, yes, that is groundbreaking and it could be productivity enhancing. That's not what anybody's talking about. They're talking about building roads and bridges.

Audience: Along with that a little bit, we hear about deadline inflation, CPI. A number of people make a distinction between that and producer price inflation, in other words, capital goods, which is considered to have some effect or bubble if you will, to our frothy PEs, for example, or let's just say PEs where they're at this higher level than they've been for some time. Would you address that a little bit? I'm curious what your opinion of that distinction between the two is.

Dr. Sonal Desai: I think they're two very different animals. PPI is less important from the perspective of the macro economy in terms of GDP. It is an input. CPI is more important in a country like the US from a macroeconomic level, but again, 70 percent of this economy is consumption. So I would say they're really distinct from one another. PPI is going to have an impact on the ability on profit margins, as you mentioned, so its macro impact is a bit more indirect, so the impact on PE ratios would come more from the PPI front probably than CPI. But again, unfortunately I'm not an equity expert so precise impact on the PE ratios is something that I would set aside.

Audience: Would you care to talk about demographics here in the United States and its impact on growth? There's a lot of talk about there's a whole boom generation that is going to be a more inquisitive household formation and what the impact that that might have secularly in your view.

Dr. Sonal Desai: So demographics are very important. Demographics are huge and that is one element of the decline in the participation rate, there is no doubt. So the participation rate in the US has been dropping and everyone said in the post GFC world it collapsed. What is more important though is that the participation rate has actually been declining since 2000. It has been on a secular downward trend, and then yes, the participation rate collapsed in the post-global financial crisis period. However, two-third of that decline in participation the Fed believes was not secular but was cyclical, which implies that that piece of the participation rate should actually come back.

Now in terms of actual impact on the US economy, as the US economy ages, unless, and this is of course a dirty word in the current world, but unless we continue to have substantial immigration, the US GDP growth rate is going to decline, not go up, and that is of course what has happened all over the euro area. The euro area, by the way, their potential growth rate is around 1 percent. The US is at 1.7. Now I would say the US potential growth rate used to be around 2.7, 2.8. A large part of the decline in the growth rate you can attribute more to productivity changes rather than just labor force changes, but definitely you could reinvigorate the productivity cycle by deregulations, et cetera, et cetera, and get that potential growth rate up even if you continue to have the secular decline in the population demographics.

I don't know if that answers your question or not.

Audience: I'm just talking more about the organic growth, the eco boom that is becoming closer to household formation and will be more inquisitive and the multiplier effect there in and that impact on our economy. Is that not significant in your modeling?

Dr. Sonal Desai: No, it's not a part of our modeling. It is not. So you're talking about the fact that over an extended period of time, people have not been forming their own households in the past seven years and they're gonna move.

Audience: They're still living in mom and dad's basement.

Dr. Sonal Desai: Mom and dad's house. I think that actually ultimately will have an impact, and I'm saying ultimately because it's not clear to me that in this six, seven years, this is not a generation, and jury's out whether this is the first generation which is becoming a little bit more European in the sense that it is amenable to renting for a lot longer period of time, and yes, household formation are very different from what we have historically thought about as going back, buying a house, and creating a boom in construction in that sense.

Audience: The demographics in Japan just make it extraordinarily difficult to have inflation and have an effective monetary policy because there's almost no immigration. Can you expand on what tools they have and how it could or may play out?

Dr. Sonal Desai: So in Japan, this is a situation where you truly are looking at a Friedmanesque idea, where you'd say that inflation in the end, in every case, is going to be a monetary phenomenon. So the Bank of Japan currently has expanded its balance sheet enormously. Ultimately, you get to a stage where it is buying the entire debt off the government. Now clearly in most situations, if you had inflationary expectations built it, the true danger is that you are looking at a potential hyperinflationary situation because it's just money. It's just paper money.

Now what they are doing is trying to induce a certain amount of yen depreciation for a couple of reasons. It feeds through into the imported good cycle, and also, if you look at what else Abe is trying to do, so on the one hand, you have the first arrow which is coming from the BOJ, so they're expanding their balance sheet, trying to print more money, trying to get the inflation and inflation expectations up by yen depreciation. So that's one element of it.

The other part of it is they're doing structural reforms which as structural reforms everywhere are, are painful. They're trying to get the labor market to be more mobile, lots of different structural reforms, which are painful. The quid pro quo, so to speak, there is just somehow get the stock market up so on the one hand, you have inflation. You have a population which is overwhelmingly made up of pensioners and pensioners like deflation. They're on fixed incomes and that fixed income in real term grows and does deflation.

To get buy in from the pensioners, you need the equity market and you need asset prices to go up, so that's another way of looking at it where they need the Nikay to go up. The Nikay is made up largely of exporters who benefit from yen depreciation and the Japanese stock market post the three RO piece of time. When the yen decreases, the Nikay goes up. When the yen appreciates, the Nikay drops. So in a sense, the success of economics is very much tied up into this.

Now long term, this is what of course the BOJ worries about, the longer-term implication of effectively getting closer and closer to a helicopter drop of cash. It could lead to hyperinflation at some stage. The point is, that's, for the Japanese, almost a champagne problem to have. They're still in a situation where that stock is on an explosive path. The only way to get the debt-to-GDP ratio down is to get the denominator growing a bit more. You can do it by real GDP growth, which is the structural reform effort which isn't doing brilliantly right now, or you can do it through CPI inflation, which for the longest time has been moribund.

