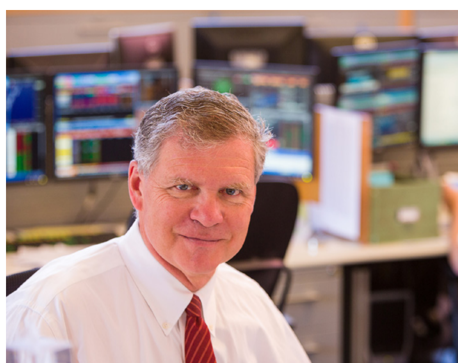
Stretched Valuations, Faster Growth and Noisy Politics Ahead

After a volatile 2016, investors should gird for more volatility in 2017. The "reflation" trade in the wake of Trump's election has stretched U.S. equity market valuations even further and pumped up high-yield bonds. Will economic and earnings growth come through? *Caveat emptor*. In Europe, populism may prevail, but electoral surprises don't stop people from going to work. The same holds true in China, where money can be made notwithstanding fears of a debt avalanche. Identify relative values, and make money over time, not by trying to time the market.



A Conversation with CIO Brian McMahon and Senior Advisor Bill Fries, CFA

Brian McMahon is responsible for Thornburg Investment Management's overall investment activity. He also co-manages Thornburg's global equity portfolios. He managed Thornburg's laddered bond portfolios from their inceptions until 2000 and remains actively involved in securities analysis for various Thornburg managed portfolios. Brian holds an MBA from Tuck School of Business at Dartmouth College and a BA in economics and Russian studies from the University of Virginia. Brian joined Norwest Bank in 1979, and held various corporate finance positions before joining Thornburg Investment Management as chief investment officer in 1984.

Bill Fries is senior advisor of Thornburg Investment Management. He joined the firm in 1995 as the founding portfolio manager for Thornburg's first equity strategy, and until 2016, he co-managed Thornburg's international equity strategy. Bill maintains his role as investment analyst, providing his knowledge, insight, and experience as he mentors and collaborates with the investment talent at Thornburg. Bill began his career as a securities analyst and bank investment officer. His more than 40 years of investment management experience includes an extended tenure as vice president of equities at USAA Investment Management Company. He is a CFA charterholder.

Q: Secular stagnation: ***A year ago, the outlook was for secular stagnation, anemic economic growth and continued deflationary pressures globally. The market seemed positioned for this scenario until mid-2016, when dispersion and volatility began to increase markedly. The U.S. Federal Reserve just hiked its benchmark interest rate for the second time in nearly a decade. China's producer prices recently turned positive for the first time since early 2012. Although China's economy is slowing moderately and Europe's is still not growing much, does the notion of secular stagnation still hold?***

Bill Fries: Uncertainty in Europe triggered by the surprise outcome of the U.K.'s Brexit vote dampened an already soft economy. However, the recent strength of the dollar, reflecting the U.S.'s economic health, rising interest rates and the November election results, may well work to ultimately boost economic activity in major exporting countries. This, along with renewed U.S. consumer confidence, could be enough to generate sustained or even accelerated global growth. Major exporting nations like Japan, China, and Germany are particular beneficiaries, with some flow back to emerging markets and positive impacts on commodity prices and inflation. Employment growth should follow and benefit world GDP.

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Brian McMahon: I think prior expectations for more weak years in 2016 and 2017 began to get reset higher. There was too much pessimism about the global economy, commodities prices, and industrial production. But as first quarter and second quarter 2016 earnings came out, they were supportive of equities, and a challenge to those central bankers who said we need to print money and keep rates lower for longer. And then we also saw some uptick in inflation and wages, even in Europe.

I met with management teams of 50 companies in Europe last June. I came home the day of the Brexit vote, on June 23. There was a lot of anxiety about the result and stocks traded off. But after talking to so many companies in different industries, it felt like the market reaction was wrong, and that the volatility was misplaced. We hung in there with our portfolios and didn't panic. I had spoken with 20 companies that we owned, and another 10 to 15 of their competitors. I believed then that based on our fundamental research, things were okay in Europe. And the management teams were also saying their businesses were okay.

