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Investing in a low growth environment.

The Investment Report.



The Economic Landscape

Nothing is changing

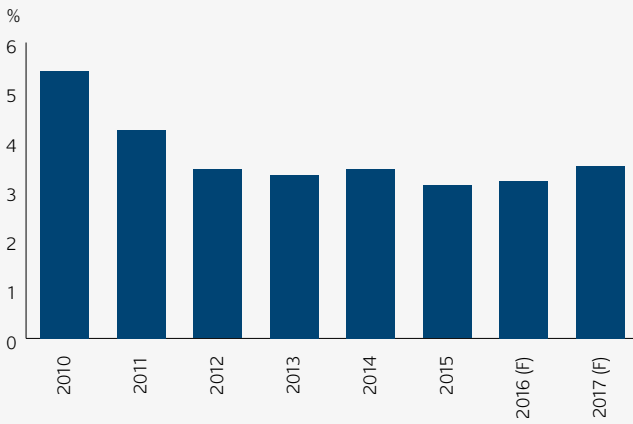
When the Global Financial Crisis (GFC) spread across the world through 2007-2008, the economic impact was deep and significant, leading to recession in many of the world's major economies. This recession was then followed by a solid recovery in 2010 (see Chart 1), as both fiscal and monetary policy action was taken to restore growth.

However, as also demonstrated in Chart 1, since 2012 global economic growth has been stuck at around 3% pa each year. 2016 and 2017 look like they will see growth very close to this level, despite the extraordinary amount of policy easing currently in the global economy.

In many ways, the current economic environment is nothing new. The world seems trapped in a low growth; low inflation; low interest rates environment. We expect this situation to persist.



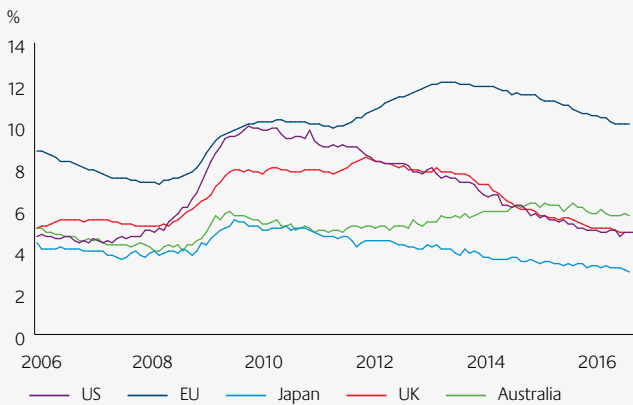
Chart 1: Global economic growth 2007-2017



Source: IMF data as at October 2016.

One important feature of the world economy that is worth remembering is that although 3% pa global economic growth is well below the pre-GFC trend (which was a little over 4%), it is far from a disaster. Indeed, as shown in Chart 2, 3% pa global gross domestic product (GDP) growth is evidently enough to support the labour market, with the unemployment rate trending down in all major economies. Importantly, this improvement in the labour market is not associated with rising wages pressure.

Chart 2: Major economy unemployment rates



Source: Bloomberg. Data to 12 October 2016.

Low inflation almost everywhere

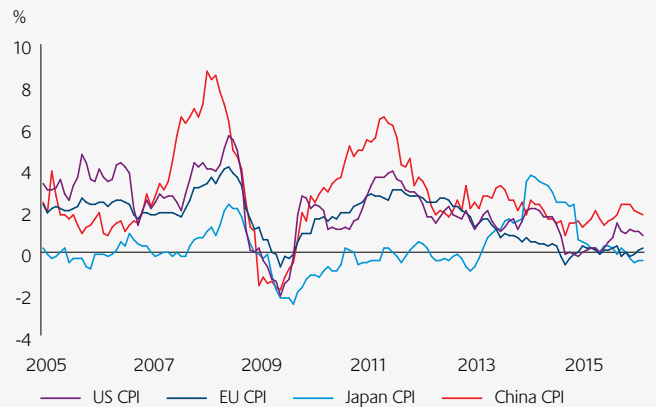
One of the major features of the post-GFC world is the fact that inflation is low almost everywhere. In our view, there are a number of reasons for this global low inflation environment; some cyclical and some structural.

In cyclical terms, inflation is being held down by the modest level of global economic growth as well as the low level of wages growth, which is partly a result of the large increase in the global supply of labour coming from countries such as China and India. Lower commodity prices, especially oil, have also had a noticeable impact on inflation and inflation expectations.

