ClearBridge Investments

Podcast: ClearBridge Mid-year Outlook 2019: Confidence or Caution?

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With Large Cap Growth and All Cap Growth Portfolio Manager Margaret Vitrano (MV), International and Global Growth Portfolio Manager Michael Testorf (MT), and Investment Strategist Jeffrey Schulze, CFA (JS)

JS: Hello and welcome to the latest ClearBridge Podcast. This is Jeff Schulze, CFA, Investment Strategist at ClearBridge Investments. ClearBridge is a global equity manager with 142 billion in assets under management, committed to delivering long-term results through authentic active management. ClearBridge tailors our strategies to meet three primary client objectives in our areas of proven expertise: high active share, income solutions and low volatility. We integrate ESG considerations into our fundamental research process across all strategies.

So it's hard to believe that we're already halfway through 2019. Both the U.S. and international equity markets are up double digits so far this year, and the U.S. economic expansion is on the cusp of being the longest ever. So will the positive momentum continue? Or are we in for a rocky second half? I'll share my thoughts on the macro outlook, and I'm pleased to be getting some expert help on the equity outlook from two of my colleagues and frequent visitors to the podcast booth: Margaret Vitrano, Portfolio Manager for the Large Cap Growth and All Cap Growth strategies; and Michael Testorf, Portfolio Manager for our International and Global Growth strategies. Thanks for joining me in the booth.

MV: Thanks for having us.

MT: Thank you.

JS: And the topic of today's podcast is, ClearBridge Mid-year Outlook 2019: Confidence or Caution? So we'd love to get your feedback about the topics we cover and how we can make our podcast better. You can contact us with questions, comments and suggestions by emailing us at Podcast@ClearBridge.com. So what a year that we've had since the middle part of 2018. The S&P 500 is up about 10% over the past year, but we've had two significant drawdowns. We've had the 20% drawdown in Q4 of last year, and we also had a 7% drawdown last quarter. And higher volatility is something that I think a lot of our listeners are going to have to expect going forward. In fact, if you think about volatility it has a three-year lag of a flattening of the yield curve. And if you look at a chart of this, volatility is going to be going up a lot higher. And a lot of the volatility has weighted in around trade wars. If you have a chart of the S&P 500, you could see that the last three peaks that we've had in the S&P 500, as soon as something from a trade war was announced, the market dropped, recovered, and then the trade war escalated, dropped recovered, wash and repeat. So I guess the first question that I have for both of you are, are we going to see a resolution with the trade war with China? I guess that's the trillion dollar or billion-dollar question, Michael?

MT: Yes, I'm in the camp that I think there will be a solution at one point in time. I'm in the camp where I say Trump wants to be re-elected in the 2020 election, and therefore he wants to show a strong economy. So in order to do that, I mean you have to come to a solution. But I think it could get worse

before it gets better. That's the point. And in order to get the economy going, I think you have to come to a kind of conclusion somewhere in quarter three or quarter four to give the economy time enough to recover. So from that perspective I'm kind of a little positive.

JS: Well, I think you make a lot of sense. Because you think about the only presidents in the post-war World War II era that have not gotten re-elected for a second term, three of those presidents, which were Ford, Carter and then also George Bush, Sr., or George H.W. Bush, they all had a recession within two years of that re-election program. So "It's the economy stupid" actually means something when it comes to re-election bids. So you're optimistic for Q3 or Q4?

MT: Cautiously optimistic, please.

JS: (Laughs) Okay. Margaret do you share the same sentiment?

MV: I guess I think about it a little bit differently. I think that what we've seen so far out of recent discussions is no agreements. The bigger picture here is that I think the U.S. and China are going to have a frostier relationship over the next decade versus the last decade, and I think a lot of that comes down to the idea that China is intent on building technology and biotechnology and electric vehicle industries, and some of those put them more in direct competition with us versus the last 10 years. So that's not going to be something that can be solved with an agreement around a specific sector of the economy, or tariffs. I think that most importantly to your point about the election and the economy staying in good shape, I've been thinking a lot about the impact of all of the headline risk about China and potential trade wars and a frostier relationship and what that means for business confidence and consumer confidence, because of course you need businesses to feel good about their outlook, to continue to want to spend capex and invest in their businesses and get that multiplier effect back in the economy. And you need consumers to still feel good about their outlook, so they're really important for GDP and you need consumers in the U.S. to keep spending. So business confidence and consumer confidence are two things that the longer this rhetoric goes on, the more that's a risk to be concerned about.

