CONCORDE

Concorde Investment Management

INVESTMENT STRATEGY DURING THE GREAT GLOBAL TRANSITION
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SUMMARY

- THE POSSIBLE SCENARIOS IN THE MACROECONOMIC BACKDROP HAVE BECOME MORE RELEVANT THAN IN RECENT DECADES, AND PERHAPS EVEN CRITICAL, AS THE DOMINANT FACTOR IN DEFINING THE CONTEXT FOR INVESTMENT DECISIONS.
- THE THREE MAIN POSSIBLE SCENARIOS – DEFLATION, INFLATION AND TRANSITION OF GLOBAL ECONOMIC GROWTH LEADERSHIP – CAN HAVE SIGNIFICANT AND NON-CORRELATED IMPACT ON THE OUTCOMES OF INVESTMENT CAPITAL DEPLOYMENT.
- THE TIMING, DURATION AND MAGNITUDE OF EACH SCENARIO CANNOT BE KNOWN WITH CONVICTION DURING THIS PERIOD OF UNCERTAINTY, BUT CAN BE ANTICIPATED AND OBSERVED WITH INVESTMENT DECISIONS MANAGED ACCORDINGLY.
- NEAR TERM INVESTMENT POLICY REQUIRES A DEFENSIVE BIAS RELATIVE TO THE INFLATIONARY AND DEFLATIONARY SCENARIOS, BUT WITH A VIEW TO CORRECTLY POSITIONING FOR THE NEW ECONOMIC REALITY OF THE SHIFT IN ECONOMIC GROWTH LEADERSHIP TO EMERGING MARKETS.

Establishing an investment policy, the allocation of assets across various classes of investments, has traditionally been affected by two primary sets of criteria: (1) the needs and specific circumstances of the owner of the account (need for current income, tolerance for risk and volatility, time horizon for performance, etc.) and (2) a mostly bottom-up analysis of choosing the best opportunities relative to other choices.

The general global economic backdrop in which investment decisions have been made has been relatively stable for decades and therefore was of lesser, though not insignificant, importance than these two primary sets of criteria. However, the current transition environment is not as predictable and presents new and significant risk/opportunity factors in the near term. Therefore, a third set of criteria — that of an understanding of the broader and global economic changes underway and the implications on investments — must now receive more and deliberate consideration in establishing investment policy.

This paper is about the consequences of very different possible scenarios and the relevance of the transition context in which decisions about the deployment of investment capital must be made. This paper is focused on the changing context and how to think about being alternatively defensive and aggressive in the global economic transition period that is underway.

THE CURRENT CONTEXT OF THE CHANGING MACRO ECONOMIC FRAMEWORK RENDERS HISTORICAL "CONSERVATIVE" STRATEGIES INEFFECTIVE.

Over the last several decades, the global economic and investment backdrop was broadly understood and fit within a stable, or at least a consistent, framework of assumptions and boundaries:

- US economic hegemony,
- US dollar as unquestioned global reserve currency,
- unlimited US military projection capability,
- emerging markets reoccurring fiscal problems,
- unquestioned axiom that real estate prices always rise,
- governments don't become insolvent,
- a seemingly endless propensity of governments of the developed world to pile entitlements on aging populations.

There were most certainly variations over the years and other important dimensions of the "known" backdrop, but the possible outcomes were basically bounded by these and other factors. But today many of those "givens" and traditional boundary conditions have been violated or are under challenge, at least for the near term.

Depending on the skill of policymakers, the transition from the former post WWII global economic framework to a new version could range from difficult, at best, to painful, to possibly disastrous. Simple bottom-up analysis of investments, explicitly or implicitly based on the global backdrop of the last several decades, which is the experience base for most professionals in the investment community, will be insufficient and inappropriate in the multi-year transition period. Perhaps most importantly, the relative timing and impact magnitude of possible scenarios, some of which could be dire if investors are positioned incorrectly, and how to optimize performance outcomes, cannot be known at this stage of the transition.

