GDP … Profits … Equities

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August, 2012

All That Matters is Growth

And Policies That Promote Growth

- Three Invariant Rules.
- What Happened? Why?
- Recessions: The Happen. They End.
- Big Positives. Big Risks.
- A Map of Possible Outcomes.

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Three Invariant Rules

1. **Real GDP Growth = P + N**

   P = productivity growth
   N = working population growth

2. **Equity returns = Δ EPS + ΔPE + dividends**

3. **Never fight the Fed, ECB, or a liquidity flood**

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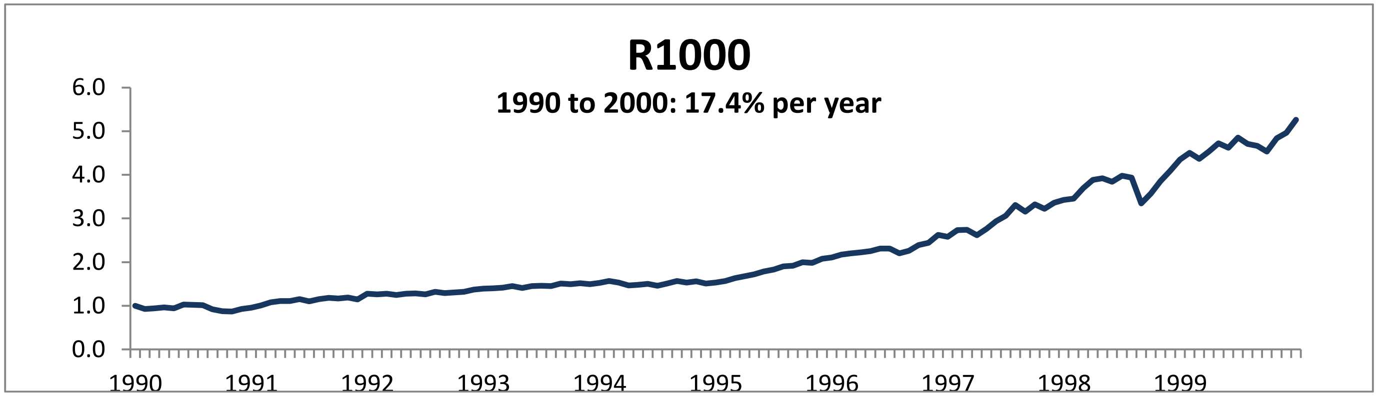
When Earnings Grow and PEs Expand



Dec. 31, 1990 to Dec. 31, 2000	R1000	R1000 Value	R1000 Growth
Actual Return, Annualized	**17.4%**	**17.4%**	**17.3%**
Earnings Growth	9.5%	9.6%	6.9%
Multiple Change Annualized	5.1%	4.0%	8.2%
Dividend	2.2%	2.9%	1.2%
Estimated Annualized Return	**17.6%**	**17.2%**	**17.1%**
P/E (Year 1) at Dec. 1990	14.1	12.3	16.3
P/E (Year 1) at Dec. 2000	23.2	18.14	35.9

