The next 15 years – Is there a "New Normal" ahead?

Delaware Investments Presentation

© Richard C Marston

Wharton School, University of Pennsylvania

Outline

1. Is there a “New Normal” ahead for stocks?
2. Is the thirty-year bull market in bonds finally over?
3. Is it possible to avoid the New Normal by diversifying beyond U.S. stocks and bonds?
   - Diversifying into fast growing economies
   - Diversifying into alternative investments

Bill Gross introduced the "New Normal" too soon – in May 2009

- S&P 500 reached its bottom on March 9, 2009 – just six months after Lehman failed.
- It has been a ***great cyclical rally*** ever since then.

- Through September 2016, the S&P 500 is up by 220%

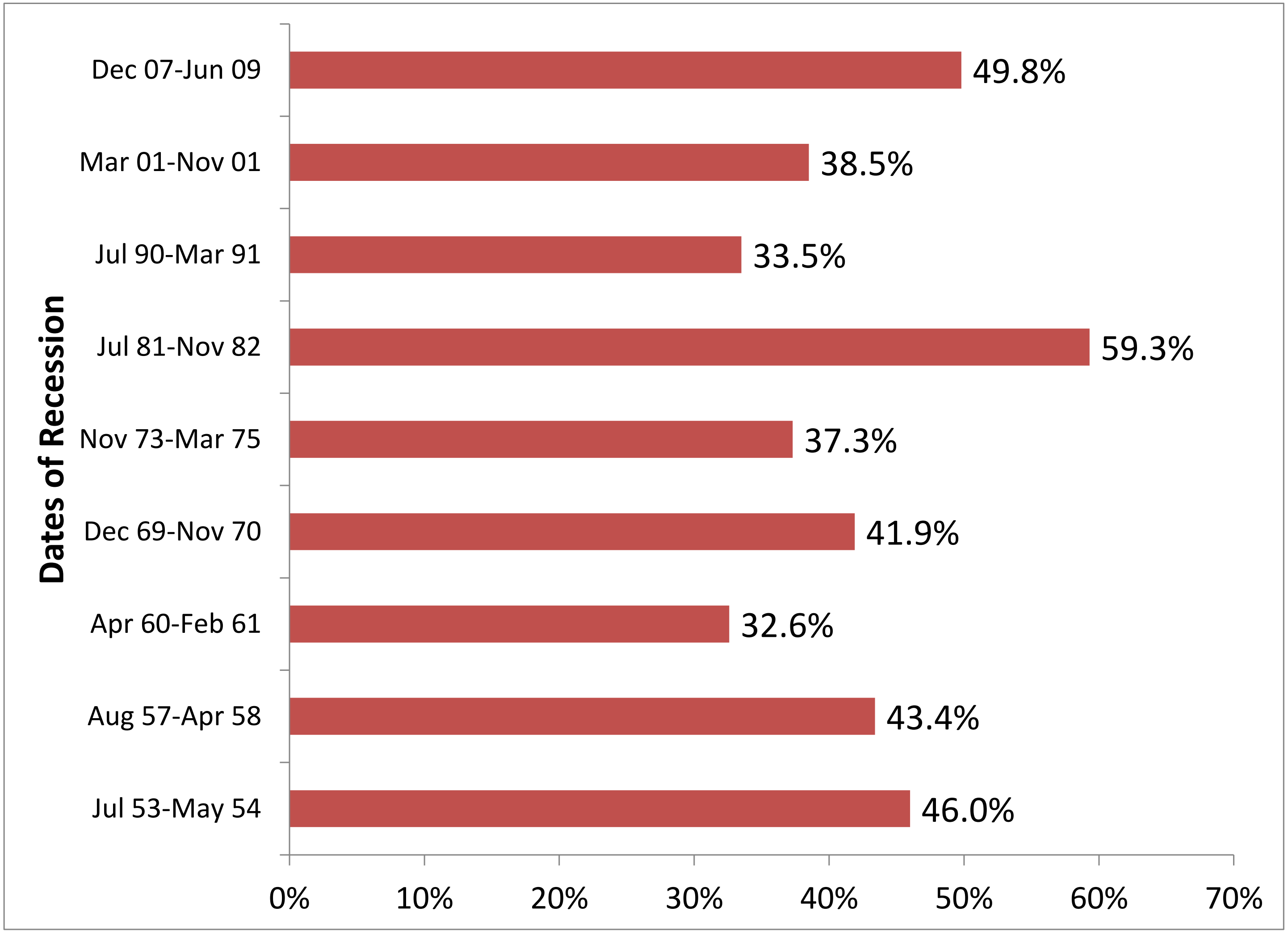
- ***After a recession, we always experience a sharp cyclical rally***

S&P 500 in Last 15 Years, 1999-2016

Source: S&P

Returns after Recession: S&P 500 return in 1st 12 months

Source: *Investing for a Lifetime* (2014), Table 3.3



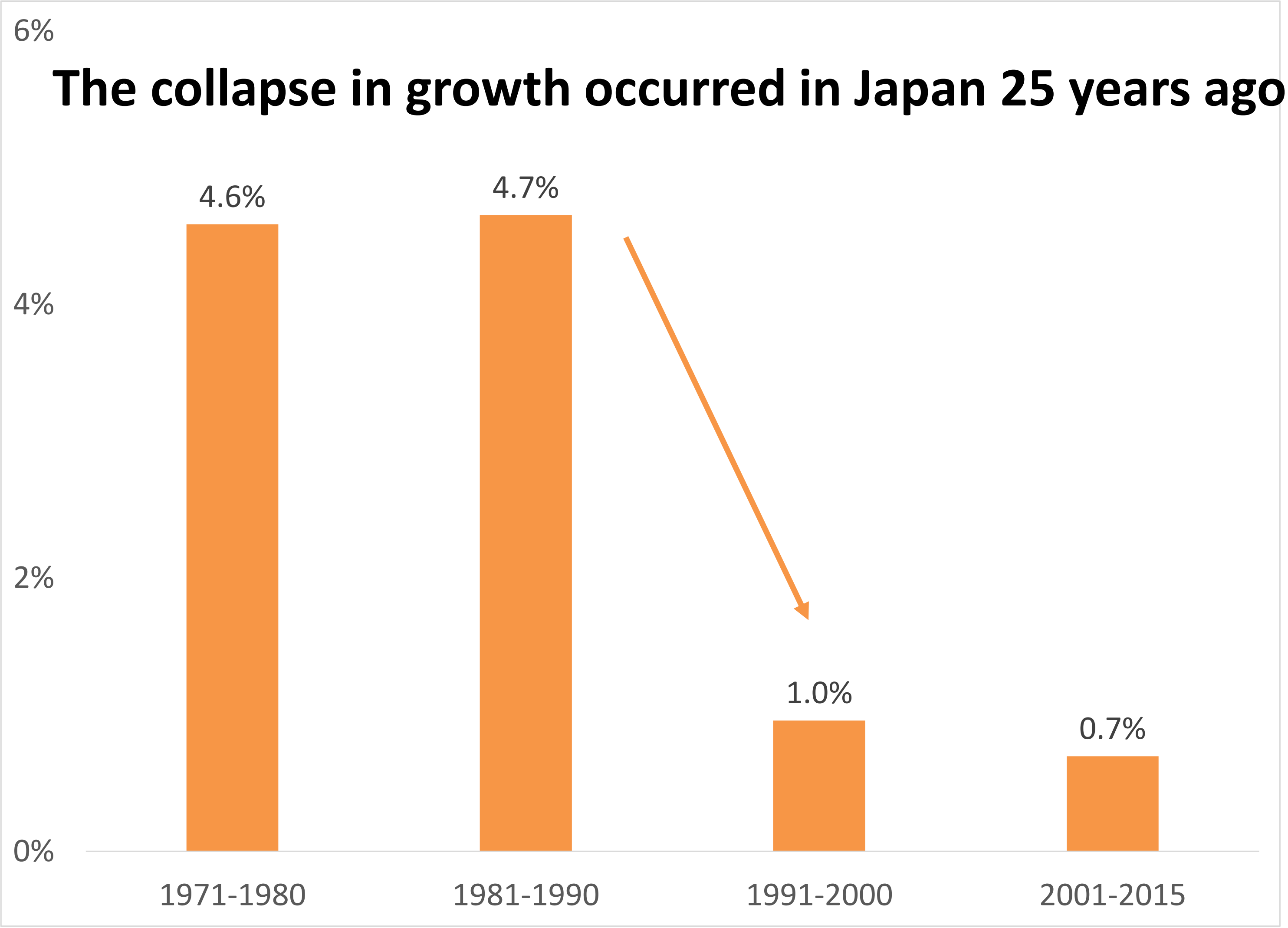
The true “New Normal”

- Yet Bill Gross may be right that stock returns in the future will not what they have been in the past.

- Future stock returns may not be as high as in the past because ***growth in the industrial world has slowed down***.