Because of the divergent possible scenarios and the dramatically different potential impacts of the scenarios, the current context suggests that a defensive investment posture during this transition period must be central to investment policy, though not to the exclusion of the extraordinary opportunities that will emerge during the transition. To add further discomfort to deliberations about the deployment of investment capital, some historically defensive capital preservation strategies, like investing only in short term cash (in US dollars) might be precisely the wrong approach under the possible scenario of a significantly weakening US dollar or in the case of accelerating inflation, but could be precisely correct in the possible scenario of deflation. Good defensive strategy of the past is not necessarily good strategy during the transition phases. So while it may be instinctively obvious that investment policy needs to be defensive in these times, but also to position portfolios where they should be for where things will ultimately end up, the "how to" and timing are not so obvious, and in fact can be counterintuitive.

Concorde establishes a customized investment policy for each client based on macro factors, the financial markets and the specific circumstances of the client. Our views are influenced by our own opinions combined with those of numerous sources of research and analysis we utilize to support our investment activities, which we feel reflects the best views from a variety of thoughtful analyses.

TOP TEN EXPECTED FEATURES OF THE GLOBAL ECONOMIC AND INVESTMENT BACKDROP OVER THE NEXT 5 YEARS.

To develop an appropriate investment allocation policy we must first understand the primary drivers of unavoidable changes in the balance of the global economic system, partially as a result of the unsustainable fiscal condition of many of the developed countries and partially as a result of demographic trends. These drivers, some of which are already in early stages, form the transition environment. A "wait and see" approach of reacting to the timing, duration and magnitude of these drivers will not be acceptable because by the time one "sees", the waiting will have rendered required defensive steps too late to be effective. Picking the right mix of assets at the right time has always been the challenge of a good investment program; however the current context makes it more critical than in previous periods because the outcomes are potentially so different depending on each scenario.

There are ten primary features (many of which are interrelated) which form the basis of our current perceptions and influence our recommendations for clients' investment policy and asset allocations.

1. <u>US will kick its fiscal problems down the road,</u> with some combination of insufficient government cost cuts and inappropriate tax increases on the productive part of the economy, until the global financial markets (primarily the bond markets) force a crisis induced solution. That solution will be the socialization of the aggregate government debt burden (e.g. printing money and spreading burden over the entire society) leading to inflation and a weaker US dollar. All levels of US government debt have been growing since the 1970s and have obviated or papered over historical problems (sliding competitiveness, excessive entitlements, excessive public sector employee compensation, etc) with public resources which have reached their limits. Politics in times of slow growth tend to be ugly and the coming period will be no exception. Delaying the inevitable increases the risks of a deflationary period as an element of the crisis induced solution.

2. <u>US income inequality and higher than acceptable unemployment will persist</u> due to the lack of applicable skills for new age jobs and until re-education prepares workers. The facts, which have been obviated in recent decades by excessive debt fueled growth, are that routine skilled jobs (e.g. analysis, accounting, and legal discovery) and routine non-skilled jobs (e.g. call centers, textiles, and simple manufacturing) can be accomplished by machines or outsourced globally to lower wage markets. Non-routine non-skilled jobs (e.g. construction, fast food, and retail) do not have sufficient value add to demand high wages. Only non-routine high skilled jobs (e.g. consulting, engineering, physicians, nurses, and complex manufacturing) can command growing wages. These facts are the primary basis for the income inequality issues and, in the popular vernacular, are often blamed on globalization and global outsourcing of jobs, but without an understanding of why. For two reasons there will be little upward pressure on general US wages during the transition. One is due to the continuation of post retirement-age workers, which have under-saved, in the workplace and the other is skill mismatch with those job categories that can command high wages. Politics can't fix this issue but can polarize the discussion as class warfare and deflect the debate from the realities.

3. US will experience slow and below historical trend growth as consumption drops from its current levels of over 72% of GDP back to or below historical trends of 66%, due to the dynamics of deleveraging and aging demographics that will combine to lessen the impact of the US consumer, both domestically and globally. Some of the increase in consumption was fueled by growing debt, which will reverse in a period of deleveraging and will hinder the US from easily "growing" out of its debt problems without major — and politically unpalatable — restructure of much of its economy. That restructuring will be a burden to growth and to the US consumers' role in growth.

