

# Global High Yield Perspectives

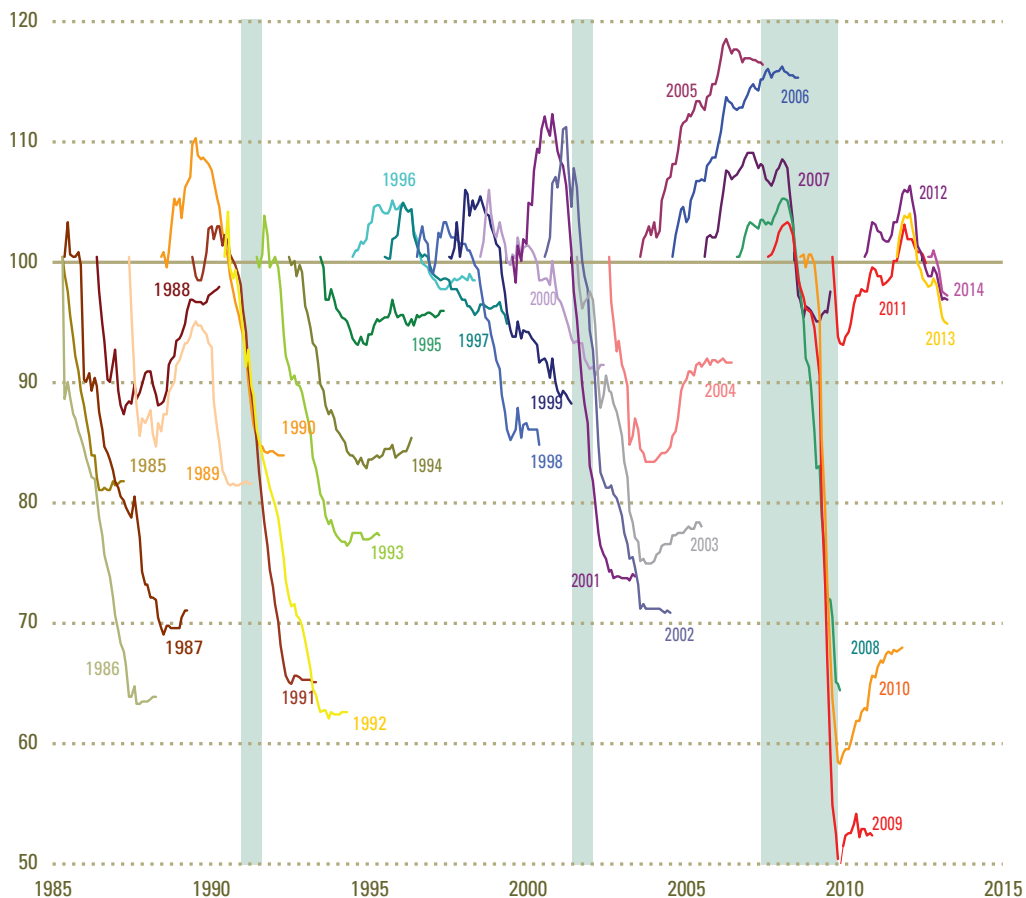
4Q 2012

## EXCESS CAPITAL MARKET RETURNS FROM EFFECTIVE CITIZENSHIP

### INTRODUCTION: WHAT LIES AHEAD

History is often a better forecaster than any market strategist. Market strategists at this time of year typically resort to their crystal ball to develop earnings and return expectations for the next calendar year. Simply reviewing analysts' historical earnings forecasts for the S&P 500 (see [figure 1](#)) highlights the immense difficulty associated with forecasting. Analysts have at least learned, "if you have to forecast, forecast often," as aptly put by Edgar Fiedler, former assistant Treasury secretary for economic policy under both Nixon and Ford administrations.

**Figure 1** The Triumph of Hope Over Experience: Forecast S&P 500 EPS  
Revisions to S&P500 Consensus Forecast; Index First Forecast = 100



Indexed to 100 for first forecast of each year. NBER Recessions shaded.  
Source: IBES/DataStream, NBER, Morgan Stanley Research

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Fiedler would further quip, that instead of becoming one of those analysts who “live by the crystal ball and soon learn to eat ground glass,” one should emphasize the factors creating broad investment opportunities and risks. Valuation opportunities associated with these factors in distinct markets always present themselves.