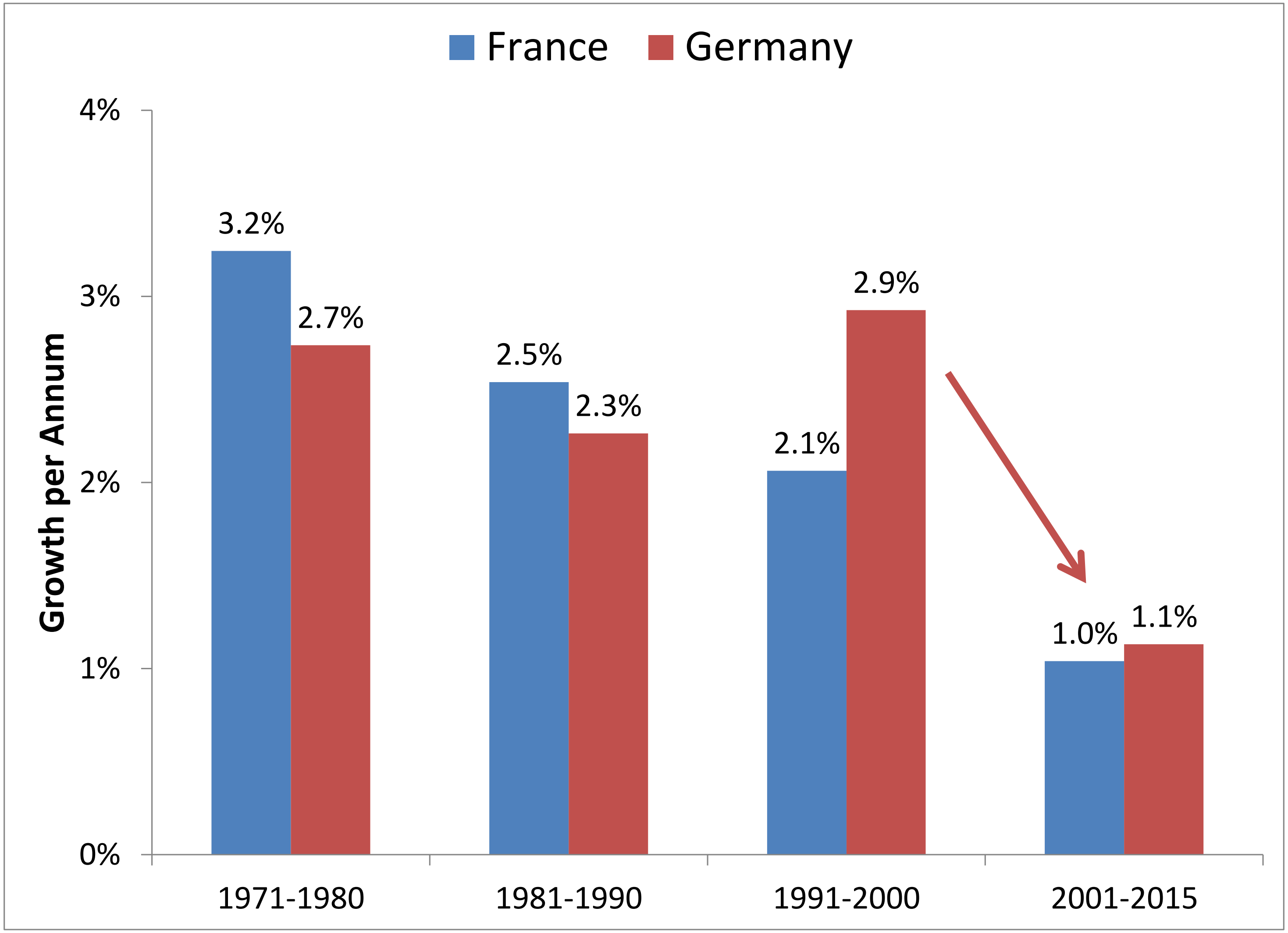
Real GDP Growth in Japan

Source: IMF, international Financial Statistics



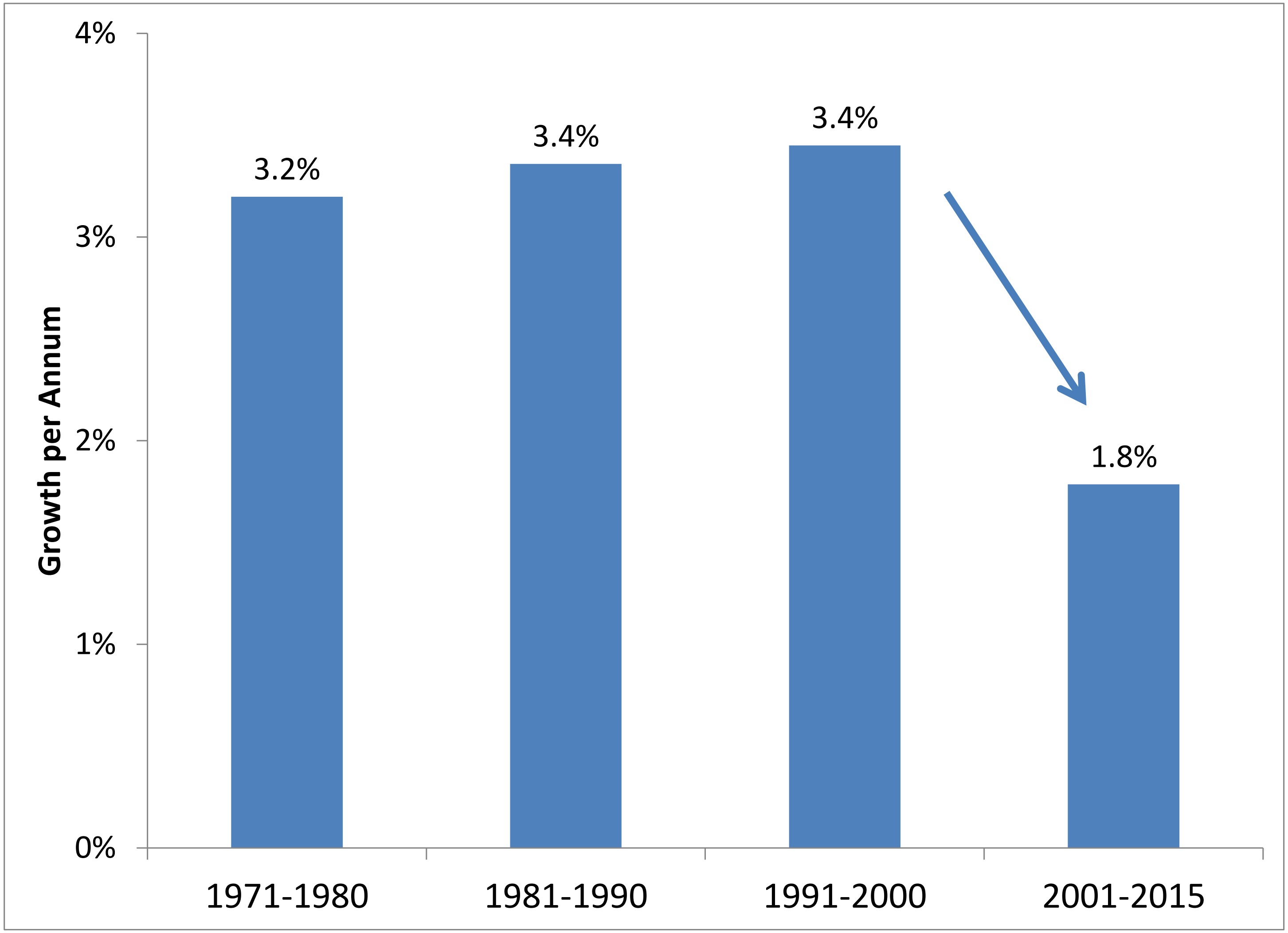
Real GDP Growth in Europe

Source: IMF, International Financial Statistics



Real GDP Growth in United States

Source: Bureau of Economic Analysis

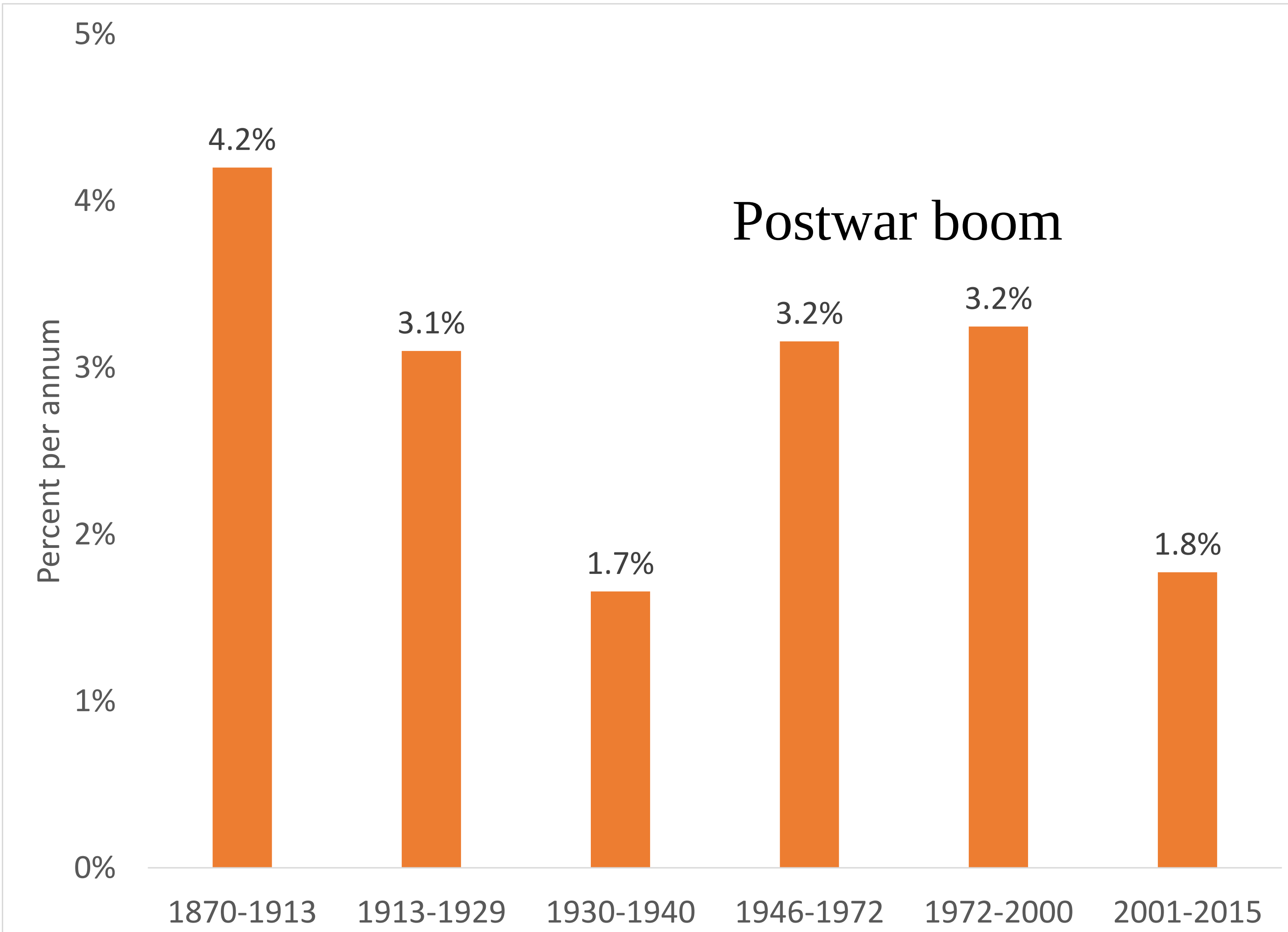


Long view of U.S. growth

- U.S. economy grew rapidly in the 19^{th} century – but never as fast as China!
- Slowdown in 1930s depression, then postwar boom that extended until 2000.