JS: Well, and you know, obviously there was nothing agreed to at G20.

MV: That's right.

JS: The only agreement was to not increase tariffs and to buy some ag product here for the U.S. and to open up some sales over to Huawei, right? So the uncertainty's that out there is still going to be out there for the foreseeable future. If you look at a chart at business confidence, it's been dropping significantly for over the past nine months. Consumer confidence surprisingly has actually remained relatively high. I think that's a reflection of a strong labor market. But if that third tranche goes into tariffs, that $300 billion worth of goods, which is primarily consumer related goods, I think that's really where you could start to see the consumer get a little bit more non-optimistic about their prospects, stop spending, and then have a decrease in economic growth.

MV: I completely agree. I mean the fact that we didn't have that next round of tariffs put in place is really important for the consumer. I do worry about that headline risk the longer this goes on. But I think to your point, when it impacts consumer pocketbooks, that's when we have really a bigger problem.

MT: It's very visible right? I mean these are electronics, these are TVs, these are laptops. These are what you use every single day. So you will see the 25% increase in pricing.

JS: Well and the consumer actually bore the brunt. Washing machines went up 20% back in early 2018. Consumer prices on washing machines went up 16%. So it wasn't the Chinese producer that ate the margin on that. It wasn't the U.S. manufacturer, the company that sold it, it was actually the U.S. consumer at the end of the day. I'm in the opinion that if we do see a trade deal it's probably going to be Q3 or Q4, as you get closer and closer to the election in 2020 the economics won't make sense for Trump to move forward with it, because the Chinese will know that they'll give him a weak deal. And I think from his perspective, a weak deal is actually worse off than no deal at all. So if we don't get some sort of resolution in the next six months, I think this is something that's going to bleed into 2020 and beyond.

Now you mentioned confidence, Margaret. Business and consumer confidence being heard. And the ClearBridge recession risk dashboard that we have, we saw two variables turn from green to yellow this month with basically manufacturing PMI new orders moving to yellow and then also jobs that are hard to get went up significantly and that turned to yellow as well. So trade wars are actually having an effect on the dashboard and the overall signal turned to yellow, which means increased caution and the rising risk of a recession moving forward. Do you guys have any thoughts? Do you think that if trade wars go into full effect, is this recessionary? Or is this just going to bring GDP growth down a little bit further from maybe 3% level to maybe 2%, 1.5%?

MV: Hard to tell. Certainly I think the economy in the U.S. is slowing anyway. So if we do have another round of tariffs put in place, that 300 billion at 25%, that's 50 bps off GDP growth. So that's not enough to push us into a recession, starting from two. But it's certainly a headwind. It's a headwind that could be offset by the Fed easing. But it's a headwind in the context of overall growth slowing anyway, so I would say it's not a positive.

JS: And Michael, what do tariffs mean for non-U.S. companies in global supply chains? This isn't just going to be a U.S. phenomenon, right? This is something that's going to affect the world?

MT: Right. The short answer is it's negative without any doubt. And you said earlier, when we have positive news on the trade war, equity markets are going up, and vice versa. Right? So what you have to think about is the world is really, really very connected through all the global supply chains. And this untangling of the global supply chains will be very, very difficult and secondly it will take a lot of time. So I mean some countries are definitely winners out of the whole thing, like Vietnam for example. Right?

So a Chinese company can pack up and bring the production facilities over to Vietnam, that could be a winner. Brazil could be a winner, but like agricultural goods were being produced in Brazil and being sold instead of U.S. agriculture goods. But I want to warn a little bit about that, right? So you cannot put everything from China into a Vietnam. Because the infrastructure is not there, the ports are not there, and at point labor will be also scarce, which we have seen.