4. US will emerge from the period of slow growth, austerity, excessive debt and divisive politics, to be stronger and move toward becoming more competitive. The unavoidable forced restructure of the economy, in terms of improved tax policy, reduced entitlements, slowing new debt issuance and initial stages of re-education of the work force, coupled with the weaker US dollar, will lead to a resurgence of the US manufacturing base, general improvement in US competiveness and growth in US exports of products and services. Currently these factors are tremendous burdens on US economic competiveness. The adjustment to the "new normal" processes will be underway as the US emerges from the difficult transition period. At that point "new is old" with growth tied to productivity not artificial debt fueled activity. Timing is difficult to know at this stage, but based on historical cycles that were precipitated due to excess debt, the emergence will take three to seven years.

   In addition to the restructure, demographics will be somewhat supportive of the US efforts to return to competiveness. US demographic trends are not as favorable as the emerging economies but not as bad as most of the rest of the developed world. "Favorable" demographic trends simply means there is an increasing trend of more workers, producing goods and services, paying taxes, etc. relative to the portion of the population that is not working but receiving entitlements and healthcare and not paying taxes. The ratio of non-workers to workers is called the "dependency ratio". It is important to understand, that US demographic trends, primarily due to immigration, are much better than the rest of the developed world which means the US will not experience as much of an economic drag, manifested in terms of taxes, entitlements, healthcare costs, public infrastructures requirement, etc, of the "non-working" part of our population (ages 0-15 and 65+) as other developed countries.

5. US Dollar will weaken, interrupted by periods of flight-to safety strength during geo-political risks or deflationary stages during the transition, relative to currencies of creditor nations and emerging market economies that have correct fiscal policies and more favorable demographics. Simply put, in order to monetize the excessive US government debt burden, as dollars are created faster than the US economic engine behind them grows, the value of each respective dollar will decline and the US dollar dominance as the world's reserve currency will diminish. In truth, the US dollar has been in a bear market since 1970 and only interrupted by two 5 year rallies (1980 –1984 and 1998 -2002) along the way. A "weak" dollar is often perceived as undesirable in terms of its impact on US economic hegemony (world reserve currency status, US economic purchasing power, etc) but can also be viewed as a good thing in terms of US export competiveness and attractiveness of US-made goods to our own domestic market. Each in turn has its merits, but based on

excessive monetary creation, the dollar relative weakness is unavoidable and therefore a factor in investment decisions. These temporary strength periods should be used to reposition portfolios.

6. Further deflation in values in many asset classes is a likely stage of the transition. Deflation in values could become severe unless extraordinary skill by policy makers is exhibited in the management of the deleverage cycle. It will precede the unavoidable future inflationary trends that are, when compared to the alternatives, a politically acceptable method to manage the excessive debt loads of both governmental entities and individuals. This means that some defensive positioning is necessary regarding the deflationary risk but a repositioning will be necessary as inflationary pressures commence.

7. Global economic leadership will begin a long term transition from being the exclusive or dominated domain of developed economies, including the US , Eurozone and Japan, which now find themselves burdened with the results of poor fiscal policies of recent years and adverse demographics relative to the developing and emerging markets that exhibit appropriate fiscal policies and favorable demographic trends. Volatility in financial markets will persist during the transition which will have periods of both inflation and deflation in various countries and asset classes. The shift in global economic growth leadership to emerging markets will be primarily a function of demographic trends.

8. Emerging market's domestic growth will begin a long term strong upward trend for those countries with sound fiscal policies and favorable demographics. Growth will be powered by domestic consumption, as a percentage of their respective GDPs, and a decreasing dependence on the now broken export-to-developed-nations dependent model for economic growth. The wage arbitrage driven differential which helped power the export driven growth of recent decades in the emerging markets will give way to growing middle class demands for regionally produced products and services.

