January 2020 – Volume 10, Issue 1

The Essence

The Marshall Plan

The Second World War ended in 1945. Much of the developed world, particularly Europe and Japan, was in tatters. Soon after, economies began to recover, but outside of the United States, the progress was slow. Former General of the Army and then Secretary of State George Marshall, on June 5, 1947, gave a speech at Harvard University. [Credit to Wikipedia, the free encyclopedia.]

"*The modern system of the division of labor upon which the exchange of products is based is in danger of breaking down. ... Aside from the demoralizing effect on the world at large and the possibilities of disturbances arising as a result of the desperation of the people concerned, the consequences to the economy of the United States should be apparent to all. It is logical that the United States should do whatever it is able to do to assist in the return of normal economic health to the world, without which there can be no political stability and no assured peace. Our policy is not directed against any country, but against hunger, poverty, desperation and chaos. Any government that is willing to assist in recovery will find full co-operation on the part of the United States. Its purpose should be the revival of a working economy in the world so as to permit the emergence of political and social conditions in which free institutions can exist.*"

"Life must be understood backwards; but it must be lived forwards."
~ Søren Kierkegaard (1813-1855)

The European Recovery Program, commonly known as "the Marshall Plan," was enacted by Congress and signed into law by President Harry S. Truman on April 3, 1948. From 1948 to 1952, the United States (together with Canada, but acting primarily on its own) gave over $17 billion (~$100 billion in 2019 dollars and equal to ~6.6% of 1948 GDP) in economic assistance to help rebuild Western European economies. Awards were divided amongst the participant states roughly on a per capita basis. Thus, the U.K. received 26%, followed by France (18%), West Germany (11%) and some 15 other countries. While there was an agency set up to distribute funds and monitor the program, it was left largely to the receiving countries to spend; repayment was not required.

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[As a side note, Russia (the USSR) developed a similar plan, named after its Foreign Minister Vyacheslav Molotov, but its conditions were far more onerous and ultimately less successful.]

By most but not universal accounts, the Marshall Plan was successful in building back Europe so as to "equalize" the living standards of its citizens, have them be productive and instill a sense of hope for the future. Without the Marshall Plan it is believed that Europe could have either floundered, given way to the strengthening forces of communism or made way for future dictators. But by the early 1950s, most West European economies were either back to, or in several cases, significantly beyond where they were pre-WWII. It was a great success.

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The only major Western European nation excluded from receiving funds from the Marshall Plan was Spain. Its leader, Francisco Franco, was highly unpopular in the U.S. This changed when Franco openly denounced Moscow, but still, Spain benefited from the Marshall Plan much less than did its neighbors.

We in no way wish to minimize the unique situation of WWII – the sacrifices or the horrors that accompanied it. We are using the aftermath and the Marshall Plan as an example of the U.S. enacting policies to help those who could not help themselves. We will divulge our investment lesson shortly, but first …

Closer to today, we find a parallel to the Marshall Plan, but not borne out of bloodshed. On February 21, 1972, President Richard M. Nixon arrived in China for an official trip. He was the first U.S. president to visit the People's Republic of China since it was established in 1949. Nearly 30 years later, on December 11, 2001, as relations continued to improve between China and the rest of the world, the World Trade Organization (WTO) admitted China as its 143rd member.

Banking, financial services, insurance, telecommunications and other industries in China were opened up to foreign investment. In exchange for these and myriad other reforms, Chinese companies gained access to the global market. So, while European Marshall Plan monies were used to a great extent to purchase American goods and services, China's ascension came about via a concerted effort to EXPORT goods throughout the world. The economic results, however, were similar.