And then you can look at some other Southeast Asian countries. But again, what would happen if Mr. Trump says, "You know what? I figured out how you do it, and I will tax you in Vietnam or whatever country for that product or for the whole country. I mean I wouldn't play that game in the portfolio. So from my perspective it is a negative and a resolution would be definitely wanted by the overall international equity markets.

JS: Yes. And I think obviously tariffs are having an effect on global growth, right? You've seen China slowing. Obviously, this is well before tariffs, but nonetheless they're slowing. Europe is stubbornly weak. And if you look at PMIs, and if you're not familiar with the listening, PMI stands for Purchasing Managers Index, anything above 50 is considered expansionary. Anything below 50 is contractionary. Sixty eight percent of the global economy's PMIs are below 50, which means that it's contracting.

Are we going to see a global recession? I personally don't think we're going to see a global recession. But the risks are continuing to rise and trade war is certainly going to exacerbate those risks. I know Michael you do a lot of work with Europe. What are your thoughts, that's been a tough space over the past year?

MT: It definitely … I mean I try to be also the devil's advocate. There are also some positives, before I come to the negatives clearly. But the positives are … I mean the euro zone, if you look at what has happened in the euro zone over the last years after the financial crisis, we were a little bit later in terms of QE. But by now actually wage growth and employment has done fairly well. I mean today, we're on 7.6% unemployment in Europe. The low before the financial crisis was 7.3. And we're better by 2% today before the euro was introduced.

JS: Wow.

MT: So the consumer is actually doing well. And if you look at the consumer PMIs, which are currently 52.8, so they're in expansion territory, they're doing fairly well. But the longer, whatever, the trade war

lingers, the more there will be also weight on the consumer. Because the other side of the economy is the manufacturing side. And the manufacturing side in Europe is weak. So we're talking about somewhere around the 48 level for the euro zone, and my home country, you figured out I have a German accent, so it's already at 45. So this is definitely in a downward draft. And if that lingers a little longer, unemployment will be not as strong as it is currently. And then the multiplier effect doesn't work anymore. So from that perspective, it's not all bad. But we'll see also impact on the trade war there.

JS: Well, now Germany, 40% of their economy is tied to exports, and a lot of those exports actually go to China, believe it or not. And I think Chinese weakness is the key reason why you saw Germany's weakness. But they've been aggressively stimulating over the course of the last 12 months. I think at last count they've done 86 easing moves? Is the rubber going to hit the road here soon? And you're going to start to see a pickup of global growth?

MT: I mean you have seen already some improvements from that side. So China, just to put it a little bit in perspective, it's a big number you mentioned, but how does it translate into dollars or renminbis? So in total it was 2.8% of total GDP was spent already on stimulus over the years 2018 and 2019 so far.

JS: And that's bigger than the U.S. package by the way.

MT: That is much bigger than the U.S. package, and in dollar terms it's even bigger than the last stimulus and the stimulus before in China. So I mean we have seen also some positive impact on financial conditions in China. So that has happened over the last six months. But I would say even that there would be further stimulus coming. So for the time being, for '18 and '19, we have done it differently than in the last two stimulus rounds. This time we are trying to help the consumer, the state-owned companies, the private companies, via tax cuts and lending facilities. And we have done a lot of reserve requirement cuts which help the banking system to push liquidity into the system. That will continue. Our RRR cuts will continue for sure in the next months. And then depending on where we stand in the trade war, will we go back to the fixed asset investment by basically building more motorways and airports and railways and all that kind of stuff?

JS: Ghost cities? (Laughs)

MT: And ghost cities. So that depends very much on where we are in the trade war discussions and how much China is actually slowing down. So we're going to see. And the other part is actually the currency. The Chinese renminbi. If that goes over seven it will create a lot of turbulence in the markets, and particularly when it goes into the regions 7.2 and higher.

JS: I think the Chinese are really happy that the Fed is starting to at least examine a rate cut. I think there's an 83% chance of a rate cut in July. Over 60% chance you get another rate cut in September. And if you have a couple of rate cuts that should be a little be more of a weaker for the dollar, and it will be stronger for the renminbi, which will help them be able to do a little bit more stimulus moving forward.