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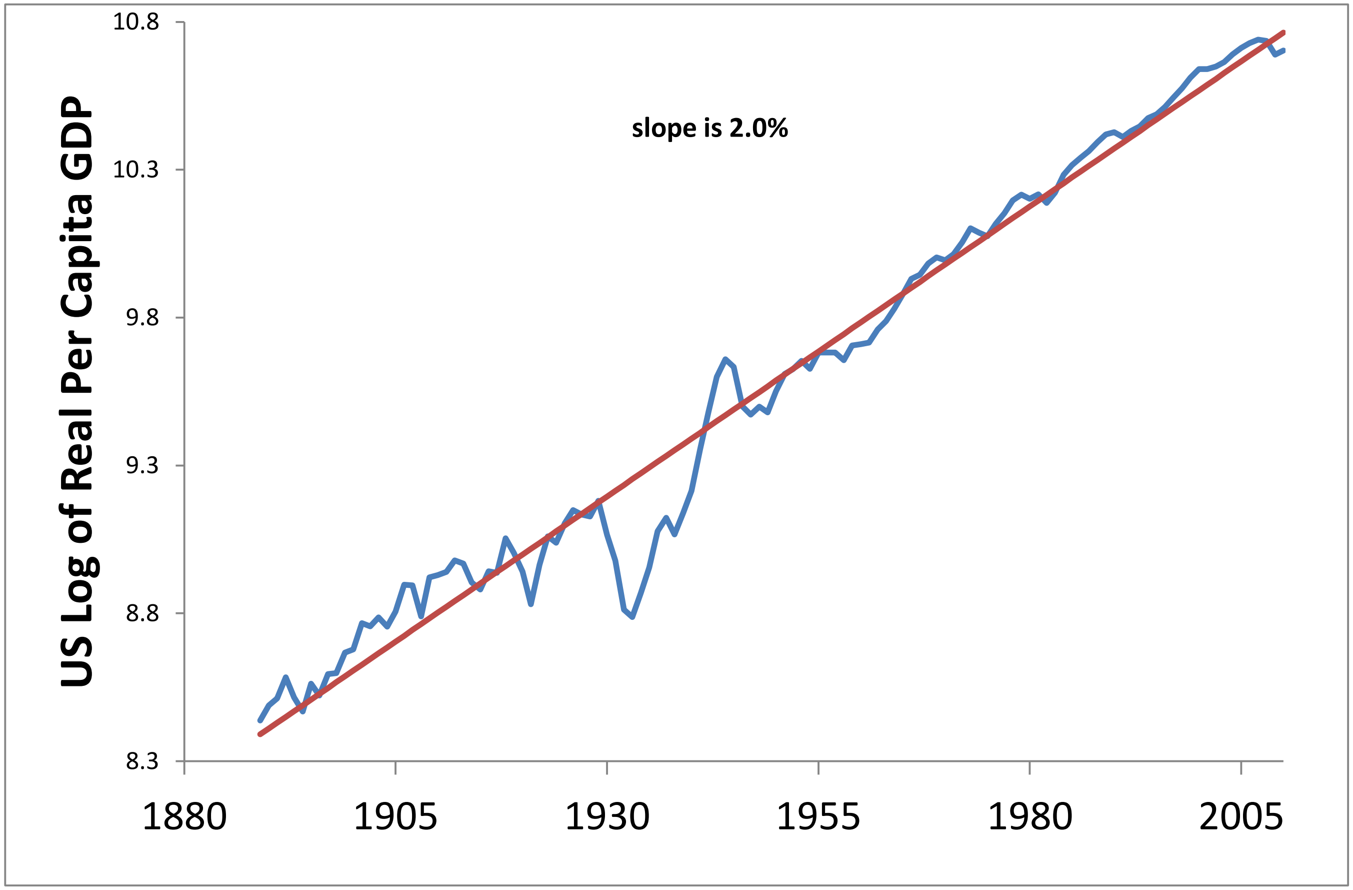
Some Perspective: The Remarkable US

Productivity growth = 2.0% since 1890
Trend GDP growth = 3.0% since 1890
Productivity growth = 2.1% since 1950
Trend GDP growth = 3.2% since 1950



source: Robert Lucas, Kevin Murphy. Bureau of Census. Department of Congress

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What Happened? How Bad?

2008 - -2012

Imbalances

- US housing
- US savings
- Global savings (current account imbalances)
- Eurozone productivity, wage disparities

Events

- US housing bubble bursts
- Lehman/Reserve fund failures
- US non-bank bank run, 11% of GDP
- A sudden stop worldwide, then recession
- The Fed and FDIC save the day
- US federal fiscal stimulus; state & local austerity
- Austerity in the UK
- China and other EM stimulus
- Central Banks absorb exploding government debt
- Greece debt problems and bailout, and no growth

- US QEs
- Eurozone: LTRO, ESM, ESFS, ECB
- Growing fiscal deficits
- Sovereign debt no longer risk free
- Eurozone, austerity dominates
- Greece: bank runs, default and euro future
- Contagion: Spain & Italy
- Southern Europe in recession
- Eurozone at stall speed; PMIs below 50
- UK at recession speed
- US growing, below trend
- EM growing, but slower pace--China slowing

Perspective

Eurozone 1945

100mm people < 1,500 calories/day

Communism on the rise: 40% in Italy

Life Expectancy (1950); circa 66 years

US 1929

Inflation: 0.0%

Long-term bond yield: 3.6%

GDP per capita (2005$): $8,106

Life expectancy: 57 years

US 1980

Inflation: 13.5%

10-year bond yield: 13.6% (February)