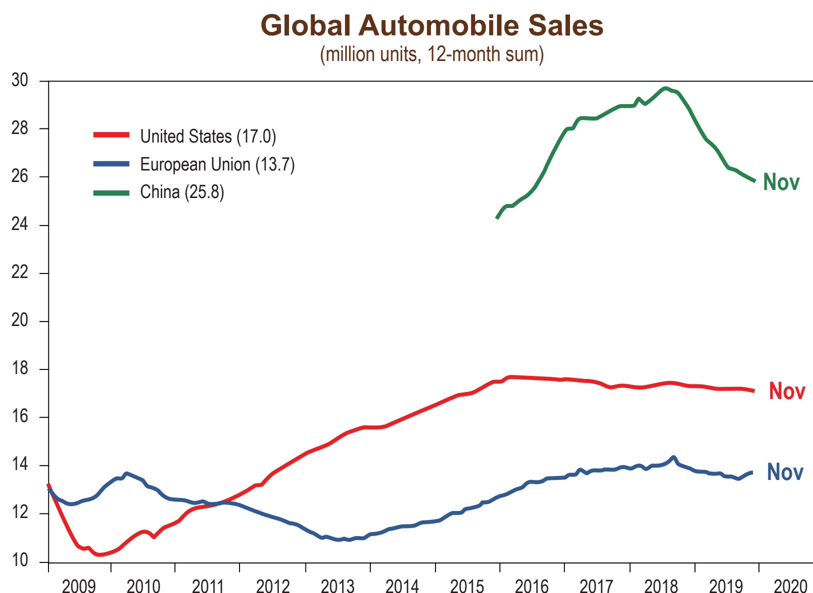
Since the WTO admittance, China's economic expansion has been nothing short of a "Marshall Plan" type success. GDP growth has compounded at a greater than 8% rate (slipping below that only recently), while the living standard of the average citizen has meaningfully closed the gap with the rest of the world. Further, just as Europe built up its own infrastructure so as to thrive after the Marshall Plan ceased, so is China working to diversify its economy away from mostly exports to a more balanced internally driven ecosystem.

Why do we describe these two periods and present them as analogous? Or, what investment lessons may we learn?

The Past Is Not the Future

The 1950s and '60s witnessed extraordinary economic growth the world over. Measures of fiscal, economic and monetary policies of that time were in somewhat uncharted territory. Surely, one could not harken back to the "roaring" '20s, "depressing" '30s or war-torn '40s as comparators. There were too many variables that had changed in structure. For instance, while strong money supply growth had historically signaled higher inflation, the increased funds of the time were very productively spent on massive infrastructure projects, such as airports, railways and the U.S. Interstate Highway, all in use to this day – perhaps in need of upgrades, but that's a topic for another time.

The ascent of China (and other Asian nations) onto the world economic scene, after being absent, has also changed the nature of the global economy. Both were "Marshall Plans" that changed the world's economy FOREVER. Both also rendered historical financial measurement tools outdated. Take the following graph as but one example:



Sources: Haver Analytics; Yardeni Research

The above graph depicts passenger vehicle sales in three parts of the world. The blue line represents Europe, the red line is the U.S. and the (far higher) green line is China. Two points are noteworthy: First, China now equals that of the other two combined. Perhaps, while interesting, this is not overly relevant to the world's economy. Automobiles represent only about 3% of both U.S. and global Gross Domestic Product (GDP). But don't diminish auto's importance to the tens of **millions** of people around the planet who are either directly or indirectly employed by this industry. Also relevant (as evidenced by reports of recent talks) is that vehicle trade (cars, trucks, trains and airplanes) is typically, by value, the largest import and/ or export category for many countries. Thus, Mexico, Germany, Japan, Korea, France and the U.K. are highly intertwined with the U.S. on these products. Current political rhetoric notwithstanding, China is not on this list

(for autos). This is all new and different relative to trade in prior decades.

Secondly from the graph, note that the green line dates back only several years. To say that data measurement of economics must change to incorporate new trends is, we believe, a major understatement.

Our point is that today, we would argue, history is not such a good guide of business or economics. Much of what others focus on may be relevant for ***prior*** periods. Thus, the study of "business cycles," monetary policies, fiscal programs, debt levels, relative interest rates/currency levels, etc. all have their bases in a world structure that ceases to exist. As we pointed out back in July 1994, in a Quarterly Report (written by this author) entitled "*Driving Through the Rear View Mirror*," it is like trying to navigate the road with one's eyes glued to the mirror. [Or, updated for today, to one's electronic devices!]