MT: Yes.

JS: Now Margaret, thinking about the slowing global economy, obviously it hasn't turned yet, what sectors or U.S. multinational companies do you think continue to be more at risk with this type of backdrop?

MV: Well, the world is so interconnected now. A global slowdown would have some impact on most U.S. sectors across the Russell 1000 Growth Index. Forty percent of the revenue of those portfolio companies comes from outside the U.S. So what happens outside of our borders is really important for stocks here at home. A few sectors I would highlight, number one, energy. A softening global economy, particularly in Asia, means less demand growth for oil and that means oil prices go down. That's not good for the energy stocks, the energy sector in the U.S. And of course your point before, slowing GDP growth in China does have ripples over into Europe. And so the slower demand growth and the impacts on the energy sector will ripple into outside of just China.

Secondly, I would highly industrials. Longer lead time businesses like aerospace and defense should be fine, given some longer-term secular growth in those sectors. But short cycle businesses certainly are

going to be under pressure. Information technology. There are certain parts of tech that are going to be more stable. Things like enterprise spending on security and database software, that should be relatively stable. But semiconductors, application software, advertising-driven businesses, those are all going to be more vulnerable.

JS: Any sectors in the U.S. that may be able to avert a slowing global economy?

MV: Well, you know, if things slow globally, the obvious, the historical place you would run to would be staples. But I would say staples are really diversified and have a lot of exposure to emerging markets now. So I would caution you to think that that's an absolute safe haven. Consumer discretionary is an area where if the U.S. consumer is in okay shape, then actually that sector is relatively protected, given that most restaurants and retailers are U.S. predominantly, in terms of the sources of the revenue. I mean think about Home Depot. It's really a U.S. company. So even if things slow in China, or things slow in Europe, companies like that should be a little more resilient actually.

JS: Let's talk a little bit about something that most of the people that I have my conversations with, they have fears coming into 2019, which is political risks. And maybe ground zero for political risks are the EU. So there's a lot of things changing at the margin across the pond, if you will. Michael, can you shed a little bit of light upon what your expectations are?

MT: I mean definitely some, I mean Europe is prone to political risks because there are so many countries which have to agree on certain things. But again, there's also a different speed in terms of the Northern part of Europe and the Southern part of Europe.

JS: The beer drinkers versus the wine drinkers?

MT: That's right. (Laughter) So Italy is probably the prominent one. And I wouldn't be surprised to see new elections coming up at one point in the next quarters. Currently we have a Prime Minister and Deputy Prime Ministers and the Deputy Prime Ministers, at least one of them, Mr. Salvini on the Right Wing. He is a populist, and anti-EU guy. He would like to get into power. And currently he is in the lead, but I think he will wait for a little bit until he has an even stronger lead, and will try to force a new election.

So then the next question would be, what will he do once he is really in power? So and my best guess is, once you're in office, you will tame down your language a little bit. Because you have to govern. These are huge decisions Italy has to make in terms of staying in the euro, which I do believe will happen. But also what kind of reforms do I put in place in order not to go over the maximum debt ceiling, which Italy has.

JS: And they're desperately in need for some reforms over in Italy.

MT: Absolutely. I mean we had some reforms being implemented four years ago. But some of them got reversed or tamed down again. So we need a strong leader who can put things in place. And then the other one which is overshadowing us for now exactly three years is Brexit.

JS: What's Brexit? I've never heard of it? (Laughter)

MT: Yes, most of the people get sick and tired of it. So in my opinion there will be no solution in quarter three and we will linger into quarter four. That will be also the deadline, the new deadline, which of course could be extended again. But the chances of hard Brexit are increasing because the frontrunner currently is Boris Johnson. And if I should sum up, what can he actually achieve if he is in power? I think versus the EU, I think the fronts are pretty hardened, and I think he will not be able to get anything more out of the EU. But will he be better with the Conservative party? And I think the short answer is yes, because he was a Brexiteer. And perhaps he has a chance to unify and to come to a compromise.

