

MORNING KEYNOTE: LATE CYCLE LAMENT



JAMES MONTIER

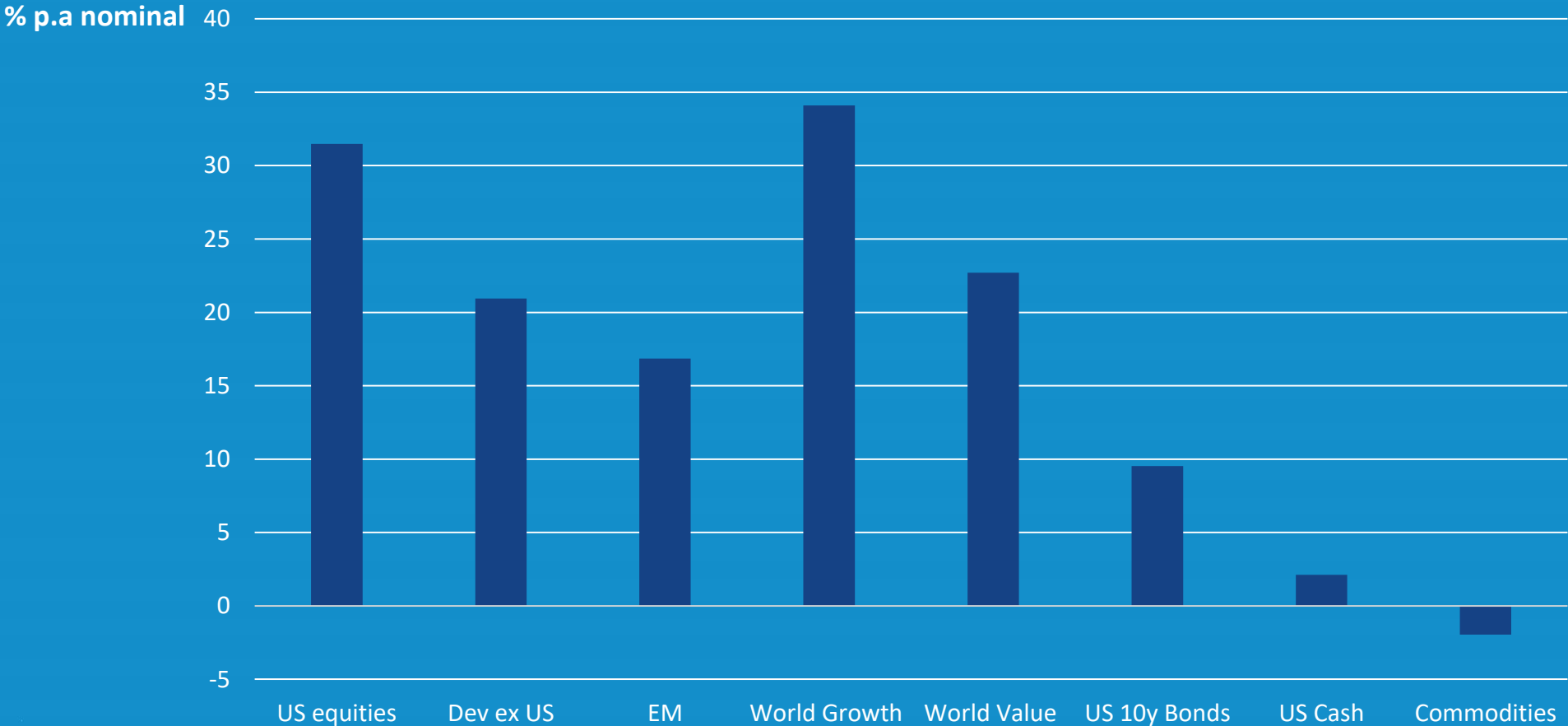
PARTNER AND SENIOR ASSET ALLOCATION STRATEGIST