GDP per capita (2005$): $25,640

Life expectancy: 74 years

US 2010

Inflation: 1.6%

10-year bond yield: 3.3%

GDP per capita (2005$): $42,832

Life expectancy (2008): 78 years

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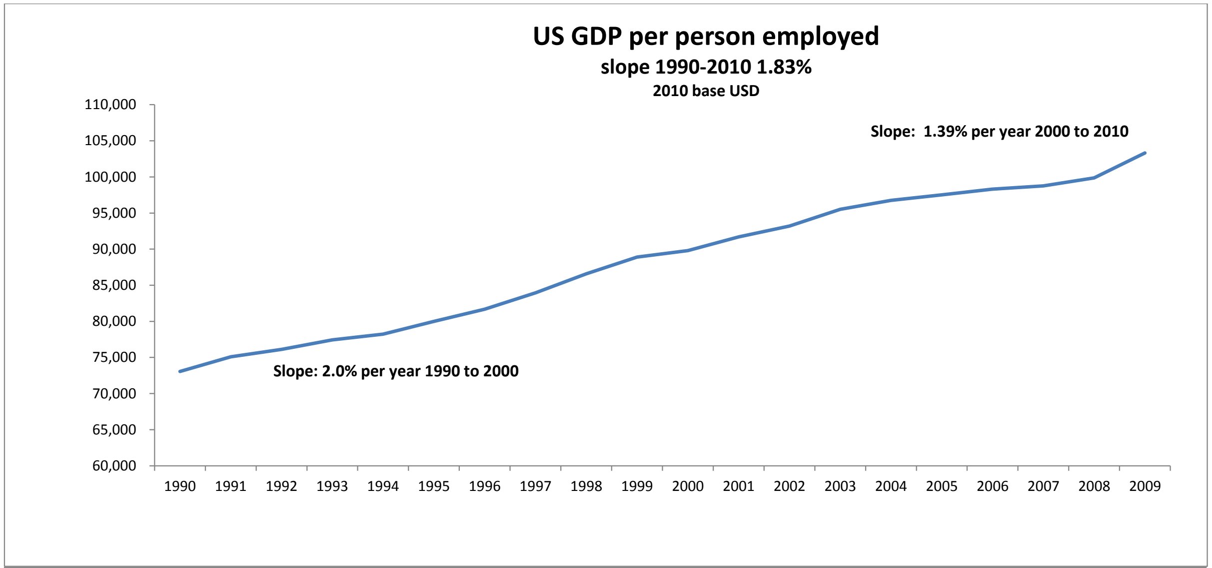
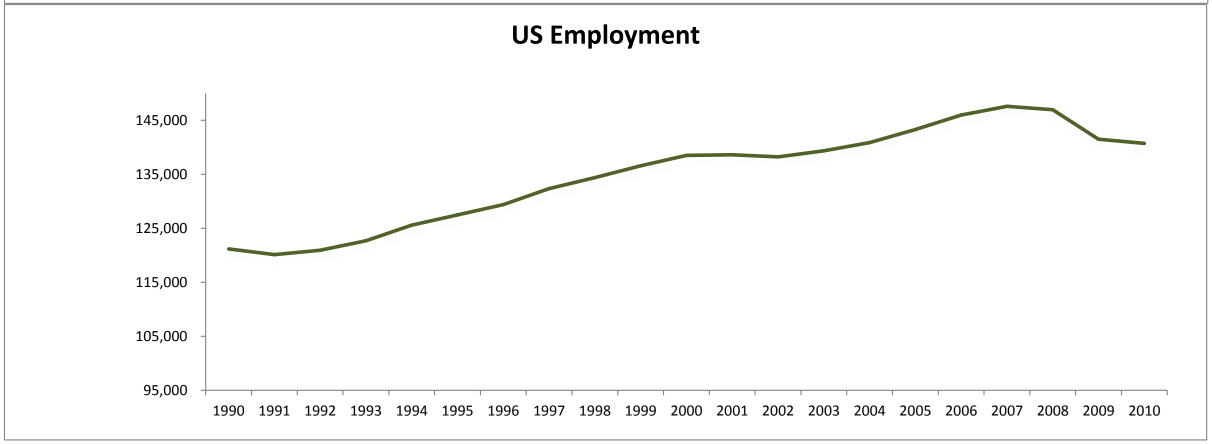
Here is the Challenge





source: Conference Board Total Economy Data Base (TEDI). Stephen Sexauer

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Recessions and Growth

- **Recessions happen. Recessions clear imbalances.**

- **Growth comes from change (productivity), <u>not from the Fed.</u>**

- **Stopping change stops growth—and keeps the imbalances.**

- **Productivity from:**
    - **Human capital**
    - **Physical capital = investment = profits (a good thing)**
    - **Improvements in technology and innovation**

- **Growth uses lots of energy.**

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Big Positives

- **Profits**
  - **At all-time high as a % of GDP**
  - **Near the long-term trend; innovation continues**
  - **Corporate balance sheets: rebuilt/strong**

- **Imbalances**
  - **$1 trillion in bad assets written off—limited Zombie banks**
  - **Housing trend demand is 1 million units; supply of starts is running at 480-760k; some inventory shortages**
  - **US Savings rate: household and corporate**

- **Energy and Manufacturing**
  - **Energy supply: global growth constraint lessened**
  - **Balance of payments gains**
  - **Global political rebalancing**
  - **US manufacturing boom**

