

Mega trends for investors

Investment insights

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Key points

- This note focuses on key trends relevant for investors.
- These include constrained growth in advanced countries, heightened volatility, higher savings, increased political dysfunction, low inflation, the Asian century, strong commodity prices, globalisation, ageing and slowing populations and the environment.
- The key implications for investors: get used to lower and more volatile returns; favour assets that offer a decent income yield and/or clear growth advantages such as Asian shares, resource stocks or investments likely to benefit from ageing populations.

Introduction

The day-to-day noise surrounding investment markets can be very distracting, making it hard for investors to see the wood for the trees. This is particularly the case with the Global Financial Crisis (GFC) and its aftershocks continuing to roil markets at a time when investors are getting bombarded by more and more conflicting information flows. As such, it is valuable to be mindful of longer term themes that will impact investment returns over the next five years or so.

Here are some key medium term trends worth bearing in mind:

1. Low growth in advanced countries

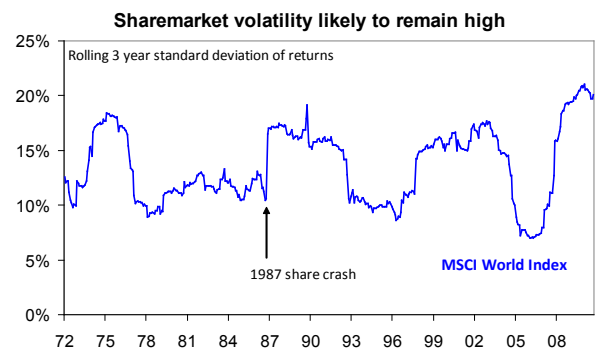
Numerous studies have shown that for countries in the aftermath of financial crises, economic growth tends to be fragile and constrained as debt levels are reduced and confidence is constrained. This is certainly proving to be the case in the US and Europe and is likely to remain the case for several years as households and the public sector remain focused on reducing debt.

Implications – investors will need to look beyond traditional advanced countries if they seek higher levels of capital growth from their investments.

2. Increased volatility

The combination of high private and public sector debt levels in developed countries, extreme monetary policy settings, so-called currency wars (as indebted advanced countries intentionally or otherwise seek to lower their currencies), greater government intervention in the economy and increasingly twitchy investors, means we have entered a more volatile macro economic

environment. As Japan has seen, with six recessions in the last 18 years since its bubble economy burst in the late 1980s, this is resulting in more frequent and more volatile economic cycles and a corresponding increase in investment market volatility.



Source: Bloomberg, AMP Capital Investors

Implications – depending on an investor's time horizon and risk tolerance this suggests a greater focus on dynamic asset allocation strategies that move between assets (subject to opportunities) as buy and hold may not work so well; a greater focus on protecting capital values; and a focus on quality high yield investments in order to provide a greater certainty of return.

3. Back to saving in developed countries

Economic uncertainty, a desire to reduce leverage and reduced investment returns making it harder to meet retirement objectives mean 'consumption is out and saving is in' in many advanced countries. This has seen household savings rates rise in countries such as the US, Australia and New Zealand. This is part of the necessary adjustment from consumption to investment in developed countries and may have further to go. For emerging countries the opposite is likely to apply as growth rebalances towards consumption.

Implications – the shift from consumption to savings will further limit growth in advanced countries. The key opportunities for consumer stocks are in emerging countries.

4. The end of the financial era

To the extent that financial deregulation and rising debt ratios ushered in the financial era over the last 30 years which saw huge growth in the finance sector, rising savings rates and financial re-regulation suggest the financial era is long over.

Implications – favour real stocks, eg industrials and materials, over financial stocks.

5. Policy dysfunction in advanced countries

It seems the quality of economic policy making and political leadership goes in cycles too. The 1980s – with Reagan and Thatcher – ushered in a period of rational economic policy making and strong political leadership. This appears to have given way to a period of regulatory interventions in economies hindering

growth, political bickering (witness both the US and Europe in response to their debt problems) and weak leadership, which some would suggest is similar to what Japan has suffered from over the last twenty years.

Implications – this adds to weaker growth and more volatility.