These cyclical developments have been aided by two major structural trends; demographics and technology. It is our view that demographics are playing a key role in subduing inflation, where aging populations in some of the world's major economies, especially Japan, are putting downward pressure on prices.

Technology has played a crucial role. With the rise of online shopping and the availability of an 'app' for everything, technology has enabled the supplier of any good or service to get much closer to the buyer, thereby removing many layers of 'middle-men' and significantly lowering costs and prices.

Chart 3: Inflation is low almost everywhere



Source: Bloomberg. Data to 12 October 2016.



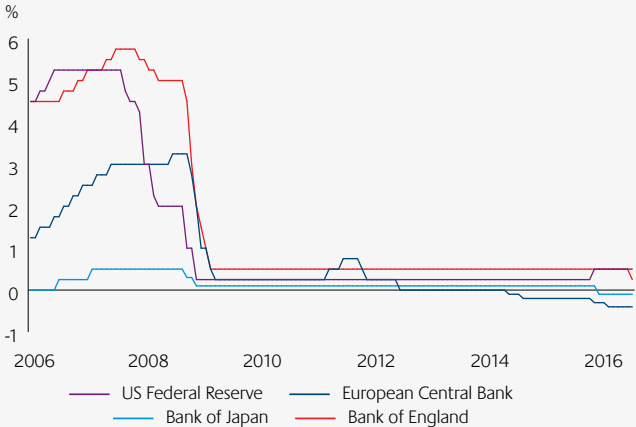
Monetary policy

The low inflation environment is critical to the outlook for financial markets, as it is having a significant impact on global monetary policy. As is well known, most major central banks target inflation at 2% ie. US Federal Reserve (Fed), Bank of England (BoE), European Central Bank (ECB), Bank of Japan (BoJ) and the Bank of Canada (BoC). The Reserve Bank of Australia (RBA) and the Reserve Bank of New Zealand (RBNZ) have more flexible arrangements, targeting 2-3% and 1-3% respectively. For much of the time, these central banks have worked with a 2% inflation target, the primary goal was to get inflation down to 2%. Now the challenge is to get inflation up to 2%.

This desire to increase inflation to the 2% target has led to the implementation of extraordinary monetary policy measures across most of the world’s major economies. Quantitative easing ie. central bank balance sheet expansion by asset purchase programs, has become common-place in the US, UK, Europe and Japan.

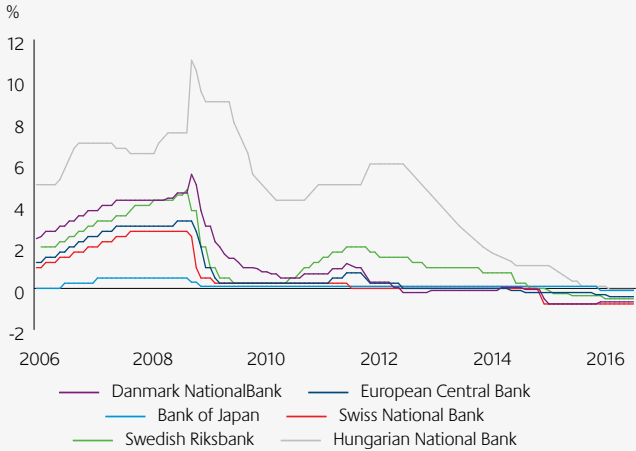
Official interest rates have been cut dramatically across nearly all major central banks, while six central banks currently have their official interest rate set in negative territory ie. in Europe, Japan, Denmark, Switzerland, Sweden and Hungary. For further details on the impact of negative interest rates, please see our report published in July 2016, [Negative Rates: Are there any positives?](#)

Chart 4: Major central bank policy rates



Source: Bloomberg. Data as at 12 October 2016.

Chart 5: Six central banks have gone negative



Source: Bloomberg. Data as at 12 October 2016.

