

BEARISH ON THE U.S. MARKETS, YUSKO LOOKS TO JAPAN AND RUSSIA FOR GROWTH

Jeremy Schwartz – Global Chief Investment Officer
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Last week Professor Jeremy Siegel and I chatted with Mark Yusko, Chief Investment Officer of Morgan Creek Capital, about his thoughts concerning extended U.S. valuations and global markets that may offer abundant potential beyond that of the United States.

Reactions to the April Jobs Report Professor Siegel was generally encouraged by the April jobs report. He especially liked that hourly earnings were up only one-tenth of 1%, as he believes it allows the U.S. Federal Reserve to be more patient about hiking interest rates. Yusko struck a more doubtful tone. He thinks that in order to get the 3% growth the Fed is looking for, job growth that should run in the range of 260,000 to 280,000 jobs per month. Professor Siegel retorted that poor economic growth recently has been a function of weak productivity—and that current job growth could be translating to 4% to 5% [gross domestic product \(GDP\)](#) growth if it weren't for such dismal productivity. For the first time in 22 years, we witnessed two consecutive quarters of negative productivity growth in the U.S. **Why Is the Fed Saying the Market Is Expensive?** Fed Chairman Janet Yellen recently commented that equity valuations are high on a historical basis, but she added the caveat that they are not that high when we consider the low-interest-rate environment that we are in today. Siegel believes that we could be in a long period of slow growth, with GDP averaging 2%. He thinks this will keep the 10-year [TIPS](#) at levels not more than 1.5% and the 10-year [nominal Treasury](#) rate at 2.5% to 3% when adding [inflation](#) on top of real interest rates. Siegel believes this could justify a 20 to 22 times price-to-earnings ratio ([P/E ratio](#)), while the [S&P 500](#) is currently trading at a P/E ratio of 18 times earnings and its average since 1954 is 16.5x. Yusko believes that equity [valuations](#) are near highs today. He cites the market cap-to-GDP ratio being second only to the period after the technology bubble in 2000–2001. He also places a high value on the [price-to-sales](#) metric and is concerned because margins are rolling over and profit growth is negative. Yusko points to GMO co-founder Jeremy Grantham, who sees returns over the next 10 years averaging -1.1%. **Julian Robertson Now Bearish for Third Time in 15 Years** Yusko pointed to his mentor, Julian Robertson, founder of the famous Tiger Management. Robertson has been [bearish](#) three times in the last 15 years. The first time was 1999–2000 when he shut down his hedge fund. The second was right before the subprime crisis in 2007. Robertson started getting more bearish last November and has reiterated those worries recently. Yusko is looking for a repeat of the 2000–2002 bear market scenario for U.S. equities. Professor Siegel cautioned that P/E ratios on the S&P 500 were closer to 30x earnings in 2000–2001 and 90x earnings in the Technology sector with real interest rates between 4% and 5%—much tougher competition for stocks. Siegel believes we are in a very different market environment today—[interest rates](#) near zero and more reasonable P/Es—and believes comparison to the 2000–2001 time frame is less relevant. **Buying Japan Today Is Like Buying the U.S. in 1984** while Yusko is worried about the opportunities in the U.S., he believes that Japan's future is bright. Yusko expects the U.S. market to lag Japan's significantly over the next eight years—by as much as two to three times the relative return potential. Yusko also believes the key to achieving this return is to hedge the

yen. He thinks the yen-per-dollar currency pair could reach close to 130 by the end of 2015, rise closer to 140 to 150 in 2016 and reach 175 to 200 on the yen over the next four to five years. For perspective, Yusko recalls how the yen used to trade at levels closer to 350. Japan has excessive debt, and Yusko believes Japan has no other way out but to devalue its currency. He is further encouraged by GDP prints that look positive and inflation trending closer to 2%. Yusko believes buying Japan today is like buying the U.S. in 1984. **Emerging Markets Quite Attractive** Looking more globally, Yusko believes Japan beats Europe, Europe beats the U.S. and emerging markets (EM) beat them all in the coming years! In EM, he is optimistic on service economies such as South Korea, Taiwan, China and India that are beneficiaries of lower oil prices. Commodity countries such as Russia and Brazil, on the other hand, have a harder time and should struggle with lower oil prices. Yet, one of Yusko's top 10 surprises coming into the year was that Russia would be one of the best performing markets after very disappointing performance. He believes we are just getting started with Russia, and we may see up to triple-digit returns from the country. *I want to thank Yusko for another great conversation on his outlook for the markets, and we look forward to keeping in touch on his major themes. Read the Conversations with Professor Siegel Series [here](#).*

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DEFINITIONS

Gross domestic product (GDP): The sum total of all goods and services produced across an economy.

TIPS: Treasury Inflation Protected Securities.

Nominal Treasury: Rate on the treasury security not adjusted for inflation.

Inflation: Characterized by rising price levels.

S&P 500 Index: Market capitalization-weighted benchmark of 500 stocks selected by the Standard and Poor's Index Committee designed to represent the performance of the leading industries in the United States economy.

Valuation: Refers to metrics that relate financial statistics for equities to their price levels to determine if certain attributes, such as earnings or dividends, are cheap or expensive.

Bear market: A sustained downturn in market prices, increasing the chances of negative portfolio returns.

Real interest rate: Interest rate accounting for the impact of inflation. From the nominal interest rate, which does not account for the impact of inflation, the rate of inflation is subtracted to get to the real interest rate.