GMO

LATE CYCLE LAMENT

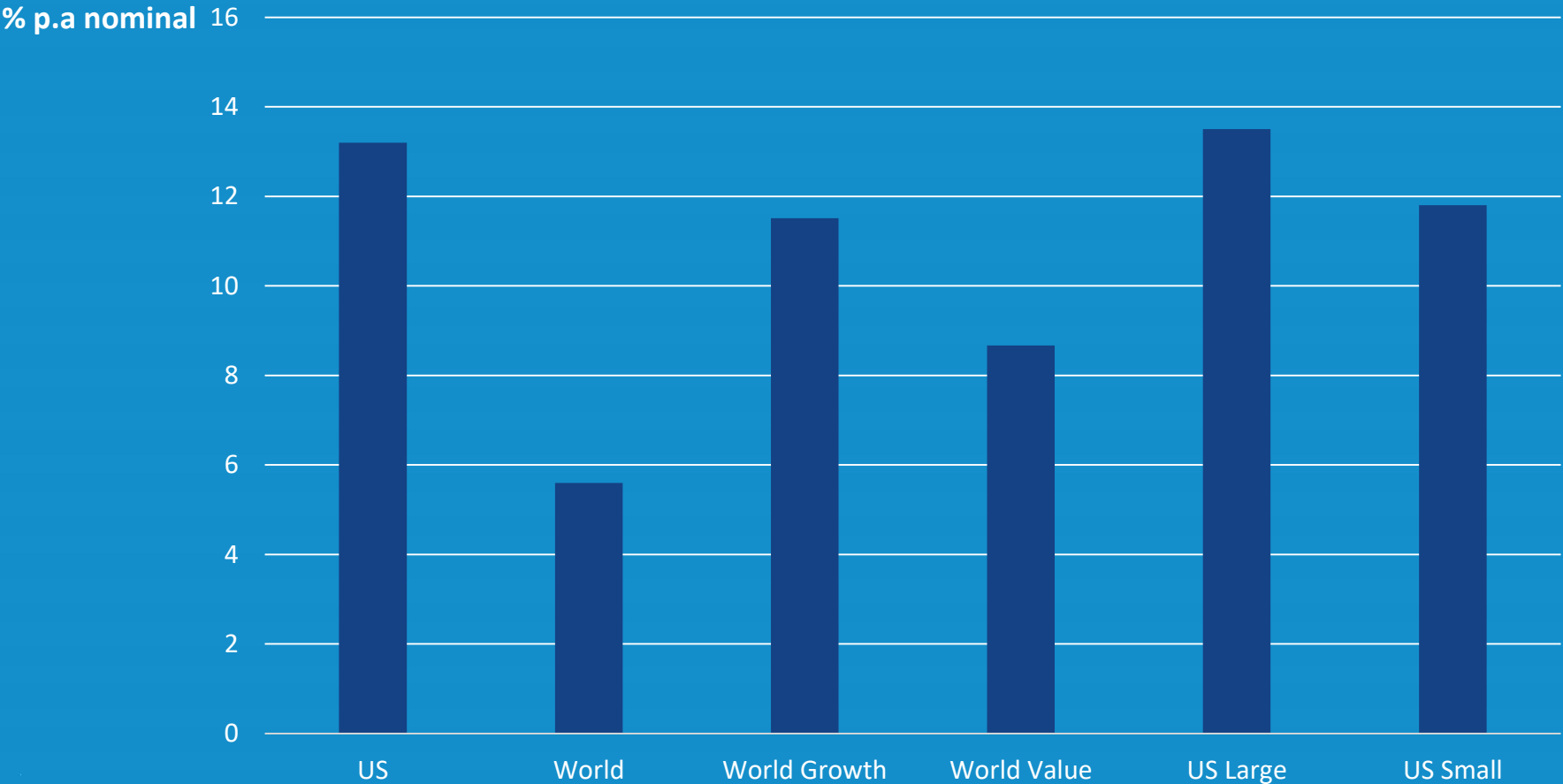
James Montier

2019 – A BANNER YEAR FOR US EQUITIES



Total returns except commodities, Source: Datastream, Bloomberg

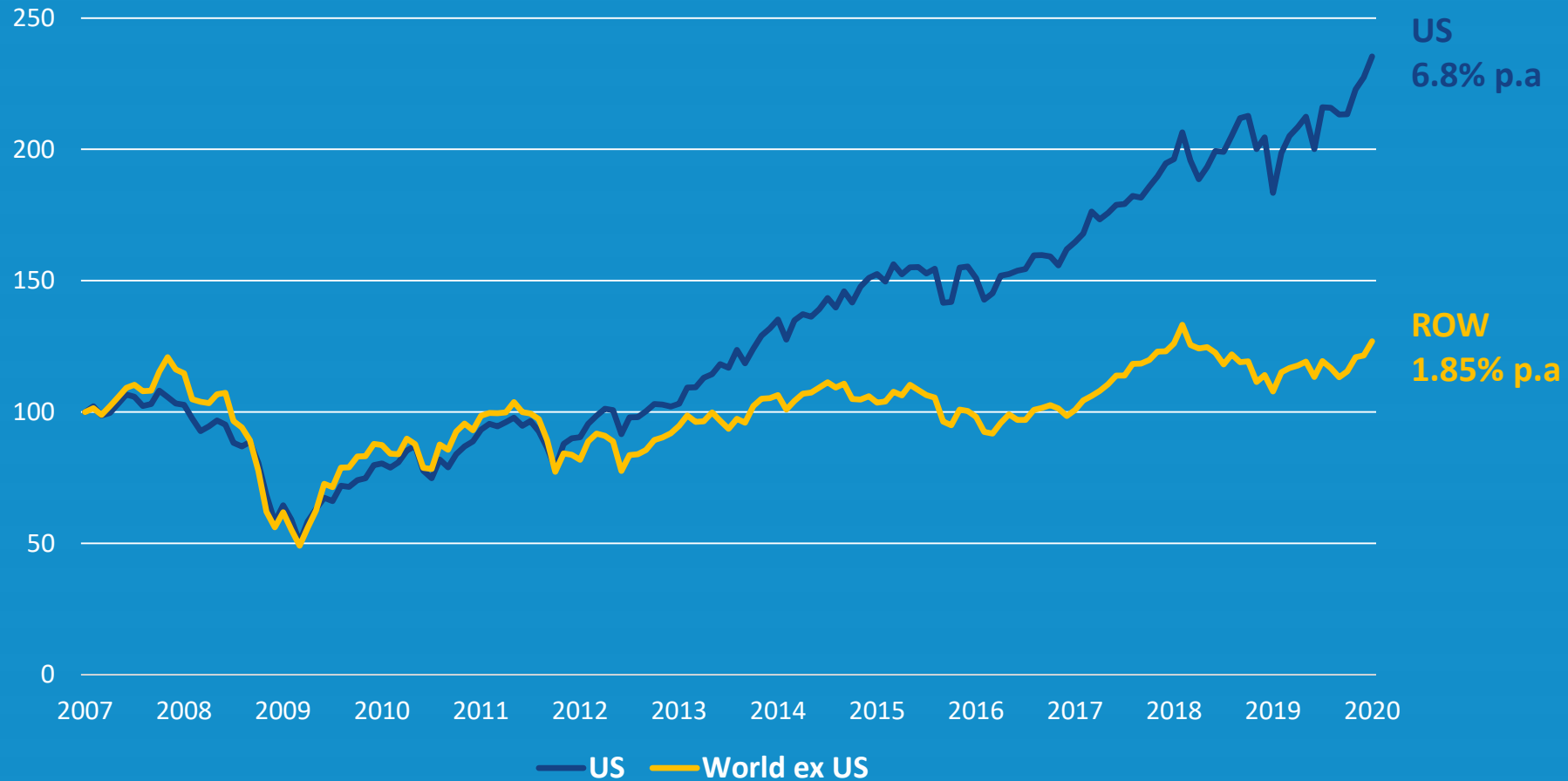
IN FACT, IT'S BEEN AN ODD DECADE



Source: Datastream, Bloomberg

NOT OWNING THE US

The pain of an asset allocation contrarian – US vs ROW Real Returns

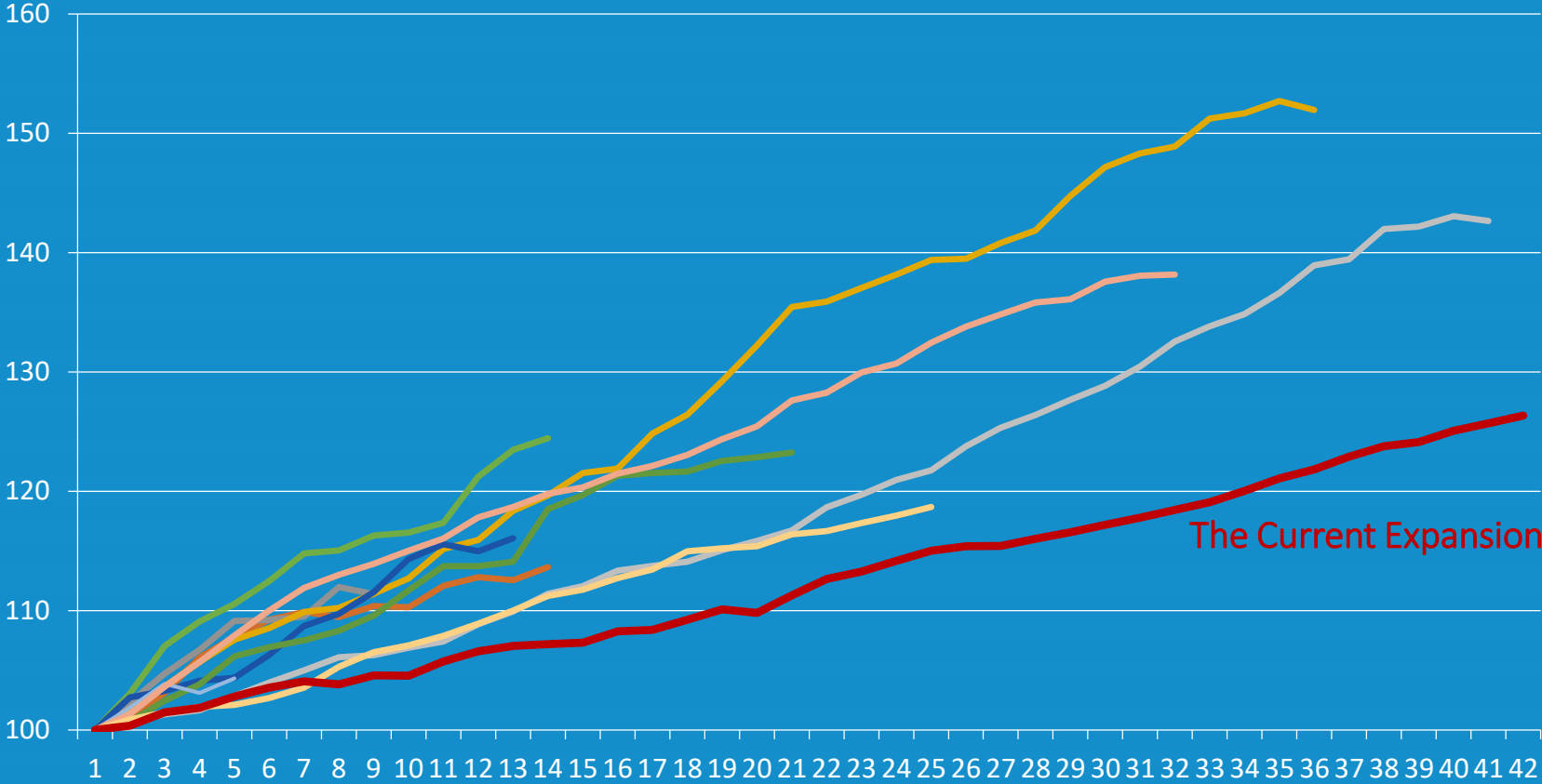


Source: Datastream, GMO

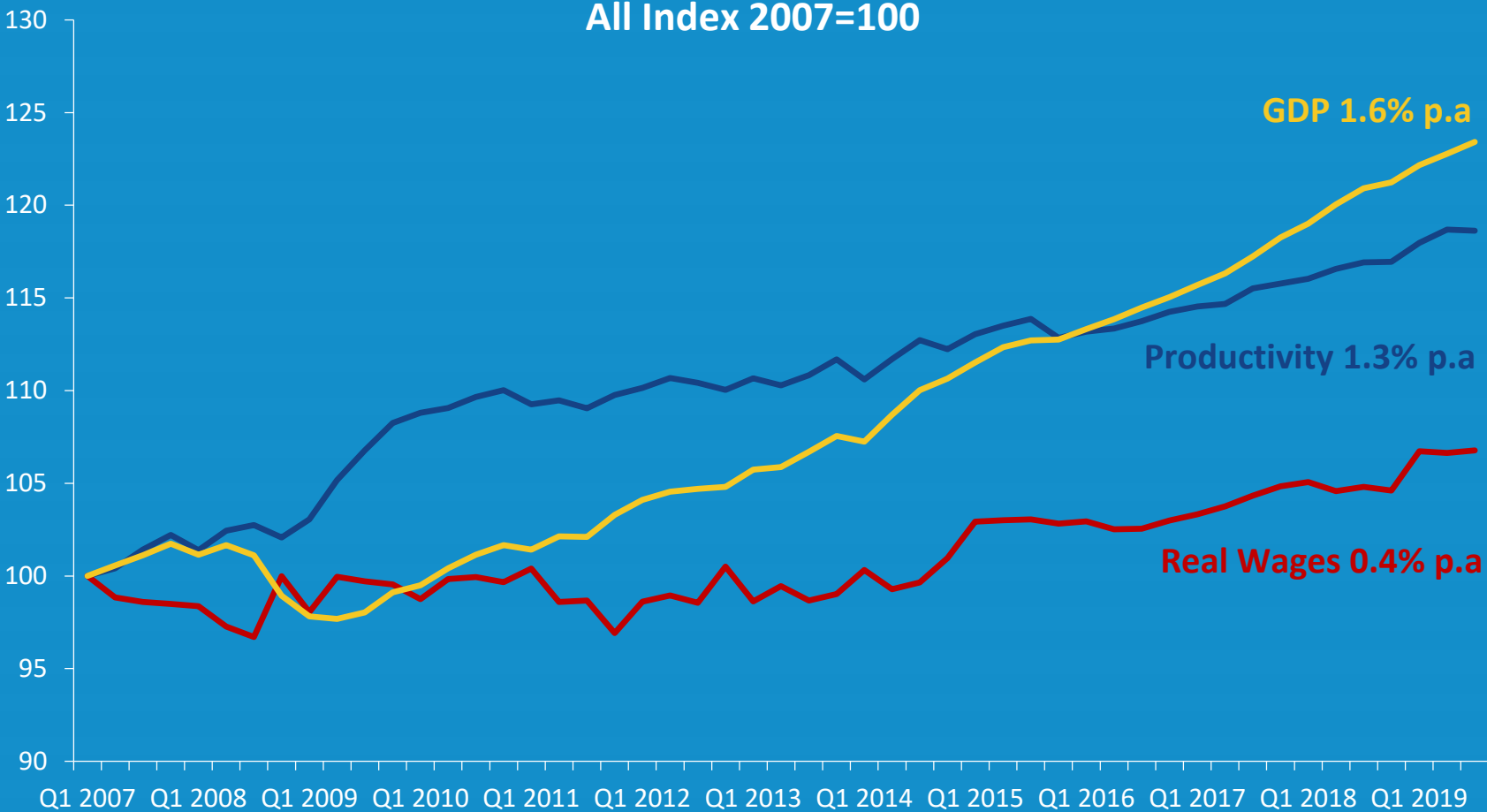
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REALITY CHECK – THE WEAKEST AND SLOWEST RECOVERY EVER!

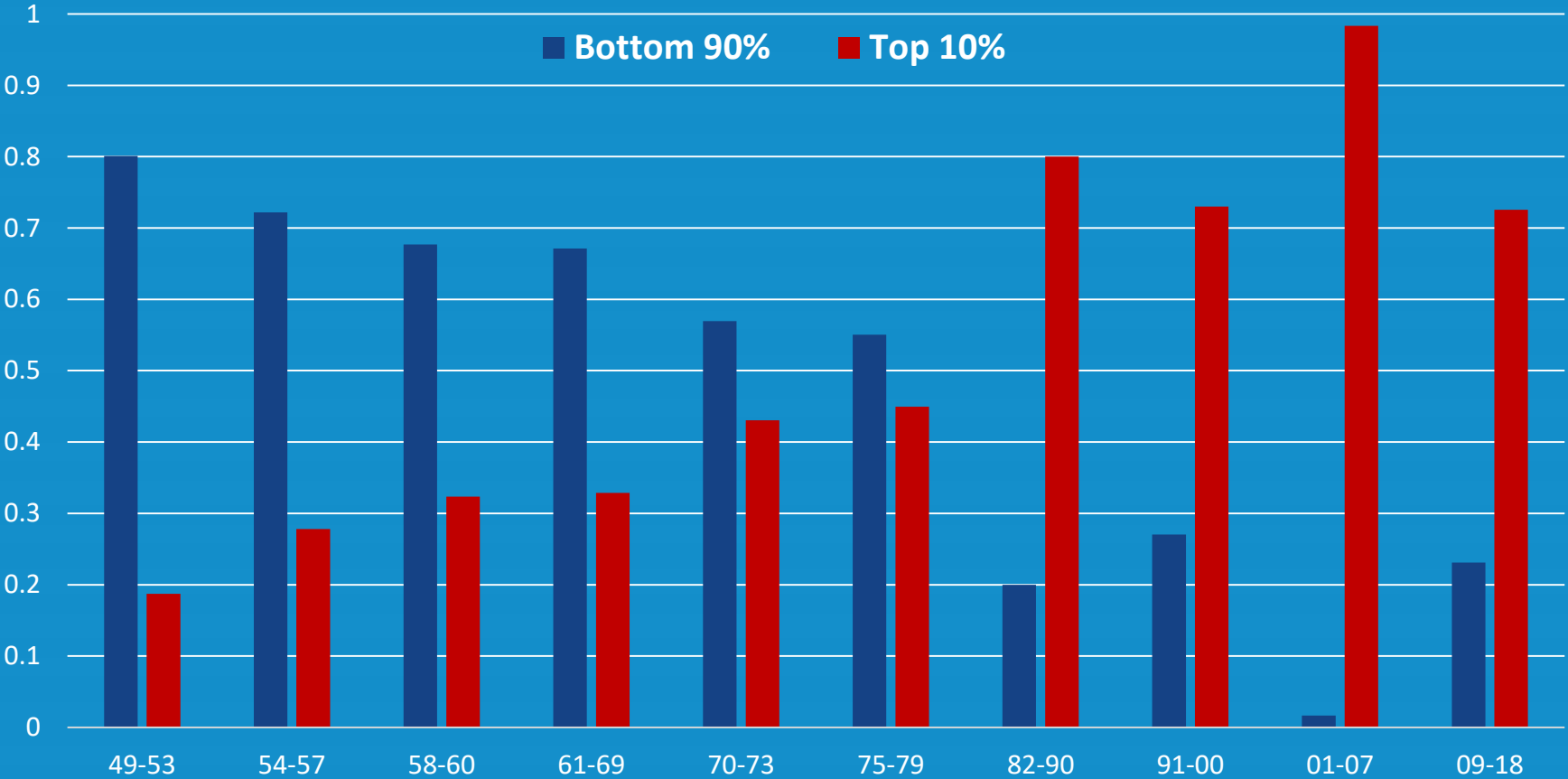
GDP Flight Paths – Post War Expansions



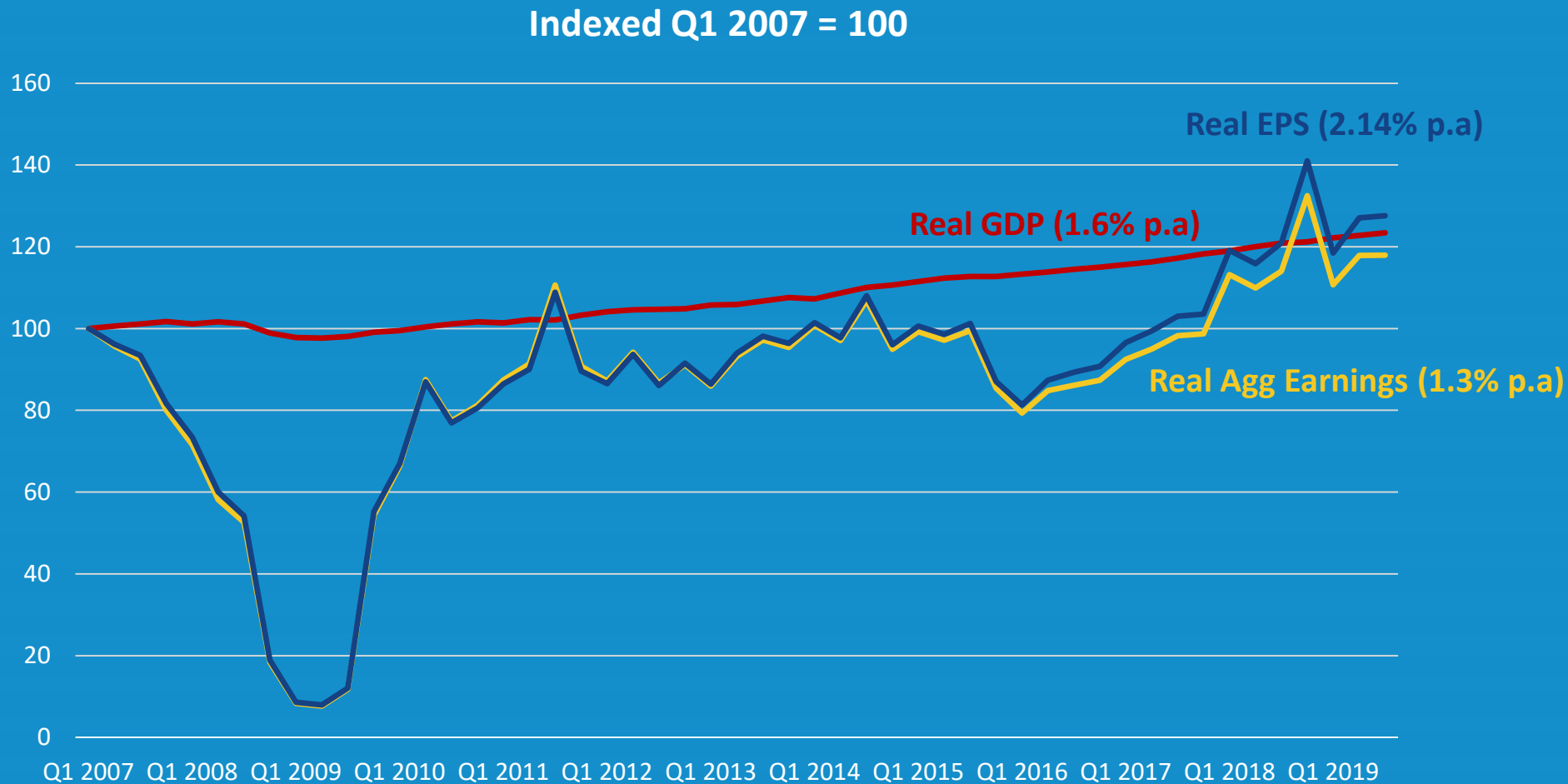
AND IF YOU THOUGHT THAT WAS BAD...