JS: Maybe I'm wrong, but I think of Brexit as Y2K. Kind of a lot of similarities to where we were 20 years ago. If you think about Y2K, it's not like chief technology officers just sat there and at the last minute tried to make changes when Y2K happened. They fixed all the bugs in their systems years before it actually went through and then Y2K was a non-event. You think about a lot of the British companies that need access to Europe. They have been setting up offices over the last couple of years. I think it's hurt their profitability, but nonetheless, they've set their expectations for the worst-case scenario. And then lastly, if

you have a Brexit, back to Y2K, IBM stock didn't sell off the month before Y2K. It sold off about a year prior, and then priced in what the downside effects were. And I think the same thing will happen with Brexit. I mean is that too easy an explanation for the implications of Brexit?

MT: Yes, I think it's probably a little bit more complicated. (Laughter) If it goes in the direction it will be a one-time shock, actually yes. People will put more inventory because it would take longer until goods cross the channel and so on. But certainly jobs will be gone out of the City of London. The City of London is probably the biggest loser of the whole thing. Because financial jobs are … some of them go to Frankfort, sometimes and then to Paris, and so on. But these jobs will most likely not be coming back. And the attractiveness for London, probably at least over the next few years, will also probably decline. What happens after that, we have to see. That depends on the politicians, what they make out of the whole thing.

JS: Sure.

MV: I would just add, just to get back to business confidence, which I'm going to sound like a broken record. But I think the biggest issue around Brexit as I hear it from my portfolio companies right now, is the uncertainty of what's going to happen, and what it's going to mean for their business, means that they're delaying spending. And so once you clear the decks on that, and at least we understand the rules of the game, then we can get back to business. So it's almost like a clearing event, that businesses are a little bit frozen, because they don't really know what the rules are and the costs are yet.

MT: I agree 100%. Sorry, I should probably have put that in the first place because it's so important. (Laughter)

JS: Now one of the risks that we've obviously seen here recently is the slowing on the manufacturing side of the economy. We've got to view the U.S. manufacturing PMI number here recently at 51.7. Within that you saw some weakness in new orders. Is this just a temporary slowdown? Or do you think that we have more weakness to come Margaret?

MV: I think no question things are moderating. Even when we talk to companies in the industrials sector, they're still seeing growth, but things are moderating. And to your point that 51.7, you know that's down from 61 a year ago, so it's down pretty significantly. It is still in expansionary territory, and we do still have hopefully a Fed cut coming our way that will act as stimulus. But things are absolutely slowing. Within our industrials sector I would say that we're a little bit more defensively positioned. You know, we own things like UPS, which is a lot more geared to business ordering and consumer spending online than it is to the manufacturing part of the economy. So that's how we've tried to pivot a little bit more defensively to try to add some things within industrials at different drivers.

JS: Yes, if you think about manufacturing PMI new orders, which happens to be one of the indicators again on the dashboard, outside of a Fed tightening, people think of the PMI cycle as the business cycle. When you don't have Fed tightening, the average low that you see on manufacturing new orders is around 49. When you do have Fed tightening the average low is 40. So since the Fed's been tightening for the last couple of years, new orders being at 50, would suggest that we probably have a little bit more downside to go on that front. Now obviously this has been, we're getting closer and closer to late cycle. And I know you have been doing some repositioning. You just talked a little bit about your industrials positioning that you'd done. Can you talk a little bit more on some other things that you've done on a portfolio level?

MV: Sure. First and foremost, I would agree with what you said earlier about volatility. I mean I think this part of the cycle is when you should expect volatility to be a relevant factor. We saw it in the fourth quarter, we saw it in the first quarter, in the second quarter a little bit. We're going to see it again. So you shouldn't be surprised to see that happening. And that all makes sense to me. Because the data points that we see about the economy are more mixed. And so obviously that creates volatility. The way we're thinking about investing into that is that you just want to make sure you're balanced. We are absolutely a growth portfolio, a growth strategy, and we own things like Uber that are pro cyclical growth. But we also own things like Advanced Auto Parts that are more defensive. And Uber, that has great long term secular growth, both in their rides business and their eats business. Their leadership position. They're still in investment mode. But we do see a path to profitability for them. On the flip side, Advanced Auto Parts is basically a play on fewer

cars being sold. More older cars driving, where you still need new brake pads and new windshield wipers. And if you believe that that is going to be the case then a company like an Advanced Auto Parts should benefit. So I just think you want to make sure to have a little bit of balance in the portfolio so you can manage through that volatility.