So how does this all end in the very long term? Unless they get actual productivity growth really surging, I would say not very well. You'll have either an explosive debt stock or you get extremely high inflation at some stage.

Audience: It seems that the impact of some modest inflation relative to a lack of inflation that we have is going to be pretty profound and that the impact of modest inflation on our fixed income bond portfolios is going to be really challenging. Many of us tried to address this possibility by playing with durations. What is your strategy for some inflation fixed income portfolios?

Dr. Sonal Desai: So thank you for that because I was trying not to talk too much about our strategies, but I would say that our strategies are exactly positioned for that. To put this in perspective, any index you care to look at, whether it's the Citi, or the JGBI, or any global fixed income index, currently has not just duration but historically high amounts of duration in it, between seven and eight years. Our strategy is effectively at zero. We have no duration. This is not only because we have no duration in the US, or in the euro area, or in Japan. Even in emerging markets, which we happen to like, by and large, we have very short duration. There are a few cases where we think duration offers value.

Brazil, for example. We see some value there. And therefore, our strategies have what I like to call some residual duration weighted across the strategy coming from emerging markets, and for that, we are paying ten-year swaths here in the US. We are paying ten-year duration in the US, so US duration is actually minus two and a half years or so, so we effectively reduce our duration to zero.

I do think that in an inflationary environment, if your portfolios need to have fixed income and I think probably it makes sense to have fixed income always, you can effectively hedge out. You can make money in a rising rates environment. It's just how you structure your portfolio. It's not simply by being short duration. We're also short Japanese yen. We're short the euro and we're also long a whole bunch of currencies which we think are enormously undervalued relative to the US dollar.

When I am long a country, like I'm short duration but long the Mex peso, a country where the short-end rates are closing in on 6 percent, the currency is close to, by any metric, at least 30 percent undervalued, and this is assuming a 20 percent tariff, about 30 percent undervalued at least, and you have a central bank which is going to raise rates together with the Fed, at least again, if not in advance of the Fed, so what does that deliver to?

I'm investing in dollars, so when you have a currency that's fundamentally undervalued, if the Fed raises rates, if we see inflation in the US, the dollar will actually tend to depreciate against currencies like this one. I have constructed an inflation-hedged piece of my portfolio by being long the Mex peso, short duration there. I take the carry of close to 6 percent and I expect obviously to increase it. So that in dollar terms is going to deliver an inflation-hedged outcome.

Yeah.

Audience: One area you haven't commented on is high-yield bonds. Could you give us some idea on that?

Dr. Sonal Desai: We actually exited all our high-yield bonds, for all practical purposes, so of course global bond is only sovereign or quasi sovereign if we do have strategies which includes pred sectors and we exited our high-yield bond positions largely because we see them, while there were pockets of value, no doubt about it, we see that as close to _____ well price given where we are in the cycle.

Now I agree that growth is probably gonna go up. We're not talking about a massive bunch of defaults. That's not the point. I think in an absolute way, you're not being paid for the risk which you are carrying in high yield and you're taking on duration, so we just don't like them.

Audience: I'd like your thoughts on the unemployment rate, 'cause the reported unemployment rate is about four and a half but you use six. The real unemployment rate is about nine and half. So to what extent does that delta represent slack that still has to work off before we realize to having a discussion about real wage inflation?

Dr. Sonal Desai: So U6 is amazing. My father asks me about U6. Everyone knows about U6 now, but U6, every time it is reported in the press and the U6 is at nine and a half, I feel like that is such shoddy reporting because the true question is when the unemployment prior to the global financial crisis, one of the low points in the few years prior to the global financial crisis, U3, which is the standard unemployment rate, had dropped all the way to 4.2, and I want to ask do you know what U6 was at that time? Well, it was around eight and a half. Guess what? It's typically around twice the level of U3.

I've looked at this over an extended period of time. U6 appears to always be about twice the level of U3, therefore if I look at that nine and a half, yeah, it might come down to nine but it depends on where you think that NAIRU today is and it isn't that there is excessive slack in the economy. It appears that the way U6 is measured and the way this country's labor market works, there are always at least as many people working who would like to work more hours as the number of people who are not working at all. So that two times, it's not an anomaly. It's another way of saying is four and a half too high? If four and a half is not too high, then nine and a half is really actually not that high. It's the relationship which has always been there.

Dr. Sonal Desai: Thank you very much. Thanks for your attention.

[Applause]

Debashis Chowdhury: For our final group session today, I'd like to introduce Liz Ann Sonders. Liz Ann is Chief Investment Strategist at Charles Schwab where she has a wide range of investment strategy responsibilities ranging from market and economic analysis to investor education.

Many of you are likely familiar with Liz Ann's work as she is widely published and a regular guest and guest host on many programs on CNBC, Fox Business News, Bloomberg, CNN, and PBS. She was a regular panelist and guest host on PBS's original Wall Street Week with Louis Rukeyser. Blast from the past.

Liz Ann is also regularly quoted in financial publications including The Wall Street Journal, The New York Times, Barron's, Financial Times, Market Watch and Associated Press articles.

Back in 2005, Liz Ann was appointed and served on the president's advisory panel for Federal tax reform, which was the bipartisan commission that was put together by President George W. Bush. She's also the senior vice president and member of the investment committee at Windhaven Investment Management. So please join me in welcoming Liz Ann Sonders.

Liz Ann Sonders: Thank you so much. Thanks everybody. Nice to be here. It's a typical, beautiful southern California day.

Debashis Chowdhury: Yeah. Sorry we couldn't dial it in.