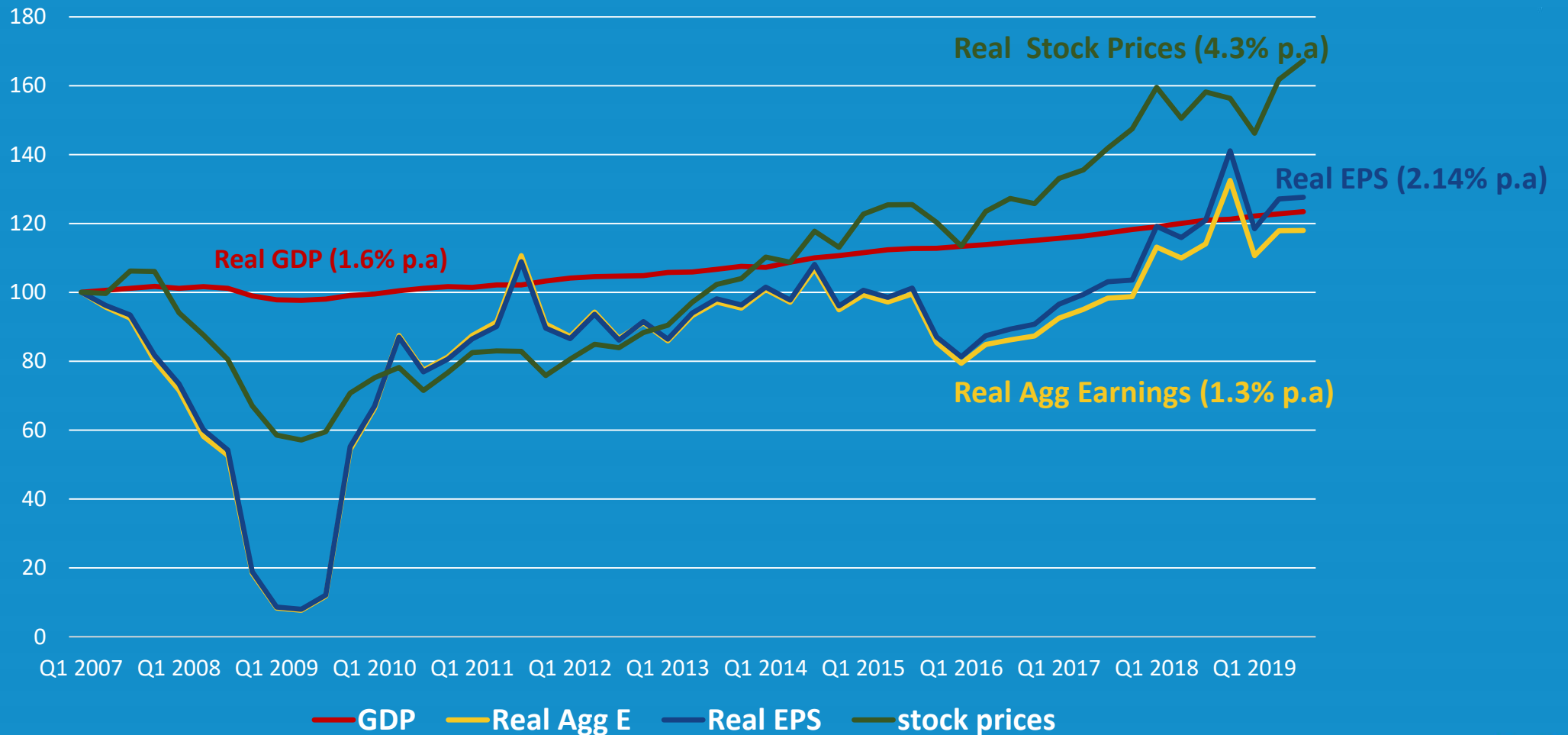
THE TOP 10% ARE CAPTURING THE INCOME GROWTH



BUT SURELY EPS IS JUST FINE...



BUT REAL STOCK PRICES HAVE SOARED...



WHEN WOULD YOU RATHER BUY?

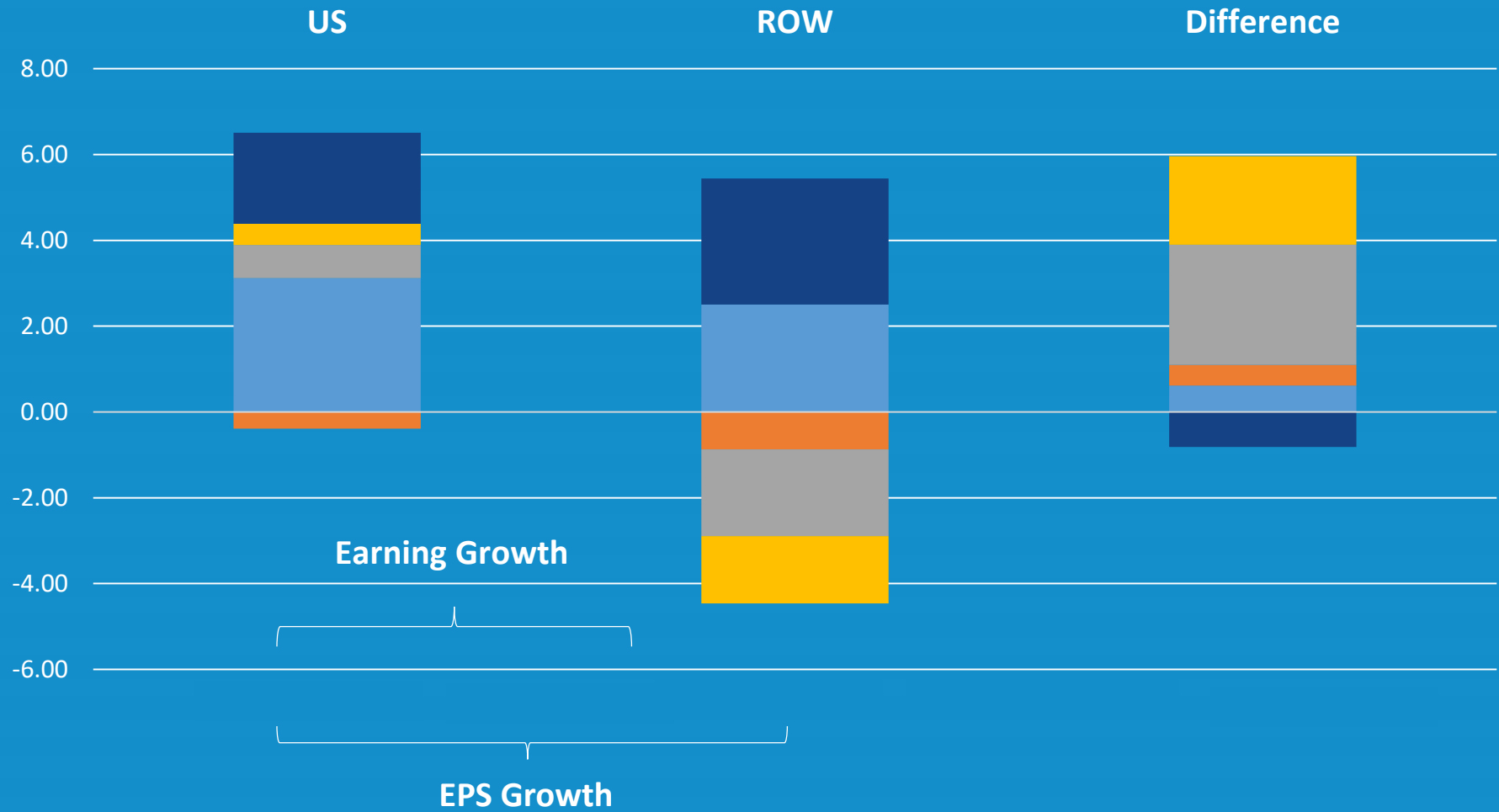
There are three principal phases of a bull market: the first is represented by reviving confidence in the future of business; the second is the response of stock prices to the known improvement in corporate earnings, and **the third is the period when speculation is rampant – a period when stocks are advanced on hopes and expectations.**

There are three principal phases of a bear market: the first represents the abandonment of the hopes upon which stocks were purchased at inflated prices; the second reflects selling due to decreased business and earnings, and the third is caused by distress selling of sound securities, regardless of their value, by those who must find a cash market for at least a portion of their assets.

– *Robert Rhea, The Dow Theory, 1932*

DECOMPOSING THE PERFORMANCE GAP

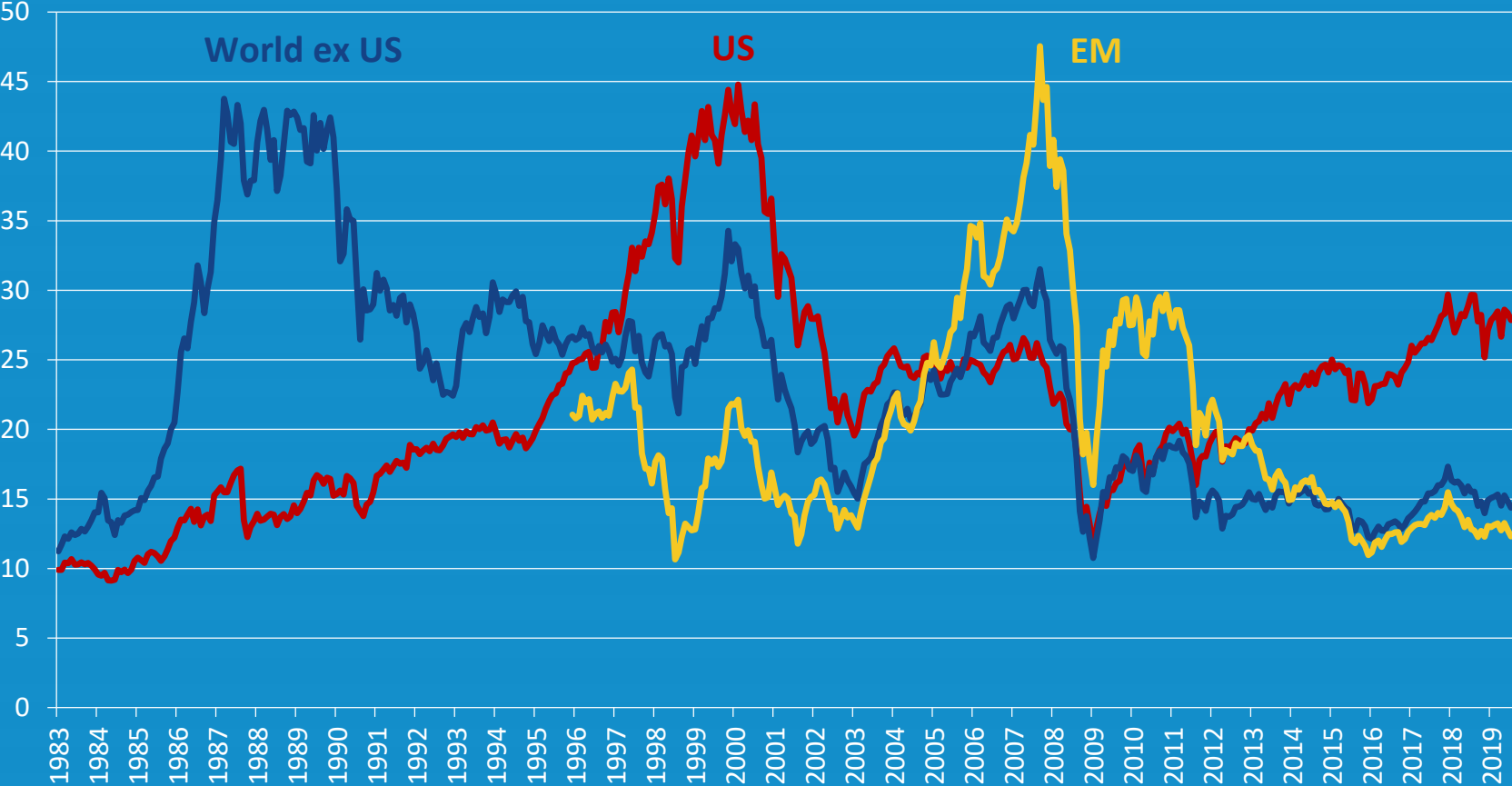
US vs ROW, % p.a



Source: Datastream, GMO

SHILLER PE AROUND THE WORLD

Anything but the US



Source: Datastream, GMO

TO GET 5.7% REAL FROM THE US YOU NEED TO BELIEVE...