U.S. GDP growth since 1870

Source: NIPA, Table 1.1.6 and F 10-16



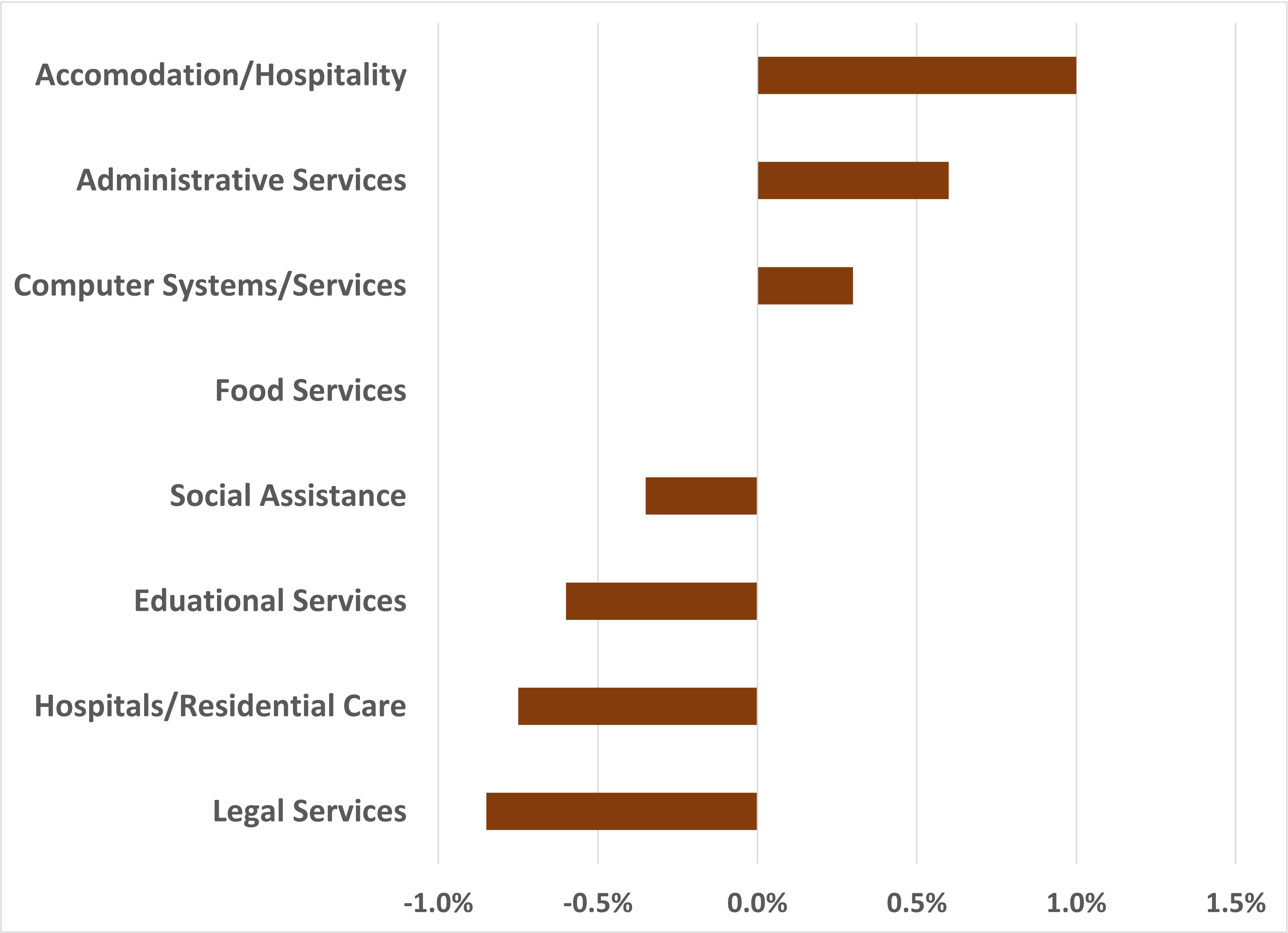
Long view of U.S. growth

- Growth in industrial countries is slowing partly because ***productivity growth is slowing.***
- A major reason for the slowdown in the growth in output per hour is the ***shift of the economy towards services and away from manufacturing***.

- ***Productivity in most service sectors is way below that in manufacturing or agriculture or mining***

Annual Growth in Productivity in Services, 1987-2014

Source: Brookings Institution (WSJ, 10-31-16)

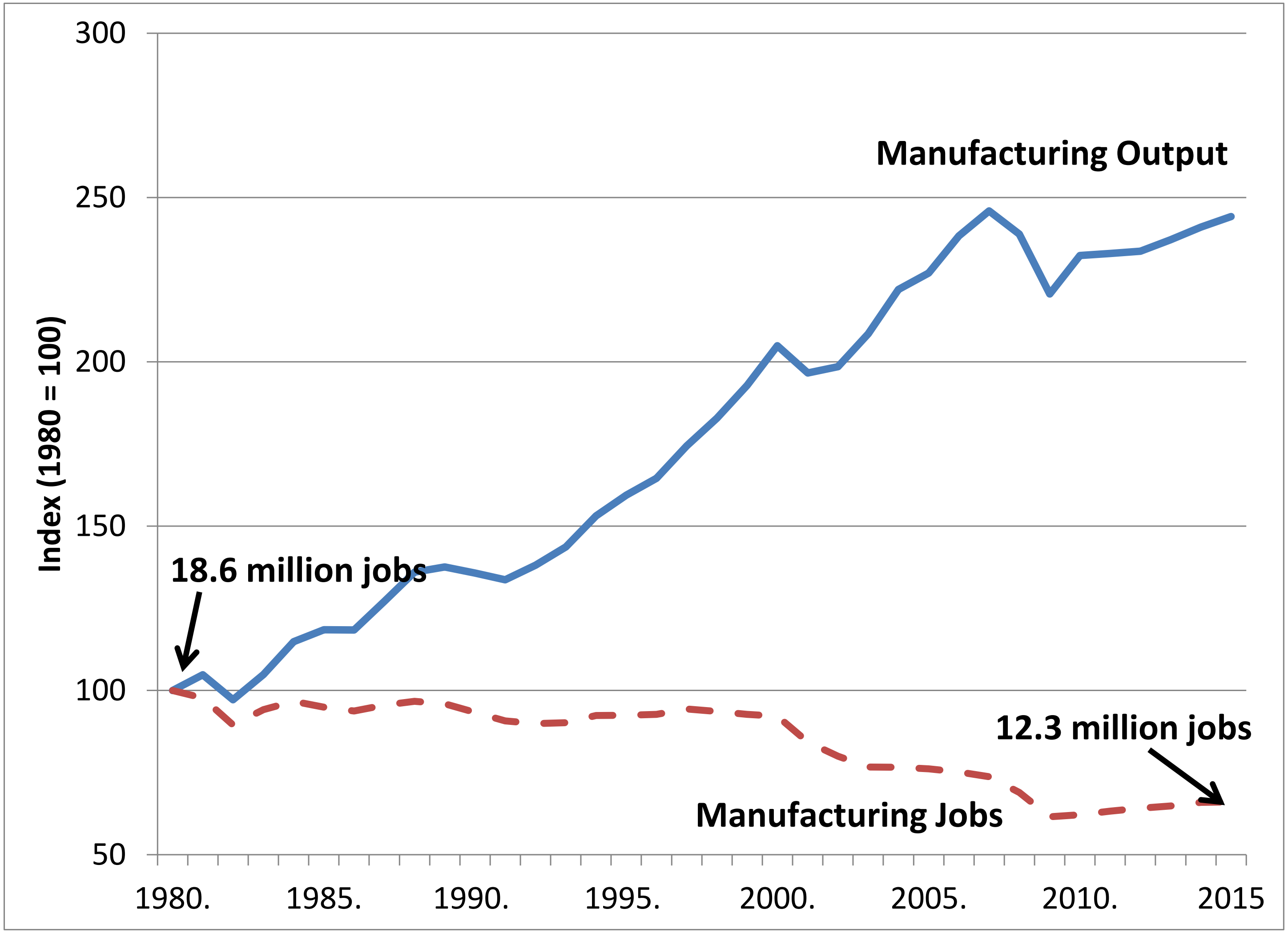


Two Trends in Manufacturing

- Will examine two trends in manufacturing since 1980:

1. ***Growth in manufacturing output (adjusted for inflation)***
2. ***Growth in employment in manufacturing***

Production and Employment in Manufacturing



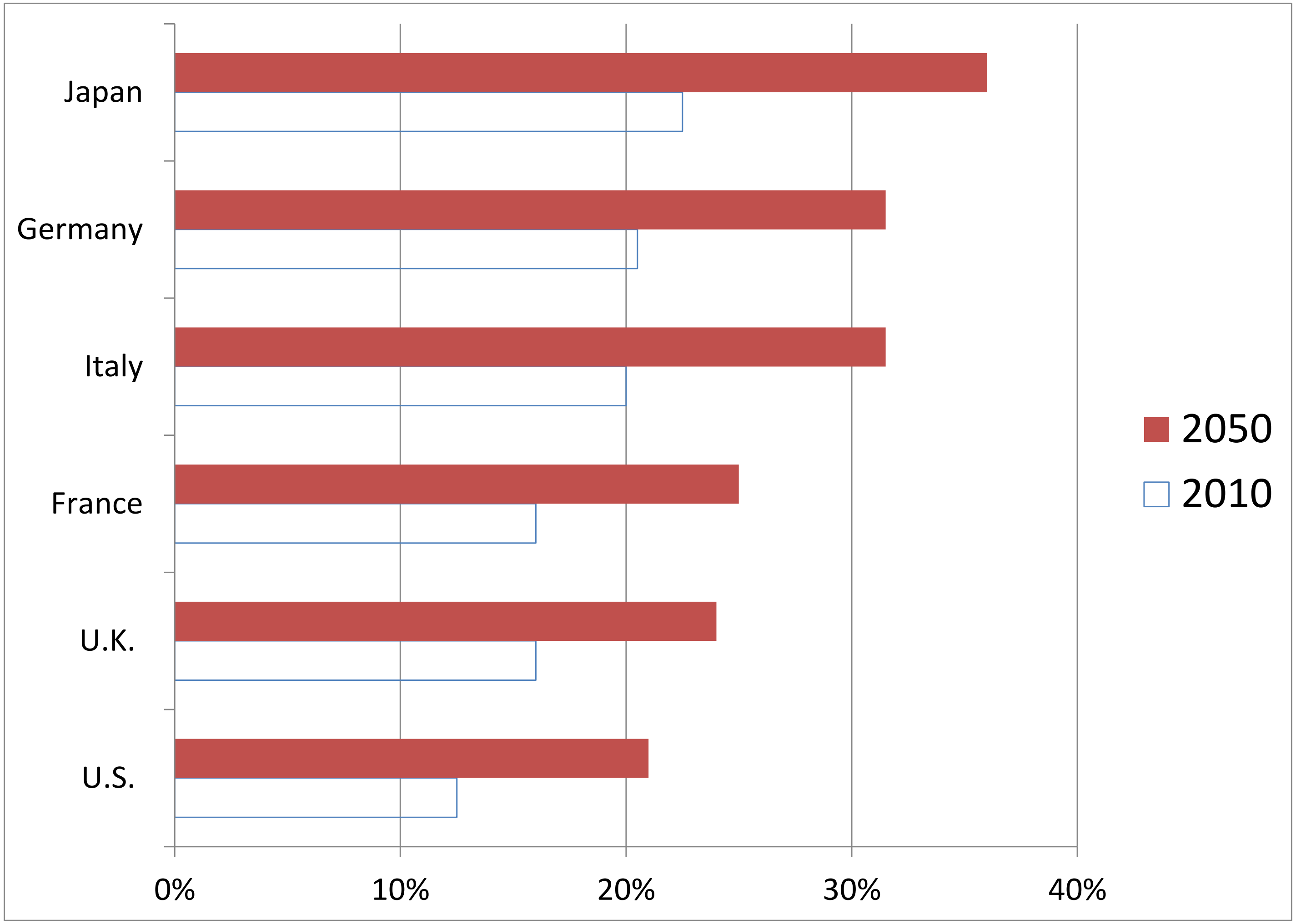
Bureau of Labor Statistics and Council of Economic Advisors