Now the most important question is if the current mild optimism is misplaced. It's probably not. There should be more growth following through, but maybe not as much as the optimists hope.

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Q: Populism: ***Brexit, Trump's election, and the resignation of Italy's prime minister after a failed referendum on amending the country's constitution were all significant political events, to which markets reacted with sharp swings. Should investors expect more political surprises and market volatility in 2017, given elections in France, Germany, and likely Italy, not to mention divergence in central bank monetary policy, with the Fed tightening and European and Japanese central banks still suppressing rates?***

BM: The short answer is yes. But, we went through all those things in 2016, and equity markets still delivered pretty good performance in the U.S. Outside the U.S. the performance was more mixed in dollar terms. But we've weathered these market storms. They leave some people too afraid to invest, and then they miss out. At the ground level, people still wake up and go to work and try to make a buck. In cities everywhere, people are still stuck in traffic, and at end of day, I feel pretty good about having them working for us, through our ownership of their companies' stocks.

Generally, I'm constructive about investing in these people, regardless of the Obamas, Trumps, Merkels, and Hollandes around the world. If presidents and prime ministers don't do a good job, they get thrown out sooner or later. And if they do okay, they may stick around a little longer. But investors will make the most money with time, not by trying to time the market around these kinds of political events.

Q: U.S. Economy: ***After years of discounting Fed interest rate and GDP projections, the market is now largely in alignment with the central bank's forecasts. It's clear Trump's election and his cabinet picks are driving higher growth and inflation expectations, based on proposed individual tax cuts and corporate tax reforms, deregulation, and fiscal stimulus via infrastructure spending. What's your take on the outlook for U.S. growth, inflation, and interest rates?***

BF: There seems little reason to doubt rising interest rates, especially at the short end. If the Fed's three projected rate increases for 2017 are actually implemented, the yield curve will flatten with the spread between the short and long ends contracting. Because absolute levels are relatively low, interest rates should not be much of a detriment to profits and growth in the corporate sector. While there was a modest pause in U.S. growth early in 2016, the election of an administration with an ardent growth philosophy makes a material economic contraction near term unlikely. Impacts from easier interpretation of regulations could be an early stimulant. That said, tax change expectations are so high, and they will take time to work out. The outcome may disappoint as the conflicts with budget constraints get incorporated.

In any event, recent economic data are encouraging. A good holiday shopping season should lead to a healthy inventory restocking cycle. The much talked about infrastructure spending will take awhile to get from idea to execution, but even project planning has some positive economic impacts. Commodity prices are already up on potential changes in supply/demand balances. Oil prices have doubled from last February. Inflation will likely pick up some as energy costs pervade most economic activity.

BM: Republicans now have the burden of delivery. If they deliver, then I think the stock market appreciation and the modest interest rate increases will be supported. If they don't deliver, we'll get "lower for longer" rate levels, because the economy will end up suffering. The tax code in the U.S. is terrible. It's an impediment to economic efficiency and progress. Most people in both parties agree with that. But they don't agree on what to do about it. Different interest groups want different things. We'll see if Trump can forge a deal.

Q: U.S. Sector Outlook: ***Where do you expect to see the biggest impacts of deregulation—banking, energy and associated pipeline infrastructure, small business formation? How much of an impact might deregulation have in terms of spurring more growth?***

BF: Since the financial crisis, bank lending has not been notably robust. This is sometimes attributed to capital regulation, but it may just be from weak loan demand. Easing regulations for smaller regional lenders as distinct from systemically important lenders may help make more funding available for local borrowers. While this might stimulate additional lending for working capital, banks are not typically in the venture capital business, so the impact of more lenient banking regulation may not have the hoped for impact on business formation.

Environmental regulation with regard to the energy business may not change all that much under the Trump administration; some of it is as much local as federal. Perhaps one area impacted might be permitting of pipelines to facilitate moving Canadian oil sands production to refineries in the U.S.