▪ P/E

- Average PE 1871-2018 → 14.5x
- Current level → 25x
- To get 5.7% real → 32x

**Higher than the peak
during the tech bubble ...
3 standard deviation event**

▪ Return on Capital

- Historical average → 6%
- Current → 7.1%
- To get 5.7% real → 10.2%

**A nation of FAANGS....a 4
standard deviation event**

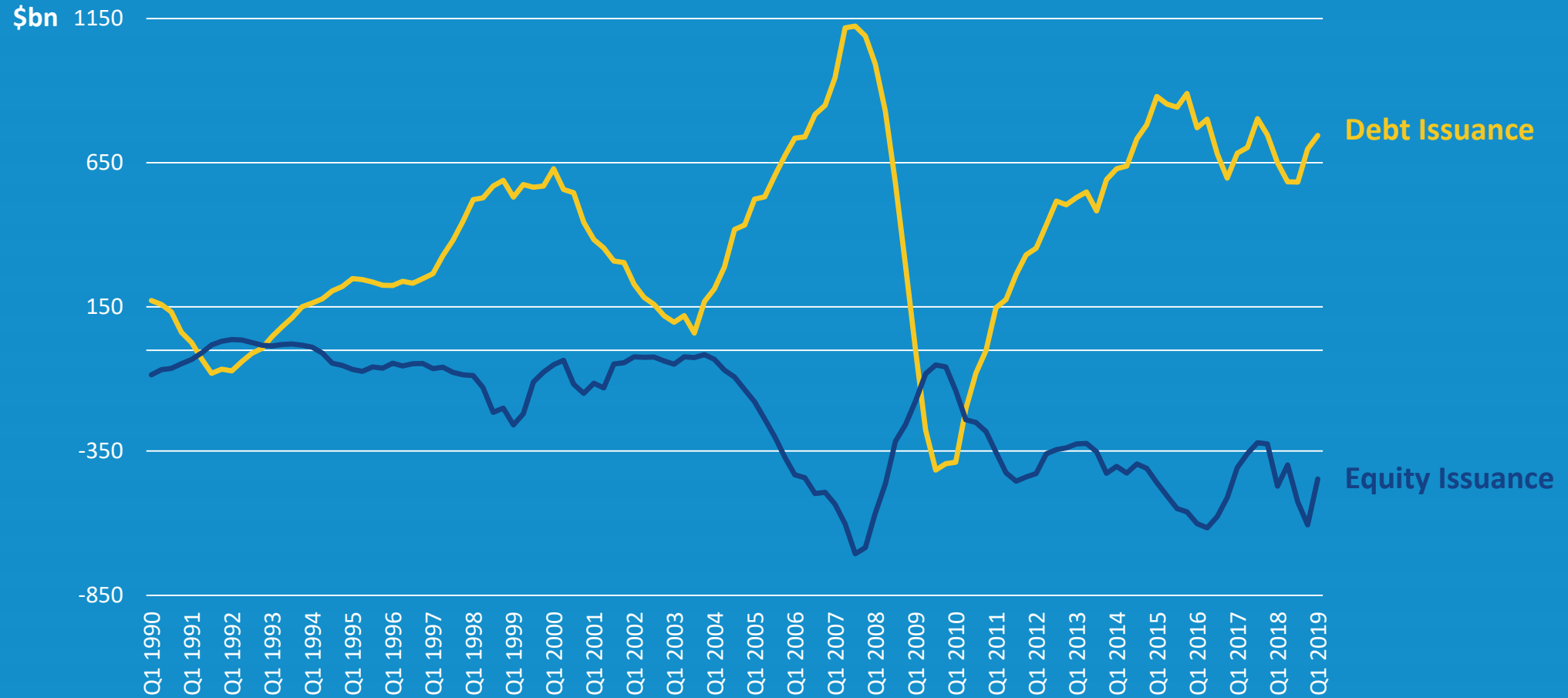
▪ Growth (and yield)

- Historical average → 6% (4% yield + 2% real growth)
- Current → 5.1% (1.8% yield + 3.3% growth)
- To get to 5.7% → 13.5% (starting with 1.8% yield implies 12% growth!!)

A 6 standard deviation event!!!

BUYBACKS

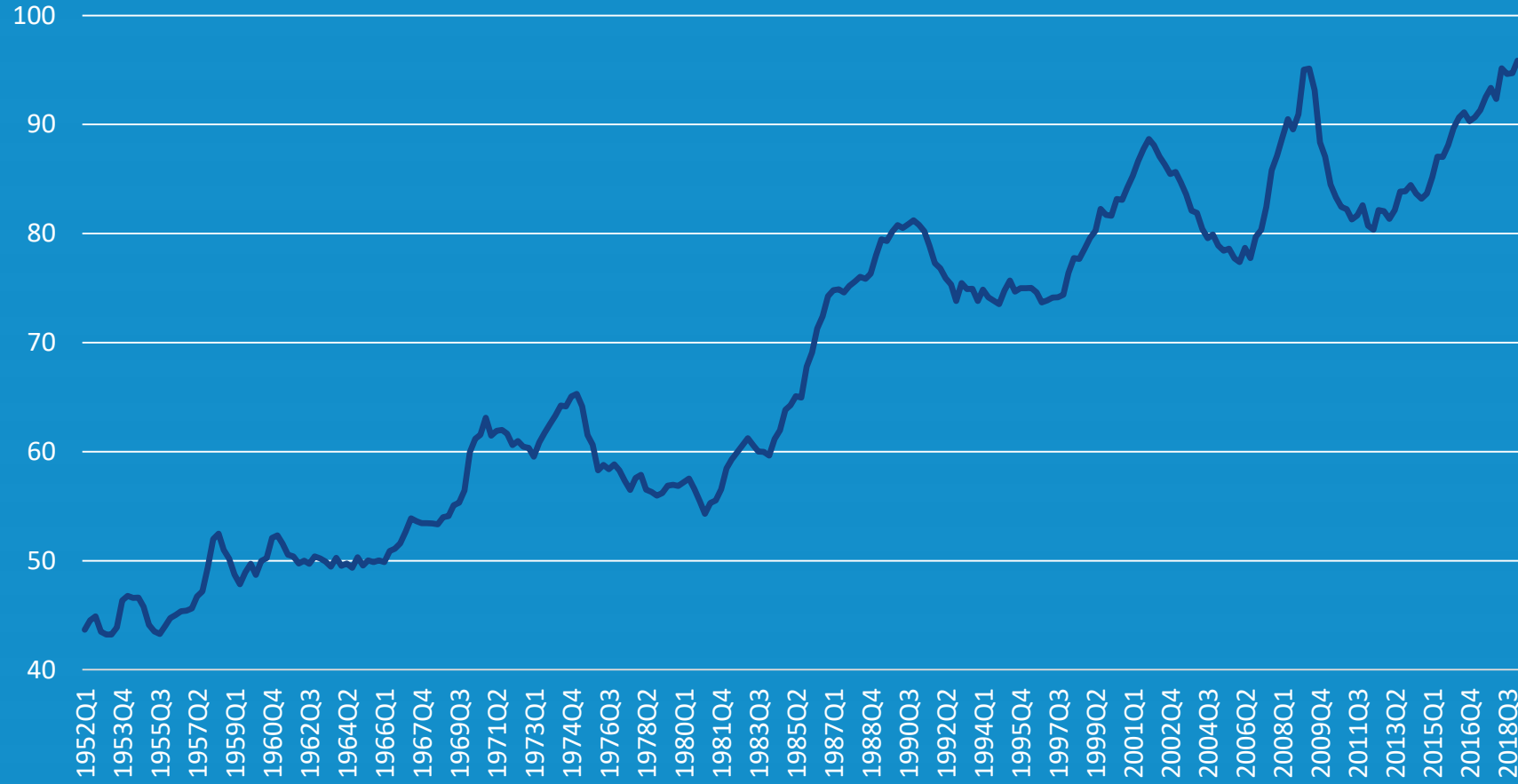
A massive debt for equity swap



Source: Federal Reserve, GMO

US CORPORATE DEBT TO GVA (%)

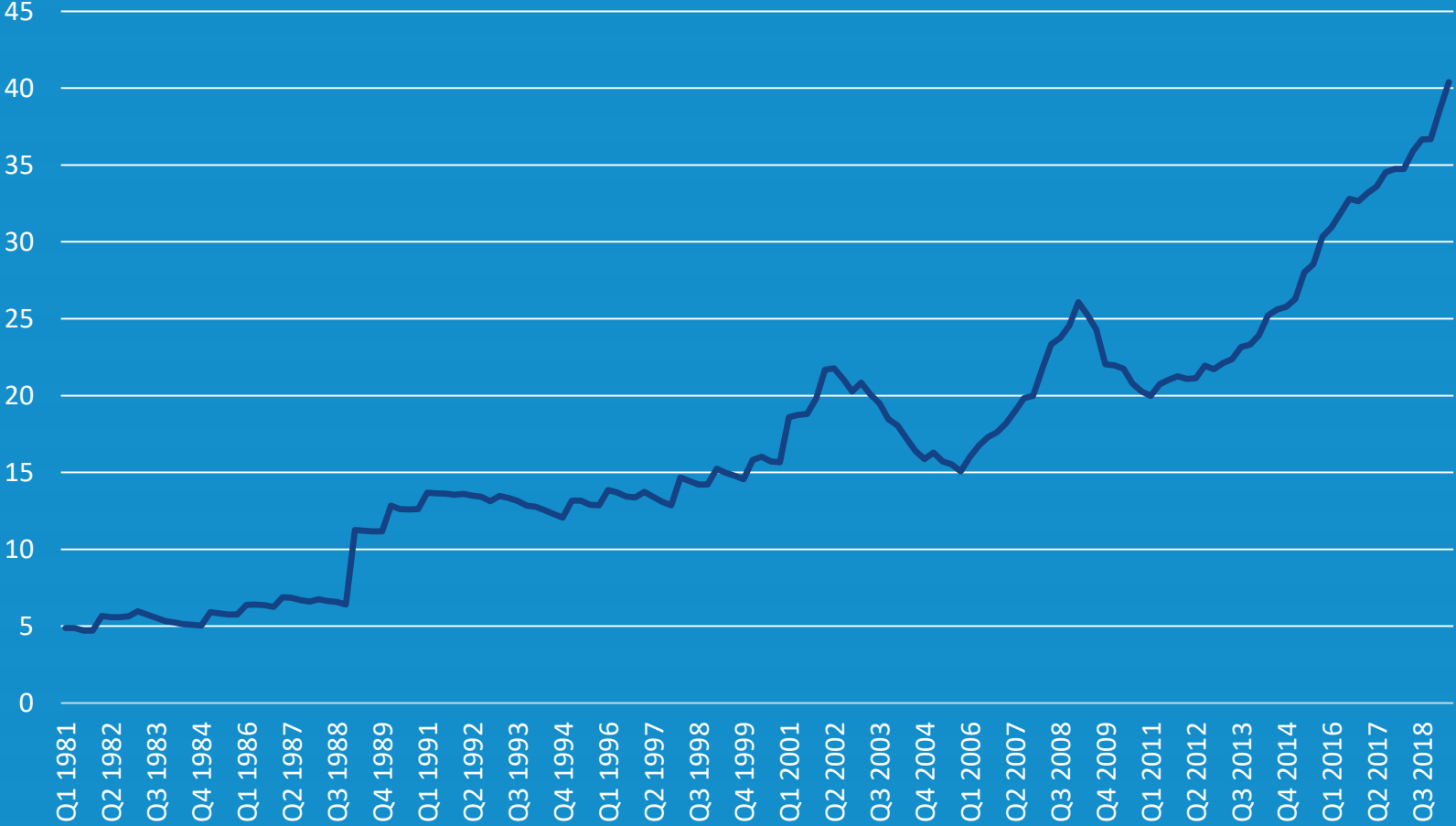
Minsky like vulnerability



Source: Federal Reserve, GMO

AND THE LISTED SECTOR IS DRIVING THIS

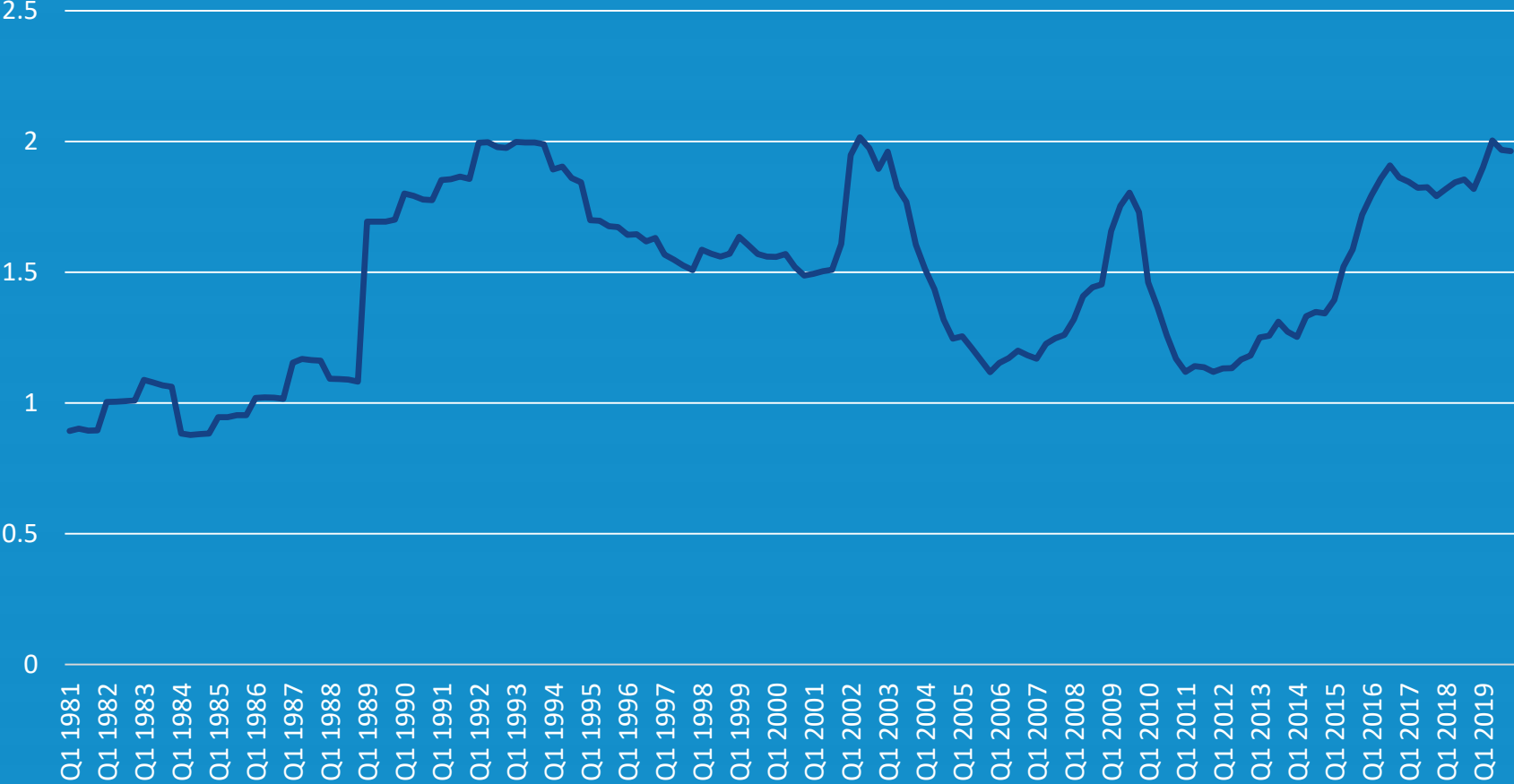
US non fins listed sector Net debt to GVA%



