Richard Bernstein Advisors

The Leaders In Pactive® Management

Insights

December 2019

Richard Bernstein Advisors

Richard Bernstein Advisors LLC (RBA) is an investment manager focusing on longer-term investment strategies that combine top-down, macroeconomic analysis and quantitatively-driven portfolio construction. We strive to be the leading provider of innovative investment solutions for investors, and our competitive edge is our research-driven macro style of investing.

Our top-down macro approach differentiates our firm from the more common, traditional bottom-up approach of most asset managers. Our extensive array of macro indicators allows us to construct portfolios for clients that are innovative, risk-controlled, and focused on overall portfolio construction instead of individual stock selection.

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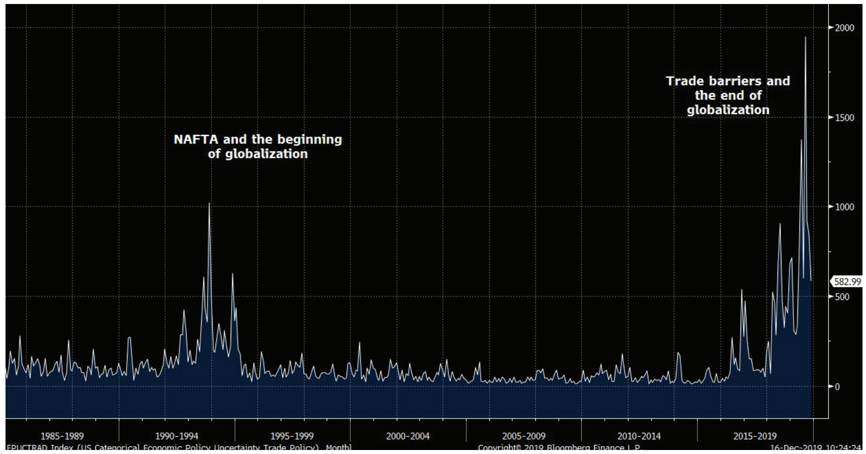
Investing for December 31, 2029—The End of Globalization

Rather than write yet another short-term "Year Ahead" report, it might be much more fruitful to investigate secular investment changes. Market leadership always changes decade by decade, and the leadership of the past decade, which are now lauded as "core investments", seem highly unlikely to be the leadership of the next decade.

Globalization has historically acted like an expanding and contracting accordion, and our long-standing hypothesis has been that the accordion is contracting. Politics both inside and outside the United States have been supporting our contention. Trade barriers, the fraying of alliances, populist governments, and even military tensions are all on the rise.

Chart 1 shows the Baker, Bloom, and Davis Economic Policy Uncertainty Index for Trade. There have been two periods of extreme trade policy uncertainty. The initial period of the early-1990s was the beginning of the modern period of globalization. NAFTA was implemented and there was significant uncertainty regarding the implications of increased global trade and flexible supply chains. Today's unprecedented uncertainty (nearly twice the uncertainty associated with NAFTA) is clearly associated with the repercussions of the reversal of free trade.

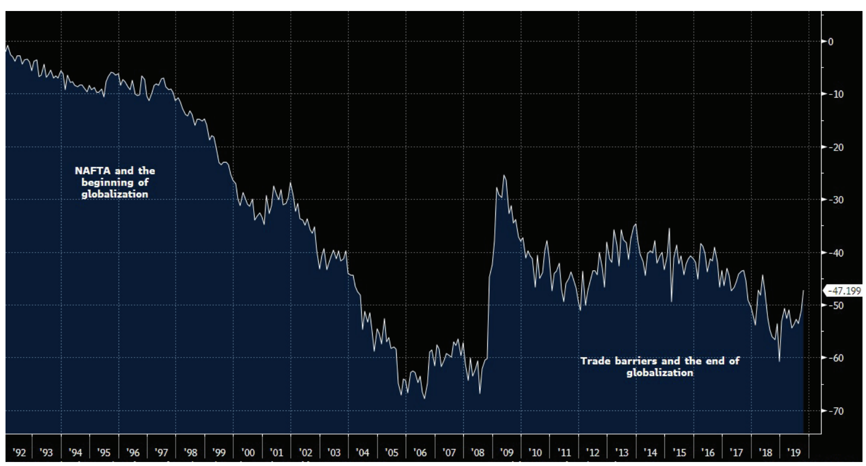
CHART 1:
US Trade Policy Uncertainty Index
(Jan. 1985 – Dec. 2019)



Source: Bloomberg Finance L.P.