Health care insurance and drug pricing will be areas of focus for the new administration. Complexity will slow change in the insurance and reimbursement arena, but drug pricing will continue to garner headlines and likely remain under pressure, especially for high-cost maintenance prescriptions. New unique drugs addressing an unmet need will still have pricing power.

Q: U.S. Equities: ***Since the mid-2016 record low in the 10-year U.S. Treasury yield, ostensibly defensive, low-volatility equities have been under pressure, which intensified as the Trump reflation trade lifted U.S. benchmark equity indices to record highs. Are U.S. stock investors getting ahead of themselves, given index valuation multiples?***

BF: The forward earnings estimates for the S&P 500 approximate $128 and $133 for 2017 and 2018. On the recent bluechip index level of roughly 2260, the market price/earning ratio (P/E) for this year and next are approximately 17.7x and 17.0x, respectively. This is only slightly above the trend since 2011. A P/E of 17.7x for 2017 is the same as an earning yield of 5.6%. Compared with investment alternatives, it's not all that bad. And if earnings come through above current expectations, it will produce a better valuation.

The fluctuation of securities prices is always with us, responding to fundamen-

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tal changes and perceptions. This year will likely have its share of volatility, but today's overall market price seems reasonable, should earnings growth develop as expected.

BM: Some things are expensive. Our job is to find things that aren't stretched. That's what we try to do every day. For example, we don't think T-Mobile, in which we have a full position in our Global Opportunities strategy, is too expensive. It's the third-largest U.S. wireless provider by subscribers, and trades at 6.5x EV/EBITDA. We think it could fetch 8x to 10x EV/EBITDA. So it should have some upside.

CME Group is another one. It benefits from the market volatility, which higher rates generate across asset classes. It's a great business, matching global buyers and sellers of futures, options, swaps, and related financial products. Its trading volumes last quarter were up around 30% from the year before, and it offers a dividend yield of 4.7%.

There are deals to be found outside the U.S., too. Taiwan Semiconductor also trades at 6.5x EV/EBITDA, sports a dividend yield of just over 3%, and net cash of more than 5% of its market cap. Its annual sales are growing 11%, and it still has a number of projects in the pipeline.

Not everything is super expensive. We sift through the rubble, trying to find good businesses that aren't terribly expensive.

Q: U.S. Treasuries: ***Turning to fixed income, U.S. Treasuries have taken a beating recently, inflicting total return losses on investors in long-dated Treasuries. The 10-year U.S. Treasury yield has been hovering well over 100 basis points off its mid-2016 lows, recently close to 2.6%. At what point do longer-dated U.S. Treasuries become attractive, quite apart from their relative attractiveness against other G-7 bonds?***

BM: I think you buy long bonds when the yield is better than the implied yield on wage inflation. Not everyone at Thornburg agrees with me, but I don't think we're there yet—at least by the Atlanta Fed's nominal wage inflation data, which I prefer. In November, it ran at 3.9%, well above 10-year Treasury's 2.55% yield. If the implied wage inflation yield is greater, skepticism that the government is committed to restraining inflation's impact on its own bonds on an after-tax basis might be justified.

Q: U.S. High Yield: ***Like U.S. equities, U.S. high yield had a banner year in 2016, as spreads compressed sharply. How much upside might be left, considering the prospect of faster economic growth?***

BM: I'm a little leery. Spreads have come in, which is part of its great performance. The greatest performance came from high-yield energy and commodities paper, the stuff nobody wanted a year ago. If the U.S. economy is buoyant, at least you have a coupon. But I would guess at some point it's vulnerable to some shock. I don't know what that might be. Maybe higher inflation without faster economic growth driving rates up. Or maybe the economy not doing as well as expected, so credit risk reemerges. Perhaps either of those things: an inflation-driven rate spike, or the economy not doing well enough and credit risks surface. Caveat emptor to those piling in. High yield has had such a good recent run that we have been taking some profits and selling some positions in our Investment Income Builder portfolio.