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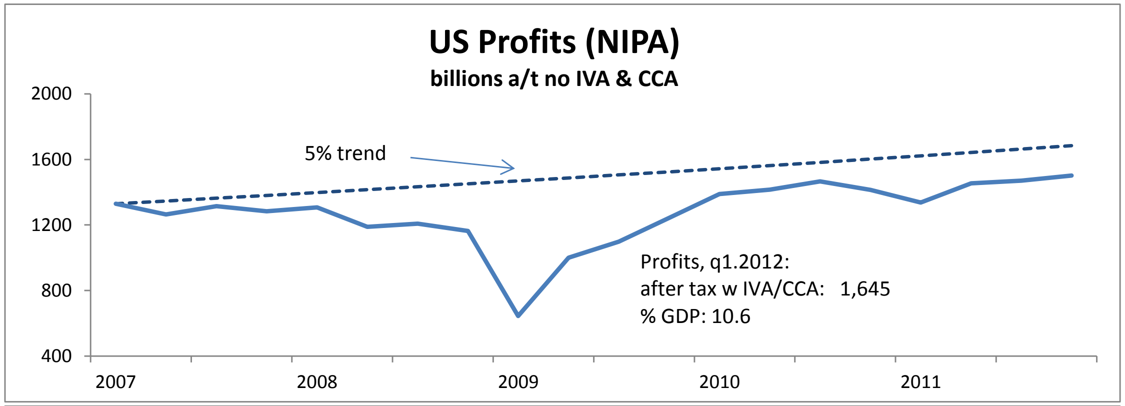
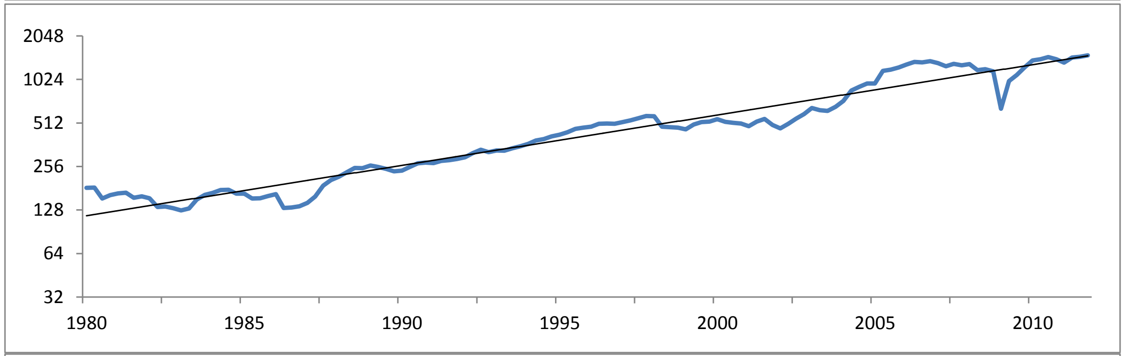
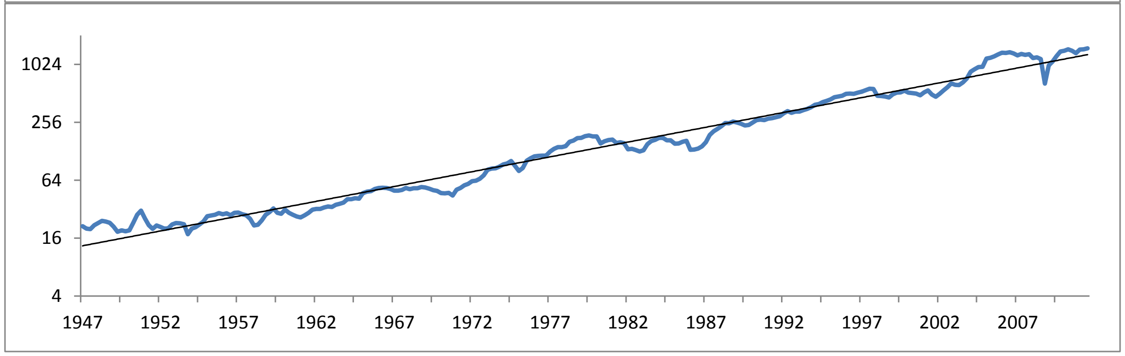
US Profits

Since Q4.2006: before tax, 3.4% p.a.; after tax, 4.1% p.a.







source: BEA

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Energy: Global Growth Uses a Lot of It

Real GDP Growth = P + N (P = productivity. N= employment)

8 barrels of Oil = One life's work
Output per life per person:
11.2 billion gram-calories. **44 million BTUs**
(think farmers in Western China, emerging markets)

60 barrels of oil = One year's work
Output per year per person:
84 billion gram-calories. **333 Billion BTUs**
(think you and me, developed markets with technology)

When 2 billion-plus people in third-world economies are pursuing a better life, they will need energy to succeed. A life's work of labor for them is about 8 barrels of oil of output (BTUs). People in the developed world have working for them about of 60 barrels of oil of energy every year--from making iPhone chips to surgical scalpels to building our roads. An energy supply curve that is upward sloping and shifting to the right (driven by incentives, innovation, and technology) makes all the difference.

