June 2016 Investment Newsletter

What is the medium-term view?

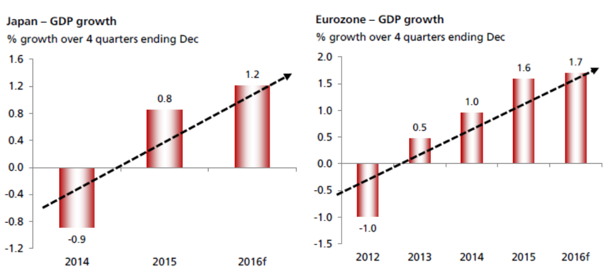
1. The medium-term view — Developed Economies

Global growth is our “urgent priority", G7 leaders said during their meeting on 27th May.

Everyone seems to be wringing their hands over global growth prospects, and we often see headlines such as global growth ‘heading lower’ or going to ‘disappoint’. This made me curious—where is global growth heading, and what is the actual potential growth rate?

Trading opportunities arise when the medium term view is actually decent but market sentiment is at panic levels, thus resulting in oversold assets and giving cause to buying. Therefore we want to get a handle on economic growth prospects, which directly affects the medium-term view.

Here’s where I think global growth is heading: I believe it remains on track. The US looks set for 2% growth this year, virtually unchanged from the 2.1% averaged for the past 5 years. Japan is to grow by 1.2% over the next 4 quarters. Europe full year growth is expected to be around 1.6%. While sub 2% growth does not look very attractive, they do represent improvement:



Charts 1 & 2: Japan and Eurozone growth. Source: DBS research.

Sure, all these numbers may seem dismal compared to the 3% growth US experienced in the past, so we do have to tackle the next question— what is the actual potential growth rate, and are we growing at that potential?

I take reference from DBS Research who had written a very good series on potential GDP growth rates, and I will summarize it here. When it comes to GDP and its growth, the arithmetic is quite simple: since GDP is output-per-worker times the number of workers, GDP growth is the sum of output-per-worker growth and labor force growth. Thus, if output-per-worker – productivity – grows by 1%, and the labor force grows by 2%, the economy would have grown by 3%.

Most of us are aware that population growth has been falling. Here is a chat that illustrates this quite well:

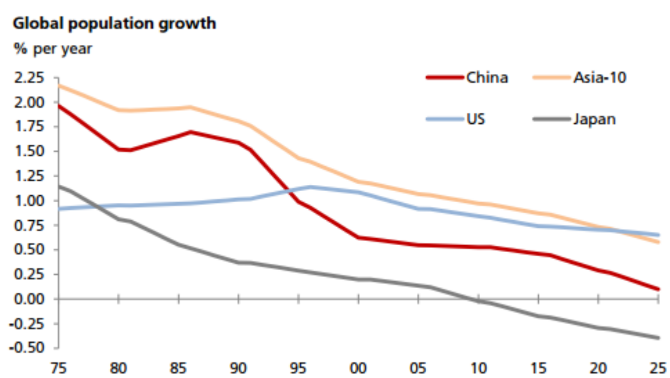


Chart 3: Global population growth. Source: DBS research.

According to the UN's latest (2015) population projections, working age population growth (WAPG) throughout much of the world has slowed sharply. Not only is falling population growth an issue, we have to contend with older populations too. If population growth is falling and the population is getting older at the same time, it would mean that the growth in working age population is falling even faster than the total. A drop in WAPG means potential GDP growth – that which can be sustained over the medium-term – has fallen more sharply than many realize.

In Japan, total population growth has already fallen below zero at -0.2% in 2015. Meanwhile the working age population is shrinking five times more rapidly by a full 1% per year. A similar situation exists in Europe where the population growth has been slowing for years and the WAPG there is around zero. In the US, the baby boomers began retiring 5-6 years ago and the WAPG is falling rapidly too. Fifteen years ago, it was 1.4% per year and today it's 0.4%. This translates to slower potential GDP growth – it is one to 1.5 points lower today than it was 10 years ago. If we used to think of US potential growth being around 3%, today it's 2%. We have a similar story for Europe's potential where it is 1.5% today instead of 2.5% in the past.

We have discussed about labor force growth and know that it is at a lower level. Now let's discuss about productivity growth. The top range for productivity growth in a high-income country (like Japan or Europe or the US) is usually about 1.5% per year, and it's not always the case a country reaches that level in any given year. However, if we assume the G3 is on a 1.5% productivity growth track and we put this together with WAPG in the US, Japan and Europe, we can arrive at the potential GDP growth numbers.