Q: China: ***Economic growth continues to slow in China, which is now grappling with some debt issues of its own. Capital outflows have cut the People's Bank of China's foreign reserves to about $3 trillion from $4 trillion in mid-2014, even as the central bank has tightened capital controls. Chinese equity markets were among the worst performing in 2016. Yet China's Producer Price Index, as noted, recently turned positive. What's the outlook for the country's economy and markets?***

BF: Recent Chinese manufacturing Purchasing Managers' Index (PMI) data continue to be encouraging with November at 51.7 compared with October's 51.2 (50 indicates expansion). Non-Manufacturing PMI was 54.7, up from 54.0. The data include a sub-index construction component that dropped to 60.4 from 61.8, as tighter home-purchasing measures impacted the sector. Chinese investors like real estate. The services sub-index rose to 53.7 from 52.6, encouraging a view that the economy is becoming more balanced, though state-owned investment remains an important driver, and is up 20% in the first 11 months of 2016. Private investment was up 3.1%.

The debt level is what makes investors nervous about China. It's running about 265% of GDP. Private sector credit

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growth declined steadily from over 20% year-on-year in April 2013 to around 12% since the summer of 2015. And since then local government bond issues and domestic credit have expanded steadily, with annual credit expansion peaking last spring. Like in Japan, this debt is largely internal and supported by high domestic savings, which amount to about 50% of income. While the debt level remains a concern, it is not expected to unravel any time soon.

Equity markets will be influenced by flows as currency worries and rhetoric from the Trump administration blow against business fundamentals, which remain generally healthy in the private sector and China's internet, telecom, energy, and commodity sectors, where we have exposure.

BM: Chinese stocks were left behind a bit in 2016. But I'm okay with China's outlook. The big state-owned banks may have to sell more equity, and the government may have to print money to bail them out. I also think China's private debt is probably manageable, and that's certainly true at the household level. And the same thing about people getting up and going to work applies there, too, nights and weekends included. I'm not bearish on China. It's an industrious and economically ambitious place.

The chances to make money in China are pretty good. Enthusiasm for China ebbs and flows as the years go by. In the second quarter of 2015, the stock market was soaring to nearly nine-year highs. That wasn't so long ago. Now it's stumbling along. But there are some great, attractively priced companies in China.

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As for China's economy, the government's challenge is to continue rebalancing growth toward more consumption and less investment. They're doing it.

Q: Oil: ***Shifting gears–What about oil? Organization of the Petroleum Exporting Countries (OPEC) and its aligned non-OPEC producers recently agreed to cut output by 1.76 million barrels a day (b/d). The deal spurred a roughly 20% jump in oil prices, which are now up around 100% from their year-ago lows. OPEC is reportedly targeting $60 to $70 per barrel oil prices, but that level leaves quite a lot of U.S. shale oil production economic. What's the outlook for oil prices?***

BM: I think they'll be volatile. But over time, if consumption continues to rise, we will see firm oil prices. Investment in new production is off globally. The guys financing the last big rounds of industry investment to achieve 95 million barrels a day of OPEC and non-OPEC output are basically not spending that money anymore. In the U.S., a lot of people assume you can turn a key or push a button, and theoretically I think they can. But many people supporting that effort are not going to go back to North Dakota without a huge increase in pay. They can get paid to build things elsewhere. They have more location and job choices now.

Net oil demand growth was up 1.4 million b/d last year. Most energy analysts expect more than 1 million b/d in demand growth this year. Oil inventory watchers think more oil will be consumed than produced starting this spring. It could happen. Electric vehicles aren't arriving that fast. And when global inventories start to decline, and odds are they will, then oil prices will begin to overcompensate. How much they have to overcompensate before capital comes back in, we'll see, but it will also have to go on for a while to make it evident that somebody's getting rich.