Source: Worldscope, GMO

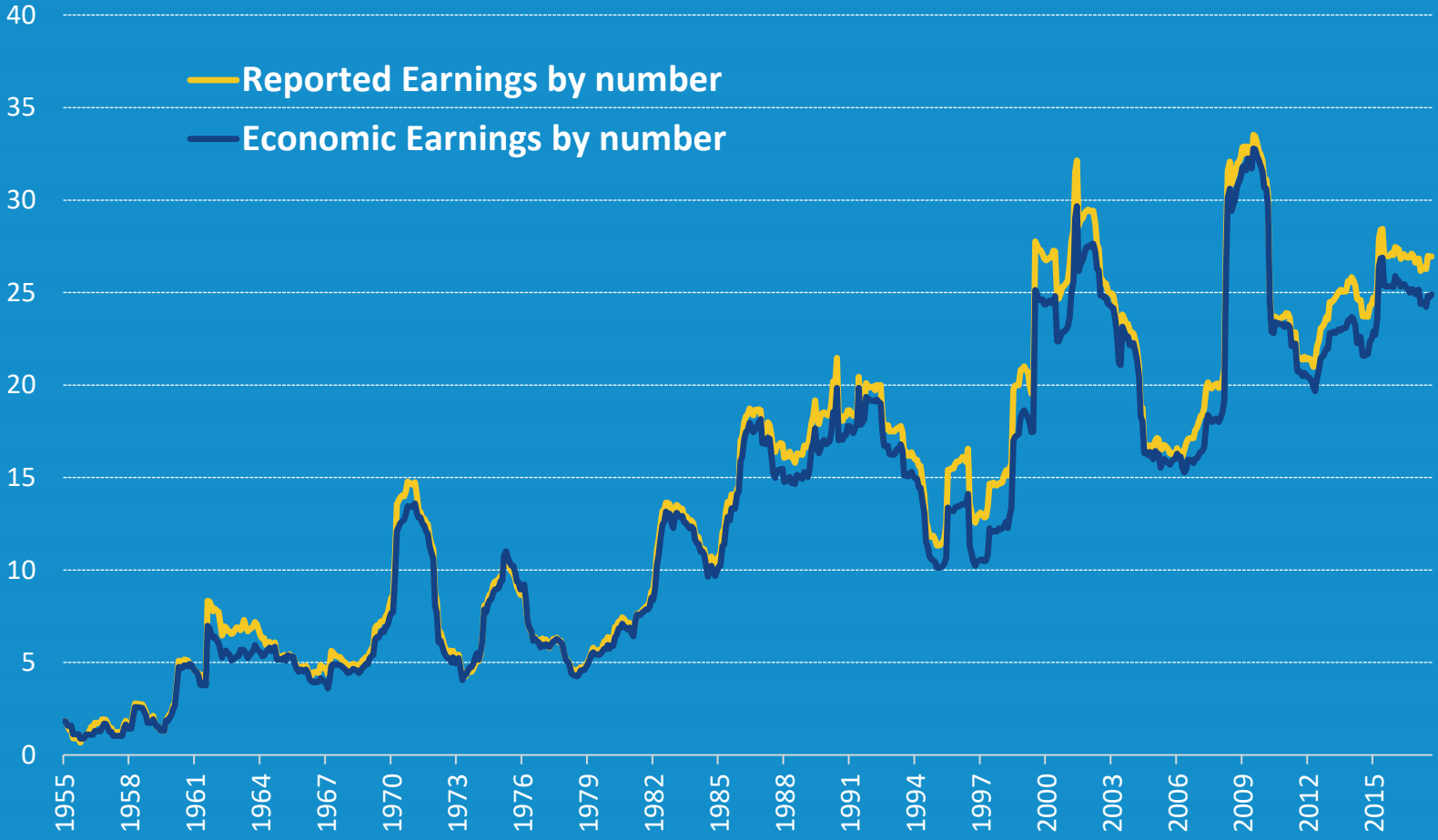
AND THIS AT THE PEAK CYCLE NOT TROUGH!

US non fins listed sector Net debt to EBITDA (x)

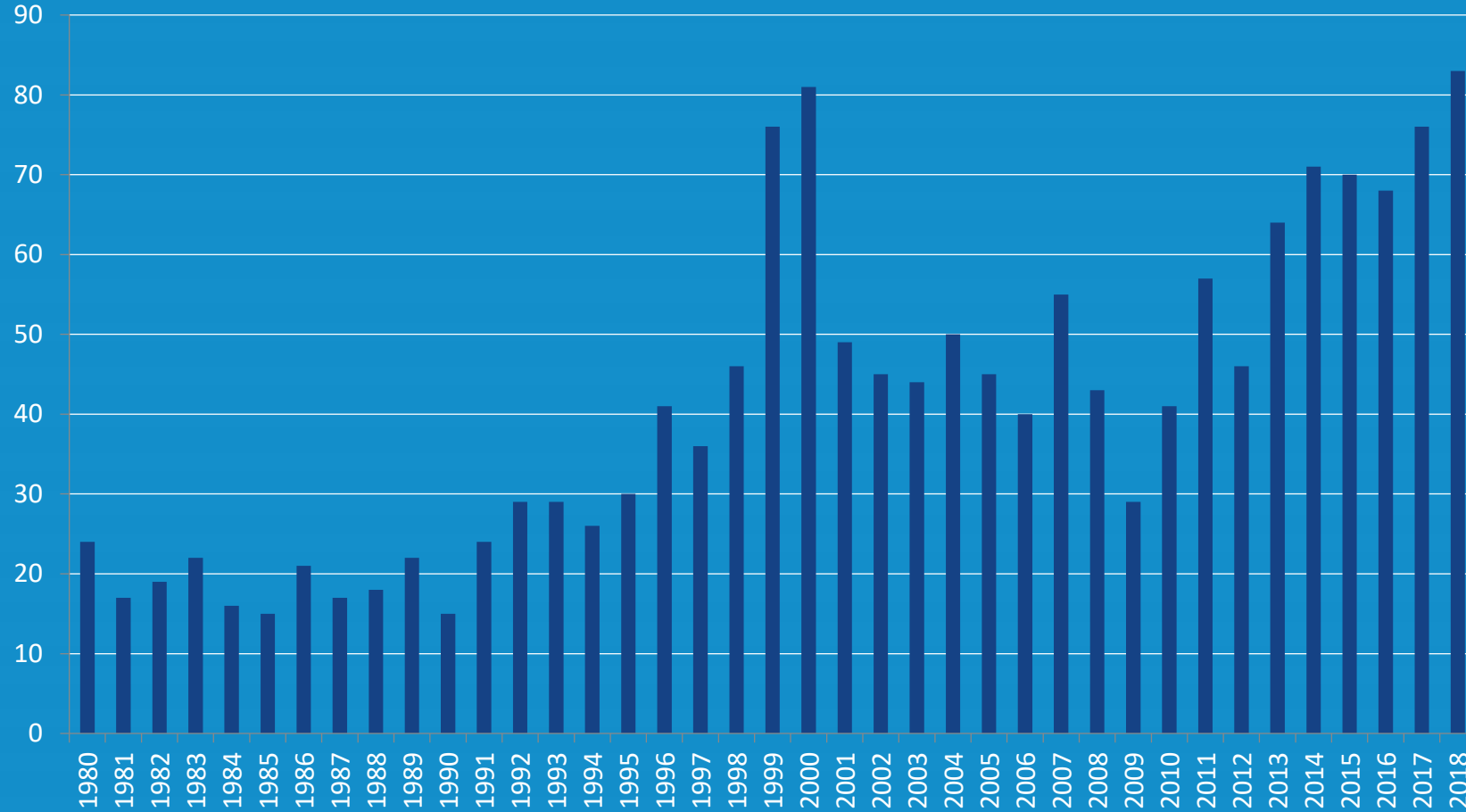


Source: Worldscope, GMO

AND A QUARTER OF ALL FIRMS ARE MAKING LOSSES!!