Let's go through the examples, starting with Japan. If we add 1.5% productivity growth and –1% working age population growth together, we get a potential growth of 0.5% per year – exactly what Japan grew by in 2015 and just about the 0.6% full-year average growth that consensus expects in 2016.

Now let's look at Europe. Again we add the assumed 1.5% productivity growth rate and 0% WAPG together the potential GDP growth comes to 1.5% – 0.1% higher what Europe actually did grow by in 2015 and 0.1% lower than what consensus expects in 2016.

Finally, for the US, we add the productivity growth of 1.5% to the WAPG of 0.4%, giving us potential GDP of 1.9%. This is 0.2% slower than the 2.1% growth averaged for the past 5 years and 0.1% slower than what consensus expects this year.

Therefore, we see that the developed economies (the US, Japan, Europe) already seem to be growing at their potential rates. This tells me that we have to get used to the 'slower' growth and right now global growth is as good as it gets.

2. The medium-term view — China

Now let's turn to China. People have been worried for four years now about a hard landing. Bearish calls on China's bad banks are mounting. 'Massive Bailout' needed in China, screams a Bloomberg headline. However I get very skeptical about China going bust whenever I keep seeing news about big time shorts on China. The RMB has stabilized, and market valuations look cheap now, trading at a valuation of around 10-11x forward PE.

It is sometimes amazing how everyone seems to condemning China when it is the only major economy in the world today pursuing significant structural reforms. The medium-term view for China, and effectively to global growth, would very much depend on how these structural reforms turn out. Can the China government effectively pursue the reforms necessary to keep long-term growth as strong as it can possibly be? I am inclined to think they will come out fine.

China has not been keeping still either and in the past two years it has been focused on capital market reforms, with the internationalization of the RMB and opening up of the capital account. With all the gyrations in the stock market, it is easy to forget that these reforms have been implemented much more quickly than most imagined 5 years ago. While capital has indeed flowed out of China over the past year this neither surprises nor makes the reform any less successful, as that is how an open account works. Moreover, to the extent outflows force officials to pursue consistent, sustainable policies that's an additional plus.

China's stimulus has also starting to have an impact on the ground, lifting property prices and supporting PMIs. Supply-side reforms have also stepped up, with measures to reduce capacity in steel and coal by 10% before 2017 and cutting annual working days for coal miners by 16.4%. The government will also curb new cement capacity until 2020. There is also commitment to further lower business cost and cut red tape, for example, in the rolling out of the VAT system which is expected to lower the service sector's tax bill by RMB 500bn, or 0.7% of GDP. The government has pledged to continue with stronger fiscal and monetary stimulus, which should be positive for equities.

On equities, recent comments from the new China Securities Regulatory Commission chairman signal that IPO registration reform won't be launched in 2016, which should allay investors' concerns that the market will be inundated with new share issues. Instead, there should be positive catalysts to Chinese equities if the government makes progress on these three new policy priorities:

- launching the Shenzhen–Hong Kong Stock Connect
- getting A-shares included by MSCI
- developing China's budding OTC exchange, the National Equities Exchange and Quotations (NEEQ).

Conclusion

Therefore, having discussed about the medium-term outlook of the major economies, I am pretty sanguine: the medium-term picture looks fine, with global growth remaining on track, oil prices stabilizing, and RMB stabilizing. Thus I will continue to pursue a plan of diversified portfolio strategy and to add to risky assets only on weakness/ panic levels.

The volatility that we are expecting has not materialized. We continue to see equities trading in a narrow range, as if waiting for some catalyst to break out of its range. Volatilities are declining fast across all asset classes. Fixed income volatility stands close to its lowest level since 2012. Even currencies' volatility is dropping. Either volatility levels do not reflect current market risks, or the market view current the risks as benign risks.

We should also recognize that we are in a low-yielding environment — government bond yields in many countries are zero or negative — so if we are getting any sort of yield in bonds we must surely be taking on credit risk. Returns in alternative investments (such as private equity, etc) are expected to be lower too because people are simply chasing yields all over. Therefore we should be realistic to expect lower returns if we maintain the same level of risk-taking. We would also continue to stress the importance of owning uncorrelated assets to withstand global shocks that will inevitably come.

Notes:
1. Details on global growth rates: DBS research—'What lies north', and 'Global growth: what is potential and where is it headed'
2. Sources: Bloomberg, BCA Research, DBS research, UOB Research, HSBC Research

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