Q: As a fundamental, bottom-up research shop: ***Thornburg focuses on individual stocks and bonds. But the degree of sector dispersion across the MSCI World Index since mid-2016 is striking, with consumer staples, telecom, real estate, utilities, and health care all down mid-single digits, and industrials, energy, materials and especially financials posting double-digit advances. How sustainable are the dynamics driving the dispersion?***

BF: The dispersion in sector results has differing origins. Consumer staples corrected from overvaluation and were used as a source of funds as the market rotation developed. Telecom and utilities reflected classic behavior as potential moves up in interest rates became apparent. Health care sold down on the expectation of no matter who won the U.S. election, drug pricing freedom would be curtailed. Much of the adjustment in these sectors seems to have occurred. Industrials, materials, and financials are still under repair and relatively inexpensive on normalized earnings. Results should improve over the next several years. While only time will tell if there is more upside, these sectors had been the most depressed on cyclical fears.

BM: What's striking to me is the *intra*-sector dispersion around the globe. So telecom in the U.S. has done way better, with roughly 20% returns in 2016, and outside the U.S. it's produced a negative

return of 8% or so. Among utilities, in the U.S. they're up around 12%, and ex-U.S. they're also down around 8%. In consumer discretionary and consumer staples, and some other sectors, it's much the same story. I think that's where there's opportunity. A couple years or so ago, it was exactly the opposite scenario.

Given U.S. blue chip returns, some wonder why invest outside the U.S. But it flips around. If the U.S. has outperformed ex-U.S., maybe you should go where relative bargains and more potential upside are found. There's also another point to consider: right now the dollar spends well outside the U.S., and it's not just for vacationing in Europe. For U.S. investors, overseas investments cost less now.

Q: Return expectations: ***We hear much about investors having to lower their return goals. Should pensions, endowments, and other investors expect lower future returns?***

BF: Pension funds lowering return goals is a reflection of aligning expected returns with results produced in recent years. Part of the adjustment likely reflects the low interest-rate environment in recent times and exceptional bond returns over the past decade, until recently, as well as fairly modest equity returns of the last few years. With interest rates rising, bond total returns may slide some, but the income opportunity will be improving. Investors using a laddered maturity approach to their bond portfolio as practiced for decades at Thornburg have no need to reduce return expectations for bonds in the long run. Equity return opportunities in diversified portfolios are much like in the past; frustratingly volatile, but as potentially rewarding over time as ever.

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BM: Public pension managers have set return targets too high, higher than earnings for the most part. They were also putting too much money in illiquid and low-volatility investments, given the long duration of their liabilities portfolio. They can have a certain amount in illiquid investments. But they've learned that if stock prices go down, illiquid product prices go down even more.

Q: Active/Passive: ***Ground-level interest rates and quantitative easing proved a tide that lifted nearly all boats, to the benefit, it seems, of passive investment over the discriminating, valuation-sensitive approach of active managers. As U.S. rates rise, what's the impact on market efficiency, and should active investors, via price discovery, have a better shot at outperforming?***

BF: I am not sure that rising rates make the market more efficient. Active managers always have a shot at outperforming passive products. It comes down to execution and to a lesser extent the market environment, which of course includes interest rates. The most aggressive growth active managers would expect to do well in rising stock markets and value managers do relatively better in sinking markets. Both have the opportunity to outperform in either market, but the odds change when there is momentum in market direction.

Passive management is also not without risk. When material market corrections occur, passive investors feel it. Of course they can redeem and go to cash. Getting back in is the other half of that trade, and not always psychologically easy.

BM: This debate's been going since I was in graduate school in the late 1970s. Sometimes it's more intense, sometimes less. Right now it's intense because in periods of financial repression active management on average has underperformed passive investments. But I also think truly active managers always have an opportunity to outperform. Although 2016 didn't pan out for all of Thornburg's equity funds, every one of our equity mutual funds outperformed from inception to the end of last year. Despite periods when they underperformed their benchmarks, they added value over time. ■

Important Information

Thornburg Investment Income Builder Fund
Top 10 Holdings (as of 3/31/17)

Holding	Percentage
China Mobile Ltd.	4.3%
Atlantia S.p.A.	3.1%
JPMorgan Chase & Co.	2.9%
CME Group, Inc.	2.8%
Royal Dutch Shell plc ADR	2.7%
Orange SA	2.7%
Roche Holding AG	2.6%
Taiwan Semiconductor Manufacturing Co., Ltd.	2.1%
BT Group plc	2.0%
Novartis AG	2.0%