Liz Ann Sonders: I'm only here for 20 hours, and this is a -

Debashis Chowdhury: Next time.

Liz Ann Sonders: Oh well.

Debashis Chowdhury: Next time. Well, let's get started. We've had a number of speakers today talk about views on what the post Trump elect world may be like. Suffice to say that in the last two months since the election there was, I think, many surprise of the outcome of the election, and that many more people surprised at the movement of the U.S. equity market since then, which has been a pretty sustained rally. So what are your thoughts on the outcome and the implications to different markets?

Liz Ann Sonders: So I think there's several things, but before I tie it, specifically, to the win by Trump, and why we think maybe that the market has had the reaction that it has. If you were on the day before Election Day, and you took a rearview mirror and looked at what was happening in the economy just in the several prior weeks, and use, for instance, as a proxy the Citi Economic Surprise Index, which for those not familiar with that index: it measures relative performance in the economy. So it looks at how data is being reported relative to expectations, so it's not an absolute measure of growth, but it's a relative measure of growth.

That bottom, that index bottom, and turned up quite sharply in mid-October. So you could argue that some of the basis for this improvement predated the results of the election. Not only that, but corporate earnings, S&P earnings. The worst quarter in what was a four quarter earnings recession was Q1. Then we started to read them out of that. As a Q3, we actually pulled out of the earnings recession, so I think that was a factor, too. That's not to say that the rally has nothing to do with the results of the election.

So to go to what I think the market is reacting to as it relates to the election, I think it is clearly a pro-business administration. Ray Dalio has been writing updates post-election and making them public through Linkedin, which is unique for Ray Dalio of Bridgewater. He's usually pretty quiet and does not sort of pass around willingly a lot of what he puts together, and he did a report that was a one month later look. He had an interesting table that I got permission to use when I do presentations with charts and graphs. It went back, I think, to the Eisenhower days, and looked at the government experience of cabinet officials, and the business experience of cabinet officials, and then the cumulative total of the two of them.

On the business side for the Trump administration at the key cabinet level positions, that's assuming they get approved, is 83 percent. That is so far higher than, I think it was single digits for the Obama administration, so I think the sort of pro-business approach that clearly he's taking, the methods via Twitter we could giggle about, but I think that's what the market is keying off. We were having fun talking about it at our table, the sort of the war on business is over. Maybe the bull market and corporate compliance is ending.

The other important force, I think, that is affecting the market behavior is that we are shifting from monetary policy being the only game in town, to now fiscal policy taking on a greater amount of importance. I think the market was getting tired of monetary policy being the only game in town. So those are the three sort of broad reasons behind, in our view, the rally that we've seen.

Debashis Chowdhury: So sticking on the theme of policy and potential policy implications we now have the GOP in the majority, and the senate, and in the house.

Liz Ann Sonders: And in governorships.

Debashis Chowdhury: Right. So now there's a view that there will be pro-economic growth policies. Counterbalancing that is this view of the consequences, or unintended consequences of protectionist movements and tariffs. How do you reconcile those two?

Liz Ann Sonders: The short answer is we don't know. Hopefully the combination of Munition and Ross might not slam on the breaks as much as many people think on that protectionism side. Trump, so far anyway, he's not sworn in yet, so he's not the president yet, seems to be trying to use the Twitter bully pulpit, and kind of force companies to rethink what they're doing without having to legislate change. That said, when the collective group of strategists at Schwab put together our 2017 outlook, that was absolutely at the top of the list of risks looking into 2017. If that really starts to move up the priority spectrum, and starts to offset the benefit of deregulation to some degree, tax reform, infrastructure spending, I think that does represent a risk.

The other risk is that I think some people are maybe overenthusiastic about the immediacy of the benefits of some of these pro-growth policies. When in fact, getting anything through the bureaucracies of Washington, having served on a tax reform commission, the devil is always in the details, and the details are harder to flesh out than I think a lot of people realize. In general right now, those pro-growth policies, I think, are to the great benefit of the economy, particularly corporate tax reform.

My good friend Ed Yardeni, many of you may know who he is. Very well know Wall Street economist. The consensus for S&P earnings in 2017, I think, is $132 dollars. He just took his number to 148, just based on the prospects of regulatory reform, and corporate tax reform. So to the extent it gets enacted and it's retroactive, it goes very quickly to the bottom line of many companies.

Debashis Chowdhury: So would you suggest that there is a 100 percent probability of some corporate tax reform?

Liz Ann Sonders: That's always dangerous [laughter]. Ninety five percent of something on corporate tax reform. Maybe not down to the 15 percent. It's possible it only gets down to 20 percent, and some will say, "All right, but the statutory rate is 39 percent when you add everything in," but the effective rate is 27 percent, I think for S&P level corporations. That's still a big difference if you go from 27 to 20. Then it improves competitiveness, so there are ripple effects into the economy longer term than just the immediacy of the rate change.

Debashis Chowdhury: There's obviously a number of unanswered questions about what policies will be, and none of us have the luxury of saying, "There is a certainty of X occurring, and therefore why it will occur in the markets?"

Liz Ann Sonders: Wouldn't it be nice?

Debashis Chowdhury: Wouldn't it be nice. That, of course, channels into investor sentiment. In spite of the fact, we spoke with other speakers earlier, that for now in year eight, or presumably year nine, of a positive equity market experience. In spite of that, sentiment has never been great. This notion that we should be feeling good, or euphoric about the bull market at the last eight years seems to be far from reality. I know you follow that quite a bit, and have a view on investor sentiment. Where do you think we are with that pre or post-election for that matter?