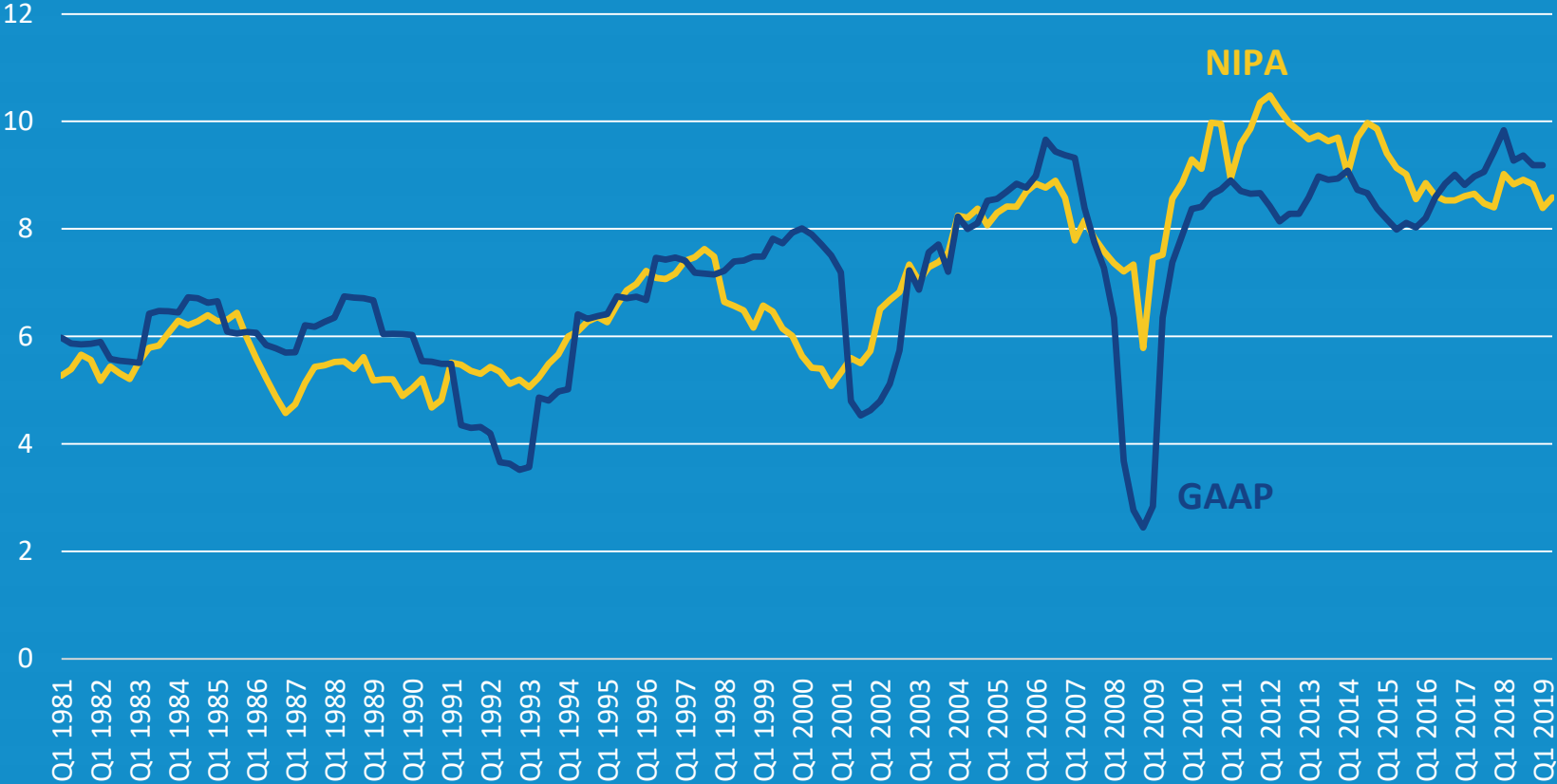


% OF IPOs WITH NEGATIVE EPS



THREATS TO CASH FLOWS ARE THE KEY CONCERN

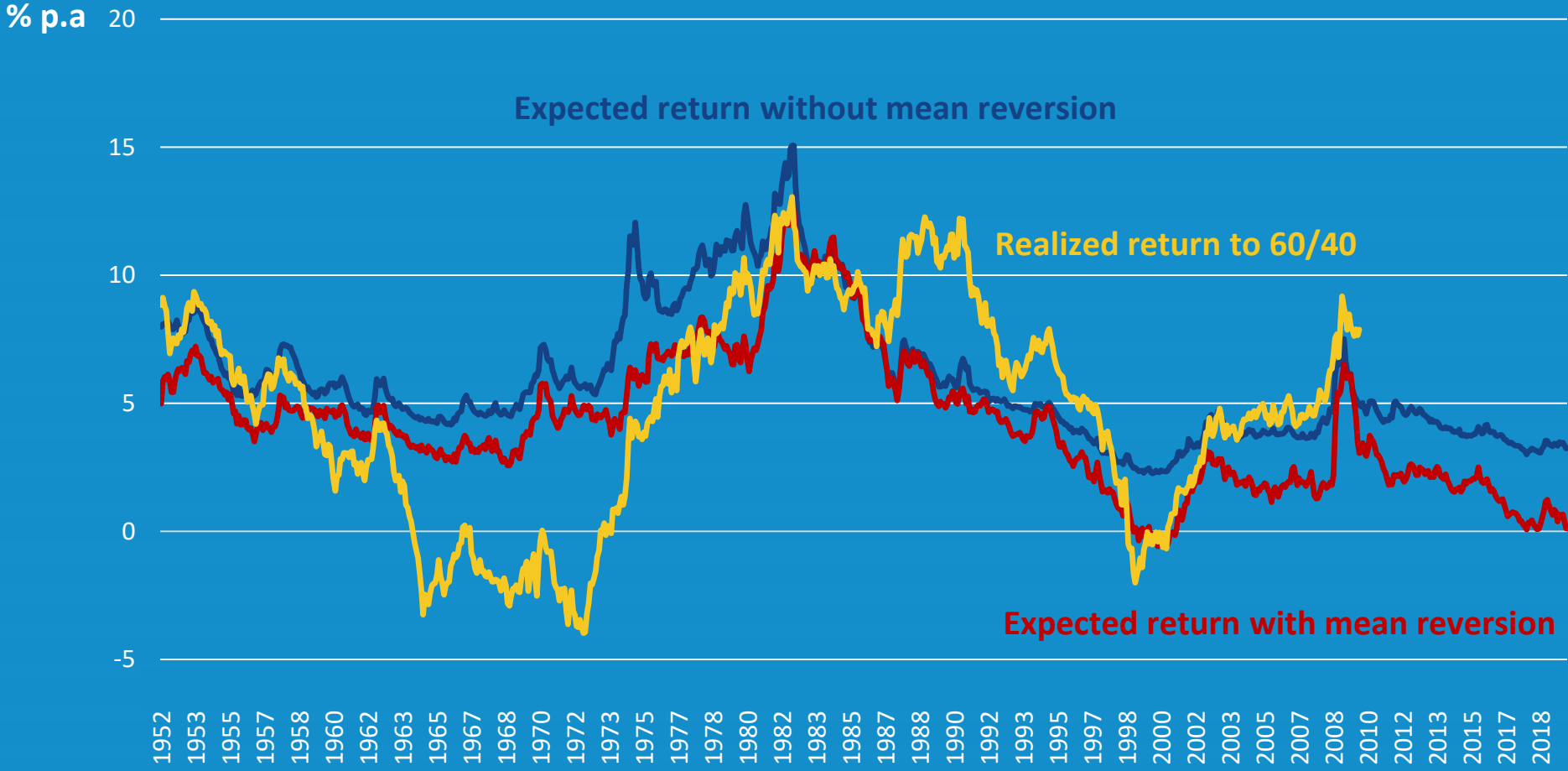
Profitability (RoS)



Source: FRED, Worldscope, Datastream, GMO

YOU NEED TO BE DIFFERENT

60/40 looks set to earn little to nothing!



CONTRARIAN AND UNCONVENTIONAL

Simple but not easy

It is impossible to produce superior performance unless you do something different from the majority. If you buy the same securities everyone else is buying, you will have the same results as everyone else.

- Sir John Templeton

The central principle of investment is to go contrary to the general opinion on the grounds that if everyone agreed about its merits, the investment is inevitably too dear and therefore unattractive.

- JMK

Be fearful when others are greedy. Be greedy when others are fearful

- Warren Buffett

HURDLE 1: HUMAN NATURE

SAFER AND WARMER IN THE MIDDLE OF THE HERD



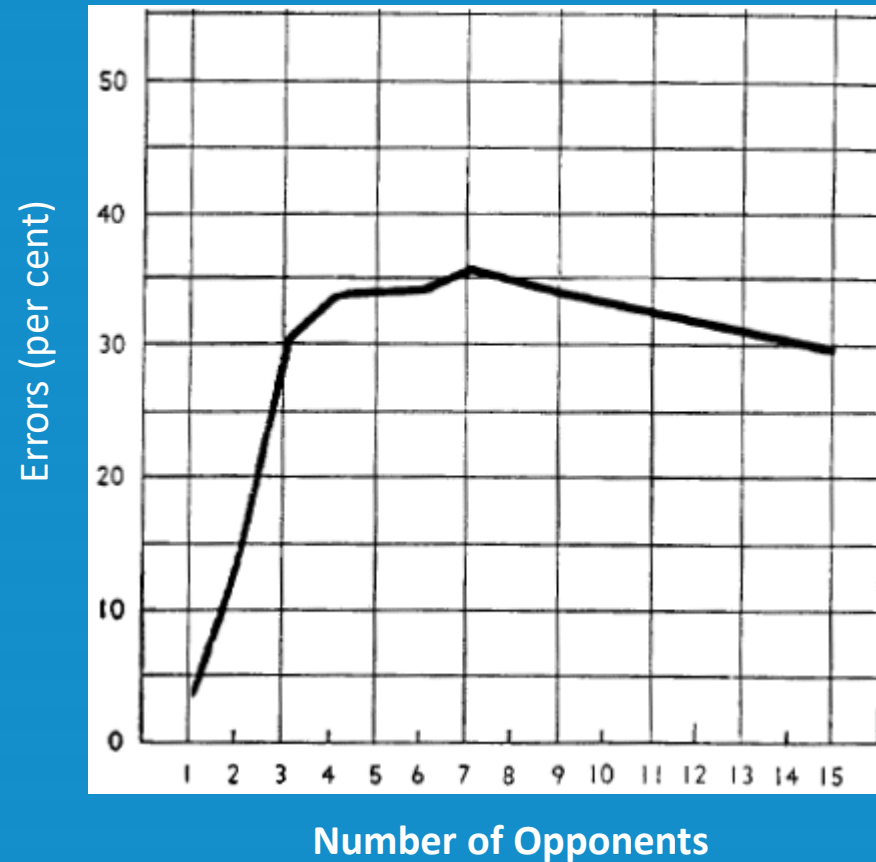
A MORE ACCURATE COMPARISON



THE SOLOMON ASCH EXPERIMENT

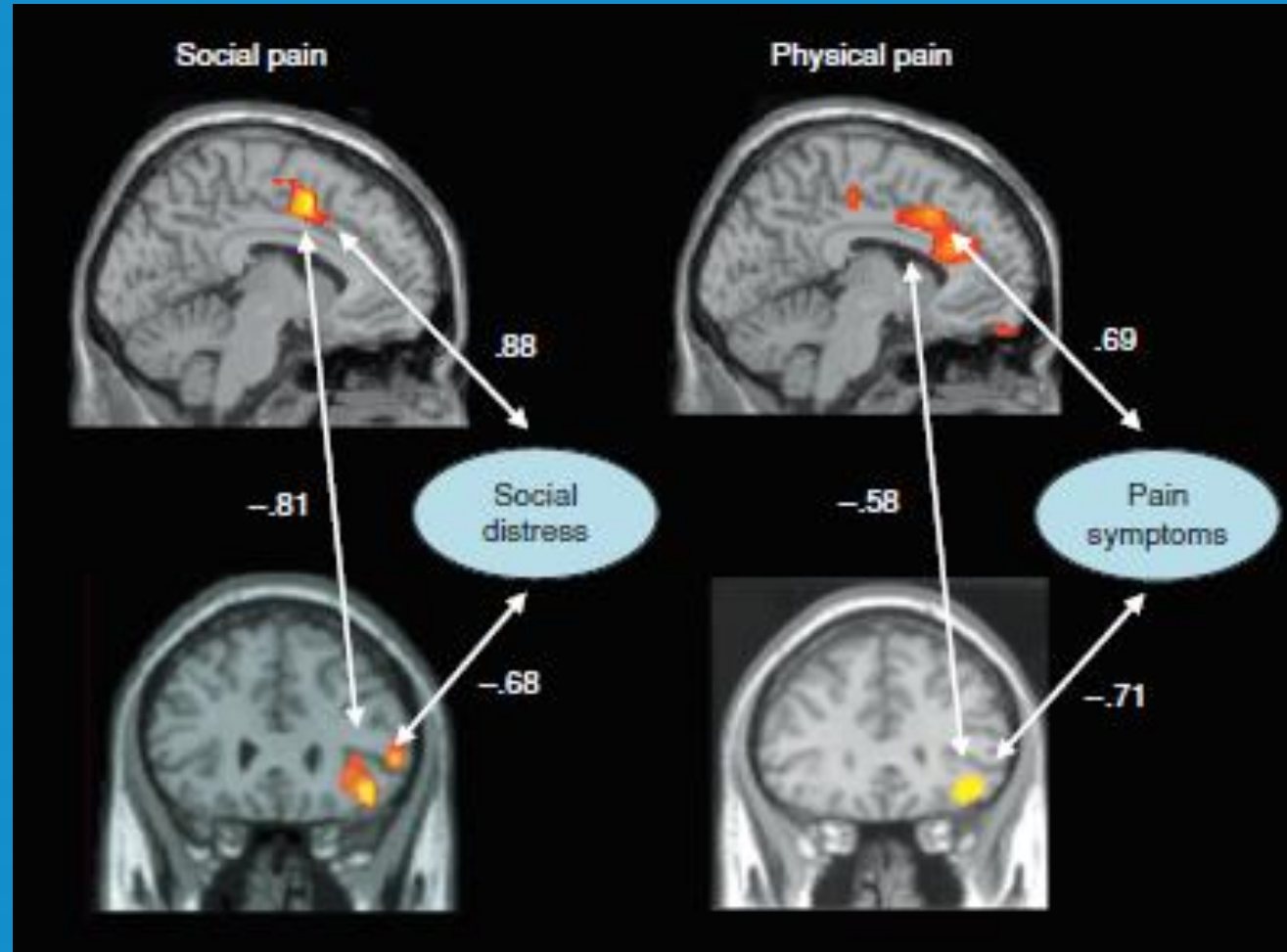


THE RESULTS



SIZE OF MAJORITY which opposed them had an effect on the subjects. With a single opponent the subject erred only 3.6 per cent of the time; with two opponents he erred 13.6 per cent; three, 31.8 per cent; four, 35.1 per cent; six 35.2 per cent; seven, 37.1 per cent; nine, 35.1 per cent; fifteen, 31.2 per cent.

SOCIAL PAIN AND PHYSICAL PAIN



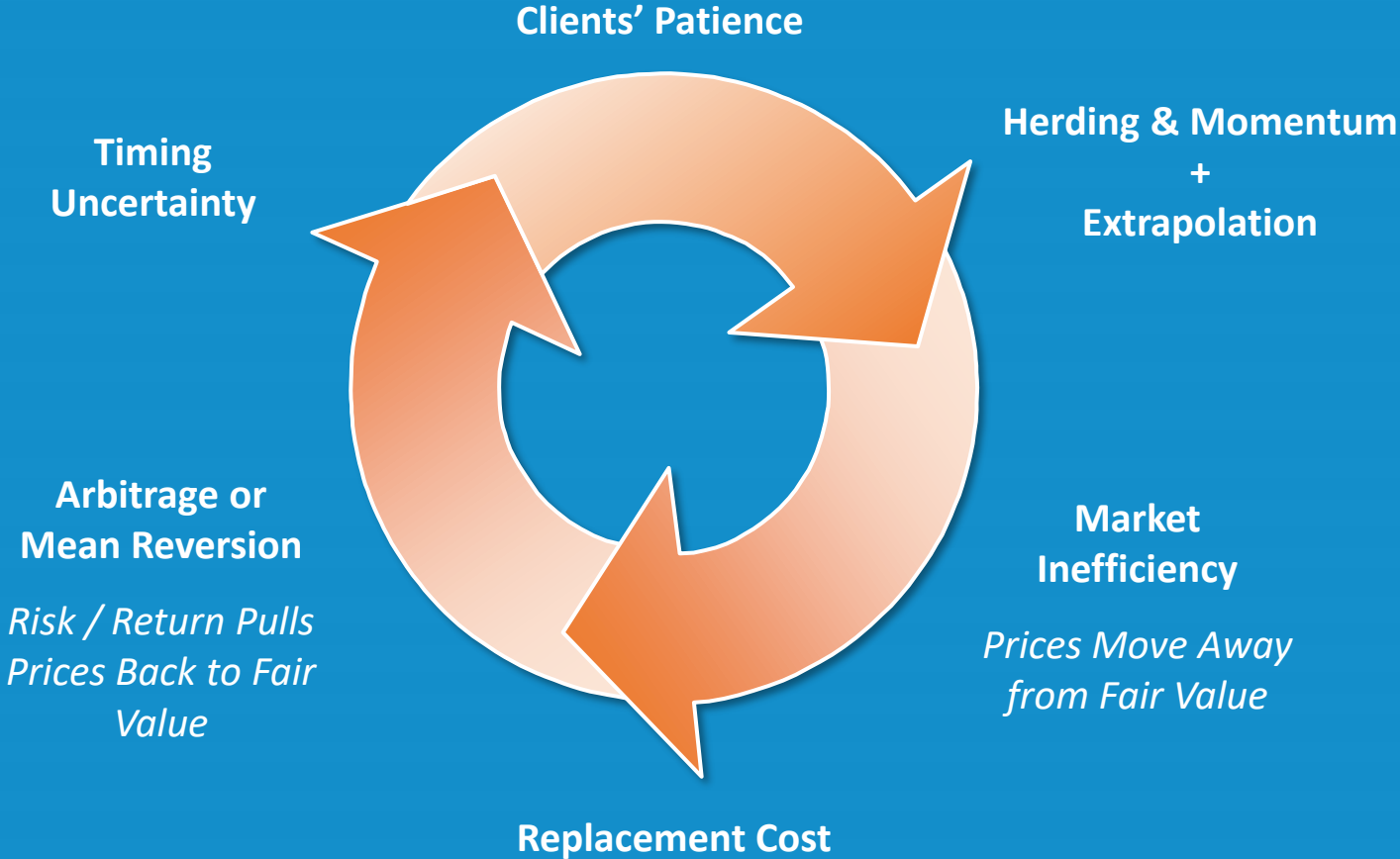
HURDLE 2: INSTITUTIONAL IMPERATIVE

KEYNES' EDICT

Worldly wisdom teaches that It is better for reputation to fail conventionally than to succeed unconventionally.