Here follow a few investment pontifications of rear-view, and potential forward, thinking:

➢ Taken from work performed by Takeshi Yamaguchi, Chief Japanese Economist, Morgan Stanley MUFG, Japan has poor demographics [an aging society], high government debt, healthcare funding challenges and below-par corporate profitability. But this consensus is looking in the rear-view mirror and glosses over important improvements. While labor *personnel* is not growing, labor *productivity* is expanding meaningfully. From a low point, this efficiency could fuel GDP and profit growth for the coming decade or longer. Deflation looks to have finally ended ("thanks" in part to high energy and other natural resource costs), while the need for the above-mentioned productivity has begun a capital expenditure period that could lead to a virtual circle of further improvements. Finally, while Japan's permanent population may continue to decline, its visitors and temporary workforce have, and are expected to continue to, more than offset this, such that the number of people present in the country could rise over the coming years.

➢ The world's industrial companies are changing in many ways. Examples include energy sources (more wind, less coal), labor productivity and the use of automated machinery, and social media as a means of communication (more of a bi-directional "pull" than "push" approach). One does not have the data available to measure the popularity of streaming media programs (such as those available on Netflix, Hulu, Disney+, etc.), yet still, measures for "broadcast" shows on CBS or NBC often make headlines.

➢ Continuing transition, the world over, from "goods producing" to "consumer" economies, including the rapid escalation of the "experiential" consumer. The former is far easier to measure and convert to economic statistics than the latter, for now.

➢ Far greater density of living; cities growing faster than suburbs and all the complexities that entails.

➢ World population growth, while continuing overall, will markedly slow down and even decline in many regions.

➢ In 1975, in the U.S., only about one-third of the adult population lived alone. Today, greater than half live alone. Partly, this is due to a greater number of elderly, where one spouse has passed. But this is also due to more adults *choosing* to remain single. This is a recently new demographic shift that may have ramifications throughout society. Undoubtedly, we believe, it is not being properly measured.

➢ With modernization comes concentration of business and industry. That is, large companies get bigger while smaller ones struggle – "Joe's Pizza Parlor" has difficulty competing with the *Domino's* chain. There is often a tendency for governments to try to control this, but historically, "rules" make the problem worse, as only the biggest firms can afford to handle the increasing complexity of regulations. There is little ability for "Joe" to pay a full-time delivery person (plus benefits) while *Domino's* can spread a delivery force over many stores.

➢ Due to a combination of demographics, longevity and increasingly generous retirement entitlement programs, in some countries (France leads the way), the average person will be in retirement up to 40% of his or her life. That is up from perhaps 10% in past generations and up from essentially ***zero*** a century ago. How will we measure "output" of a non-working population?

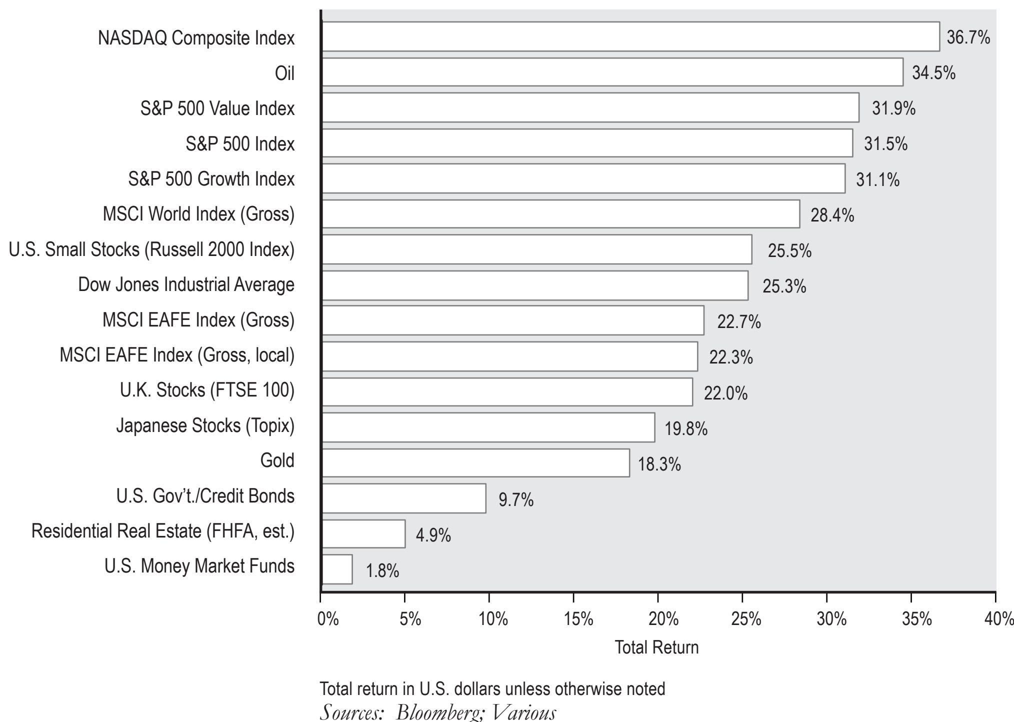
➢ While government debt the world over continues to balloon, private debt (that of corporations and individuals) has stagnated. Further, after a long time of economists worried that personal savings rates were too ***low***, they are now elevated and could be set to ***increase*** further. This pause (or is it an end?) to the "debt supercycle" is drastically different from the world in which we lived since WWII.