Liz Ann Sonders: So by way of background, part of the reason why I spend so much time on sentiment, and I consider myself a 30 plus year student of the sentiment environment, is my first 13 years in the business I worked for the late great Marty Zweig. Some of you may remember him from Wall Street Week, and he was my first boss in this business. He was a pioneer in analyzing investor sentiment. He invented the put/call ratio. He coined the phrase "Don't fight the Fed." He coined the phrase, "The trend is your friend." So I learned a lot about investor sentiment.

Maybe most importantly is that it's important to separate attitudinal measures of sentiment, and behavioral measures of sentiment. There are many attitudinal measures of sentiment. Indexes that many of you probably followed, very familiar, they get reported on quite frequently, things like the American Association of Individual Investors, or Investors Intelligence, which measures the sentiment of newsletter writers. The big newsletter writers.

Then there are other measures that look at the behavior of investors, so things like the put/call ratio. Maybe the most dominant one of those would be flows in and out of funds. In the last several years it's been complicated a little bit because what traditionally were just mutual fund flows that people would analyze in and out of the market, have now had an exchange rate of funds added to it. It gets into a little bit of a gray area because ETFs are used by not only individual investors, but institutional investors.

So mutual funds used to be a real clear way to look at what individual investors were doing in and out of the market. You muddy the water a little bit by adding ETFs, but they're so popular with individual investors I think you have to include them in. All that said, the attitudinal measures of sentiment tend to fluctuate more wildly. Right now, because of the strength we've seen in the market, many of them are sort of flashing a warning. They're up in excessive optimism territory. That's the case with investor's intelligence. It's the case with AAII, but only very recently has there been any renewed interest in the U.S. equity market through both mutual funds and ETFs.

In fact, even if you combine ETFs, which have been much more popular than mutual funds, on a net cumulative basis, not a single dollar of new money has gone into the U.S. equity market since 2007. I mean, that is stunning in a bull market as long and strong as this one has been. So I think there's still a very long runway ahead of us in terms of the behavioral side of investor sentiment. However, I think there's some risk in the short term that optimism may have gotten a little bit too frothy in attitudes.

Debashis Chowdhury: We were having a little discussion at our table about what are the low hanging fruit as it relates to investment opportunities? It almost seems like the simple solution is the best in terms of just being a good old fashioned equity answer.

Liz Ann Sonders: Equity, right.

Debashis Chowdhury: Based on what you said.

Liz Ann Sonders: Yeah. So some are calling it sort of Tina. There is an alternative, especially in an environment now where not only are yields still low, they're now moving up, which means bottom prices are coming down. So I do think that there is plenty of money that has not ventured into the equity market that could find its way into the equity market. On that sort of fund flow, back to that fund flow analysis, we have seen a turn up in the last several weeks. Certainly not strong yet, but a turn up.

I always like to remind investors, as it relates to just about any measurement: fund flows, or economic data, that inflection points matter so much. One of the mistakes, I think, investors make is that they wait until all the data is good. The economic data is good. Everything is – before they feel comfortable about investing. When, in fact, the best opportunity comes when things stop getting worse and start getting better again. That's your launch point.

Think about March of 2009. The economic data, every single piece of it was absolutely horrific, and in many cases still getting worse, but the market was sniffing out that inflection point. I think the inflection point, in terms of investor interest, may have already happened, but we're still in the very, very early stages of that. I do think that there is a lot of opportunity for investors that have not been big participants in the equity market. If you look at the percentage of household exposure to equities, it's up, but it's nowhere near the type of level you would typically see this far into a bull market, so I still think that there's some opportunity there.

Debashis Chowdhury: You mentioned the data, and you did touch upon this a little bit before, earnings growth is flat, it's a negative depending where you look. Valuations continue to be higher, but it sounds like you still think there's room for both to go perhaps.

Liz Ann Sonders: Yeah. So we had a four quarter in a row earnings recession. Obviously not economic recession, but four quarters in a row using S&P earnings. They were a negative territory in year over year, with the worst quarter being first quarter of 2916. Heading into the third quarter that just ended in September, expectations were for a negative again, and it would have been five quarters in a row of negative earnings, but we managed to eek out a positive gain in the third quarter. Fourth quarter looks pretty decent.

Right now, the consensus for 2017 is up about 13 percent year over year. That helps fix evaluation problem pretty quickly. When you now have the denominator in the PE equation appreciating at that pace. Most analysts that publish full year forecasts for S&P earnings when asked, whether their forecast that collectively represent the 13 percent growth, incorporate anything on the fiscal policy perspective, whether it's regulatory reform, or tax reform. The answer for the most part is no.

So that is also low hanging fruit in the sense that really what is embedded in that number is just, for the most part, that turn in the energy sector. So the energy sector at its worst, which I think may have corresponded to the worst overall quarter for earnings, it was negative 350 percent change in earnings. That's now moved back into sort of triple digits up positive. You didn't need much more than that to go from being in an earnings recession to a positive. The added kicker, of course, would be if you can start to add to those numbers by virtue of retroactive tax reform, and something, maybe, on the regulatory front.

Debashis Chowdhury: Maybe we'll pave it a little bit and go to a bigger picture topic, and that is really the over the last eight or nine years, a lot of time has been spent writing about the impact of the leveraging cycle in private industry, and that's happened, or happening, or continuing to happen. Now we seem to be on the other side of that as it relates to the public, that picture, which presumably it's going in the other direction. Where do you think we are in both public and private, and the implications looking ahead with the new administration?