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Energy and Tail Risk

North Dakota's Bakken Field:

- **2003: 10,000 b/d produced**
- **2/2012: 558,000 b/d produced--55-fold increase**
- **Forecast: 1,200,000 by 2020**

Note: OPEC "swing" capacity is 4 million b/d

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Big Risks

- **Japan/Southern Europe-like policies:**
  - **Lower productivity growth**
  - **Disincentives to work, save, invest**
  - **Limited change; slow growth; Zombie banks**

- **US fiscal policy:**
  - **The bond markets suddenly close**
  - **The US becomes Japan—the bond markets stay open, but the US never puts its fiscal house in order**

- **Eurozone Contagion**

- **EM slowdown: China growth collapses**

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Possible Equity Outcomes: A map

Long-term policy dominates all: Elections have consequences

Past

2008 -

Imbalances

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Events

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- Central Banks absorb exploding government debt
- Greece debt problems and bailout, and no growth

Present

-2012

- US QEs
- Eurozone LTRO
- Growing fiscal deficits
- Sovereign debt no longer risk free
- In the eurozone, austerity dominates
- Greece, bank runs, and euro future
- Contagion fears: Spain & Italy
- Southern Europe in recession
- Eurozone at stall speed
- UK at recession speed
- US growing, below trend
- EM growing, but slower pace

Future 2012 - forward	Possible Outcomes
Growth + Deleveraging	**EM up 10-15%** **US up 5-10%** **Eurozone up 10-50%**
Slow Growth	**Flat from here is good**
Debt-Deflation or Stagflation	**Don't ask**

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Outcomes and Possible Returns

		Emerging Markets	Developed Markets	
		All	United States	European Union
Policy Environment				
Liquidity/Easing On?		spring floods	tsunami	spring floods
Fiscal Policy Favorable?		yes	federal: yes state/local: no	circular firing squads of austerity
Debt-to-GDP Under Control?		for the most part	no	no
Productivity and Investment		yes	unclear	unclear
Incentives to Hire		yes	limted to no	austerity rules the day
Earnings Growth		**5-10%**	**5%**	**None-Negative**
Equity Valuations		**lower end**	**fair**	**low to very low**
Possible Equity Outcomes	**up**	**10%-15%**	**5%-10%**	**10%-50%**
	down	**15%-20%**	**10%-20%**	**as much as 40%**

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Appendix

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US

	Δ	EPS	SPX index fwd P/E	-17%	0	13%	25%
				10	**12**	13.5	15
typical recent decline	-40%	59.4		-57%	**-40%**	-28%	-15%
end F11	0%	99		-17%	**0%**	13%	25%
e(2012) at Mar2012	5%	104		-12%	**5%**	18%	30%
e(2013) Mar2012	19%	118		3%	**19%**	32%	44%

GDP growth[e]: 2.5% + 2.6 inflation =~5%

Dividend yield[l]: 2.3

source: Bloomberg

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EU stoxx

	Δ	EPS	SX5E index / fwd P/E	-20% / 8	0 / 10	20% / 12	40% / 14
typical recent decline	-23%		195	-43%	**-23%**	-3%	17%
end F11	0%		253	-20%	**0%**	20%	40%
F12	2%		257	-18%	**2%**	22%	42%
e(2012) at Mar2012	13%		285	-7%	**13%**	33%	53%
e(2013) at Mar2012	30%		329	10%	**30%**	50%	70%

GDP growth^{e}: -0.5% +~2.5% inflation =~2%

Dividend yield: 4.9

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MSCI EM

		MXEF index fwd P/E / EPS	-10%	0	10%	20%
			9	10	11	12
low 2010	-18%	74	-28%	-18%	-8%	2%
end F11	0%	90	-10%	0%	10%	20%
e(2012) at Mar2012	9%	98	-1%	9%	19%	29%
e(2013) at Mar2012	23%	111	13%	23%	33%	43%
		Δ				