JS: Let's talk a little bit about other areas of large cap technology and some of the areas that have some regulatory risks here recently. Specifically, the FANGS. Is this going to be a significant headwind to their profitability or is this going to be a cloud that is going to keep down their valuations until you get a little bit more certainty?

MV: Well, one of the things that we learned from our experience starting in 2016 in health care is that sometimes perceived risk can be as relevant as real risk, as it relates to stock price performance. We still haven't had broad health care reform, and yet the Russell 1000 Biotech Index has underperformed the market by 30 percentage points over the last three years. I draw that analogy with tech in that I think tech regulation is going to be a key issue in the upcoming presidential election. That means it's going to be in the papers at least until the election, and we know who our next president is going to be.

JS: So a year and a half?

MV: So yes, I'm not sure why that headline risk and why that headwind is going to go away in the next year and a half. Now what could happen? A whole lot of proposals have been discussed in terms of what could happen with tech regulation. Some of them are not that meaningful as it relates to the profitability of these companies. Some of them are quite material as it relates to the profitability of these companies. And so the way we've thought about it is, we've rank ordered who we think may have the most risk, and who we think has the least risk.

Facebook is our biggest overweight in that group right now because that's one where we think they've worked through GDPR adoption and we understand the cost of that and it's something that we think they could manage on a broader basis. They're about to resolve the FTC investigation, so that will hopefully be behind us. And the business remains quite healthy. I think beyond that we really need to stay tuned and try to understand what seems to be the more likely outcome of this to understand what could be material and what may not.

JS: And in healthcare, obviously that's the other area of potential regulation, and you touched on it. But do you think the overhang will be here with us for the foreseeable future?

MV: I think that health care also, and drug pricing, and potential health care reform is also going to remain one that's going to be very topical through the election until we find out who our next president is going to be. I think there's still some opportunities within health care, but I think it's going obviously going to be one that it's going to be more about stock selection probably than the whole sector.

JS: And Michael I know that you have added a couple of health care names to the portfolio here recently. Thoughts from an international manager?

MT: Yes, so we did, particularly Roche and Novartis, these are the two big companies that we have added in terms of weights. And we wanted to get a little bit more conservative and cautious in the portfolio, and brought our underweight to neutral weight again. So we're aware of Margaret what you just said about track pricing potential, but we do see that the existing pipeline of both of the companies, Novartis as well as Roche, the existing is undervalued because we do see the fate of off-pattern drags not as strong as some of the street is factoring in. And the new product pipeline is in our opinion very, very strong. So it looks like there could earnings surprise potentials. I mean regulation is definitely the thing which is sitting on top and could lead to a disappointment. But on the other hand, if it's not happening, I think then you have an extra push for this kind of sector.

MV: I would agree with you. I mean the valuations on health care are certainly compelling. I think that one of the things that you've absolutely have seen over the past, it's one of the interesting things about healthcare, is that it's idiosyncratic. If you find a cure for an unmet medical need, you'll generate returns. And regardless of whether the economy's slowing or not. And so there's definitely some appeal in that.

JS: Last time we had Biopharma trading at these levels it was when Hillarycare was being discussed in '93. And

then right after Obamacare in '09 and 2010. Obviously, the worst-case scenario didn't come to fruition and you had a massive re-rating. But as you mentioned, Margaret, with political headwinds and uncertainty for the next year we may have to wait for that re-rating higher. Now Michael, talk to me a little bit about how you're positioned right now? And obviously you talked a little bit about your pharmaceutical holdings. Anywhere else you're seeing opportunities?