Liz Ann Sonders: I think that that represents another risk factor in 2017. The idea that whether it's tax reform, whether it's infrastructure, spending. I theory it all sounds like a wonderful thing, but you really cause some problems with the deficit and in turn debt. Also, by the way, we haven't heard much yet from various members of the Trump administration on that part of it. What are the implications for the deficit and debt?

One thing I'm going to be interested to hear, and I don't think you're going to get this issue with people like Steve Mnuchin that worked at Goldman Sachs for many years, but I'm amazed, and I'm a bipartisan critic by the way, I think republicans and democrats have done this a lot, pay attention at how often our politicians conflate deficits and debt. They use the terms interchangeably, or they'll reference something associated with the deficit that I know they're actually talking about the debt. The deficit is – the Federal deficit is 100 percent of GDP. No, that's the debt. The deficit is actually about 2.8 percent of GDP.

So I'm certainly not going to ask for a show of hands of people who don't know the difference between the two, but the simplest way I explain it to my children, who may not understand, is the deficit is the annual mismatch between what you take and what goes out. If you continue to do that on an annual basis you will accumulate debt. That is the accumulative effect of running deficits. So we've seen great improvement in the deficit from the worst. I think it was 10 percent of GDP. Now to less than three percent of GDP, but it's still a deficit, which mean the debt is still going up.

Now that also has different measurements. You can look at just Federal Government debt, which is a little bit more than the size of our economy now, so that's where you get the 100 and some odd percent of GDP. If you look at total credit market debt, which is public sector debt, private sector debt, financial debt, nonfinancial debt, that's about 350 percent of GDP. That doesn't include the future debt associated with our unfunded entitlements.

If you take a consensus number of what that represents and add it to the 360 percent, you get to about 950 percent. That's a problem that continues to get kicked down the road. Now we're in a rising interest rate environment, we're going to have to start to pay the piper here. I do think that that represents the significant risk factor. Ideally, what you get when you're increasing the deficit again, and in turn increasing debt again, are a set of policies that grow the economy more sharply than this two percent pace that we have been in.

You also, though, need to reform entitlements. You cannot solve this problem without doing that, period. Anybody that tells you so is doing because they want to get reelected every couple of years. The good news is is that the private sector, particularly households, are largely through their deleveraging process. Household debt is a shared disposable personal income. The common when we measure it is way down from its peak in 2009. Not only down below the long-term trend line, if you draw a trend line that predates the housing bubble and extend that out, we're even below that trend line. So we're in pretty decent shape in the private sections.

The private sector is not a Herculean job deleveraging. The public sector hasn't even begun to address it. Now we're going to start to see diversion. A more significant divergence in the two.

Debashis Chowdhury: Let's talk about the Fed, and just what you think the path is going to be for that matter, and just what you may be hearing inside about Mrs. Yellen and where the things may go with the treasury and the new administration.

Liz Ann Sonders: Speaking of inside. One fun thing about the Fed is that I have two very close friends who, in one case Kevin Warsh, did serve on the Fed, and in a current case, Pat Parker just joined the Fed as president of the Philadelphia Federal Reserve. At the time that Kevin rolled off the Fed and went into the private sector, he teaches at Stanford, I thought, "Oh, going to get lots of juicy -." He's just as tight lipped as he was when he was inside the Fed. I thought the same thing about Pat. In fact, I even said, "Hey, next time I'm in Philadelphia let's get together." He joked, he said, "You know I'm not going to tell you anything that you don't already know." It's like, "Ahh."

It's our view that this year is not going to look like 2015 and 2016 where the Feds sort of hems and haws, and finds excuses not to move, and that we only get one rate hike. In fact, I think the market is more connected with the Feds use right now. So for the first time since the Feds started raising rates in December of 2015, the market and the Fed are actually fairly in sync. In fact, the market right now, using the futures market, actually has a slightly higher expectation for where the Fed funds rate is going to end at the end of this year, which is the first time that's been the case. That market has been way below the Fed, and it said, "You know what? You're not going to be anywhere near that aggressive, and the market has been right." Now the market is on a more aggressive path this year.

So we think three rate hikes is probably a pretty safe assumption barring some calamity in the economy. Frankly, we think it's a good thing. We've been, as a firm, we've been strongly on record as believing that although things like quantitative easing and taking interest rates to zero was the right elixir for what ailed the economy in the early stages, but that when you have a central bank eight years later still treating the economic patient like it's in the trauma room, that's not really a good confidence boosting thing. Not to mention what it's done to income disparities. Not to mention what it's done to inflating asset prices without the benefit to the economy. So we view this move, baby steps admittedly, toward policy normalization as a very positive thing.

In addition, if you look back and look at historical rate hike cycles, you can separate them into cycles that was moving quickly, which is most of the cycle since the late 1970s, not including this one, versus cycles where the Fed was moving more slowly, which there were about five of them prior to the late 1970s. In the first year of those cycles, the market did extremely well when the Fed was moving slowly. Didn't do so well when the Fed was moving quickly. Interestingly, when you move into year two of those cycles, that reverses, and if the Fed continues to move slowly, the market has to suffer a year or two. If they pick up the pace the market does better.

It's intuitive. If we're in an environment that still justifies the Fed moving as slowly as it has in the last two years for this next entire year, I don't think that's an environment very positive for stocks. So I think an environment where the Fed has to be a bit more aggressive relative to their prior past, as long as it's not way beyond expectations we think that that's a good thing for the market.