Thornburg Global Opportunities Fund
Top 10 Holdings (as of 3/31/17)

Holding	Percentage
Level 3 Communications, Inc.	6.3%
Aena S.A.	5.4%
T-Mobile US, Inc.	5.3%
Altice N.V.	5.2%
Alphabet, Inc. Class A	4.6%
Barratt Developments plc	4.2%
Baidu, Inc. ADR	4.1%
Citigroup, Inc.	4.1%
Wynn Resorts, Ltd.	3.8%
Galaxy Entertainment Group Ltd.	3.5%

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Investments carry risks, including possible loss of principal. Additional risks may be associated with investments outside the United States, especially in emerging markets, including currency fluctuations, illiquidity, volatility, and political and economic risks. Investments in small- and mid-capitalization companies may increase the risk of greater price fluctuations. Portfolios investing in bonds have the same interest rate, inflation, and credit risks that are associated with the underlying bonds. The value of bonds will fluctuate relative to changes in interest rates, decreasing when interest rates rise. Investments in the Funds are not FDIC insured, nor are they bank deposits or guaranteed by a bank or any other entity.

The laddering strategy does not assure or guarantee better performance than a non-laddered portfolio and cannot eliminate the risk of investment losses.

EBITDA - Earnings Before Interest, Taxes, Depreciation and Amortization. An approximate measure of a company's operating cash flow based on data from the company's income statement.

Enterprise Value (EV) – A measure of a company's total value, including market capitalization, total debt, minority interest, and preferred shares, minus cash and cash equivalents.

Gross Domestic Product (GDP) – A country's income minus foreign investments: the total value of all goods and services produced within a country in a year, minus net income from investments in other countries.

The MSCI World Index is an unmanaged market-weighted index that consists of securities traded in 23 of the world's most developed countries. Securities are listed on exchanges in the U.S., Europe, Canada, Australia, New Zealand, and the Far East. The index is calculated with net dividends reinvested in U.S. dollars.

P/E – Price/Earnings ratio (P/E ratio) is a valuation ratio of a company's current share price compared to its per-share earnings. P/E equals a company's market value per share divided by earnings per share. Forecasted P/E is not intended to be a forecast of the fund's future performance.

Producer Price Index (PPI) – Measures the average change over time in selling price received by domestic producers for their goods and services. The prices included in the PPI are from the first commercial transaction for many products and some services.

Purchasing Managers Index (PMI) - An indicator of the economic health of the manufacturing sector and for the economy as a whole. The PMI index is based on five major indicators: new orders, inventory levels, production, supplier deliveries, and the employment environment. A PMI of 50 or higher generally indicates that the industry is expanding.

Quantitative Easing (QE) – An unconventional monetary policy in which a central bank purchases financial assets from the market in order to lower interest rates and increase the money supply.

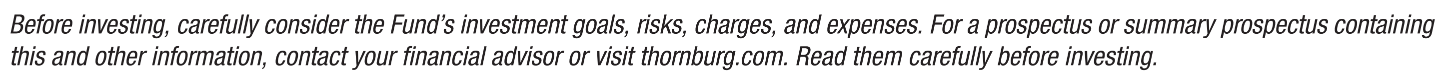
The S&P 500 Index is an unmanaged broad measure of the U.S. stock market.

The performance of any index is not indicative of the performance of any particular investment. Unless otherwise noted, index returns reflect the reinvestment of income dividends and capital gains, if any, but do not reflect fees, brokerage commissions or other expenses of investing. Investors may not make direct investments into any index.

U.S. Treasury securities, such as bills, notes and bonds, are negotiable debt obligations of the U.S. government. These debt obligations are backed by the "full faith and credit" of the government and issued at various schedules and maturities. Income from Treasury securities is exempt from state and local, but not federal, taxes.

Yield Curve – A line that plots the interest rates, at a set point in time, of bonds having equal credit quality, but differing maturity dates.

Past performance does not guarantee future results.



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