GDP growth[e]: 6% +5% inflation =11%

Dividend yield: 2.91

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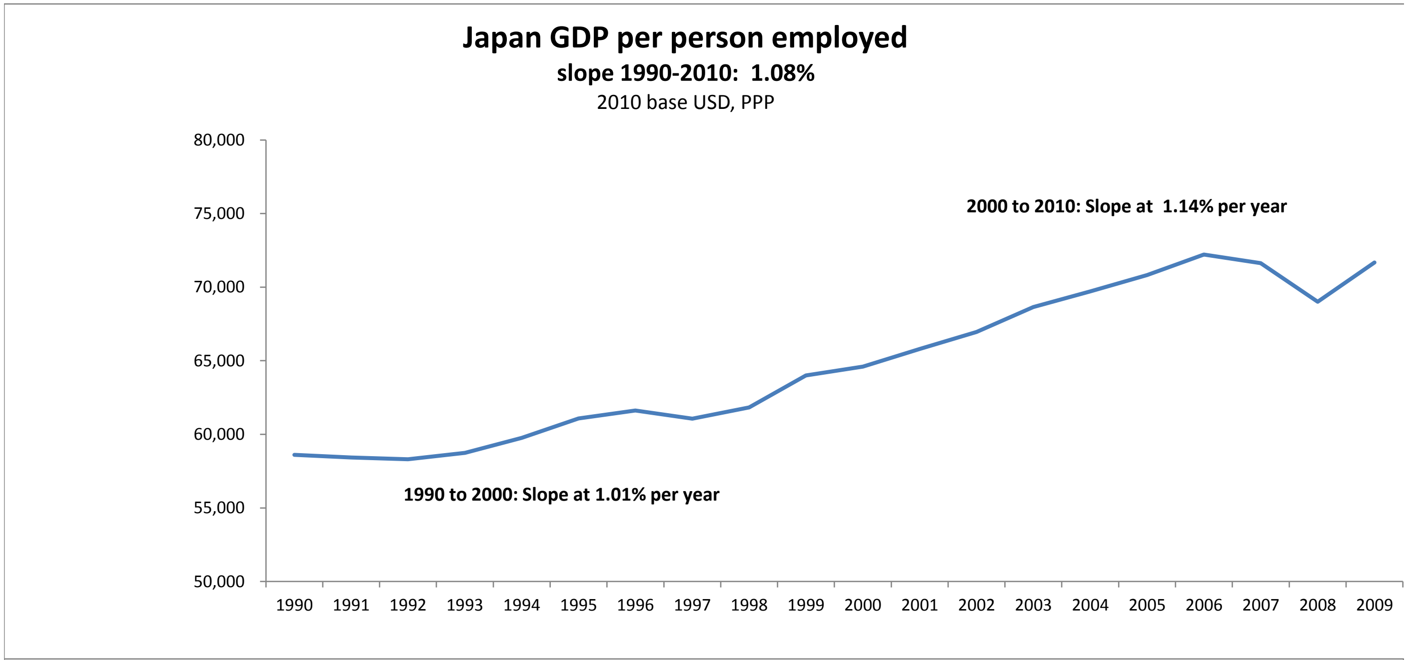
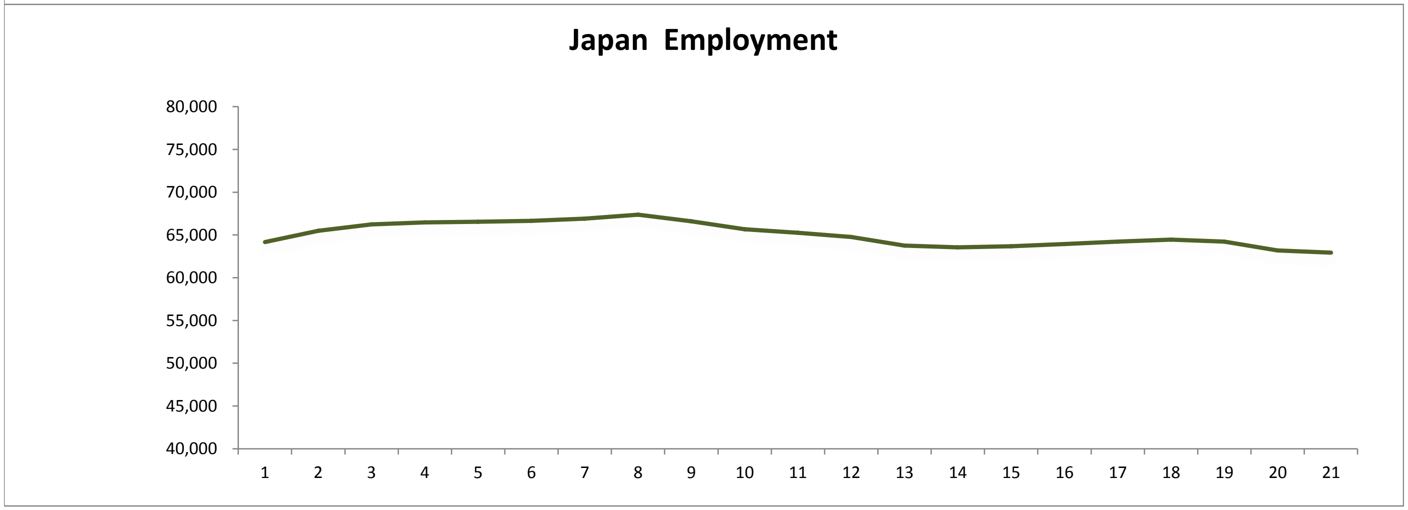
The Results of Bad Incentives (and Zombie Banks)