Debashis Chowdhury: So the history of the Fed has really been tied to monitoring, and measuring, and capping inflation for the better part of recent history, and now there's this dual mandate as it relates to inflation and employment. Presumably both of those data points are moving in the right direction, but we don't necessarily have a historical measure on what they do related to employment. How does one go about analyzing their behavior with this *[crosstalk]*?

Liz Ann Sonders: Not only that. You also have – Janet Yellen has her own dashboard of indicators on jobs. They're a little bit different than what we know for looked at in the past, and Greenspan looked at in the past. It's not necessarily just a function of different personalities and different ideologies, but different data points that we monitor, and different ways to measure job growth. A couple examples of that, the JOLTS data has become quite a bit more important than has ever been the case in the past. It's an acronym that stands for Job Openings and Labor Turnover Survey, which used to be this archaic thing that nobody paid attention to, and now it rightly so. It gets a big headline when it's reported, and there's a lot of subcomponents to it.

So the headline number is how many job openings, and that has been – it's a little bit of a saw tooth pattern, but generally skyrocketing. Then it also looks at the hiring rate. What's interesting recently is that job openings continue to go up, but the hire rate has started to flatten out. Some people view that as a concern that things are starting to rollover. What it actually represents, and companies will tell you this, is a pretty problematic skilled staff right now between the jobs that are available, and the skills that are out there, and the employees that are available. That's not a problem that gets solved in the short term. That's a longer term problem.

There's also different ways to measure wages now. The connection between the Feds two mandates, employment and inflation, is that as the economy improves, and employment improves, claimant goes down then wages start to go up, and that alters into inflation. So the common way we've always measured wages is average hourly earnings. It's the data point you get, like we will tomorrow when the jobs report comes out. One of the pieces of information that tends to get focused on is average hourly earnings.

Do yourself a favor, I wish I had a chart, one of these days we're going to do one of these fire side chats. We're going to sit up here with iPads, and we're going to put holograms just go up, or I'm going to be able to say, "Artificial intelligence, " and pop it up there. It would be easy to do. Just Google, "Chart of average hourly earnings back to '08." It may even shade the great recession, but if not, mentally draw an area representing the great recession from late '07 to mid-'09, and you'll see something incredibly odd in average hourly earnings.

For most of the great recession they were going straight up. Does anybody think wages were going straight up in the worst recession since the Great Depression? No. What was happening is average hourly earnings are an average. The majority of people getting laid off when you had seven, 800,000 jobs losses on a monthly basis were on the lower end of the wage spectrum. So what happens to a bunch of numbers if you take a lot of the lower numbers out? The average goes up.

The opposite has been happening in this recovery, which helps to explain why average hourly earnings by wages had been so depressed this entire period of time. Because of people going back and getting the jobs are also on the lower end of the wage spectrum: younger people, and that means you're adding a bunch of lower numbers into an average, the average goes down. So in order to account for the mix-shift problem in the number, the Atlanta Fed came up with what I think is a much better measure that they call their Wage Tracker.

It's similar to same store sales or retailers. You may be familiar with that concept. You can't measure a retailer's growth if you're adding in all the new stores that they might be opening. You have to look at same stores. Stores that have been open the full 12 month measurement period, what are the sales there. Well, they did this with workers. Let's look at people employed for the full 12 month measurement period, and then see what the increase is.

Now average hourly earnings have been running at about two three, two four. The Wage Tracker shows about four percent. That is a huge difference in the world of wages. So we are starting to see significant traction in wages, which is part of the reason why you're seeing a pickup in inflation. Not in the case of personal consumption expenditures, which is the Feds preferred measure. Not yet to their two percent target, but other measures like CPI are comparably above the Feds two percent target. So I think they have both sides of their mandate now are telling them, "You can move here."

Debashis Chowdhury: So given that the methodology of calculating some of that, and this idea that in certain parts of the country jobs will be coming back and repatriated, and people will go back to positions in industrial areas such as Ohio, Michigan, et cetera. Presumably, it takes a very long time for the ramifications of that to come through in the data even how you described it. So does that lead to any policy change as it relates to the employment and wage growth measures?

Liz Ann Sonders: Well, I think we've seen some policy change. I think the reason for the popularity, and now the legislation around the minimum wage, was an attempt to sort of help solve that problem. In terms of the job opportunities in the industrial world, and in the manufacturing world, a lot of people think, "Well, the elixir for that is Trump policies, or Trump Tweets on – oh no you don't Toyota. Oh no you don't GM. Oh no you don't Carrier." The reality, though, is that when you actually look at the data, try actually look at the data, most of the job losses in manufacturing have not been a function of offshoring. Been a function of innovation.

So unfortunately those jobs are not coming back, and that's where that also goes to the skills gat that we talked about. We've got some serious problems that need to be addressed that the unfortunate thing is that it's turning an ocean liner, not turning a speed boat. The good news is I think the private sector is starting to address this. There is some really cool stories out there of companies that are at the mercy of the skills gap, and they're saying, "You know what? We've got to do something about it, so we're going to set up apprenticeship programs." Some of which, there's some companies that have now figured out how to get these apprenticeship programs into accredited degrees.

"So you, 18 year-olds, instead of going to a typical four year college, come work for us. You'll get the skills you need, you'll get some additional education. We will pay you. You don't pay for your education. There's sometimes some guarantees about them working for you, and you have an accredited degree with a set of skills that the companies actually need." So I think the private sector is doing some interesting things. There's also the renewed sort of growth and interest in community colleges, and the skills and education that they offer.