MT: Yes. So I said before, we have been positive coming into the year, in particular after the big drawdown in 2018. So we were quite positive and said there has to be an upward market in the beginning of 2019. Currently though, we are more cautiously positioned. So we're a little bit worried about the upcoming earning season, and even more so about the outlook, what the management will present us, because a lot of people are actually a little bit scared. Not a little bit, they are scared about the trade war and the implication, slowing down of capex and whatever we had discussed earlier. So honestly we're not a macro investor, we're a bottom up investor. And when you look at our portfolio, what have we done? What are the typical characteristics which could help us in case we come into this kind of volatility?

So our overall portfolio is really like quality companies, and companies which have good and increasing cash flows. And I think that cash flow is very often, I mean we all talk about it, but I think in a way it's a little bit under appreciated. Because a good cash flow company, in a downturn, gives you a lot of optionality. Optionality not only because of share buybacks, what happens in the U.S. a lot, less so in whatever, Japan, or in Europe, but you have also the possibility to still pay your shareholders dividends. And even more so when it comes to a downturn, you have a chance to go into M&A at lower prices, not at top prices, at lower prices. So having these kind of high cash flow generating companies and stable cash flow generating companies will offer you some cushioning in case we come into this kind of volatility scenario.

In terms of portfolio construction, we have changed also. We have normally a three-bucket approach, which is called emerging, secular and structural growth. Emerging growth is zero to 20%. We have brought it down to below 10%. And these are the companies which are the most volatile which have very, very strong growth but very high valuation, so we are a little bit more careful on that one.

We have brought our secular growth bucket almost to the top, which is only between 40% and 60%. These are the companies which are more established with management and very strong cash flows. So these are the ones which give us most of the cushioning. And then our structural growth companies, cyclical part, as Margaret was talking about, that's also the one which we have, reduced a little bit. Like for example, CP or Canadian Pacific, which is having very, very high fixed costs, and once we come in a downturn, then your margins will be weaker. So it's as simple as that.

What we are still positive on is, as you said, also before Margaret, it's on the consumer discretionary area. So the consumer is for us one which we are still pretty well exposed. And I mentioned before that the consumer is doing well in Europe. But that is also true actually for Japan. We have wage growth in Japan, and the consumer looks good, and we have companies which are in particular in certain segments. So we have the cosmetic companies, for example, which is still a big part of our portfolio, with Shiseido and L'Oreal. So these remain best in class brand builders.

The market definitely under-appreciates the strengths of the underlying trends in cosmetics and skincare, which over the last 20 years grew 4%–5%. And with also the aging middle class coming in, I think there's a good chance that we're continuing with that kind of growth rates. And by having this kind of incredible good platform, you acquire a new company, put it on the platform, have a strong distribution network, and that is what the earnings growth in that segment will do.

We still have athletic apparel, and performance footwear, like Adidas, where the next leg of improvement will be coming from the margin side. It's not necessarily all the products. But the brand is strong, but the margin and share buybacks will be the driver. In luxury, the best in class is for sure in our portfolio LVMH. This is by far the best luxury brand in soft luxury. But also very strong in jewelry and spirits and they're coming into new business verticals like travel, for example, which has grown very nicely over the last years. So from that perspective, the consumer, I mean just naming only a few companies which are in the portfolio, is probably one of the standouts there.

JS: Now the one thing that I'm getting from everybody in this room is a little bit of a cautious tone, myself

included. And maybe arguably the powers that be that can make this cautious tone turn are the monetary authorities. The central banks of the world. Let's talk a little bit about Europe. I know Draghi, he first delayed the end of QE, and now it looks more stimulus could be on the way from his recent speech in Sintra, Portugal, which is the ECV equivalent of Jackson Hole here in the U.S. Is more liquidity coming? Or is this just dovish talk to help offset some of the euro strength that you've seen here recently?