The conclusion we reach from the above is that global economic measurement is in a bit of a "no man's land." But we are not yet suggesting alternative measures of, and we certainly are not forecasters of, economic factors. While our investment work will continue to focus on individual companies – and their future prospects *through* various business environments – if the factors that companies rely on to forecast demand for their goods and services are less accurate than historically, then businesses may have to build in a greater "cushion" for error. A certain reluctance for decision-making seems to be taking hold, and it may continue.

As always, we prefer to study individual businesses, particularly those in control of their own destinies and less reliant on broad macro trends.

EQUITIES STRATEGY

As we described in our last edition of *The Essence*, the proverbial "wall of worry" continued on full display (with a vengeance) for the entirety of 2019. First snapping back from what was a sharp late-2018 correction, equities the world over rose nearly non-stop throughout the year. "Brexit" (the U.K.'s planned exit from the European Union), Iran nuclear, Korean nuclear, China trade spats, previews of the 2020 U.S. presidential contest, etc. were no match for the roughly 30% gains realized by many global equity markets. For the calendar year 2019 (remember, we believe this to be a short and artificial measurement period), the global equity market rose 28.4%, as measured by the MSCI World Index (gross). That's an increase of 17 ***trillion*** dollars.



Total return in U.S. dollars unless otherwise noted
Sources: Bloomberg; Various

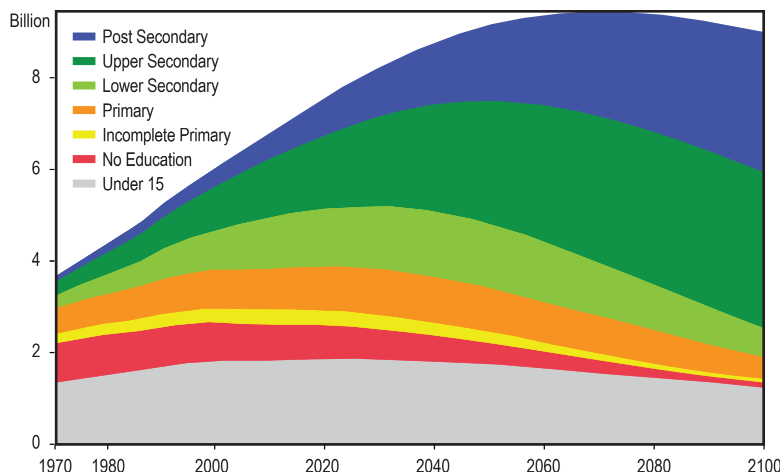
As the chart above shows, every asset class we track gained for the year. Only the "risk-free rate," as measured by short-term U.S. money market funds, languished. Long-dated bonds rose in price as yields declined to match the Federal Reserve Board's (Fed's) lowering of interest rates during the second half of the year. Residential real estate, too, slowed a bit from prior years, but still showed positive returns, even though the housing market became spotty in selected geographies. Even commodities, gold and oil ran up, but that was not reflected in measures of inflation, which (largely due to muted wage gains) remain below most policymakers' stated goals.