I went to high school in the early '80s, and Vo Tech was a big thing in my high school. Then younger people say, "I don't what you're even talking about." So I think that the economy, and companies, and even educators are coming around to figuring out this problem of this skills gap. That's where, I think, we start to see some job creation again in areas where the jobs exist. There's a lot of places where the jobs don't exist anymore. They won't ever exist, and we just have to come to grips with that reality.

Debashis Chowdhury: Well, I think that's a welcome view given the number of educational institutions that are represented here in the room. Maybe what we'll do here is open it up to questions from folks in the room. As we did before, we got a number of mics wandering around, or perhaps a couple on the front table. So why don't we go ahead and open it up. You raise your hand and we'll get a microphone to you.

Audience: Okay, I always kick it off. So three steps and a stumble – was that Marty Zweig? Did he coin that term too?

Liz Ann Sonders: Yeah. That was him too.

Debashis Chowdhury: Was that him too?

Liz Ann Sonders: Mm-hmm.

Debashis Chowdhury: So let's talk about that. So the bottom line is we get three rate hikes, and then watch out, or is it the interval of the rate hikes? I think that's -

Liz Ann Sonders: You know what? I have to say that my gut tells me that we can't look at this cycle as anything resembling the cycles in the past. That I think folks like Marty, when looking at the effects of monetary policy, I think going to observe three rounds of quantitative easing, taking the Dow at four and a half trillion dollars, much of the rest of the world going into negative interest rate territory, I'm not so sure that the same applied. That said from a Fed move standpoint, I think there are actually two risks that could maybe cause a bit of a corrective phase in 2017.

They both relate to if inflation keeps up here, and the economy really picks up, it's binary in the sense that I think the Fed either might get too aggressive, which I think the market would have a tough time digesting, or they decide to let it run hot for a while. Then the vigilantes come back into the mix, as some would argue already are, and their perception is that they've gotten behind the curve. So I think those are the risks, whether it ends up being at the point of the third hike. Maybe it's not as clean as that, but I think if the market and the Fed stay in sync, and that's what the Fed actually does, I don't think that is a big risk factor. I think either they get behind the curve, or being forced to get more aggressive would cause problems for itself.

It also depends on what long term interest rates do. Right now we're in a pretty nice environment. We're in the third major phase in the post 1920s era of coming out of the deflationary period and going back into reflation. In those prior two phases between the 1930s and then coming out of World War II, bond yields and stock prices became very positive, it correlated, and we're in that environment now. We're all taught in finance 101 that rising bond yields curse the stock market, but when you're coming out of a deflationary period and bond yields start to rise from an incredibly low base, in this case, the 10 year yield from base was 1.3 percent.

The early stages of that are very positive in stock market. Because number one, they're rising because economic growth is improving, but they're also rising because deflation risk is ebbing, and you're getting some reflation, and deflation is toxic for equities. So I think we're going to stay in this sweet spot. Ultimately, it's not just what the Fed does, but what's the long end. If the yield curve can stay fairly steep I think the market is okay. If the yield curve starts to flatten, that's a warning signal.

Debashis Chowdhury: So taking off your point of high yields, that issuance at the corporate level, both public and private, has excelled tremendously. The question is, with rates rising what's your firm's views on the potential impacts pushing companies into a distress situation?

Liz Ann Sonders: I'm not the fixed income expert, but I know our view is that certainly a year ago we thought the fault risk was fairly high, but largely concentrated in the energy and energy related areas. Obviously we've seen some improvement to the fundamentals there, so that specific risk has lessened. I think the reason why you've seen credit spreads behave is that a lot of that corporate borrowing was done not because of need, but because of a rational decision that rates are so low, and a lot of that money was used to buy back stock.

That's a very different situation as the borrowing picks up because of financial needs. We still think you're going to see sporadic defaults, but we don't think we're entering into a significant default cycle here unless rates really, really accelerate from here. That is not at the top of the list even over fixed income folks is a major concern right now. It was, again, a year ago, but it was largely specifically the energy sector.

Debashis Chowdhury: I'll ask another question since you mention negative rates, or debt being issued at negative yields. We seem to have avoided that successfully here in the United States. Rest of the world it's obviously unprecedented. Is it too early to tell what the consequences, untended or otherwise, are about that?

Liz Ann Sonders: I think our view from day one was that this was going to be a failed experiment, and I think even the central bankers themselves, that many of which were initially in favor of it whether they admit it or not, probably view it as – maybe failed experiment is too strong a word, but untended consequences. I think number one, this idea that when you go into negative interest rates you're going to stimulate borrowing and consumption and investment just did not to prove to be accurate.

In fact, what it did was complete opposite. It stimulated even greater savings, and greater concern about the long term health of the economy, which puts a clamp on things like investment and long term capital spending. So it didn't incentivize anything that was expected, and it had a lot of perverse, caused a lot of perverse fund. It's also, by the way, one of the reasons why gold went on a tear during the period it was on a tear because I got this question all the time, "Why is gold up so much? Isn't gold supposed to be going up when inflation is rising, not when you're sort of further in trench in deflation?"

What happened with gold, and the reason why I thought it lost some of its luster when we started to move away from negative interest rates, is gold has always been what they call a negative carry investment, so it doesn't earn a yield, but it costs money to store. So you're basically in the red initially when you purchase gold. Well, relative – if you're buying gold as an alternative to a currency, that's always been kind of an apples to orange comparison. Because you can buy debt in Germany and get a yield, so you were comparing a positive carry investment to a negative carry investment.