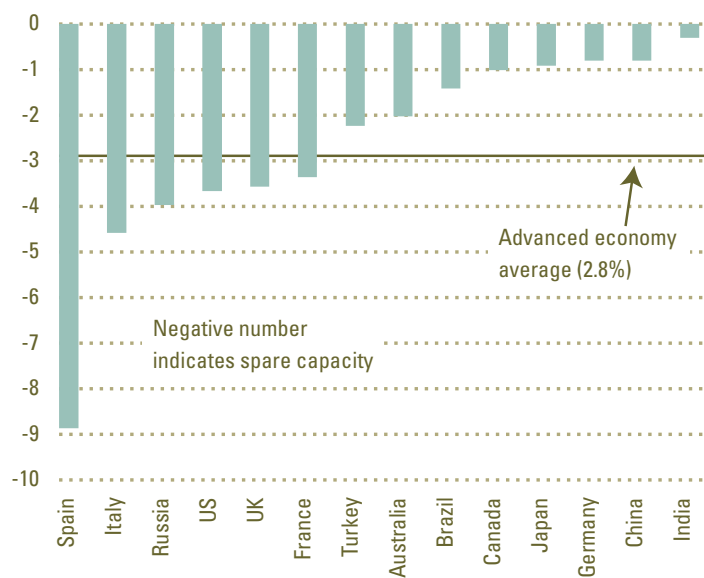
Today, our efforts are focused on the plot line and the key players in our investment drama. Understanding the investment storyline and the complex intentions of the players will determine the magnitude and duration of the investment opportunities ahead. The coming years certainly have the makings of a Shakespearean play; whether tragedy or comedy, we are all important actors in the expanding global political and capital market drama.

### ACT 1: POLITICAL RISK EMERGES IN ADVANCED MARKET ECONOMIES

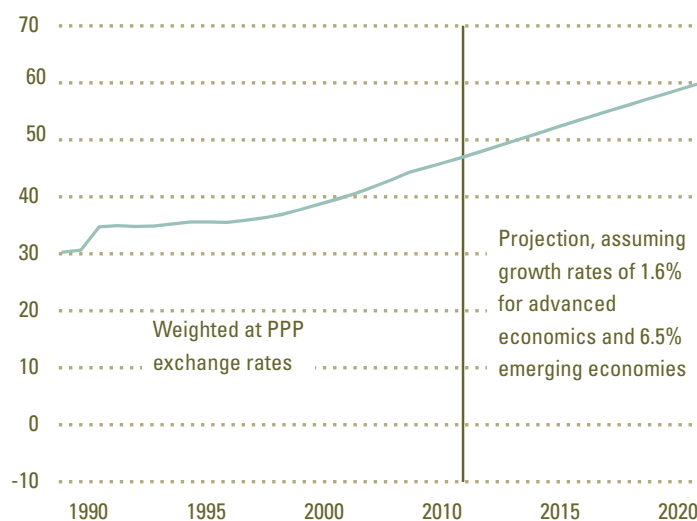
Political risk is a primary concern for this decade and has already had an influence on capital market events. Whether we are examining continental European sovereign bond spreads that have exceeded those of typical high yield investments or an overvalued yen and euro that hindered economic growth, political risk has been an important driver of returns and will continue to be moving forward.

What is so interesting about political risk is that it is impacting advanced market economies that were once thought immune to them (see [figure 2](#)). Today, investing in most advanced sovereign, credit, equity, and currency markets is more fraught with political risk than most investors have been accustomed over the last two decades. Currency volatility and refinancing risk have traditionally been concerns of emerging market and leveraged finance investors. Yet, emerging economies in aggregate are already now larger than the advanced economy markets (see [figure 3](#)) and typically have better demographic and leverage profiles.