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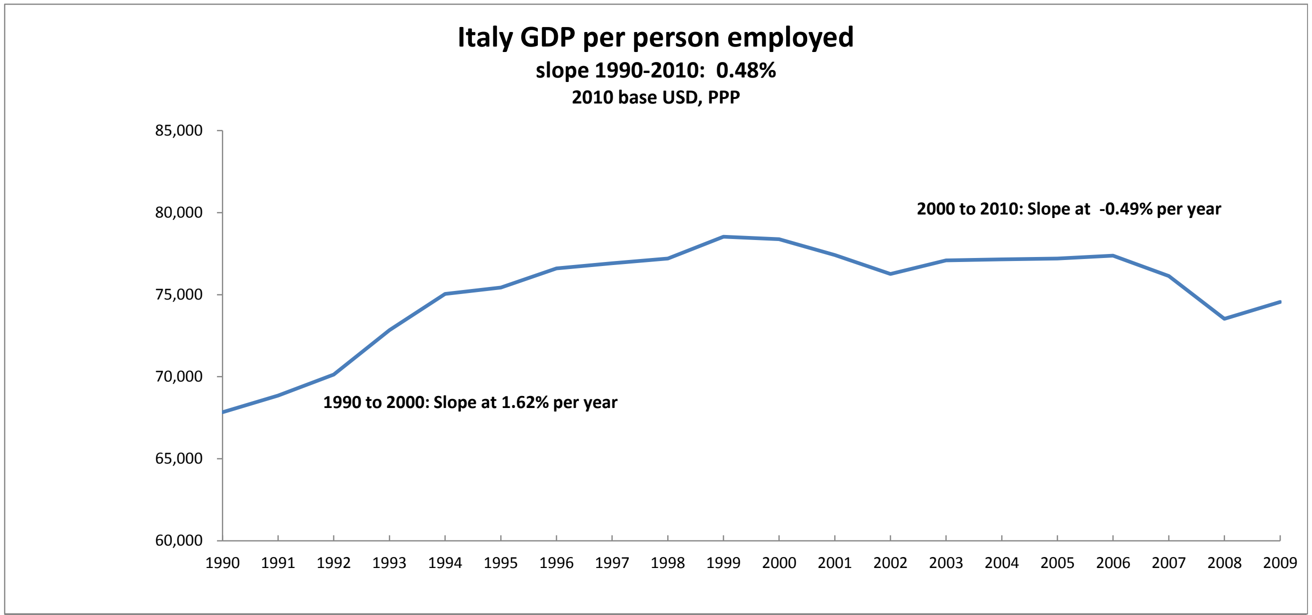
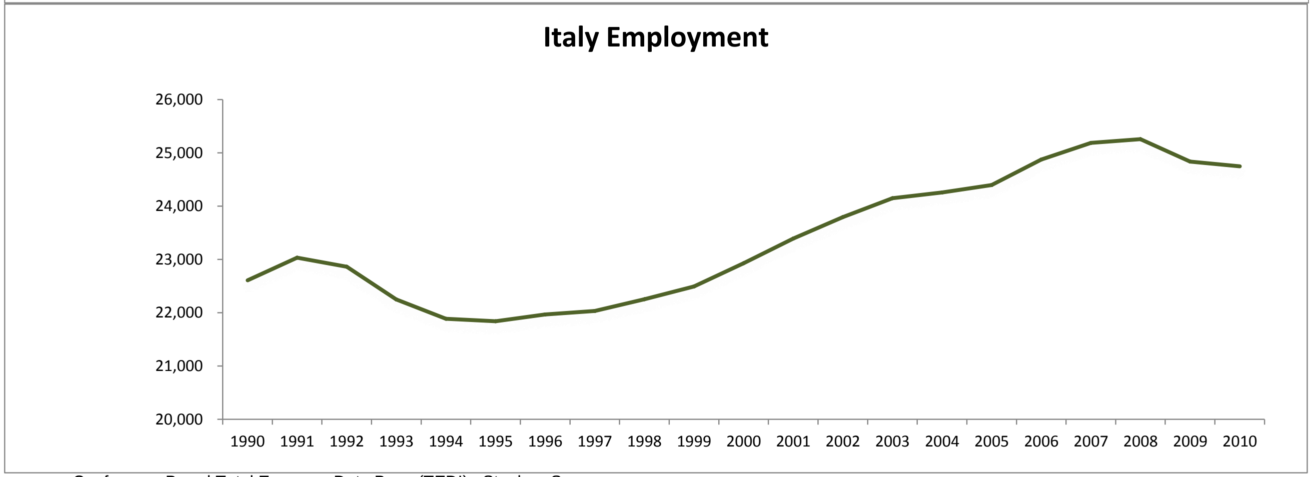
More Questionable Incentives