Negative interest rates

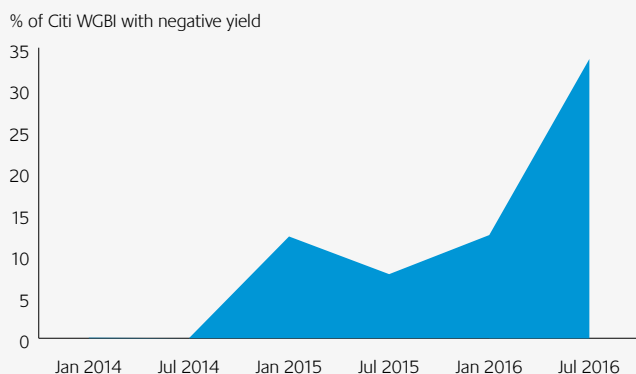
It is also interesting to note the impact of negative interest rates in places where they have been implemented.

One initial response of negative interest rates was an increase in the cost of funding for many banks around the world, with considerable uncertainty over what impact negative interest rates would have on the profitability of many banking models. This was especially the case in Japan and the European Union (EU).

In addition, negative official interest rates have had a significant impact on global bond markets. As shown in Chart 6, over the past year or so, there has been a surge higher in the share of the world’s sovereign bond markets that are trading with a negative yield.

Bonds with negative yields now represent around 30% of the World Government Bond Index – which is over \$US10 trillion worth of sovereign bonds – with most of these in Japan or the EU.

Chart 6: Share of WGBI in negative yield



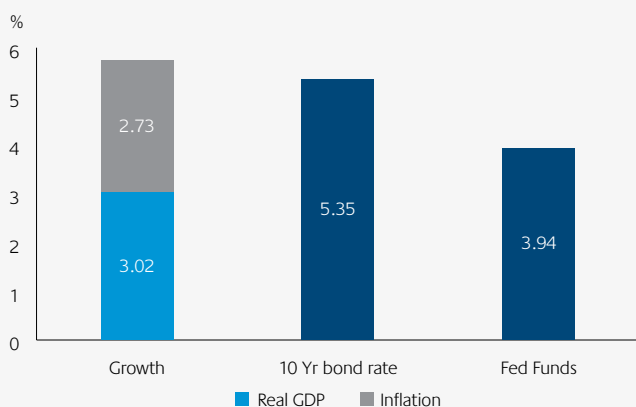
Source: Citigroup as at July 2016.

It is also interesting to observe human behaviour due to the effects of negative interest rates. Over the past year, the value of high-denomination bank notes in circulation in the EU, Switzerland and Japan has increased sharply. Data from Japan also shows a surge in the number of household safes being sold in order for individuals to keep high denomination notes at home and consequently earn a return greater than negative, i.e. zero.

The 'new normal'

In this environment of very low and negative interest rates, there is a lot of talk of the 'new normal'. One way to represent this view is through Charts 7 and 8. From 1992 to 2008, the US economy averaged nominal economic growth each year of approximately 5.75% pa (split between real growth of around 3% and inflation of approximately 2.75%). Ten year bond yields averaged a little below this rate at approximately 5.35%, while the Fed Funds rate averaged just under 4%.

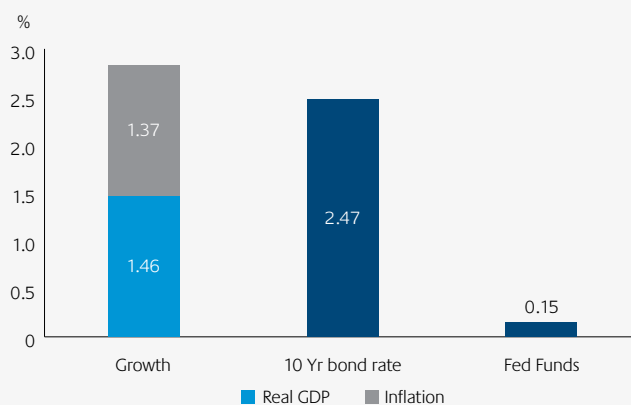
Chart 7: The 'new normal' US 1992-2008



Source: Bloomberg. Data as at 30 September 2016.

Since the GFC, however, this situation has changed significantly. Nominal economic growth in the US has averaged closer to just 2.8% pa (split between real growth of 1.5% and inflation a little lower than 1.4%). Ten year bond yields have average just under 2.5%, while the Fed Funds rate has barely been above zero.

Chart 8: The 'new normal' US 2009 - present



Source: Bloomberg. Data as at 30 September 2016.

To our mind, the 'new normal' represents the fact that whatever the given level of economic growth, the inflation rate and interest rates, and therefore the return on investments associated with that economic growth, is now likely to be much lower than in the past.

