Dodge & Cox®
Worldwide Funds

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2017 Macroeconomic Review

Question: What is the firm's outlook for inflation?

Jose Ursua: We think inflation is likely to more decisively peak out towards the Fed's 2% target. Among the reasons for that, there a few domestic ones, including the fact that growth has been running above potential for a while. We think of potential at about 1.8%. This is translated on a substantial narrowing of economic slack, measured by either the output cap, which is essentially closed, or the unemployment rate, which has reached sufficiently low levels or considerably lower levels than the natural rate of unemployment would indicate. There are other factors related to prospective behavior of the economy. Financial conditions have been very easy for a while. Generally, this leads with a lag to support or boost economic activity and confidence, and there's also the potential that the recently approved tax rate cuts on the corporate side or the personal income tax side, plus other tax measures, will have a boost which will be moderate but noticeable over the next couple of years, especially in terms of their impact on GDP growth. Another domestic factor has to do with the fading of sector-specific idiosyncratic shocks that have led to some disinflation pressures, especially on the side of medical services costs or wireless telecommunication cost. On the global side, there are also factors that might lead to higher inflation, especially the fact that global growth is running very close to as good as it gets in terms of potential growth rates, at about 3.7 or approaching that 4% max threshold that we think is potentially global growth. There's been a rebound in global trade as well and growth has been synchronised in terms of the major economies of the world, running not only at higher rates than potential but also all in sequence or harmony. So all of these factors might lead to higher inflation going forward.

Question: Where do we see interest rates trending in 2018?

Jose Ursua: On the rates side, our view has been always that rates would drive us faster than what the forwards were pricing. This has been partially correct. Over the course of 2017, the forwards moved closer to where expectations would be. And so if you split the curve into the front-end part, we think that'll be mostly driven by the Federal Reserve's hikes that will continue over the course of this year, partly because of the reasons I mentioned with respect to inflation picking up, but also because the real rate of interest will likely increase from very depressed levels after the crisis. In terms of the long end part of the curve, these boosts to the real rate, plus some repricing of slightly higher inflation expectations, plus a repricing of the term premium, which is affected by factors beyond the U.S. economy, especially the continuing programs by the European Central Bank and the Bank of Japan, will probably lead to a gradual repricing higher also of the long end. In summary, the recent flattening of the curve is likely to continue for a while, but we think that not only the front will increase but also the long end will gradually increase as well.

Question: What are our views on the U.S. dollar?

Jose Ursua: You know, it's become harder to make blanket statements about the U.S. dollar broad performance against the basket of currencies. Although it's appreciated significantly since mid 2014, 2017 was a year of depreciation that chopped off part of that appreciation that we had seen before. So we're more careful and more consistent with our investment philosophy in distinguishing forces that might lead to appreciation, on the one hand, and forces that might lead to depreciation on the other and with respect to each currency pair in particular. In the first bucket with respect to appreciation, we find the following: the U.S. economy has been growing faster than the other developed economies and frankly, above potential, like some potential growth rate. As a result of this, slack in the U.S. economy has narrowed faster than it has narrowed in other major economies, and these economies are behind the process of withdrawal of monetary accommodation because the Fed has already engaged in not only the balance sheet normalisation but also substantial progress in terms of the rate hikes that it's put in place. Other reasons for potential U.S. dollar appreciation relate to the recent tax reform. These corporate and personal income tax rate cuts are likely to lead to higher growth rates in the U.S. and also the potential for repatriation of

foreign deferred earnings that might lead also to a boost to the U.S. dollar. On the depreciation side of the argument, you have a few. First of all, the appreciation cycle of the U.S. dollar has lasted already for a while and is sort of consistent with the general length of appreciation cycles that you see historically. There's also some arguments to be made with respect to a potential for a slight over valuation of the dollar already, although it's by no means extreme. And there's also the potential for these other major economies to continue to chug along well enough so that their central banks eventually begin also their own processes of withdrawal of monetary accommodation, and eventually lead to a strengthening of those currencies with respect to the U.S. dollar. Finally, the tax cuts also had a downside, which is the potential for fiscal slippage in the U.S. After all, it does add a bunch to the national debt, and those types of factors, combined with some political uncertainty, might also weigh down on the U.S. dollar. On net, we think there is a potential for moderate appreciation and we find this, for example, to be the case against countries like Switzerland, where the overvaluation of the Swiss franc is pretty evident, at least to us, and there's also the potential for appreciation of the dollar with respect to the yen, the Japanese yen, as the EMJ continues its economic policies while the Fed withdraws. In the opposite side, say countries like Sweden might appreciate against the U.S. dollar, and on the emerging markets front, there's more dispersion across countries. On the one hand, you have countries that have structural challenges and whose currencies have actually run substantially higher than those structural challenges would indicate. These include places like Brazil, the Brazilian real, or the South African rand, and on the opposite side, we have countries that have been, we think, overly punished in recent times, especially the Mexican peso, with respect to its more favourable long-run prospects and it's also currency that you can very easily argue is undervalued.