MT: I could see it happening if we're getting into a worse economic environment. So currently there's no QE going on in Europe, so the only thing which is a little bit of a stimulus clearly is the low interest rate, which is the deposit rate minus 40 basis points. And then secondly, we have for the banking sector, TLTRO, which is number three version, which is still ongoing. But could I see purchase of bonds again, which was the typical QE measure, yes, I could see that. But it has to come with further deteriorating economy. So the BOJ, just to fill that up here, there are still …

JS: And the BOJ is Bank of Japan?

MT: Yes, sorry. Bank of Japan. Still the moderate QE and it will continue as it is. Interest rates will be locked around the zero line. And PBOC, or the Bank of China, we have talked about, I mean I see further stimulus coming. And then the other part would be the currency question, right? I mean what would happen to currencies. And given that we have seen the U.S. dollar–euro basically in a band for the last whatever, 12 months, I think there could be a good chance that Europe could strengthen and break out of that band. And why do I really think so is one, because of interest rate differential. So we talked about Fed and rate cuts to come.

So interest rate differential on the 10-years have narrowed. In the U.S. we were at 3.2. We are now basically two. Germany has +0.5 in the peak, and -0.3 for 10-years right now. So that is and on the short end, with the fat cats, that will also narrow. Then secondly, and there is a chance for that I think, if the Fed goes the other way, and not quantitative tightening anymore, and quantitative tightening, what does it actually do? It's draining dollar liquidity out of the U.S. banking system, which also creates upward pressure on the U.S. dollar. So if that turns from QT to a neutral or potentially even QE, which we haven't discussed, but that could actually be euro-positive, dollar-negative, and then at the end of the day almost everybody in every single asset class is long U.S. dollar and short every single other currency.

JS: And we have the chart, and the longer anatomy of recession deck that shows that literally everybody's long in the dollar. So usually when you have everybody on one side of a bet, it's pretty good that the opposite will occur. I'm a firm believer that the market tries to cause the most pain on the most number of people as possible. (Laughter)

MV: That's why it's so humbling.

JS: Margaret, we mentioned the Fed. Maybe QE coming down the pike here, what are your thoughts there? Are we going to get some cuts this year? Can they extend this bull market?

MV: Look, I think we've been experiencing a Fed put for the last month and a half or so, in that bad data is good. Because everyone feels like, investors, the market feels like we're going to be rescued by the Fed easing. I do think that the data probably points to easing before the end of the year, and we do hear that from our *portfolio companies as well. And we see it particularly in tech. As a growth manager we spend a lot of time* thinking about tech. And a year ago we could have made the argument, we were making the argument, that the market was expensive.

But results were so darn good. I mean we're still benefiting from tax reform. GDP growth was almost 4%. And tech companies were reporting awesome, for lack of a better word, awesome results. And now you're back at a similar point, where valuations are just at the same level as they were a year ago in June, and results are still good, not quite as good as they were a year ago. And we kind of think about that in terms of okay, well, now you have things slowing, to your point, and results are not quite as good. I think that just gets back to everything we've been saying, which is I think we're a little bit more cautious and you want to stay balanced about, in the market going forward, because I think hopefully that that does ease. I think certainly it's justifiable in the data.

JS: And while Fed policy has about a year lag time, and hit the actual economic markets, so right now we're

really just feeling the last rate hike from the middle of 2018. So even if they cut rates, which is my expectation as well, we likely won't start to feel that until early 2020, maybe even the middle part of next year. But believe it or not, if you look at the last eight tightening cycles that we've had with the Fed, on average after that last rate hike, you have the first rate cut five months later. So if the Fed does indeed cut in July, it will be seven months later, which will be right on par with what you typically see.

Again, just to kind of wrap everything up, a little bit of a cautious tone, cautiously optimistic, that we're going to have some volatility moving forward, maybe even a little bit of a drawdown here in the second half of the year. Overall dashboard is yellow, which means that recession risks are rising, but nonetheless, we could get through this choppy period, because central banks have turned and recognized this weakness and are responding to that and providing liquidity to the markets. Margaret, Michael, thank you so much for joining me in the booth here.

MV: Thank you.

MT: Thank you.

JS: Hope to have you back again sometime soon. And then everybody listening, thank you for joining in. And we hope to have you on the next ClearBridge Podcast.

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