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(A good description of terrible incentives: http://online.wsj.com/article/SB10001424052702303740704577522412881267278.html)

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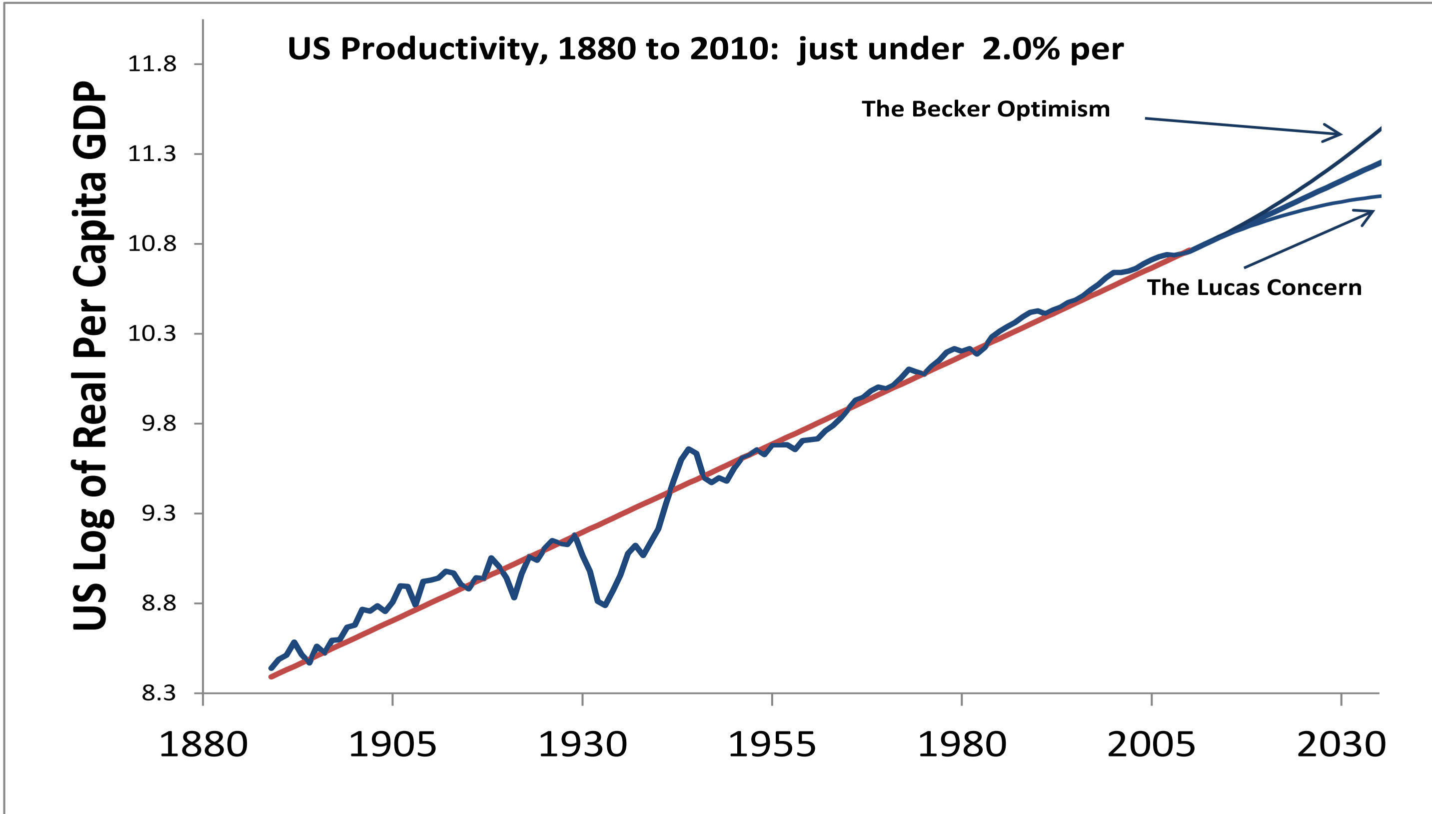

sources: Robert Lucas. Kevin Murphy. Bureau of Census. Department of Congress. Illustrative paths: Stephen Sexauer

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Allianz Global Investors (AGI) (2003 – 2012)

Stephen Sexauer has been Chief Investment Officer of AGI Solutions since inception in June, 2008, and has been a Managing Director of Allianz Global Investors of America LLC or one of its affiliates since May, 2003.

Morgan Stanley Asset Management (1989 – 2002)

Salomon Brothers: (1988 - 1989)

Mr. Sexauer holds an MBA from the University of Chicago with concentrations in economics and statistics and a BS from the University of Illinois in economics.

Economic data in this presentation are derived from internal research publicly available statistics published by Bloomberg, the U.S. Federal Reserve, the U.S. Department of Commerce and the International Monetary Fund.