Another way to put this is that the 'new normal' is not a period of below-potential economic growth, but that potential growth itself has declined.

This is the defining issue for the post-GFC world and does not look like changing anytime soon.

We remain in a low growth, low inflation, low interest rate global environment.

Everything is changing

One area that is subject to constant change however, is global politics.

As we have written about previously (see [First Insights, July 2016](#)), there is a strong anti-globalisation trend underway in the political landscape of many countries. This is clearly demonstrated in the run-up to the US Presidential election and the 'Brexit' result in the UK Referendum, but also evident in recent elections in Europe and Australia.

While there are some justifiable concerns that the benefits of globalisation have not been evenly shared across nations and within nations, the political promise to either 'solve' these concerns or somehow turn-back time on globalisation carries with it great risks.



In our view, any implementation of anti-globalisation policies could lead to:

- Less global trade – which would be bad for global growth.
- Less immigration – which would be bad for the demographics of many countries.
- Governments are likely to become more interventionist and short-term in nature.
- Government resources could then be ‘wasted’ on less productive spending and attempts to ‘protect’ some economic sectors, rather than encourage the development of new sectors.
- Larger budget deficits and more government debt could result.
- Productivity enhancing micro-economic reform is less likely to be undertaken.
- This could further reinforce the recent trend towards more of the heavy lifting to create economic growth being put on central banks.
- This could exacerbate the trend to lower interest rates.
- This could also create increased volatility in global FX markets as countries try and ‘borrow’ economic growth from others, rather than create more economic growth.

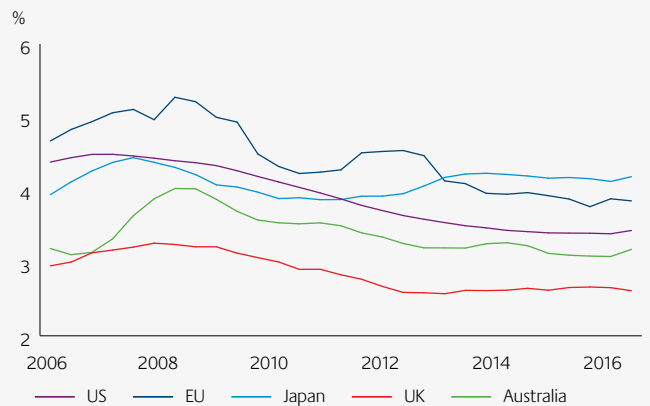
Upside risks

One potential source of upside risk for the global economy and markets could be developments in fiscal policy. We are now seeing the beginnings of a debate that suggests, with monetary policy potentially reaching the limits of its effectiveness, fiscal policy should play a greater role in helping to create economic growth.

With interest rates and government bond yields near historically low levels, the idea would be for governments to borrow and invest in productivity-enhancing assets, especially infrastructure. We have already seen this type of policy implemented in Japan and Canada, while the new UK Prime Minister and both Presidential candidates in the US have talked about using such policy and/or increasing infrastructure spending. Some jurisdictions in Australia have also been increasing infrastructure spending and this proved to be a solid source of support for the economy in the recent Q2 16 National Accounts.

As illustrated in Chart 9, after a number of years of a declining trend in government capital spending, plenty of upside remains.

Chart 9: Government fixed capital spending – % of GDP



Source: CBA as at February 2016.

Conclusion: Implications of low nominal GDP

It would appear that not much is likely to change in the economic outlook for the remainder of 2016 and into 2017. Over the year ahead, we are expecting the situation of low economic growth, low inflation, and low interest to persist.

This in turn is expected to keep the pressure on central banks to maintain, or even increase, the amount of monetary policy easing applied to support growth. The US Fed is expected to raise interest rates only very gradually, including a rate hike in December 2016 and two more in each of 2017, 2018 and 2019 to reach a peak of around 2%.

Both the ECB and BoJ are predicted to retain their extraordinary easy monetary policy conditions for some time to come.

Both the RBA and RBNZ are expected to ease monetary policy further.

Upside risks to growth could come from a greater focus on fiscal policy, with governments using the historic low level of interest rates and bond yields to borrow and invest in productivity-enhancing infrastructure.

A source of risk, however, is the concerning anti-globalisation trend now evident in the politics of many countries and the temptation for governments to ‘intervene’ or attempt to turn back the clock. Such policies are more likely to slow global growth and potentially harm those that they proclaim to support.



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