

## Mega trends for investors

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### Oliver's Insights



#### 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; the environment and weak house prices.
- > The key implications for investors are: 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 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 useful 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

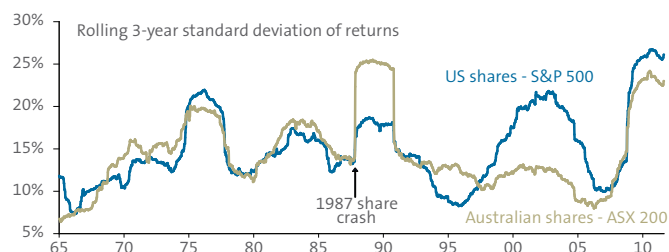
Numerous studies have shown that for countries in the aftermath of financial crises, economic growth tends to be fragile and constrained as debt levels are reduced and confidence is constrained. This is certainly proving to be the case in the US and Europe and is likely to remain the case for several 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 macroeconomic environment. Like Japan has seen with now 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.

### Sharemarket volatility likely to remain high



Source: Thomson Financial, 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 depending on 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 and Australia. This is part of the necessary adjustment from consumption to investment in advanced 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, e.g. 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, Thatcher and Hawke/Keating in Australia – 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 (i.e. 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

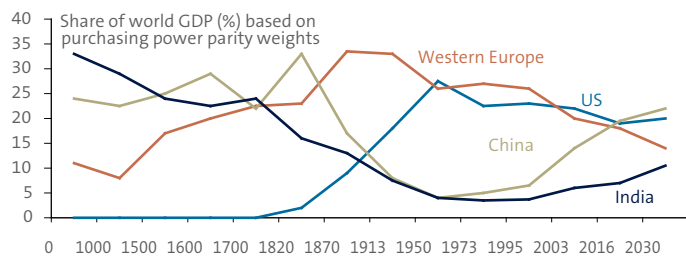
developed countries offsetting inflationary pressure flowing from high commodity prices and reduced deflationary impetus from China. However, the risk of a breakout either to higher inflation or into deflation is high. Quantitative easing, which amounts to printing money, suggests a high risk of an inflation 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 breakout 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.

### China to soon be the world's biggest economy



Source: Angus Maddison, IMF, AMP Capital Investors

Strong growth along with sound macroeconomic management, low debt levels, undervalued currencies and attractive valuations suggest non-Japan Asian equity markets will continue to outperform developed country share markets on a five- to ten-year view, notwithstanding occasional setbacks as we have seen recently on inflation concerns.

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

## 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 driven by strong structural demand on the back of industrialisation in China and other emerging countries, all at a time of still-constrained supply. Notwithstanding 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 resources stocks and the Australian economy and provides support for the Australian 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 likely has a lot further to go. Trying to fight against it - by raising barriers against 'unfair competition and a so-called tilted playing field', as some are starting to suggest in Australia again - will be futile.

**Implications** – This will benefit multinationals which are able to shift functions across boundaries but will only keep adding to the pressure on high-cost local producers, such as Australian steel makers.

## 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, e.g. Japan where the population is falling, than others such as Australia where high immigration and higher fertility rates are providing an offset. 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; bad news for suburban houses over inner city housing and coastal resorts; 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 and Australian shares; less of an issue in emerging countries.

## 11. The environmental imperative

While the global financial crisis has slowed the momentum for climate change action, putting a price on pollution looks to be inevitable, with carbon pricing a step in that direction in Australia (barring an election before July next year).

**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.

## 12. Weak house prices

Five years ago, house prices in the US, UK and Australia were all very expensive relative to incomes and rents. They have now corrected sharply in the US and UK, but the adjustment is expected to be more gradual in Australia (hopefully) in the absence of a crisis and given supply shortages.

**Implications** – With poor affordability and still low rental property yields, Australian housing is likely to provide poor medium-term returns.

## 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, e.g. Australian shares, non-residential property and infrastructure and Asian shares as opposed to US shares, traditional government bonds or Australian housing.

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