With all the market hoopla, are we re-entering an era similar to the "*Nifty Fifty?*" Recall that this was a small group of companies that from the mid-1960s to '70s were deemed "must own." "*Buy them and hold, regardless of price or valuation,*" was the common wisdom of the time. Indeed, some of those enterprises continue to flourish – American Express, Johnson & Johnson, McDonald's and Coca-Cola included. Others have been less fortunate – Xerox, IBM, Polaroid and Kmart, for example. Today, it's a group of mostly technology and social media companies that comprise a small list of "must owns." In 2019, while most sectors of most global markets increased, a few companies magnified this trend. Thus, FAANG (Facebook, Amazon, Apple, Netflix and Google's Alphabet Inc.) and a few others, as a group, meaningfully outperformed their peers. As they further grow their disproportionate weighting in passive indexes, these indexes become ever more popular and a momentum-based self-fulfilling trend takes hold. While we will not attempt to predict the future nor timing of these trends, history suggests that caution may be warranted.

However, on a more upbeat note, those who have followed Aristotle Capital, and its predecessor firms, recall that we have been mostly sanguine on the outlook for equities over a long period of time. While this optimism does not always appear to be warranted (the 2008-2009 correction comes to mind), we have remained steadfast in our belief in **long-term** investing. We came across the following graph which extends such a view.

The graph on the next page depicts global population from 1970 through that projected to 2100. While a projection out so far may seem bold, it does not seem so outlandish when one contemplates that those born today will almost all still be alive in that year.

The graph shows that, not only will global population continue to rise (creating economic opportunities for a growing society) for at least another 40 years, and more importantly, education levels will continue to increase. As described by the authors of the graph, "*… the world will be inhabited by more and more educated people. In 1970, there were around 700 million people in the world who had more than a primary education. By the end of the current century, that number will have increased 10-fold to seven billion persons* [equal to today's entire population]. *The projection also shows* [the red area] *that the number of adults with no education will decrease continuously, and that by the end of this century, virtually ALL people in the world will have received some level of education.*"



Source: Article in 'Our World in Data' by Max Roser and Esteban Ortiz-Ospina

There is much evidence to suggest that the greater the education levels, the greater degree of success, happiness and productivity of the society. Too bad this author, at his current age, will likely not still be around as a witness.

INVESTMENT ACTIVITY

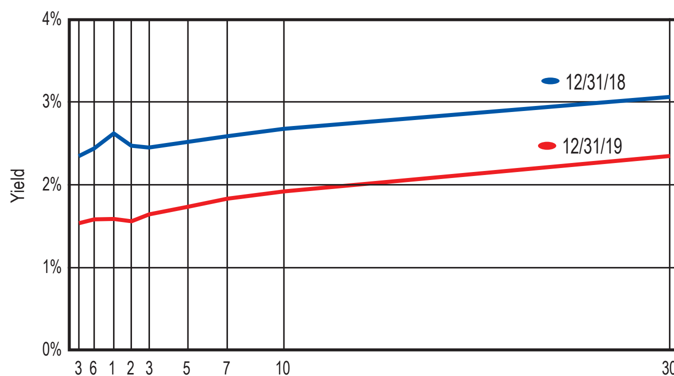
We would now like to highlight a recent addition to, and subtraction from, Aristotle Capital equity portfolios:

- **Magna International**, recently purchased in International portfolios, is a Canada-based auto parts, systems and assembly company. It is an example of forward thinking, as opposed to "rear-view driving." While we have purposely avoided most of the auto industry as significant transitions occur and future leaders are still developing, we believe Magna stands to ultimately benefit from the turmoil. The company has demonstrated consistency (even within a cyclical industry), generates a greater than 15% return on capital through market cycles, maintains low debt levels, and utilizes its FREE cash flow for share repurchases and (in most years) >10% dividend increases. Magna could benefit from industry changes, including electrification and automation of vehicles as manufacturers focus on R&D for new technologies, thus outsourcing more of their parts & assembly to suppliers such as Magna. While NAFTA represents about half of current sales, incursions into other markets represent an additional *catalyst*.

- To highlight why we may divest a business, let us describe why **AbbVie** was recently sold. This pharmaceutical business was spun out of Abbott Labs on the first trading day of 2013. One of the company's products, Humira, used for the treatment of rheumatoid arthritis, psoriasis and other autoimmune diseases, has become so successful that it comprises ~60% of the company's sales and earnings. As Humira will become subject to biosimilar competition in the coming years, AbbVie's profitability will be at risk. While we believe that the cash flows generated by Humira, even with eventual competition, may easily justify its market valuation, the use of those cash flows has become uncertain. In less than four years AbbVie has acquired three large companies (one still pending) for total consideration of $109 billion. This is completely changing the complexion of the company, and we prefer to learn more about its future from aside, for now.