Chart 2 shows the US trade balance. NAFTA certainly contributed to the deterioration of the US trade balance, but that was expected because of the opening of freer trade with more productive economies. Since 2008 (potentially the true end of globalization), there has been a noticeable change in the trade balance's trend. The balance may have deteriorated during the past two years, but the longer-term downtrend appears to be broken.

CHART 2:
US Trade Balance
(Jan. 1992 – Oct. 2019)



Source: Bloomberg Finance L.P.

Some might consider our thoughts about the end of globalization as extremely bearish, but we view them simply as highlighting a potentially potent secular change in the global economy that could present significant long-term investment opportunities.

We are aware these themes may run counter to today's consensus. Market leadership will naturally shift if the global economy changes, but investors tend to be slow to acknowledge these changes and prefer to follow past momentum. Accordingly, here are several secular investment themes one should put in a portfolio time capsule to be opened on December 31, 2029:

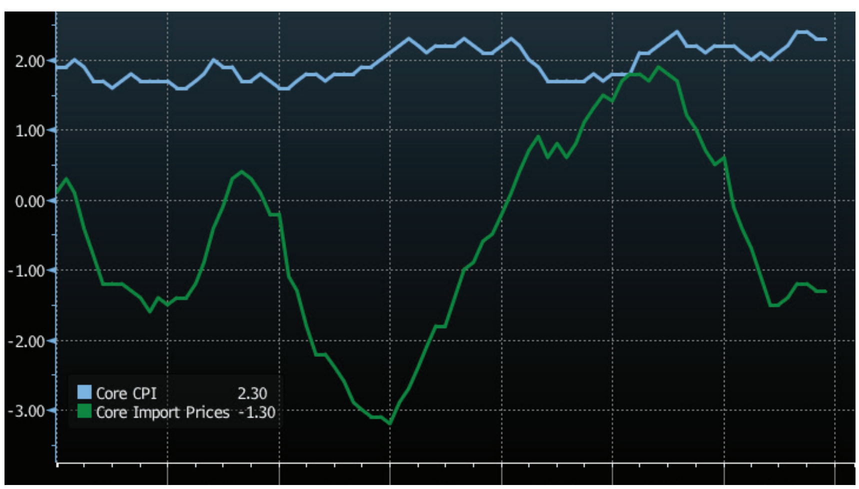
1) **Inflation**
2) **Emerging Markets vs. Venture Capital**
3) **Tech becomes dreck**
4) **Gold**

Inflation returns

For the first time in the past 30-40 years, both US monetary and fiscal policies are explicitly pro-inflation, yet investors continue to largely shun asset classes that benefit from higher inflation despite this noticeable policy change. Few investors seem to be considering the combination of the upward inflation pressures of reduced globalization and the US's current pro-inflation policies.

Economic theory suggests that globalization allows production to shift to the most productive regions, and that improvement in productivity increases competition which puts downward pressure on prices. In fact, globalization and global competitive pricing was one of the primary reasons US inflation was secularly lower than many forecasted. Chart 3 shows globalization's downward pressure on US prices because core import price increases were consistently below the US Core CPI. In other words, the US has been "importing deflation." The end of globalization implies less competition, production shifting to less productive regions, and upward, rather than downward, pressure on prices.