The true "New Normal"

- Another reason growth is slowing is that ***the industrial countries are aging.***
- That's particularly true of Japan, Germany and Italy.
- Look at share of population that is 65 years or older.

Share of Population 65 Years or Older

Source: Pew Research Center using United Nations data



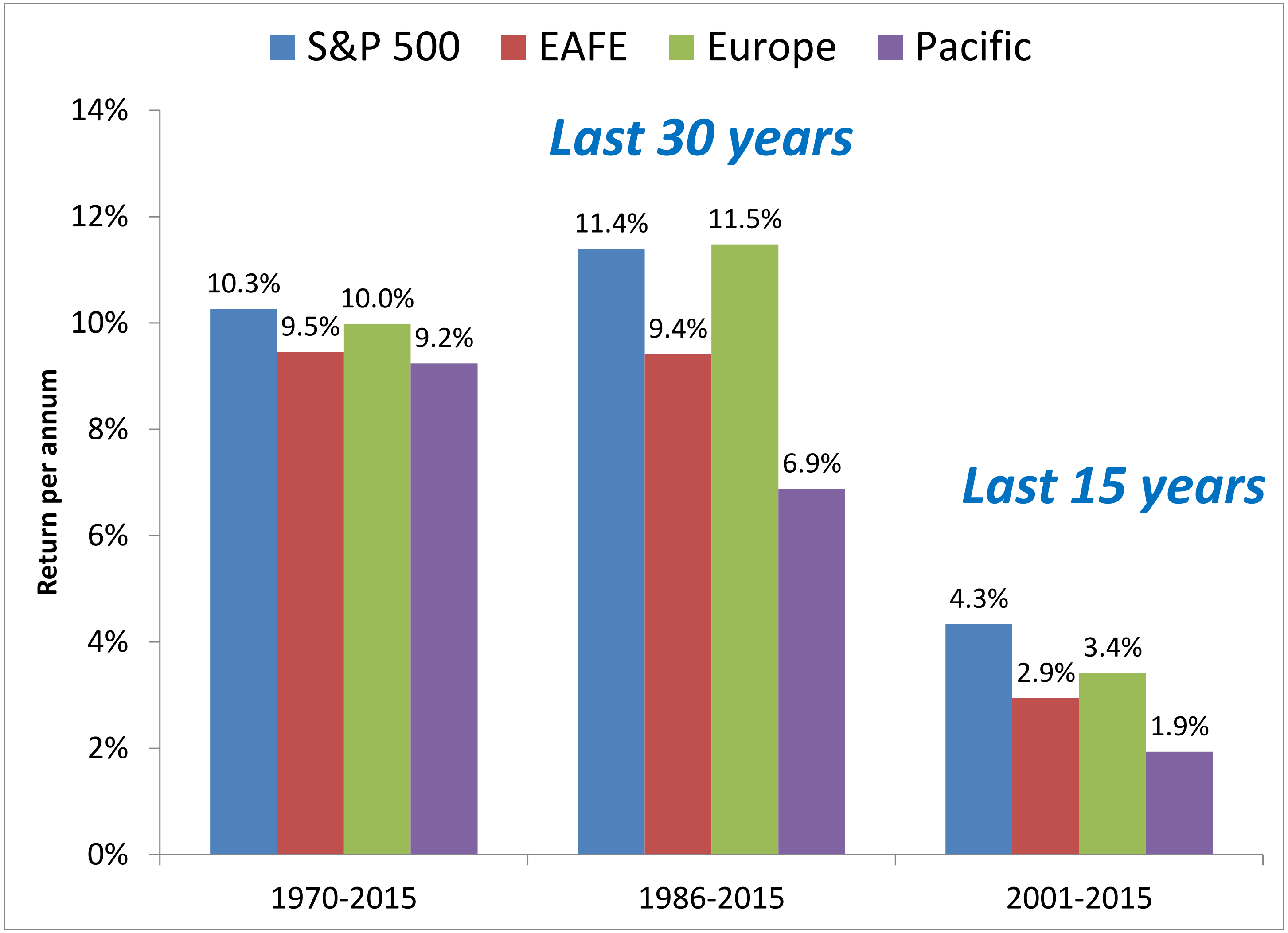
Stock returns in developed markets

- Stock returns in the developed (or industrial) countries over the last 45 years or the last 30 years **have been quite impressive**.

- ***But the last 15 years have been a different story***.
- Let's divide developed markets into three sets of markets:
  1. ***U.S. market*** represented by the S&P 500 index
  2. ***European*** portion of the MSCI EAFE index
  3. ***Pacific*** portion of the EAFE index (Japan, Australasia, Hong Kong, and Singapore)

Stocks in developed markets

Sources: S&P and MSCI

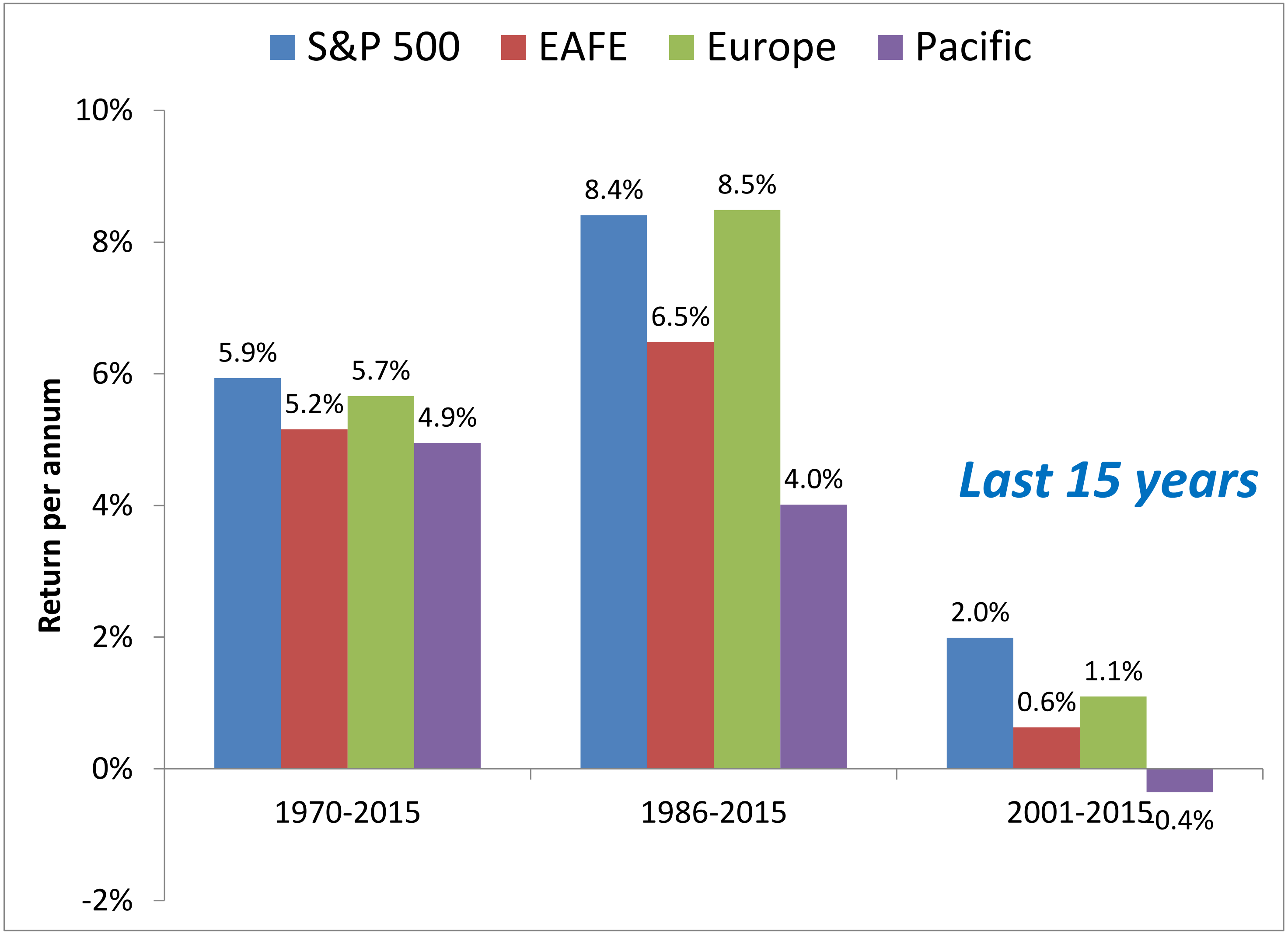


Stock returns in ***real*** terms

- Investors in the long run are interested in ***real (or inflation-adjusted) returns.***
- Let's look at the same returns adjusted by the U.S. inflation rate (since the returns are measured in dollars).
- This chart shows how miserable stock returns have been over the last 15 years.