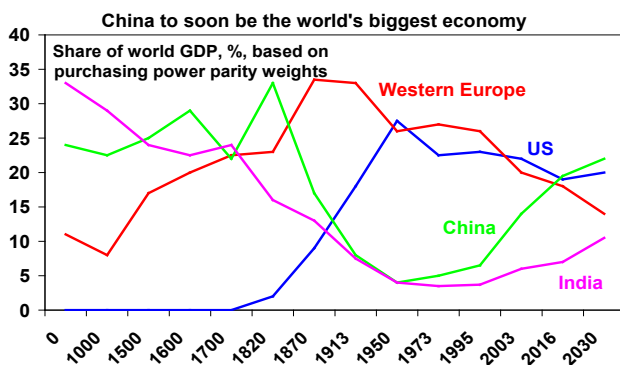
6. Low inflation – but with greater risk

The secular trend in inflation has been a key driver of investment returns historically. Falling inflation through the 1980s and 1990s led to a sharp fall in bond yields and a sharp rise in price earnings multiples (ie, share prices rose faster than earnings), which generated great capital gains for both bonds and shares. This is long over. Going forward, the most likely outcome is for inflation to remain low, reflecting significant spare capacity in developed countries, offsetting inflationary pressure flowing from high commodity prices and reduced deflationary impetus from China. However, the risk of a breakout either to higher inflation or into deflation is high. Quantitative easing, which amounts to printing money, suggests a high risk of an inflation breakout, but the experience of Japan, which has seen bouts of quantitative easing and yet years of poor growth suggests there is a real risk of deflation.

Implications – the boost to asset returns from disinflation is long over. A break out to high inflation would be bad for all assets (except gold and commodities) whereas deflation would be bad for shares and property but good for bonds.

7. The Asian ascendancy

Constrained and fragile growth is largely limited to the major advanced countries. However, combined with rapid industrialisation and urbanisation in the emerging world it is reinforcing the ascendance of China, India and the rest of Asia. Trend growth rates in emerging Asia are likely to be two to three times greater than in the developed world. China is now the world's second largest economy and in the next five years or so it will be the largest, with India hot on its tail.



Source: Angus Maddison, IMF, AMP Capital Investors

Strong growth along with sound macro economic management, low debt levels, undervalued currencies and attractive valuations, suggests non-Japan Asian equity markets will continue to outperform developed country share markets on a five-10 year view (despite occasional setbacks as we have seen recently on inflation concerns).

Implications – favour non-Japan Asian shares over mainstream equity markets (allowing for risk of course).

8. Strong commodity prices

After a 25-year bear market into the end of the last century, commodities are now just over a decade into a secular bull market. This is driven by strong structural demand on the back of industrialisation in China and other emerging countries, at a time of still constrained supply. Despite cyclical fluctuations, the longer term trend in commodity prices is likely to remain strong, possibly accentuated by a continuing long term downswing in the US dollar and other major advanced country currencies.

Implications – positive for resource stocks and the Australian economy and provides support for the commodity sensitive currencies such as the New Zealand dollar, the Australian dollar and the Canadian dollar. Expect more upwards pressure on gold and oil prices.

9. Globalisation and offshoring

There is nothing new in globalisation, but the reality is it is intensifying as cheap workers in China, India and elsewhere join the world trading system. Given the wage advantages, this is likely to go a lot further. Trying to fight against it – by raising barriers against “unfair competition and a so-called tilted playing field” – will be futile.

Implications – this will benefit multinationals able to shift functions across boundaries but will only keep adding to the pressure on high cost local producers.

10. Ageing and slowing populations

It is well known populations in developed countries are ageing and population growth will slow. This is clearly worse in some countries than others, eg, Japan where the population is falling. Over time this will lower potential growth rates in many countries.

Implications – positive for shares exposed to health care, tourism and leisure, and for those offering a decent income yield; retiring baby boomers could become a negative for shares as the focus shifts to wealth preservation and income; more negative for Japanese shares than US shares; less of an issue in emerging countries.

11. The environmental imperative

While the GFC has slowed the momentum for climate change action, putting a price on pollution looks to be inevitable, with the Emissions Trading Scheme (ETS) a step in that direction in New Zealand.

Implications – environmental pressures will add to business costs and increasing environmental costs will favour those companies that are environmentally responsible. Running environmental screens across companies in setting up investment portfolios is becoming mainstream.

Concluding comments

Pulling this together suggests several key implications for investors: returns are likely to remain low and constrained from traditional investments and volatility is likely to remain high; favour assets that offer decent income yields; and/or those that offer clearly identifiable growth advantages or scope for greater “alpha”.

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