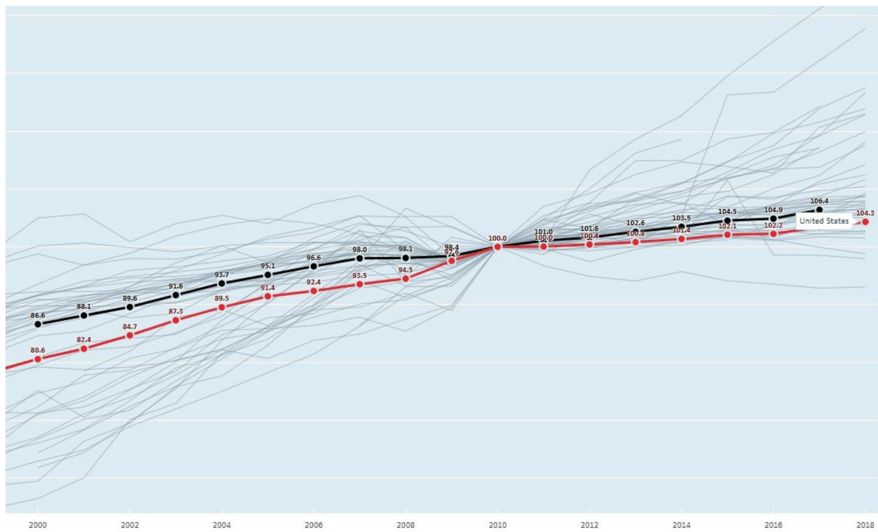
CHART 3:
Core CPI vs Core Import Prices (%YoY)
(Dec. 2012 – Nov. 2019)



Source: Bloomberg Finance L.P.

Chart 4 highlights that US productivity (measured by the OECD as GDP per hour worked) is not competitively strong. This further suggests a shift of production from more competitive economies to the US could result in higher inflation. The US simply does not have a modern enough and competitive enough public and private infrastructure to support a broad production increase without prices also increasing.

CHART 4:
Productivity by Country
(1999 – 2018)



Source: OECD

There are also shorter-term inflation pressures that investors are largely ignoring:

1) Current monetary policy is pro-inflation: The Fed has a dual mandate of low unemployment and stable prices, and the Fed just lowered rates three times. The Fed can't be worried about employment because it is a mere 3.5%, which is a multi-decade low. Thus, the only justification for easing policy is to support higher prices. In fact, there has recently been some discussion within the Fed system regarding raising the Fed's inflation target from 2.0% to 2.5%. We can never remember the US central bank ever suggesting a goal of higher baseline inflation.

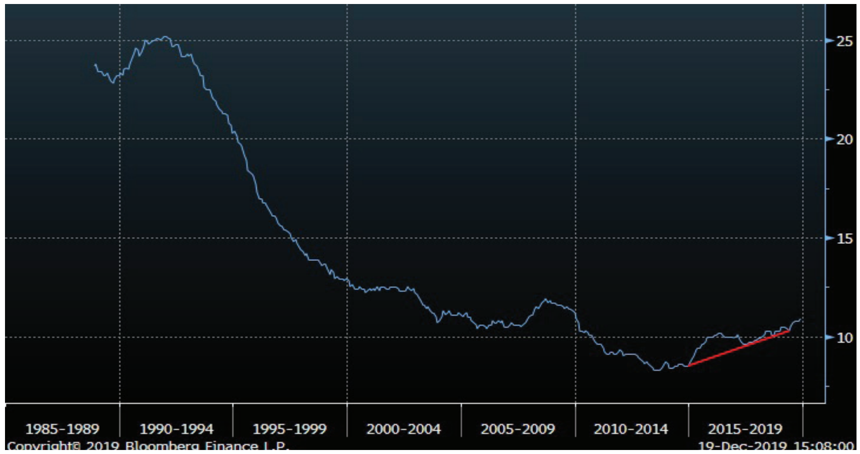
2) Fiscal policy is pro-inflation: One must remember that tariffs, by definition, are <u>always</u> inflationary. The goal of a tariff is to raise the prices of imports so that domestic companies can compete on level ground. Raising prices on a broad scale is called inflation.

3) The five-year trend in core inflation is rising at the fastest pace in 30 years (see Chart 5).

4) The NFIB compensation survey shows US small companies are planning to increase worker wages by the most in 30 years (see Chart 6).