Stocks in developed markets: *real* returns

Sources: S&P and MSCI



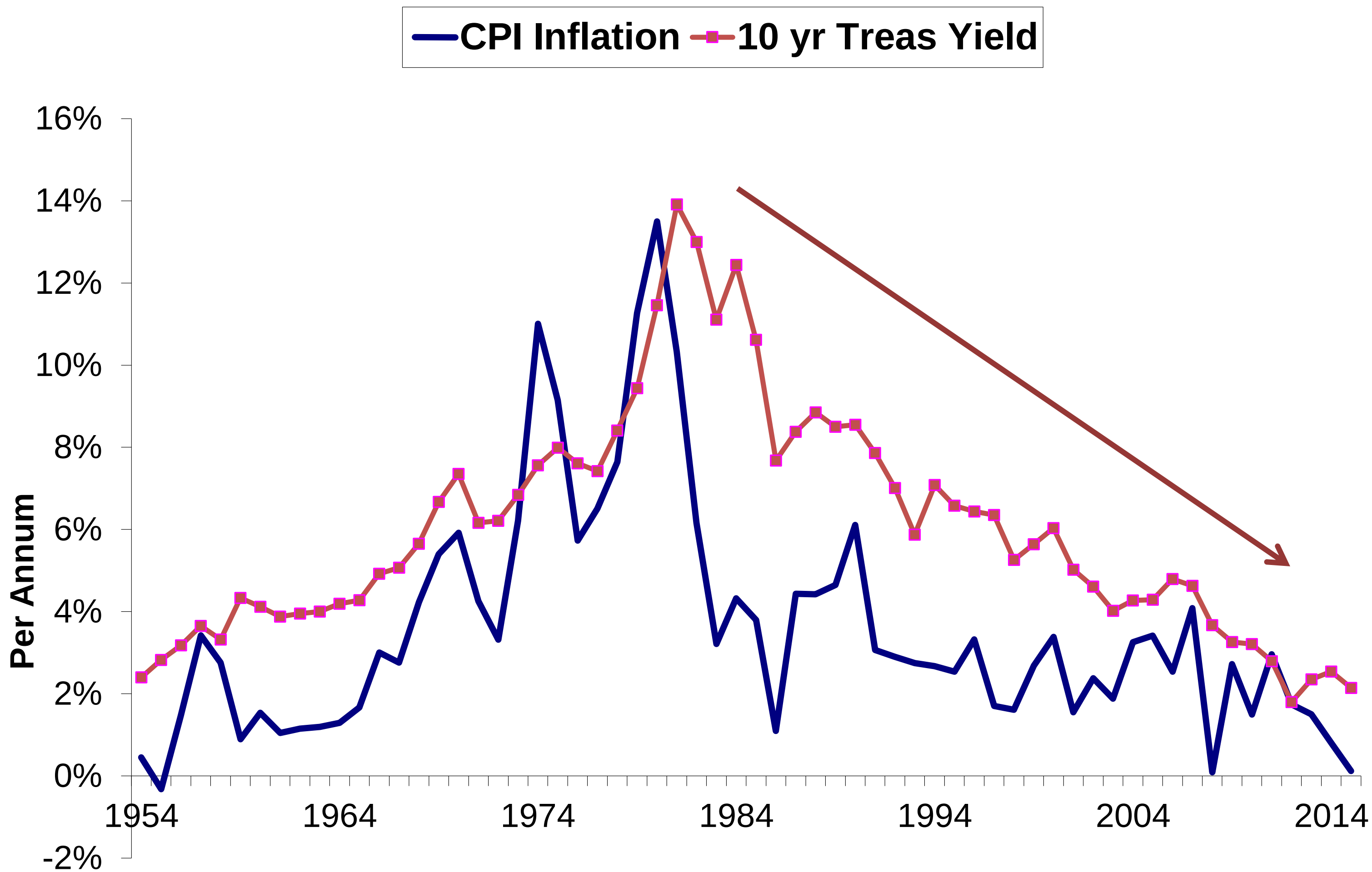
2) A “New Normal” for bonds?

- Bill Gross talked about a New Normal for stocks.
- ***But what about bonds? Surely, there is a New Normal ahead for bonds.***

- The bull market for bonds has lasted for 30 years.

Figure 3-3 U.S. Inflation and Bond Yields, 1954-2015

Data Source: IMF, International Financial Statistics and Bureau of Labor Statistics



Factors influencing interest rates

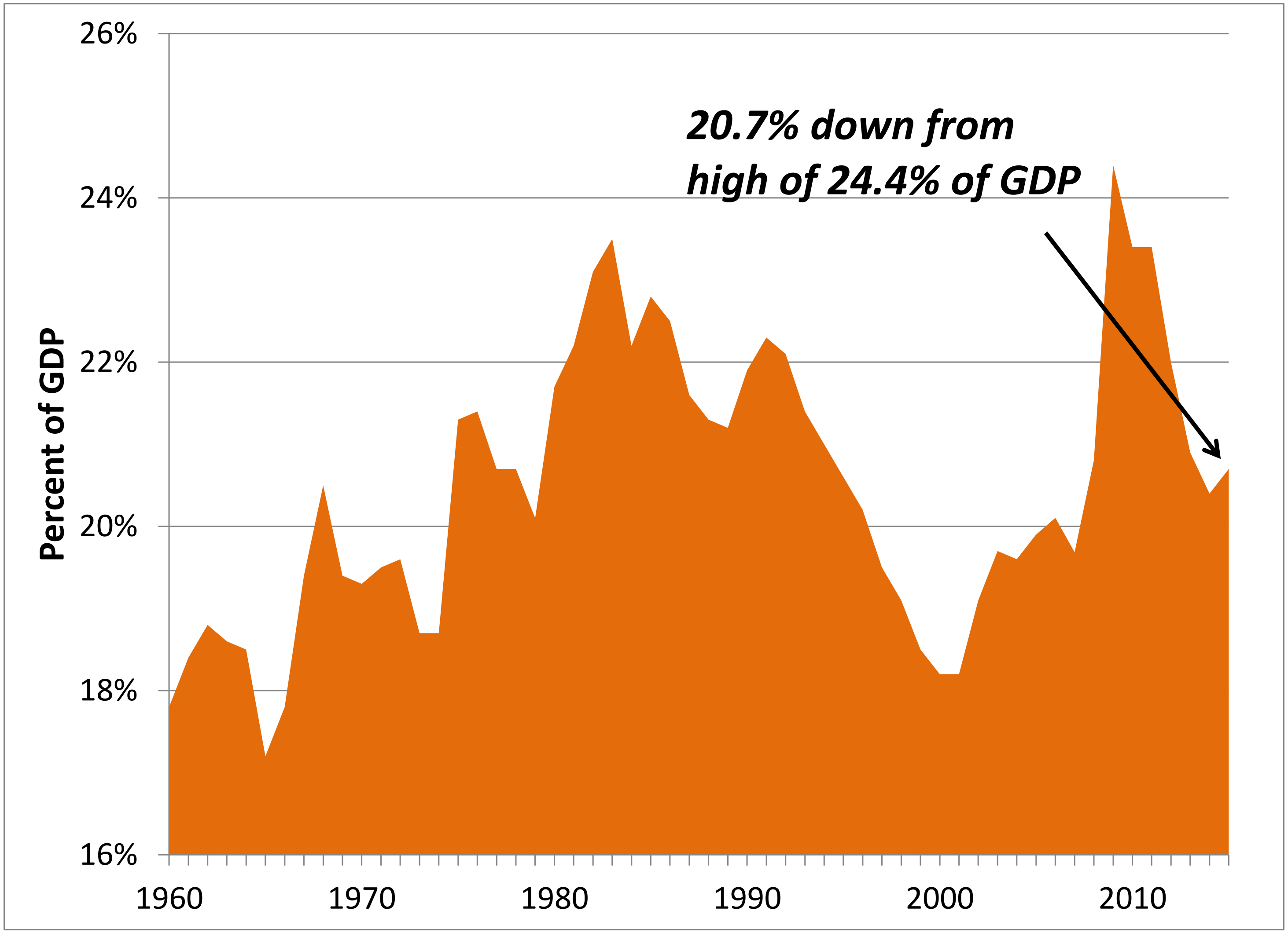
A. Fiscal deficits

B. Monetary overhang

- Fiscal deficits have been reduced dramatically in last few years.

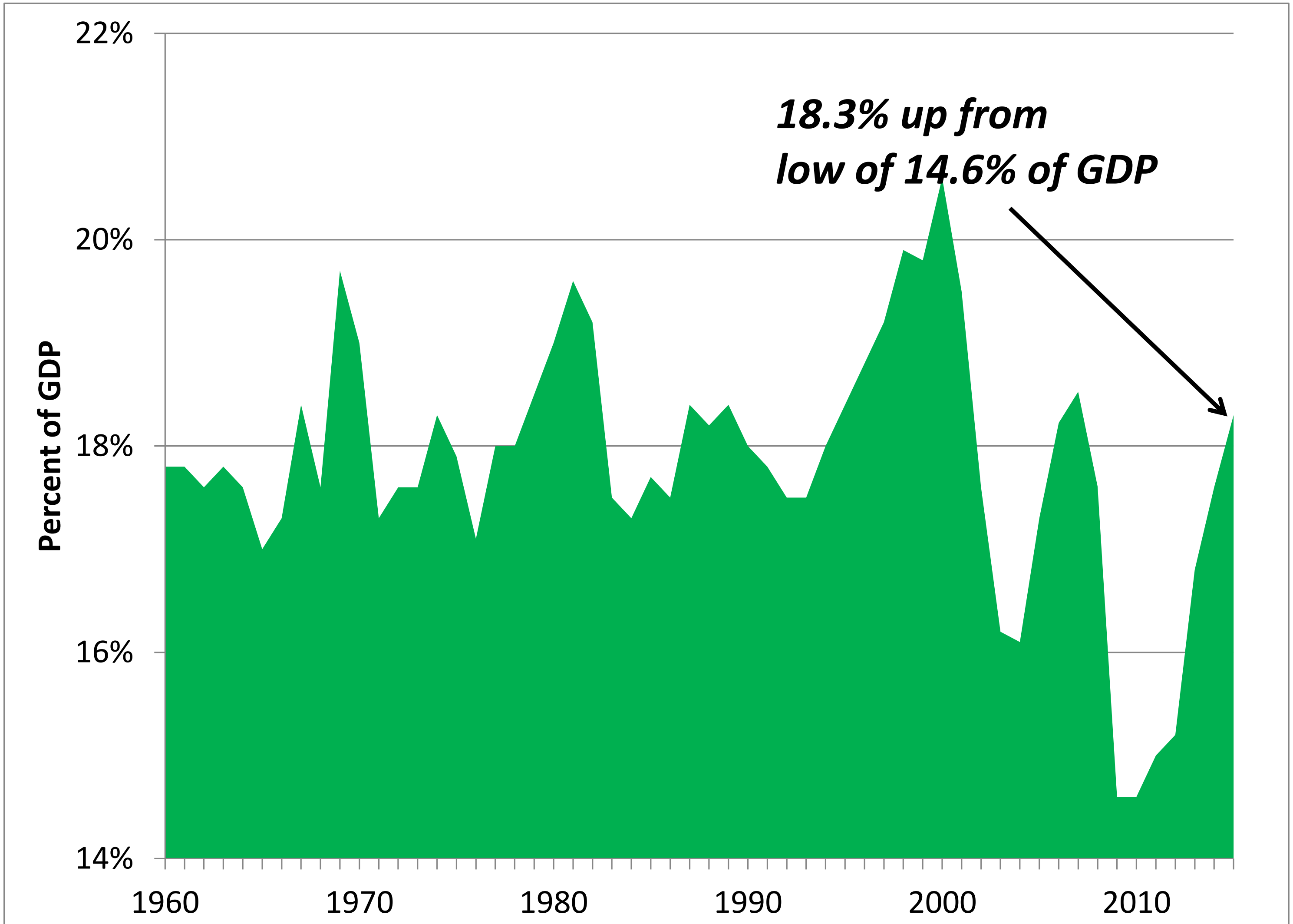
Federal Expenditure as Percent of GDP, 1960-2015