THE WORLD OF KEYNES' EDICT

Career Risk



TO GET 5.7% REAL FROM THE EM YOU NEED TO BELIEVE...

▪ P/E

- Average PE 1986-2020 → 17.5x
- Current level → 14x
- To get 5.7% real → 10x

▪ Return on Capital

- Historical average → 6%
- Current → 4.9%
- To get 5.7% real → 3.6%

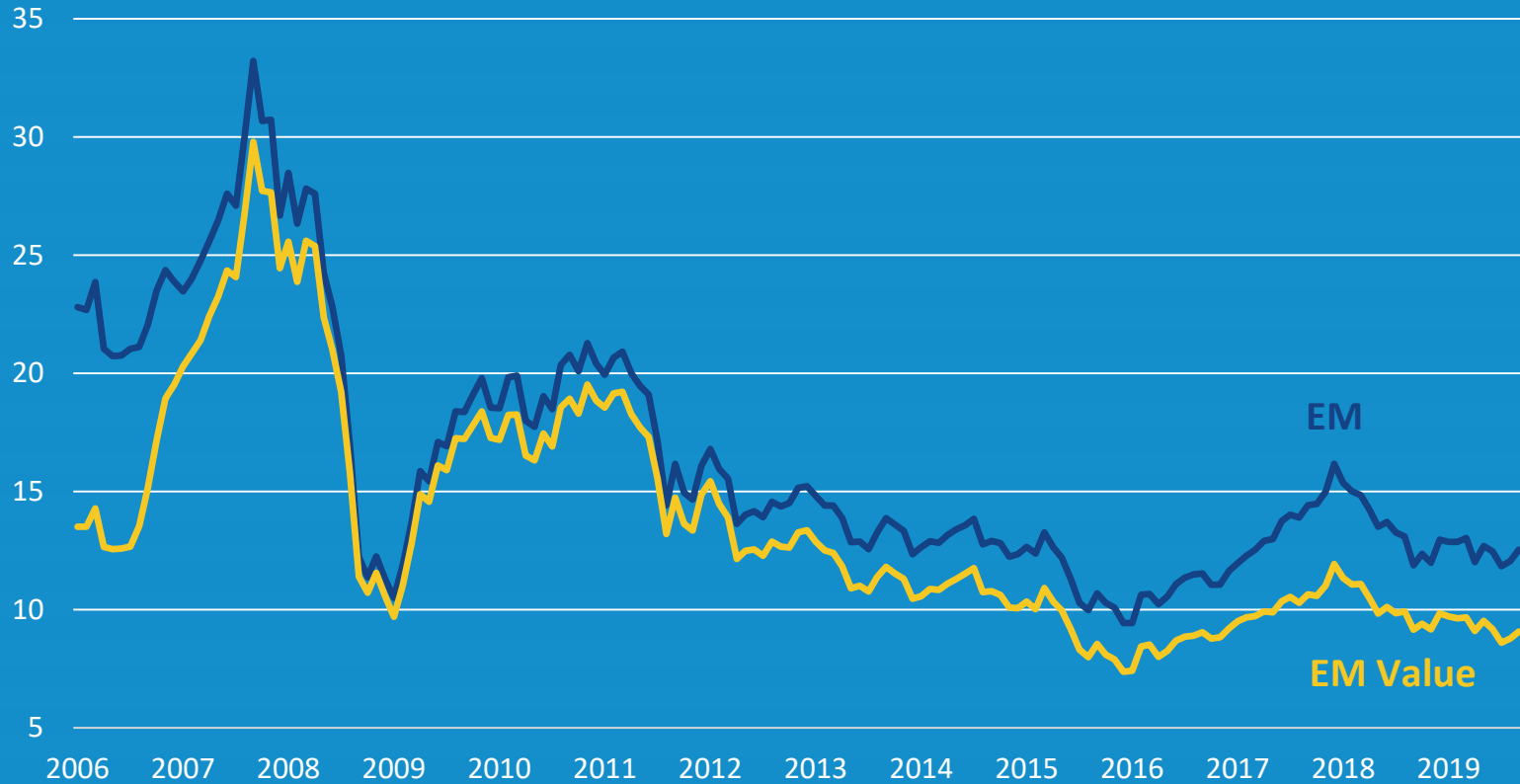
▪ Growth (and yield)

- Historical average → 6% (2% yield + 4% real growth)
- Current → 5.1% (3% yield + 2% growth)
- To get to 5.7% → -1.8%

The margin of safety at work

EMERGING MARKET VALUE EVEN CHEAPER

Shiller PE

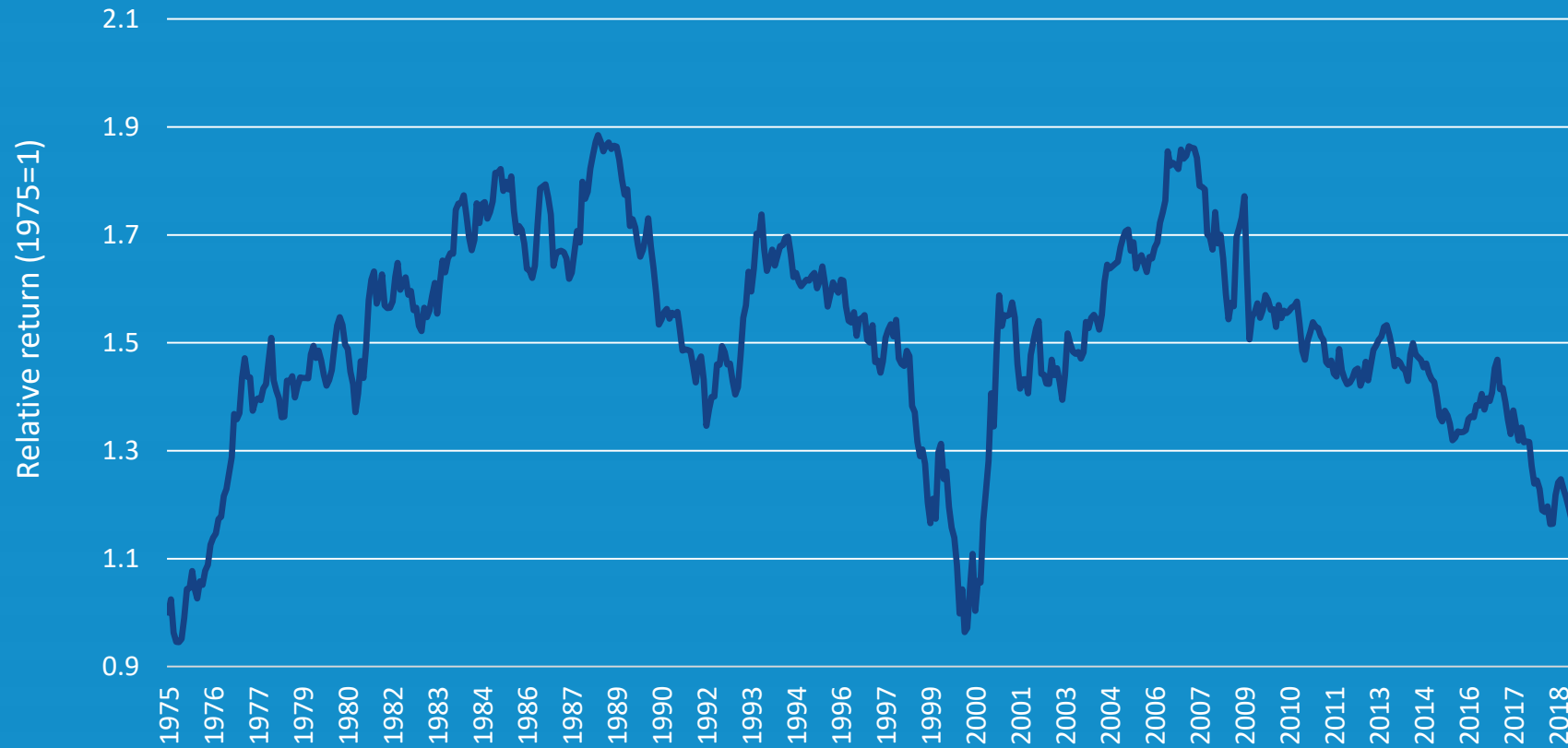


Source: Datastream, Bloomberg, GMO

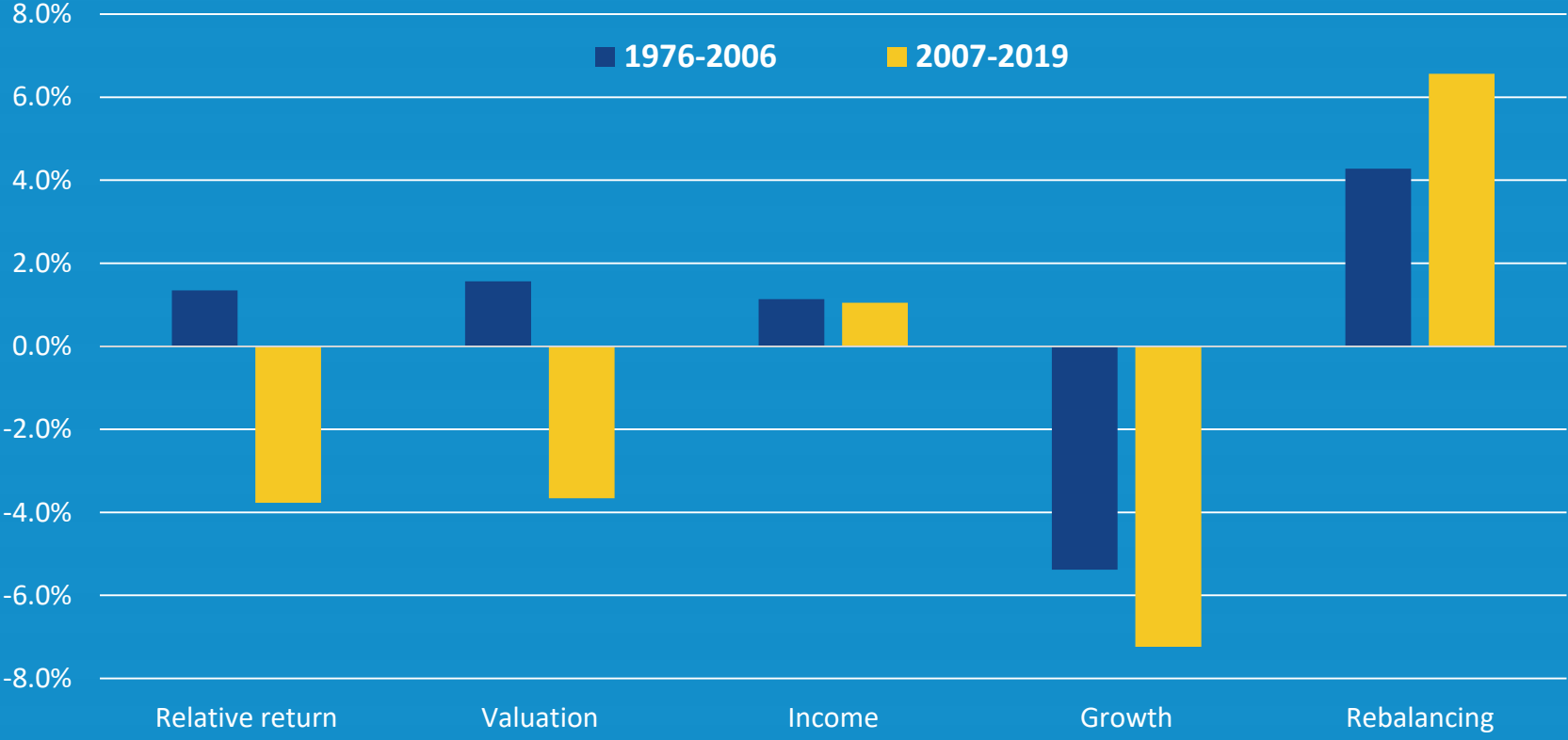
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BEING VALUE WHEN THE WORLD LOVES GROWTH