CHART 5:

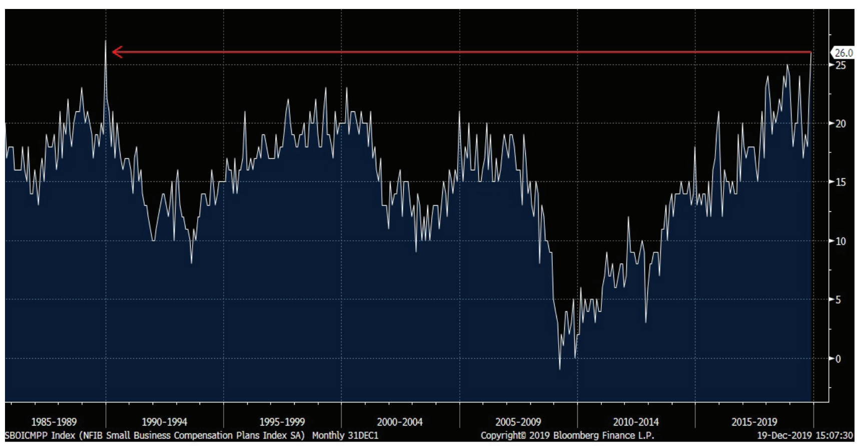
US Trend Core CPI (5-year percent change)
(Nov. 1998 – Nov. 2019)



Source: Bloomberg Finance L.P.

CHART 6:

NFIB Small Business Compensation Plans Index
(Dec. 1984 – Nov. 2019)



Source: Bloomberg Finance L.P.

EM vs. Venture Capital

In several earlier reports, we highlighted that Empirical Research Partners' analysis showed nominal flows to venture capital and private equity funds have now eclipsed the flows into US equities during the late-1990s Technology Bubble. There is also roughly $2 trillion dollars of "dry powder" (i.e., capital committed by investors but not yet called by managers) waiting to be invested globally in venture capital and private equity.

One basic rule of investing is that return on investment is highest when capital is scarce. These recent data suggest that private markets are not starved for capital. Rather, these asset classes seem historically flush with capital. Financial theory argues that the high returns historically associated with venture capital and private equity are highly unlikely to repeat.

Charts 7 and 8 show how long-term performance trends can defy popular consensus. The first chart shows compounded returns for the Thomson Reuters Venture Index and for the MSCI Emerging Market Index from 2000 to 2009. 2000 (the start point in the chart) was the end of the Technology Bubble, but consensus remained that technology-related investments were a critical part of any growth portfolio. Emerging Markets were at the other end of investors' emotional scale because EM had suffered a series of financial catastrophes and were accordingly unpopular. However, Emerging Markets subsequently outperformed Venture during the following decade by nearly 14 percentage points per year.

The situation was reversed by the end of the 2000s. Enthusiasm for Emerging Markets grew as the asset class outperformed, and by 2009/2010 Emerging Markets were considered a critical part of a portfolio. In fact, investors at that time were so enamored with Emerging Markets that many wouldn't even consider our portfolios because those portfolios had little or no EM exposure. Technology-related investments were largely unpopular because they had underperformed during the "lost decade for equities". Venture Capital significantly outperformed EM over the subsequent decade by almost 20 percentage points per year.

Because technology-related investments significantly outperformed, Venture Capital is now once again considerably more popular than are Emerging Markets. Like the investment consensus in 2000, an allocation to Venture Capital today is widely considered essential by both institutional and individual investors.

There is no scarcity of capital in Venture Capital and returns are already starting to wane, but investors' appetite for VC remains hearty. Meanwhile, investors have largely shunned EM. It will be interesting to see how these two asset classes perform over the next decade, but history suggests that EM will outperform VC.

Admittedly, investors must balance the positive sentiment backdrop for EM with the potential negative of contracting global trade. Without being political, it is possible that the world simply divides into the US and the non-US economies. The ongoing benefits of globalization might not be lost for EM in that case.

CHART 7:
Cumulative Return of Venture Capital vs Emerging Markets (Dec. 2000 – Dec. 2009)

Source: Bloomberg Finance L.P.