Economic Report of the President (Feb 2016)



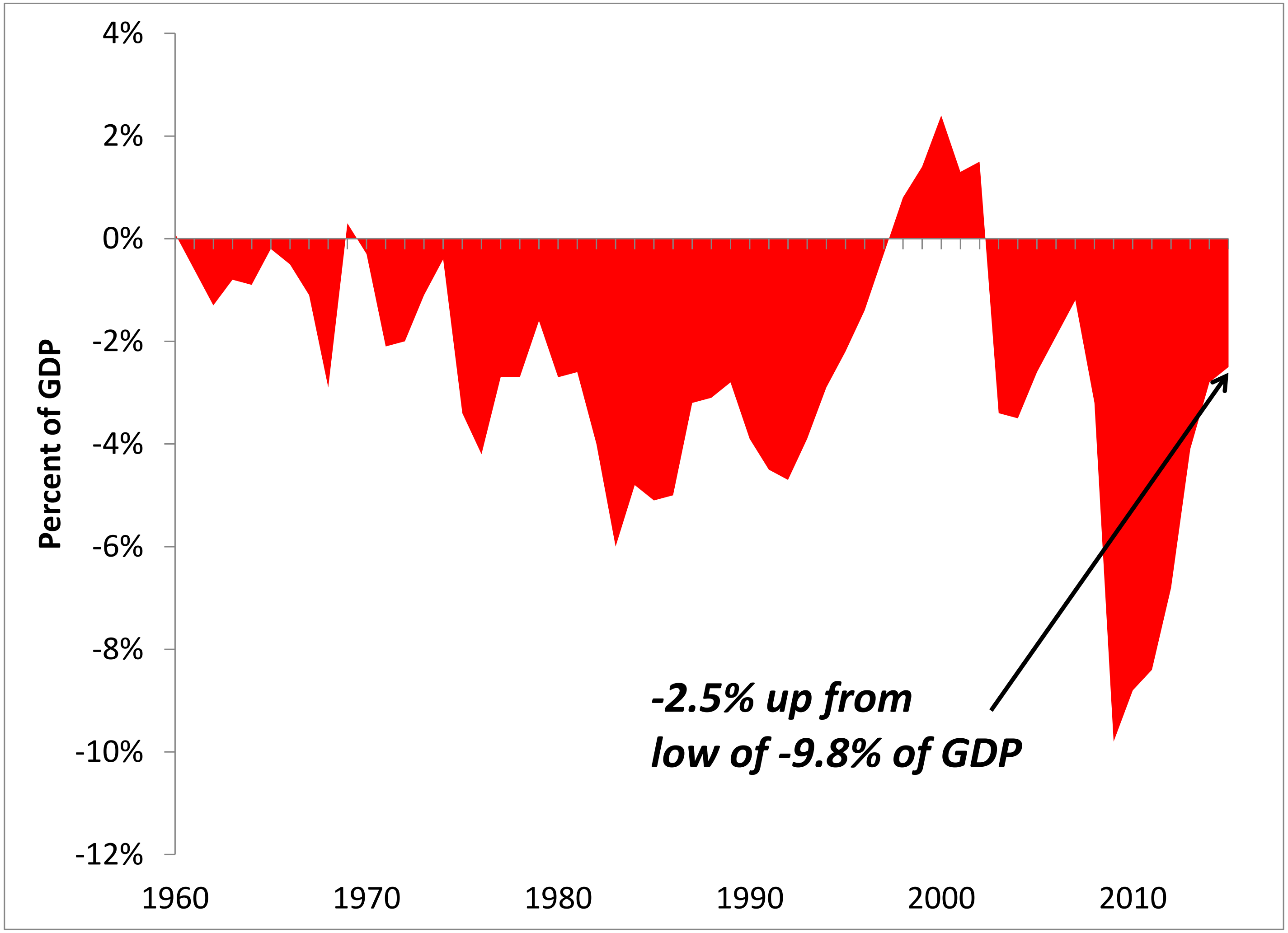
U.S. Tax Receipts as Percent of GDP, 1960-2015

Economic Report of the President (Feb 2016)



U.S. Fiscal Deficit as Percent of GDP, 1960-2015

Economic Report of the President (Feb 2016)



Factors influencing interest rates

- The election results promise that this favorable trend will not continue.
  - Infrastructure spending
  - Large tax cuts

B. Monetary overhang

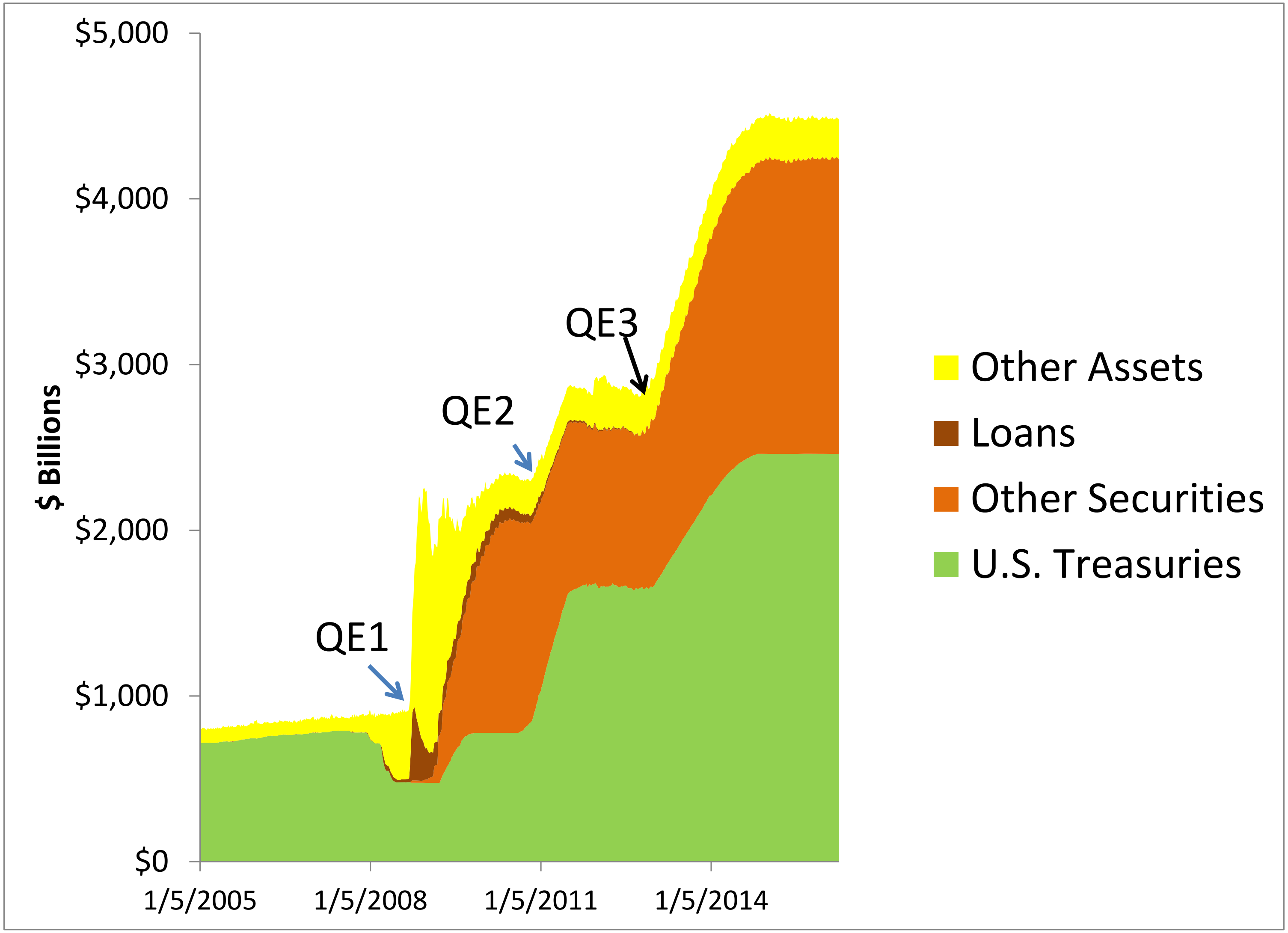
- Federal reserve did heroic work during the financial system – providing massive liquidity to save banking system and bolster economy.