**Figure 2** Output Gaps  
% of GDP; 2012



**Figure 3** Emerging Economies  
% of World GDP; 1990-2020

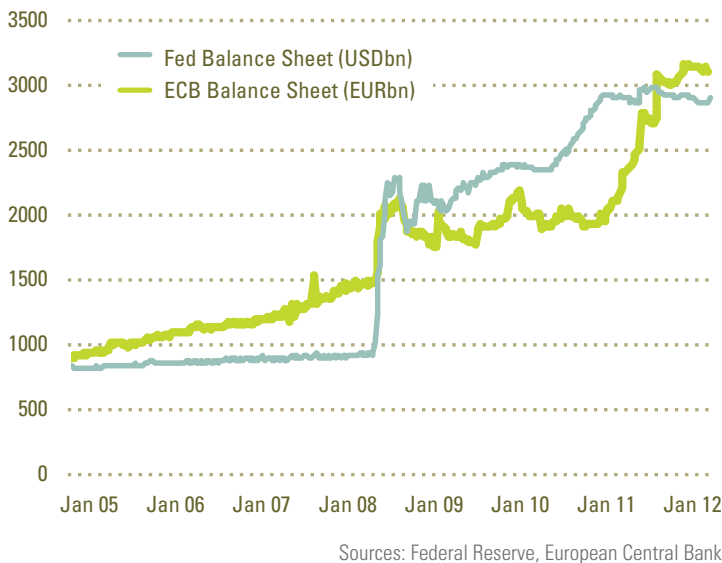


Sources: IMF, Capital Economics

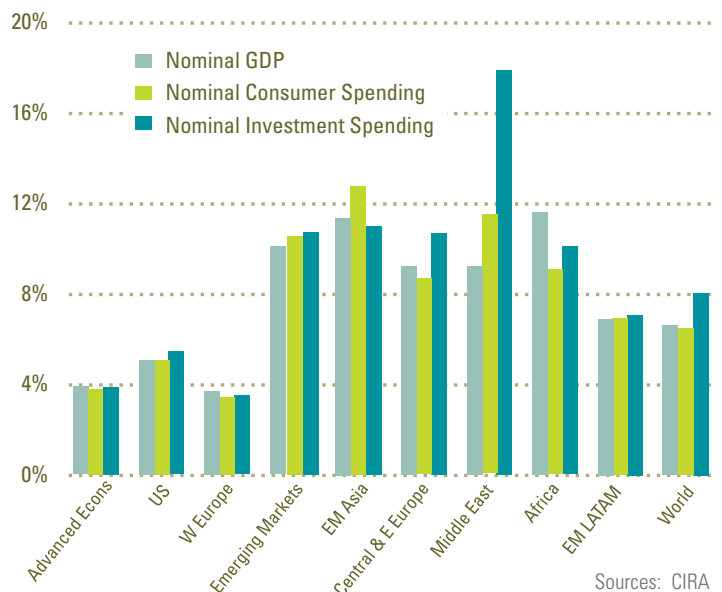
## ACT 2: CENTRAL BANKERS TAME MARKET FALLOUT FROM POLITICAL RISK

Central bankers and their toolkit of monologues and monetary acronyms have been helping to temper these advanced-market concerns and keep market participants mollified, while not necessarily emphasizing the enormity of their peace-time efforts (see [figure 4](#)). These monetary acronyms have been effective at dousing capital market flare-ups, and hopefully also will be effective in conjuring an environment for economic growth (see [figure 5](#)).

**Figure 4 Fed vs. ECB Total Assets**  
Jan 2005 - Jan 2012



**Figure 5 Forecast Avg. Annual Nominal GDP Growth**  
2012-2020



## ACT 3: POLITICIANS ASSERT THEMSELVES

The great Government we loved has too often been made use of for private and selfish purposes, and those who used it had forgotten the people.

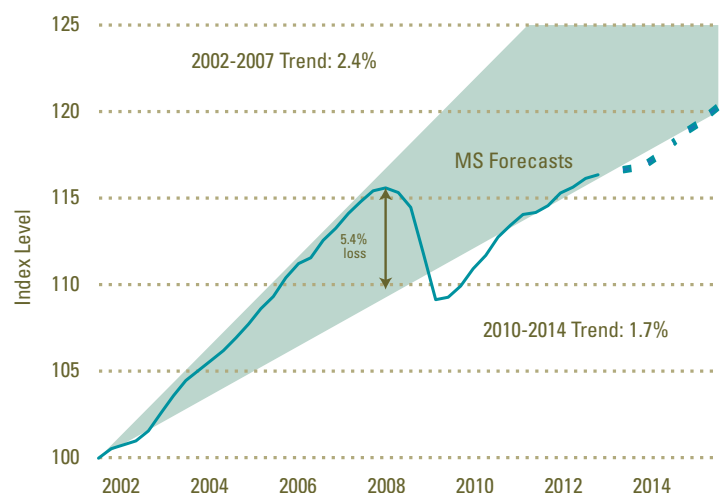
... There has been something crude and heartless and unfeeling in our haste to succeed and be great. Our thought has been, 'Let every man look out for himself; let every generation look out for itself,' while we reared giant machinery which made it impossible that any but those who stood at the levers of control should have a chance to look out for themselves.

— Woodrow Wilson's First Inaugural Address on March 14, 1913

These words could readily be expected to be heard from the lips of the current U.S. President at his upcoming second inaugural address. The concepts of higher tax rates for the wealthy, redistribution of tax revenues, and expansion of government services are core to his belief system. His world view is that the "leveling of the playing field" will make the United States—once again—a fairer and more equal place for all to succeed.

While the intentions may be noble, advanced market economies are not blessed with the historical economic growth to absorb the costs associated with these policies (see [figure 6](#)).