FIXED INCOME STRATEGY

This past year, the Fed attempted to "fine-tune" interest rates. Thus, after a three-year process of ***raising*** short-term interest rates, the Fed ***lowered*** its target rate three times, and the Fed funds benchmark rate ended 2019 at 1.50% to 1.75%. It then signaled it would pause while evaluating economic trends.



Source: Bloomberg

As the yield curve graph above shows, longer-term rates followed the Fed funds rate down, with the 10-year bond yield declining by about 75 basis points. This is consistent with inflation, as the core Consumer Price Index (as reported by the Bureau of Economic Analysis) has averaged 1.6% over the past five years.

While rates declined in the U.S., they remained firmly *positive*. Many other countries, particularly in Western and Northern Europe, persist with *negative* yields. Sweden recently said "enough is enough," and its central bank, the Riksbank, warned of dire consequences and economic dislocations should rates remain negative indefinitely. Thus, Sweden's 10-year yield is now positive (by a "whopping" 16 basis points), but its shorter rates generally remain in negative territory. In nearby Switzerland (sometimes called the "banker" to the

world), the entire government yield curve is negative, plus that of many of its corporates.

We have great respect for Federal Reserve chairpersons, including its current (16th) one, Jerome "Jay" Powell. But, as with our theme in this issue, we wonder if the Fed (and its global counterparts) are too "stuck" in the past.

Some believe that "cycles" (including the downslope) are healthy. They serve to "cleanse" the financial system of businesses, people and products that "shoot for the sky" to sell a product or buy one beyond their means. It was Alan Greenspan who first put forth the notion we could dispel with economic cycles with more clarity, transparency and urgency of Fed actions. But he and each of his successors have not been able to pull it off. We believe that market forces are best left to the "market." "Let the buyer beware" and "you get what you pay for" are, we believe, noble in their intent. Never assume that someone else (even a well-meaning government) can protect you, especially not from yourself.

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CONCLUSION

In 1948, Secretary of State George Marshall coordinated what became known as "the Marshall Plan" to help Western Europe recover from WWII. The United States bore nearly the entire cost of this aid (to the tune of 6.6% of GDP), as it was seen in its interest to do so. In 2001, China joined the World Trade Organization (WTO), an event that led to significant growth of its exports. Again, the U.S. took on the brunt of this "cost" as well in terms of receiving imports. We did not offer opinions as to the politics of these decisions, instead using these two eras as examples of meaningful and permanent changes to the global economy – for the good, it turns out, in both instances. We believe that economic measurement techniques are largely backward looking. Therefore, sharp changes in the trajectory of various factors such as these two "Marshall Plans" can result in outdated methodologies for estimating future growth.

Part of our purpose for authoring these letters is to give you, those interested in Aristotle Capital, insight into our thinking. We often say we have not "figured anything out," but see our role as one of continuous learning. This quarter we have highlighted a topic that gives insight but also is some cause for concern. Historical measures of economics, interest rates, inflation, currencies, etc. may be outdated. Just as the Marshall Plan, from 1948-1952, changed the world's economies forever, so too has the ascension of China, and its Asian neighbors, changed the world.

Our study of individual businesses shall always take precedence over macro thinking, but we do not hide from such realities. If economics is harder to predict, then companies may be hesitant in their planning. This impacts their allocation of capital and could, if left to fester for too long, harm their long-term business prospects.

We also highlighted in this edition that the Fed continues its attempts to "fine-tune" the U.S. economy. We think there is little evidence, thus far, to indicate success. While it has been able to extend economic cycles (the current one is now more than a decade old and still going strong), each such extension has ended with a harsh correction, perhaps harsher than the smaller corrections (combined) it was attempting to forestall.

No "answers" here this quarter, just a continuing accumulation of questions which we love to ponder.

This past year we have welcomed a number of new additions to the Aristotle team. This includes, most recently, Jake Wamala who joined our global analyst team to understand businesses … prospectively, over the long term.

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