Well, when you took much of the world into negative interest rates, now sovereign debt had a negative carry. So now it's negative carry versus negative carry. The playing field is level, and the price is going up in gold, so it became a great thing. Then when we moved away from – started to move away from negative interest rates, I think that's what kind of put the kibosh on gold, but it also, I think, exacerbated the mispricing in terms of asset classes. I'm certainly happy that we were never forced to go down that path because I don't think it would have been any more successful an experiment here than it was in the rest of the world. The backpedaling has begun.

Debashis Chowdhury: Your comment was a good one. When I look at what's happened over the last number of years since the recession, what we've done is we've taken the government balance sheet and we drained it, and drained it badly. Then we've enhanced the personal balance sheet and the corporate balance sheet, each of which are probably bigger than the government balance sheet in totality. When I look as an investor and thinking about investing in the United States, I sit back and say, "Understand the one year and two year things that we're talking about," but if I'm investing real estate at a five percent cap rate, that's a 30 year business fund." If I'm starting a business, or investing in a business, that's probably at least a 20 year business fund.

So when I look at the structural debt problems, the way the government's going to have to go into the other two balance sheets and draw it back in to pay for theirs, why is the U.S. a good long term investment?

Liz Ann Sonders: I kind of agree on that. I'm not necessarily sure it's a great long term investment. When we think about our views, express our views, it's not with a 30 year time horizon, it's with a significantly shorter time horizon. We are in a more mature phase of the bull market. I think we're in a more mature phase in the economy. I think ultimately we will enter the next recession based on the normal things: monetary policy gets too tight, a bit of over building, and that – I look at a variety of recession models that put the risk maybe out two years.

So I'm not so sure it's the best way. Keep in mind though that the debt problem is not a U.S. problem alone. The debt problem is a global problem. When people say, "When are we going to hit the wall in terms of this global debt problem," my answer is always, "I think we did hit the wall in 2008." What's happened since then is we have a rolling set of crises, and I think we will continue to have a rolling set of crises. I think the net effect longer term is a much more subdued rate of economic growth globally.

Debashis Chowdhury: The countries that are going to – I mean, many countries – most countries have debt problems, not just the United States. The United States has the low -

Liz Ann Sonders: Many have worse debt.

Debashis Chowdhury: Some of them are worse.

Liz Ann Sonders: Particularly those that don't print their own currency.

Debashis Chowdhury: But if you've got an economy that's going to grow at four or five percent over the long run, it seems to be me would have a better chance of winning than an economy that we don't know that can sustain itself at two or three.

Liz Ann Sonders: Well, we haven't had – we've only had two percent growth. So the hope and the key extending this is that we figure out how to get from this new normal post debt super cycle secular stagnation, pick your label for it, that we get out of that environment. The key to that, of course, is productivity. Without a pickup and productivity, which has been incredibly depressed, we at best stay in this sort of stagnation period.

I think there is a decent chance that we can lift both nominal GDP and productivity to a level that extends this recovery. Then I think, at least in relative terms, we're in much better shape than a lot of the rest of the world. If not, then I think that we stay in – I think it's more a post debt super cycle than it is secular stagnation, and that may be just the semantics of the label, but I think there's a decent chance, at least for the next couple of years, we can pull out of it.

I also think productivity is understated. The way we measure nonfarm productivity is the same way we measured it 40 years ago. When you think about how much our economy has changed, and the fact that Uber is the largest taxi company in the world right now, they don't own a single car, Airbnb is the largest lodging company in the world right now, they don't own a single hotel. When we think about point of sale and how business is transacted, and how we get our information, I just think methodology, that is the same as it was 40 years ago, is not picking up the nuances of this new economy.

If that is true, I think it's more likely that we are understating productivity, and therefore GDP growth then overstating it. Whether they fix that problem any time soon is a different story, or figure out how to actually measure that.

Debashis Chowdhury: Other questions?

Liz Ann Sonders: Covered everything?

Debashis Chowdhury: Apparently. We did cover everything. Thank you very much Liz Ann.

Liz Ann Sonders: Thank you.

Debashis Chowdhury: Appreciate it.

Liz Ann Sonders: Thank you everybody.

Debashis Chowdhury: We're going to wrap up here with the general session as this is really the last piece of all of us together. I want to cover a couple of housekeeping items. First of all, as Bob mentioned at the outset, there's three breakout sessions. If you're part of the global equity session you'll be in salon E and F, which will be directly to your left as you exit out of the ballroom here. If you're in the private capital breakout session is directly to the right. The fixed income, the global fixed income session is also down the right, and a short bit down the hallway in the Avalon room. There's plenty of Canterbury people outside to help direct you to the right place.

You will also get an e-mail survey after you return to your homes and offices. We certainly love and appreciate the feedback on the event. We know many of you have been regular attendees for going on nine years now, and every year we're certainly trying to do everything we can to make this as valuable as a use of your time as possible. So please, please provide us that feedback.

Also like to thank Katy Sullivan, who's in the back, and Reshma Patel, who also is in the back. Suffice to say, the event would not be happening if it wasn't for their efforts over the course of the year, so thank you very much to both of you for all the time and effort you put in. finally I just want to thank you as our clients. I mean, the overwhelming majority of people here in the room. Our clients of Canterbury, and we're very proud to have you as clients for many, many years in most cases, and this event just wouldn't be the same without you and your support, and we certainly look forward to continuing to earn your confidence in the years to come.

Thanks everybody. Enjoy the rest of the afternoon, and we'll see you at the breakout sessions.

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