Question: After strong performance in 2017, are emerging markets still attractive?

Jose Ursua: We certainly find very attractive issuer proposition in the emerging market space. We generally look for countries for sovereign related investments that assemble a few characteristics that are in accord with some favourable factors. These relate to fundamental economic or political institutional prospects that are attractive. There is also cases where there's the potential for currency appreciation, countries that have high carry or high real rates, countries that have the potential for a spread compression as risk premia declines, or the market's assessment of how risky a country is, is likely to decline going forward. And finally, we pay very close attention to valuation. At this time we still find a bunch of places in the emerging markets world where you can clearly make the argument that either the currency or the rate side are undervalued. In addition to this, there are factors that support the emerging market complex, as a whole. These relate to the rebounding global growth, which is connected to emerging market growth in terms of GDP terms. The rebound of developed market economies that are growing at a faster rate than their potential and they're also growing all in tandem, which helps a lot because emerging markets are, after all, smaller economies connected to these growth engines in the developed market world. There's also the rebound of most commodity prices, especially on the energy side, that help commodity exporters that tend to be in the emerging markets world. And there's also the smooth structural deceleration that we've seen of the Chinese economy that, far from a crash landing, has been pretty controlled and that obviously gives an anchor to emerging markets, while Indian growth rates are expected to remain at a very speedy rate or higher even than the Chinese growth rates going forward. So we definitely find spaces in the emerging markets world where the combination of the factors that I mentioned before, coupled with favourable growing prospects, will lead to attractive, risk/reward investment destinations. These include places like Mexico, India, Peru, Argentina, Indonesia, or Poland, where the Global Bond Fund has exposure too.

Question: What are the key political and economic events to watch in 2018?

Jose Ursua: The type of political and economic events that we look for this year, and all years, have to do with the long-term implications to our investment decisions. And so we would split this into two segments, broadly speaking. The first one would be economic type of events and the second one would be political type of events. In the first bucket, I would include U.S. decisions about trade, and these obviously range from NAFTA negotiations that are ongoing with respect to Canada and Mexico, but also decisions that must be made on specific sectors, where the U.S. has China as a main trading partner. And in general, how far the protectionist rhetoric actually goes in practice is something we're paying very close attention to. There is also important central bank decisions around the world that will shape the way their monetary policies and their economies move going forward. In the developed market side, decisions about the tapering of monetary accommodation by the European Central Bank and the Bank of Japan are particularly important. In the emerging markets world, central banks are also reaching very interesting decisions. And to give you two contrasting ones, the Mexican Central Bank has been in a hiking cycle, and we're looking for this year to be the end of the hiking cycle at some point. The Brazilian Central Bank has been on the opposite side of the spectrum, where easing has gone substantially, has advanced substantially, and so

the potential for these to either stop or be reverted at some point over the course of this year will be important to watch. In addition to this, there are regulatory factors that we're paying close attention to. The rolling out of MiFID II in the European side and their implications on other developed markets, and especially how the U.S. reacts to these regulatory changes. And finally, some decisions about, say, for example, the OPEC meetings that have obviously an impact on oil prices that have broader global implications. On the political front, I highlight elections. Elections are always a risk, but in a few places this year they're particularly important. The Italian election in March is a very important component to watch because of the potential that some euro-skeptic type of government can come into power. There is Mexico's election and it's a presidential general election in July, and there's obviously the U.S. mid-term elections in November that could change the balance of power that we've been on recently. Other than this, I'd focus or highlight the Brexit-related negotiation process and also the G20 Summit, where some of these grand agreements may turn out to actually be important. Overall, what I would say is we pay very close attention to sources of the ongoing geopolitical uncertainty that doesn't seem entirely priced, at least if you look at the volatility in equity markets. And these include factors like areas of conflict, for example in Asia or in the Middle East, or also the potential for some cyber security related or technical market related factors to become black swans. So those are the areas of risk that we pay more close attention, but it's a part of the long-term. We really care about phenomena that can change the long term more than short-term behavior.

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