9. China will engineer a "soft" landing in the near term from the recent years of overspending and over-borrowing for domestic infrastructure investment. But in the process, it will cause a slowdown in its economic activity, thereby creating hard times for China-dependent commodity driven economies. The slowdown will also cause a lessening of China's demand for US debt, further exacerbating the US structural changes, as it spends reserves to recapitalize its banks. Demographic trends turn against China in the next few years and during the transition period, but its longer term trend of wealth creating urbanization will sustain its growth.

10. The European common economic experiment will survive, although with a few less members, but the cost will be near zero regional growth for an extended period and the euro, flawed from the beginning because it involved no integration of the banking system, will be weak relative to emerging market economies that have correct fiscal policies and favorable demographics. The unfolding crisis there is grounded in the non-competiveness of many of the European countries, particularly relative to Germany, that has been obviated in recent years by excessive debt fueled growth and interconnected sovereign debt and bank debt. The result of this "zero growth" environment will be declining per-capita

economic well being, on average, in the Euro zone and a lessening contribution to the global growth equation by Europe.

INVESTMENT POLICY

With the global macro-economic backdrop in a transition that is different and more profound than typical business cycles or shifting marginal competitiveness among countries, we view the two components of appropriate policy in the current transition environment — Defensive and Offensive — differently than the recent past.

- Of the three primary scenarios, deflation and inflation require a defensive positioning during the transition. Changing economic growth leadership requires positioning that recognizes the shifting of economic growth over the long term to emerging markets. Each must be addressed with an allocation of investment assets so that each allocation will perform well, or be defensive, in certain scenarios. Under this defensive bias, all allocations will not perform well simultaneously.

Deflationary Dislocation	**Inflationary Trends**	**Transitioning Economic Growth Leadership**
• Declining asset values in most all classes • Low current yields on debt • Low to zero returns on invested capital • “Flight- to-Safety“ value increase of US dollars • Damage to emerging markets which do not yet have local demand and still require consumption by developed markets	• Increasing nominal asset values • Increasing current yields on debt due to anticipated or actual inflation pressures • Increasing nominal returns required on invested capital • Decline in value of US dollars relative to tangible assets and currencies of countries with appropriate fiscal conditions	• Continuing decline of the dominance of US economic leadership as demographic trends and de-leverage works against US domestic growth • Rising local demand in emerging market countries, primarily from increasing living standards and consumer demands

- As the passage of time reveals the likely path of the economic and political transition, the weighting of the respective scenarios impacts on asset class allocations, and concomitant underlying investments, will need to be adjusted to de-emphasize the defensive aspects, where not necessary, and to emphasize areas of emerging opportunity.

- Investments should not only be made for defensive capital preservation reasons during the transition period, but also with a view to benefit from the ultimate new framework of the global economy as it emerges from the transition to one in which the former emerging markets play an ever increasing role in global growth and developed markets continue to succumb to demographic trends and experience slower growth and loss of economic dominance.

CONCLUSION

A specific asset allocation investment policy is developed for each Concorde client based on factors specifically related to each client and to the probability weighting and timing of each scenario. Concorde's current view is as follows:

- After a period of transition the global economy will resume strong growth as many of the emerging markets shift to domestic consumption and the developed countries reach an equilibrium participation in the global economy based on the realities of demographics and capital formation. Growth, and therefore good investment opportunities, will be driven by the shift in economic leadership to emerging markets.

- The near term risk of deflationary dislocations, prior to an inflationary stage, is meaningful until the method of unwinding the excessive debt in the developed countries is understood and underway. Portfolios need an allocation to hedge this specific risk. If the impact of this scenario is dramatic then portfolios will have the capability to make investments for the longer term, during the deflationary part of the transition, at favorable prices.

- Relative to currencies of creditor nations and emerging market economies that have correct fiscal policies and favorable demographics, the value of the US dollar will decline, perhaps interrupted by periods of flight-to-safety strength during geo-political risks or deflationary transition. This weakness will be partially driven by a resurgence of inflation, because monetary policy that drives inflation is the most politically palatable method to solve the excessive debt problem. Portfolios must have an allocation of investments that will benefit during the inflationary period.

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