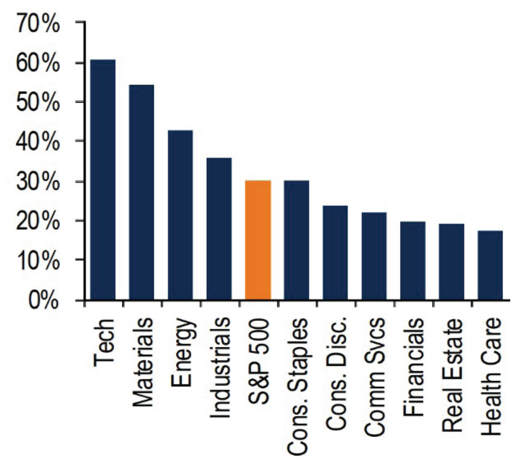
CHART 8:
Cumulative Return of Venture Capital vs Emerging Markets (Dec. 2009 – Oct. 2019)

Source: Bloomberg Finance L.P.

Tech becomes dreck

The Technology sector has been the biggest beneficiary of globalization. No other sector has such dispersed global supply chains or broad range of consumers around the world. A significant contraction in global trade could demonstrably change the profitability and growth trajectory of the sector. Chart 9 shows S&P 500® sectors' foreign exposures (non-US sales as a percent of total sales). Technology is the most foreign exposed sector.

CHART 9:
S&P 500® Foreign Exposure by Sector



Source: BofA Merrill Lynch US Equity Strategy Year Ahead: Ch-ch-ch-changes. Published on November 19, 2019.

A contraction in global trade could make growth targets questionable for foreign exposed technology companies, but it is even harder to envision analysts' lofty growth projections for the largest technology companies if antitrust regulation and disruptive capitalism continue over the next ten years. Table 1 shows the 10 largest Technology and Telecom companies within the S&P 500® as of December 31, 1999, December 31, 2010 and today. Only four companies appear in every column. Although some of the movement within the table is attributable to M&A activity, the table nonetheless reflects how difficult it is to maintain high valuations over long periods of time when success is based on significant and constant innovation.

TABLE 1:
10 Largest Technology and Communication Companies in the S&P 500®

12/31/99	12/31/10	DECEMBER 2019
Microsoft	Apple	Apple
Cisco Systems	Microsoft	Microsoft
Intel	IBM	Alphabet
Lucent Technologies	AT&T	Facebook
IBM	Google	AT&T
America Online	Oracle	Disney
SBC Communications	Intel	Intel
Oracle	Cisco Systems	Verizon
AT&T	Verizon	Comcast
MCI Worldcom	Hewlett-Packard	Cisco Systems

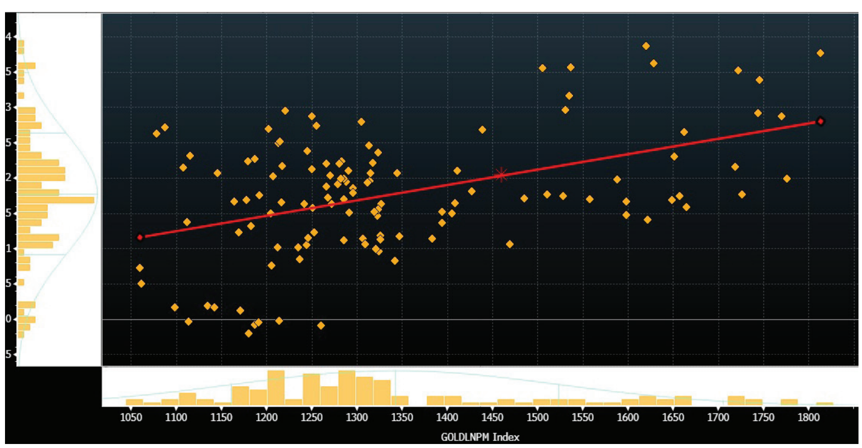
Source: S&P 500®, Richard Bernstein Advisors.

Gold

We've never been "gold bugs," but it seems appropriate to hold gold if there is a secular contraction in globalization. First, as mentioned, limiting competition through trade barriers is inflationary and gold has historically hedged inflation well. Chart 10 shows that gold tends to appreciate as inflation rises. This certainly is not a perfect fit because there are many factors that influence gold prices. However, similar regressions for either stocks or bonds would yield a flat or negative relationship.