- But legacies:

1. Fed balance sheet has ballooned.
2. So has cash at commercial banks.

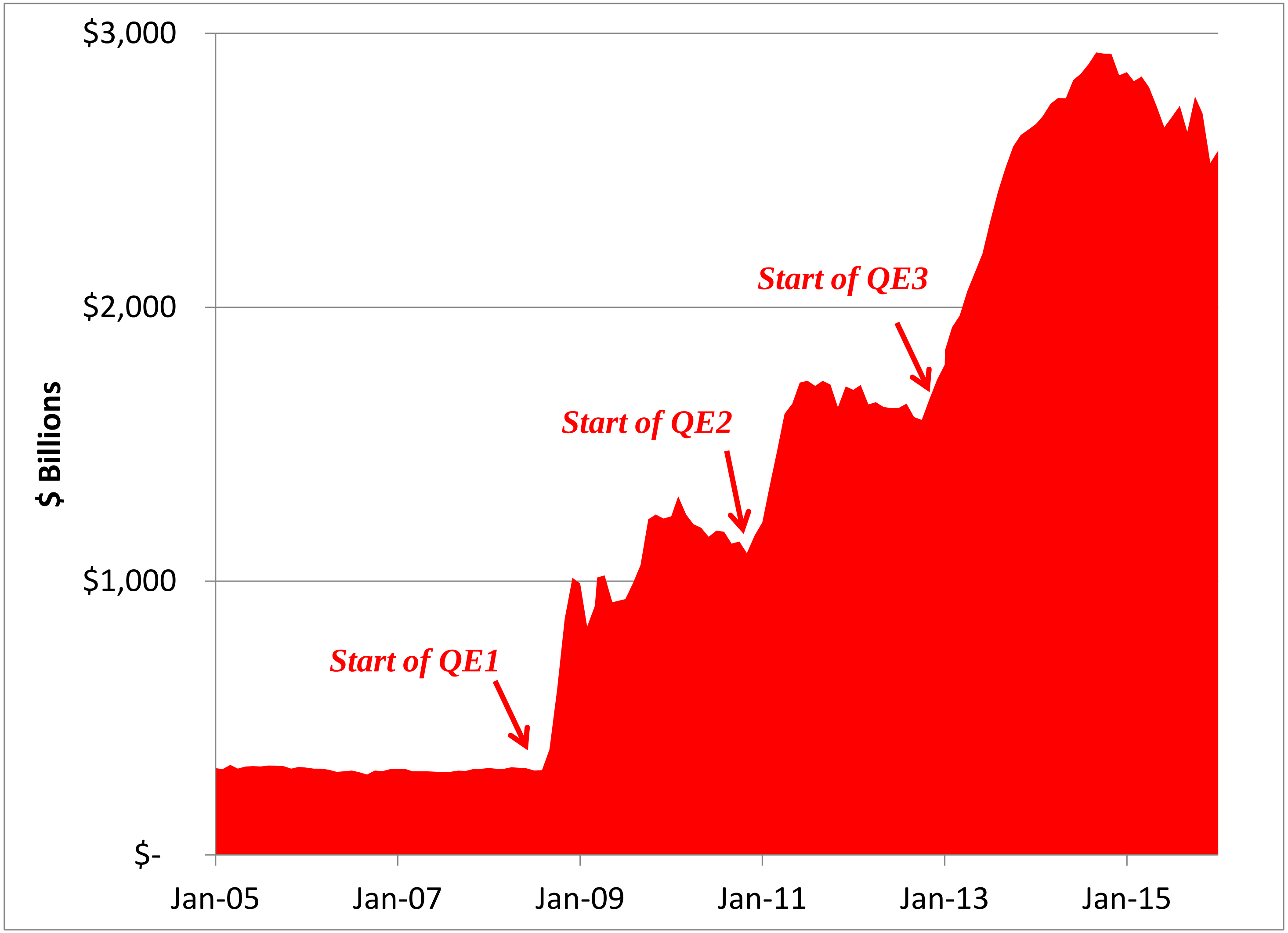
Assets on Fed's Balance Sheet

Source: Federal Reserve Board



Federal Reserve H.4.1 Release

Cash assets at commercial banks



Source: FRB H8 Series

A "New Normal" for bonds

- ***Now what?***
- Does anyone at the Fed know how to get back to normal?

- ***Two scenarios for bonds:***

1. ***<u>Good scenario</u>: Interest rates stay low forever. (In that case, real yields stay close to zero).***
2. ***<u>Bad scenario</u>: interest rates rise.***

- That surely is a "New Normal" for bonds

3. Is it possible to escape the "New Normal" by diversifying?

- If U.S. stock and bond markets promise lower returns, will diversification help?

1. One possibility is to diversify into countries that are growing much faster than the United States – ***the emerging markets***.
2. Another possibility is to diversify into ***alternative investments.***

- Let's explore each possibility.

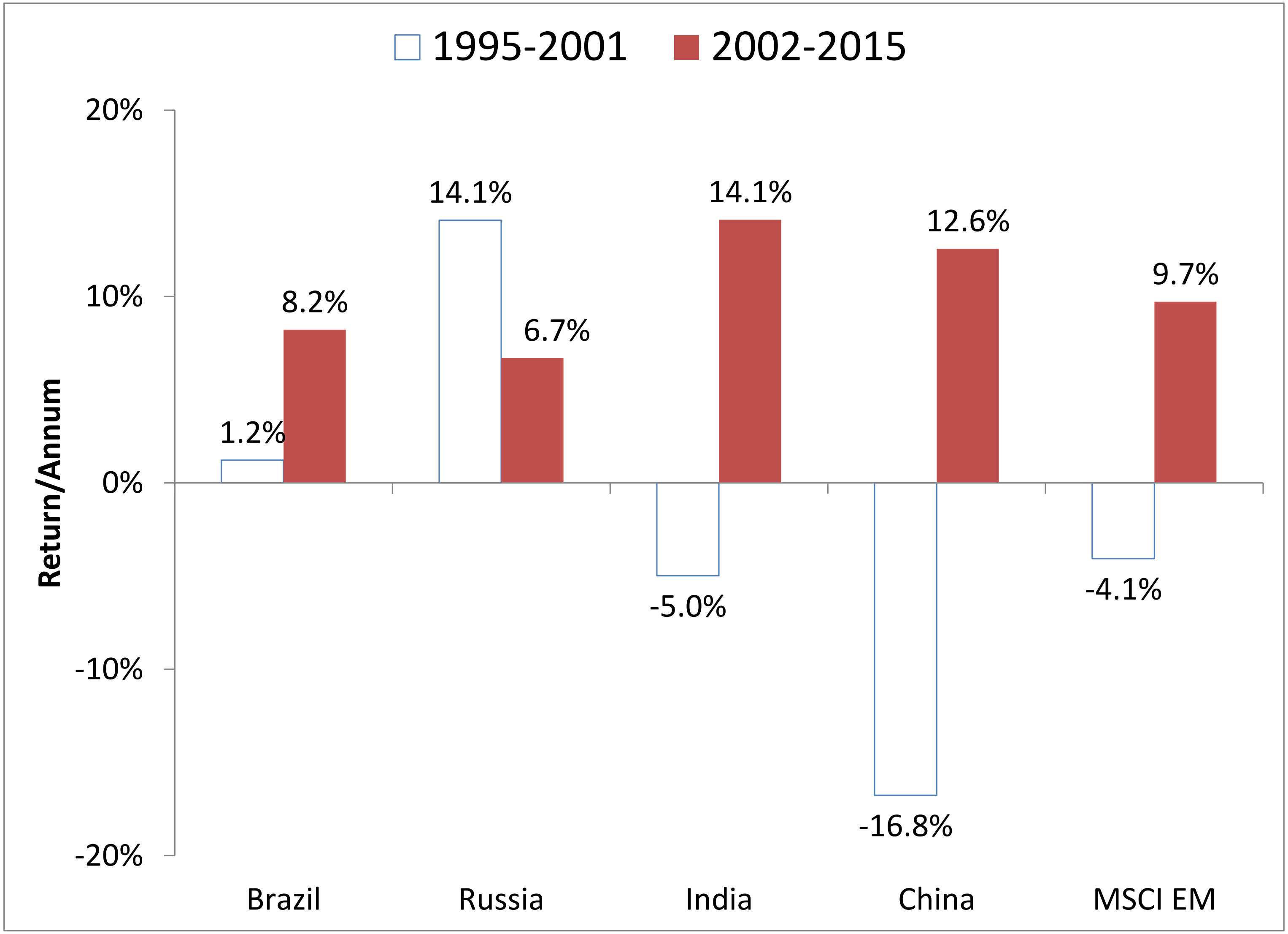
A. Diversifying into emerging markets

- Since 2001, ***emerging markets have earned the highest stock returns***, easily beating the U.S. and other developed stock markets.
- Maybe emerging markets will help investors to escape the New Normal.

- In November 2001, Jim O'Neill of Goldman Sachs introduced the BRICs
- Heralded an ***impressive decade of high stock returns*** not only in the BRICs, but emerging markets as a whole.