MSCI US Value vs MSCI US Growth Relative Total Return

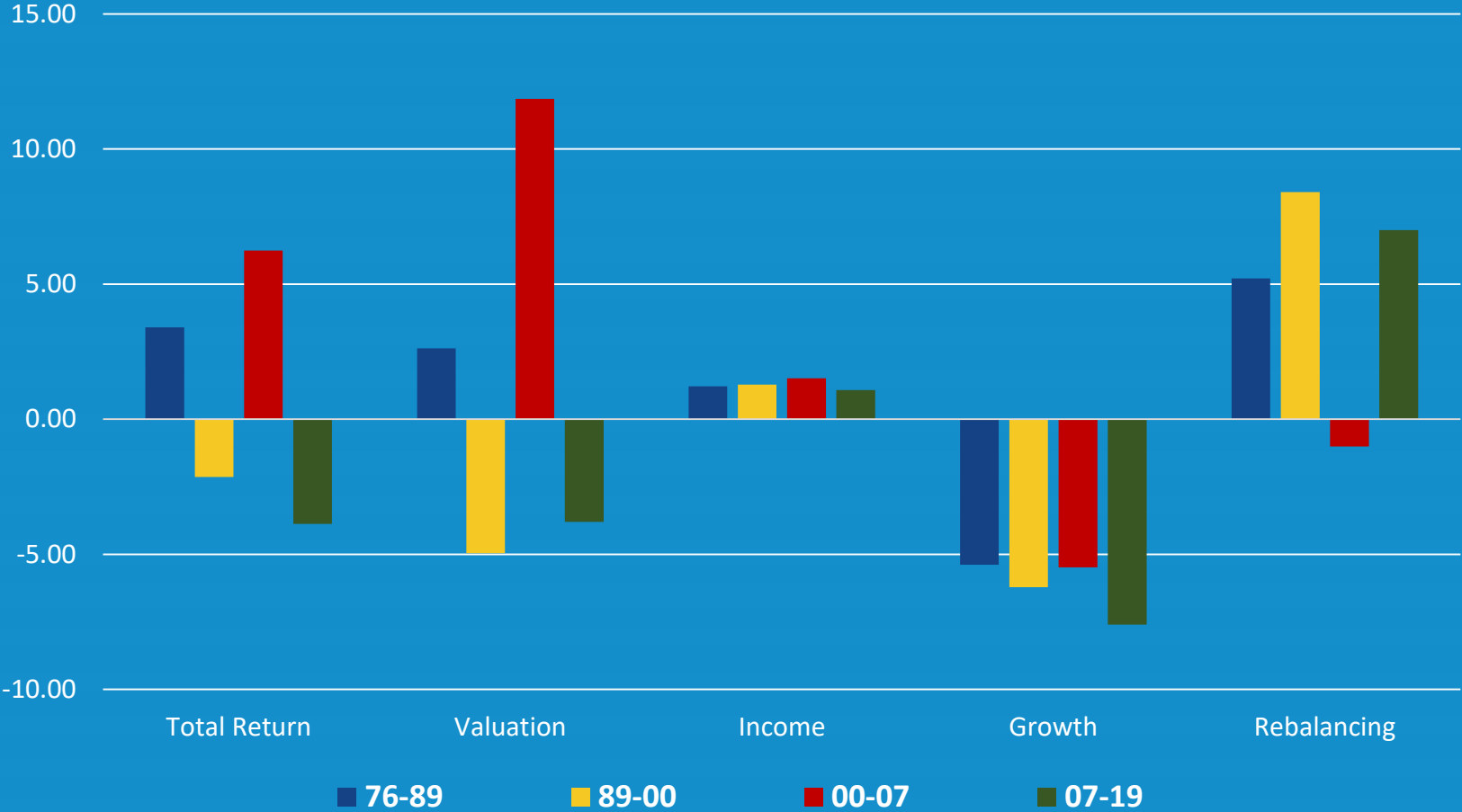


DECOMPOSING RELATIVE RETURNS



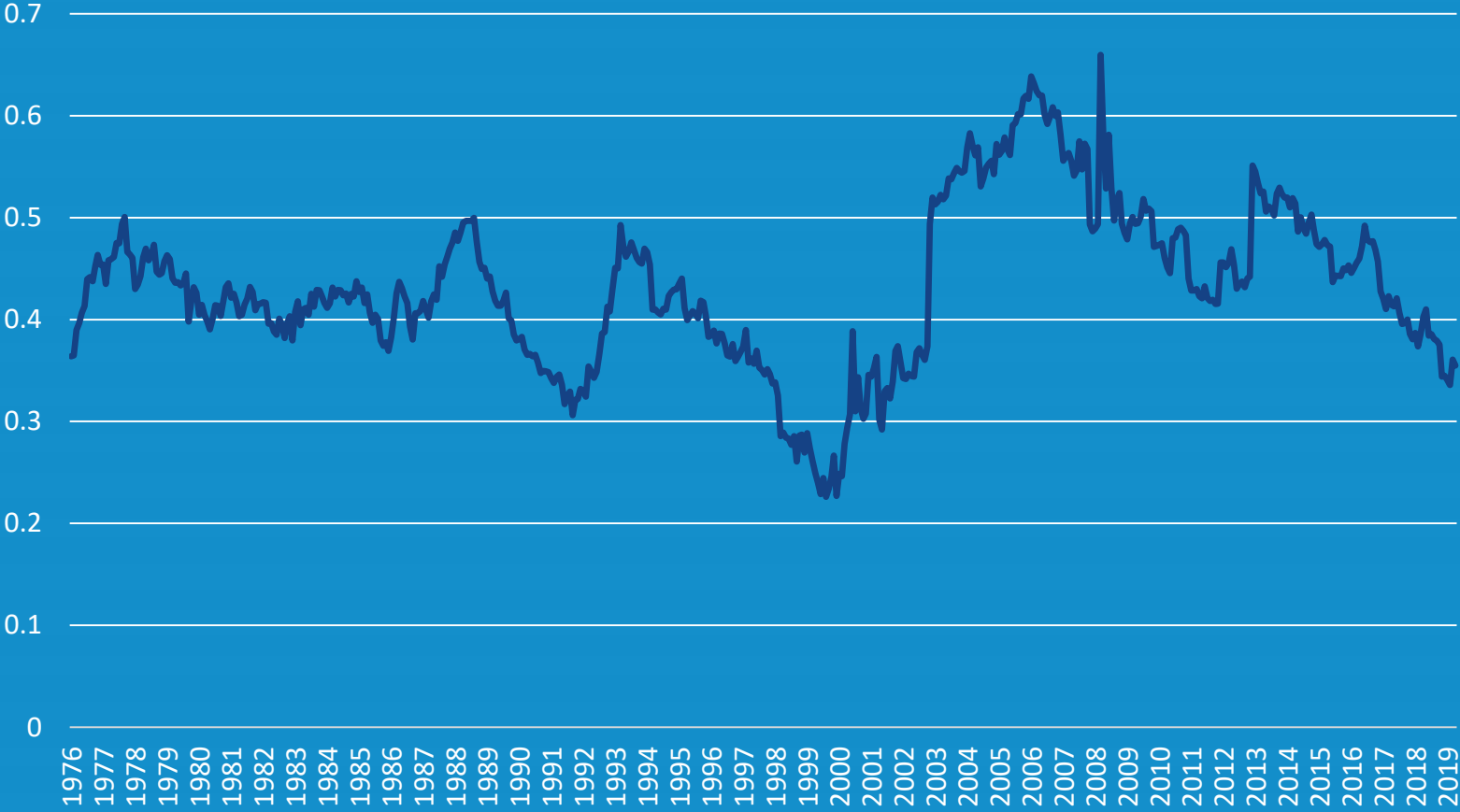
GOOD TIMES, BAD TIMES

MSCI US Value vs Growth relative returns

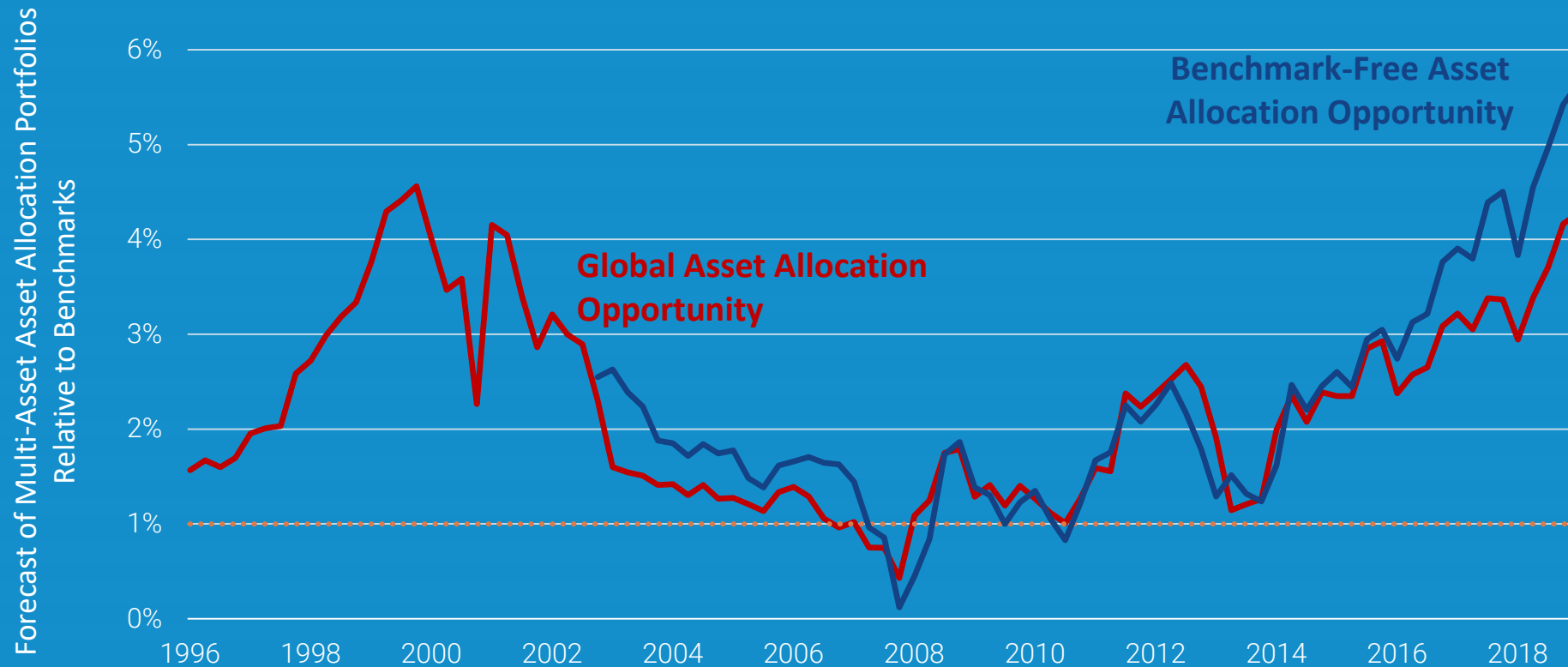


VALUATION OF VALUE

MSCI US Value vs Growth relative P/B



THE SIZE OF TODAY'S OPPORTUNITY SET

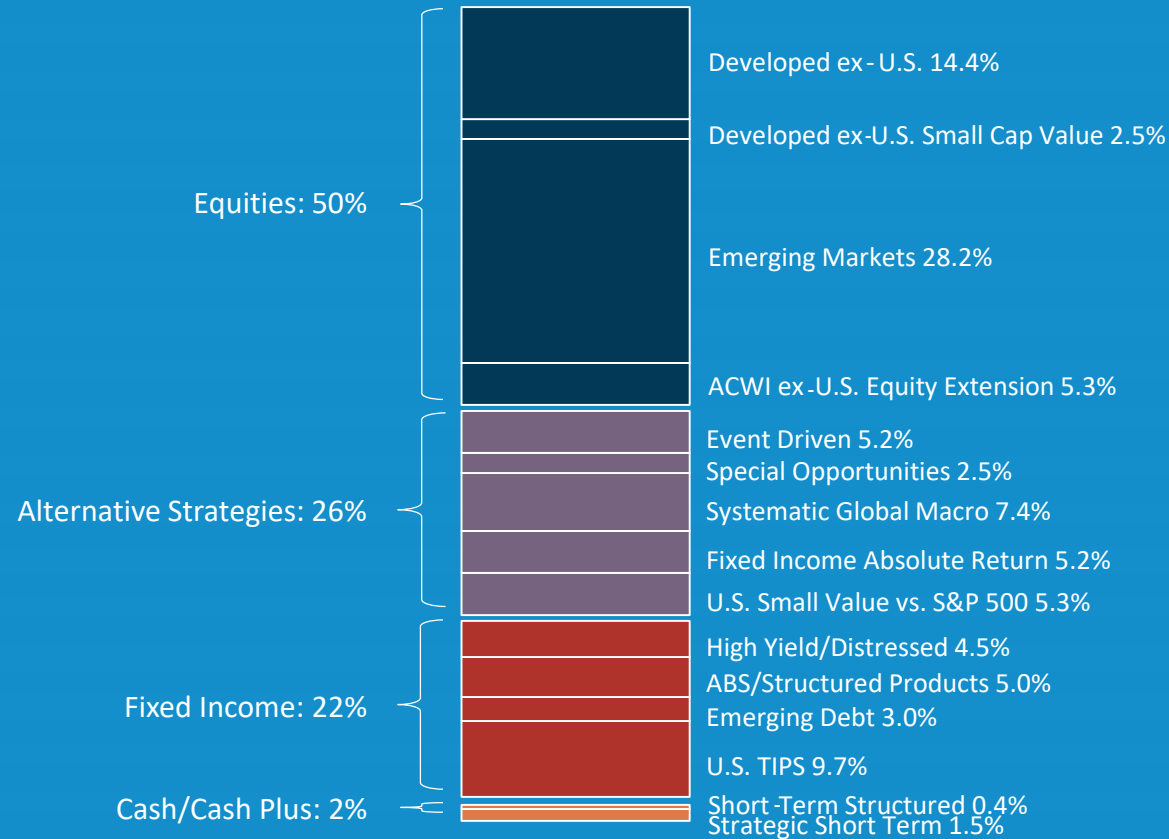


As of 12/31/19 | Source: GMO

*12/31/19 datapoint is 12/31/19 portfolio and 11/30/19 forecasts.

Opportunity is difference between forecast return of portfolio and benchmark given GMO forecasts at the time. 10-year forecasts are translated to '7-year equivalent' by multiplying by 10/7. Dotted lines are our long-term expectations of likely achievable alpha from asset allocation. Benchmark Free Asset Allocation is compared to a 60% MSCI ACWI / 40% Bloomberg U.S. Aggregate portfolio.

BENCHMARK-FREE ALLOCATION STRATEGY



As of 12/31/19 | Source: GMO

The above information is based on a representative account in the Strategy selected because it has the fewest restrictions and best represents the implementation of the Strategy. Weightings are as of the date indicated and are subject to change. The groups indicated above represent exposures determined pursuant to proprietary methodologies and are subject to change over time.

Totals may vary due to rounding.