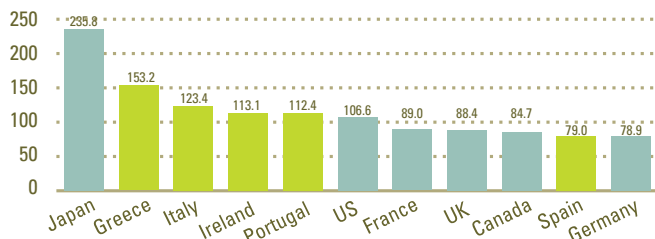
**Figure 6 Long Term Trend of Growth**  
OECD GDP: Current Cycle; 2002-2014



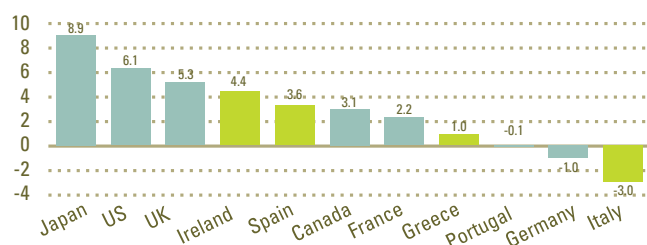
Sources: OECD, Morgan Stanley Research

Instead, we are faced with difficult policy decisions to limit deficits and growing debt (see [figures 7 and 8](#)); politicians will continue to face pressures more typically associated with those during a war effort. In most advanced market economies, citizens know their current leaders are not up to the challenging economic task; elections have become the means to safeguard the Rooseveltian chance to “level-up,” while not understanding “the evil of leveling down.”

**Figure 7 Debt & Primary Deficit to GDP**  
Debt / GDP; %, 2012E

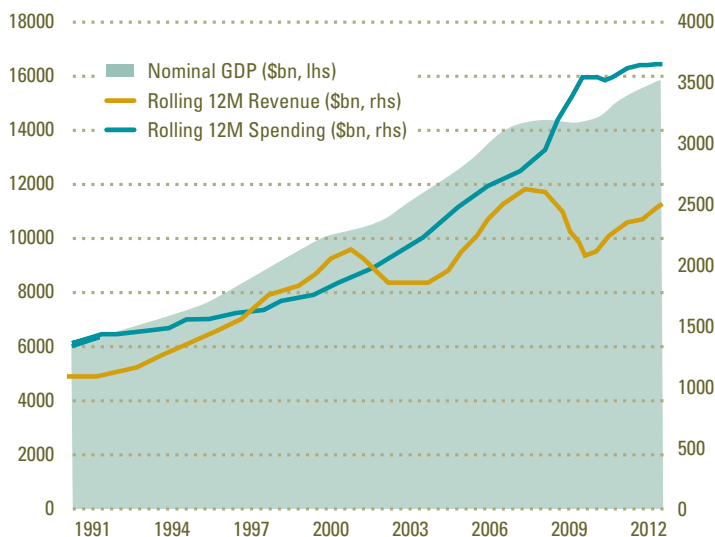


Primary Deficit / GDP; %, 2012E



Note: Primary balance = budget balance - net interest income. Debt is gross.  
Sources: IMF, World Economic Outlook Database, April 2012

**Figure 8 Nominal Federal Government Spending, Nominal Federal Revenue & Nominal GDP**



Sources: US BEA, US Treasury, CitiFX

## CONCLUSION: WHICH CITIZENS WILL ASSERT THEMSELVES

It is not the critic who counts; not the man who points out how the strong man stumbles, or where the doer of deeds could have done them better. The credit belongs to the man who is actually in the arena, whose face is marred by dust and sweat and blood; who strives valiantly; who errs, and comes short again and again, because there is no effort without error and shortcoming; but who does actually strive to do the deeds; who knows the great enthusiasms, the great devotions; who spends himself in a worthy cause; who at best knows in the end the triumph of high achievement, and who at worst, if he fails at least fails while daring greatly, so that his place shall never be with those cold and timid souls who know neither victory nor defeat.

— Theodore Roosevelt's "Citizenship in a Republic" on April 23, 1910

The large question then before us as investors is: in which arena will citizens enter to assert their proud rights? Will citizens assert their rights in advanced market economies which fathered free markets, developed property rights, and economic opportunity? Or will citizens assert their rights in upstart emerging market economies, which have quickly co-opted these egalitarian ideals?

In an ideal world, citizens will assert their proud rights in both advanced and emerging economies. However, economies in South and Latin America, emerging Europe, and emerging Asia are the markets starved for capital investment, demographically blessed, and generally open to capitalist principles.

In his same "Citizenship in a Republic" speech delivered at the Sorbonne, Roosevelt warned:

that the gravest wrong upon his country is inflicted by that man, whatever his station, who seeks to make his countrymen divide primarily in the line that separates class from class, occupation from occupation, men of more wealth from men from less wealth, instead of remembering that the only safe standard is that which judges each man on his worth as a man.

Identifying which countries' citizens apply their rights effectively provides the necessary insight in determining whether investment returns from the future will be as great as in the recent past.

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