Second, our previous chart on trade uncertainty is one of many measures highlighting the current level of uncertainty is unprecedented, and gold has historically been a hedge against uncertainty and volatility. Third, gold could become a store of value in many parts of the world should the contraction in globalization become dire.

CHART 10:
Regression of CPI %YoY on Gold Spot Price (Dec. 2009 – Nov. 2019)



Source: Bloomberg Finance L.P.

What's in your time capsule?

Decades are all different, and the investment leadership in one decade has rarely been the leadership in the subsequent decade. We think the biggest investment theme over the next ten years could be the end of globalization.

If we could bury a time capsule and dig it up in ten years, we'd put EM and inflation-sensitive assets in that vault. There's no guarantee that these themes will work, but we're confident that the world will look quite different at the end of the next decade and today's popular investment themes (like venture capital, technology, and deflationary investments) will ultimately prove inappropriate.

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*To learn more about RBA's disciplined approach to macro investing, **please contact your local RBA representative**.*

INDEX DESCRIPTIONS:

The following descriptions, while believed to be accurate, are in some cases abbreviated versions of more detailed or comprehensive definitions available from the sponsors or originators of the respective indices. Anyone interested in such further details is free to consult each such sponsor's or originator's website.

The past performance of an index is not a guarantee of future results.

Each index reflects an unmanaged universe of securities without any deduction for advisory fees or other expenses that would reduce actual returns, as well as the reinvestment of all income and dividends. An actual investment in the securities included in the index would require an investor to incur transaction costs, which would lower the performance results. **Indices are not actively managed and investors cannot invest directly in the indices.**

Thomson Reuters Venture Capital Index: The Thomson Reuters Venture Capital Index is designed to measure the value of the US-based venture capital private company universe in which venture capital funds invest.

S&P 500®: The S&P 500® Index is an unmanaged, capitalization-weighted index designed to measure the performance of the broad US economy through changes in the aggregate market value of 500 stocks representing all major industries.

EM: The MSCI EM Index is a free-float-adjusted, market-capitalization-weighted index designed to measure the equity market performance of emerging markets.

Gold: The London PM Gold Price. The LBMA Gold Price will replace the Gold Fixing Price and ICE Benchmark Administration Limited ("IBA") will become the administrator from March 20, 2015. Under the administration of IBA, the methodology underpinning the LBMA Gold Price is as follows:* Independently administrated and tradable auction process* Electronic and physically settled auction* Aggregated and anonymous bids and offers published on-screen and in real-time* Auction conducted in US Dollars. The IBA auction process is an electronic auction, with the imbalance calculated, and the price adjusted in rounds (45 seconds in duration). The auction will run twice daily at 10:30am and 3:00pm London time. The round duration will be continuously monitored for suitability. If it is necessary to adjust the duration, this will be advised to all direct participants with not less than one week's notice. For more information please see https://www.theice.com/iba/lbma-gold-price.

US Trade Policy Uncertainty Index: The US Trade Policy Uncertainty Index is one of the category-specific Economic Policy Uncertainty (EPU) indexes developed in "Measuring Economic Policy Uncertainty" by Scott R. Baker, Nick Bloom and Steven J. Davis. It reflects the frequency of articles in American newspapers that discuss policy-related economic uncertainty and also contain one or more references to trade policy. For index construction details, please visit the US Categorical EPU Indices page.

Richard Bernstein Advisors

About Richard Bernstein Advisors

Richard Bernstein Advisors LLC is an investment manager focusing on long-only, global equity and asset allocation investment strategies. RBA runs ETF asset allocation SMA portfolios at leading wirehouses, independent broker/dealers, TAMPS and on select RIA platforms. Additionally, RBA partners with several firms including Eaton Vance Corporation and First Trust Portfolios LP, and currently has $9.2 billion collectively under management and advisement as of November 30th, 2019. RBA acts as sub-advisor for the Eaton Vance Richard Bernstein Equity Strategy Fund, the Eaton Vance Richard Bernstein All-Asset Strategy Fund and also offers income and unique theme-oriented unit trusts through First Trust. RBA is also the index provider for the First Trust RBA American Industrial Renaissance® ETF. RBA's investment insights as well as further information about the firm and products can be found at **www.RBAdvisors.com**.