Figure 9-6 Returns in the BRIC Countries and Emerging Markets as a Whole

Data Source: MSCI



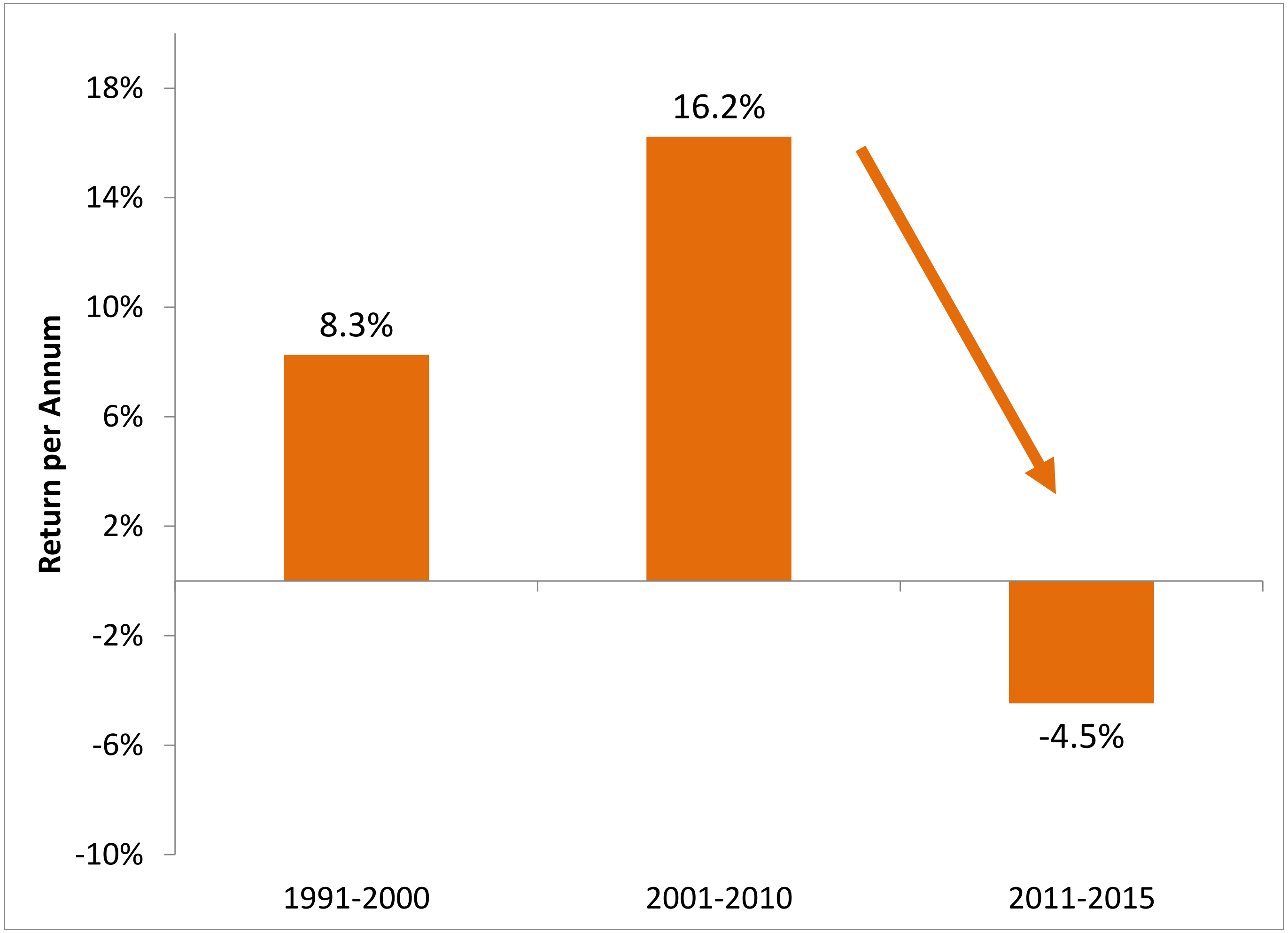
Decade of the "BRICs"

- But then in December 2013, Goldman Sachs published ***"Emerging Markets: As the Tide Goes Out"*** which forecast a prolonged slowdown in stock returns in the emerging markets.
- Is it wise to look for salvation there?

Emerging markets have faltered over last 5 years

Stock Returns in Emerging Markets

Source: MSCI EM Index

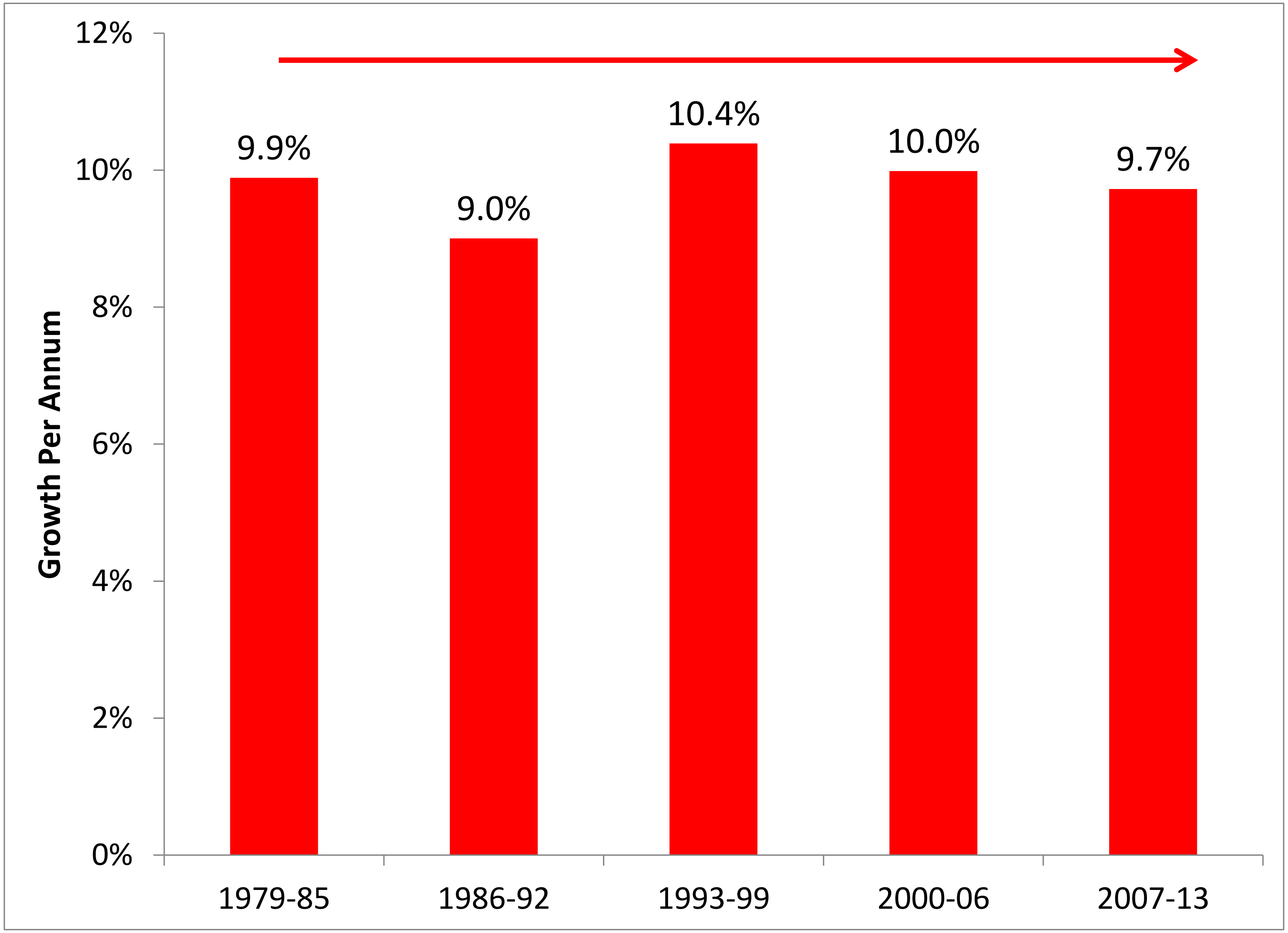


China has led all emerging markets in growth

- China has grown rapidly for over three and ½ decades.

Real GDP Growth in China, 1979-2013

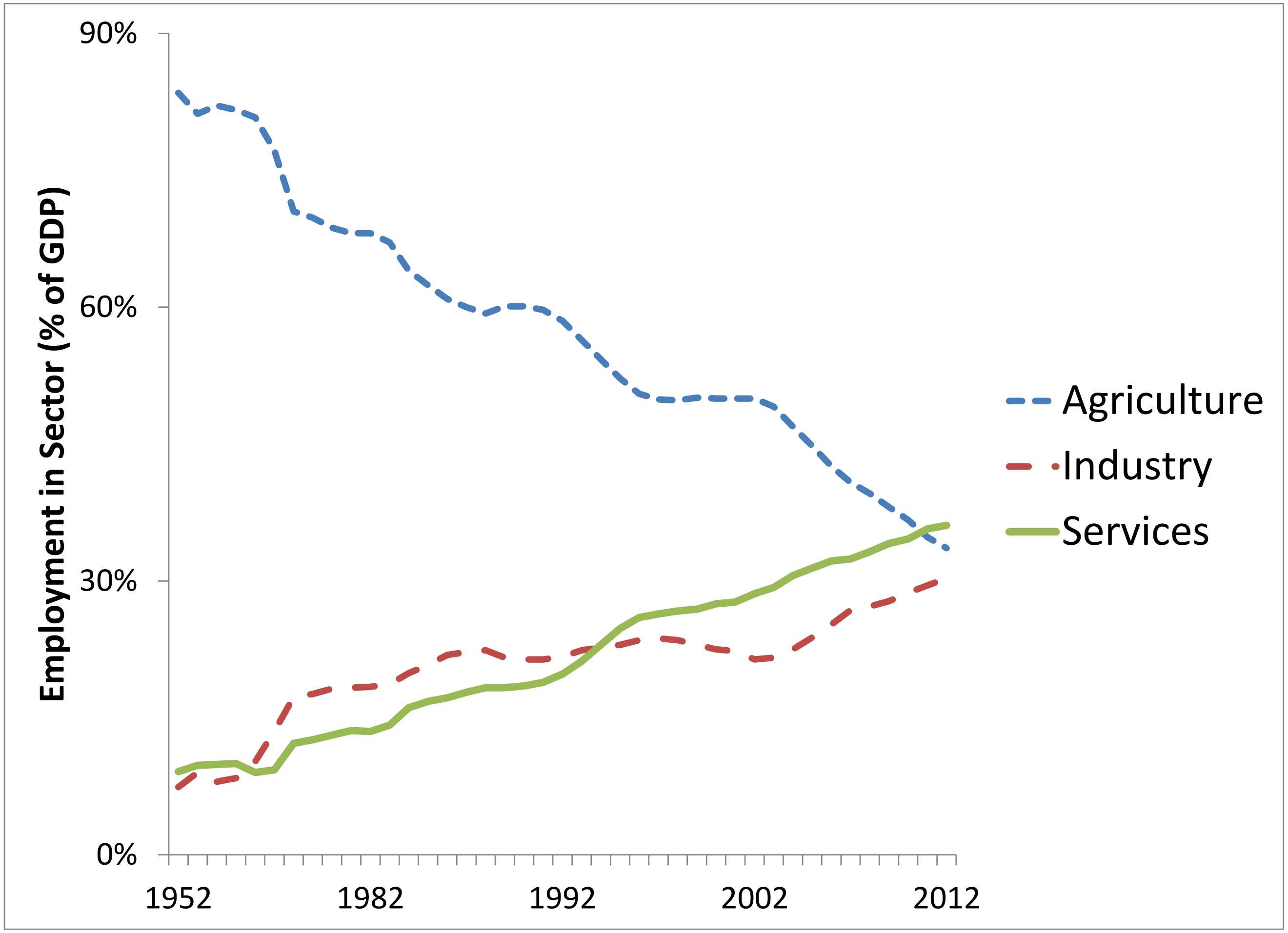
Source: IMF, international Financial Statistics



Key: lots of labor available

Share of Employment by Sector in China

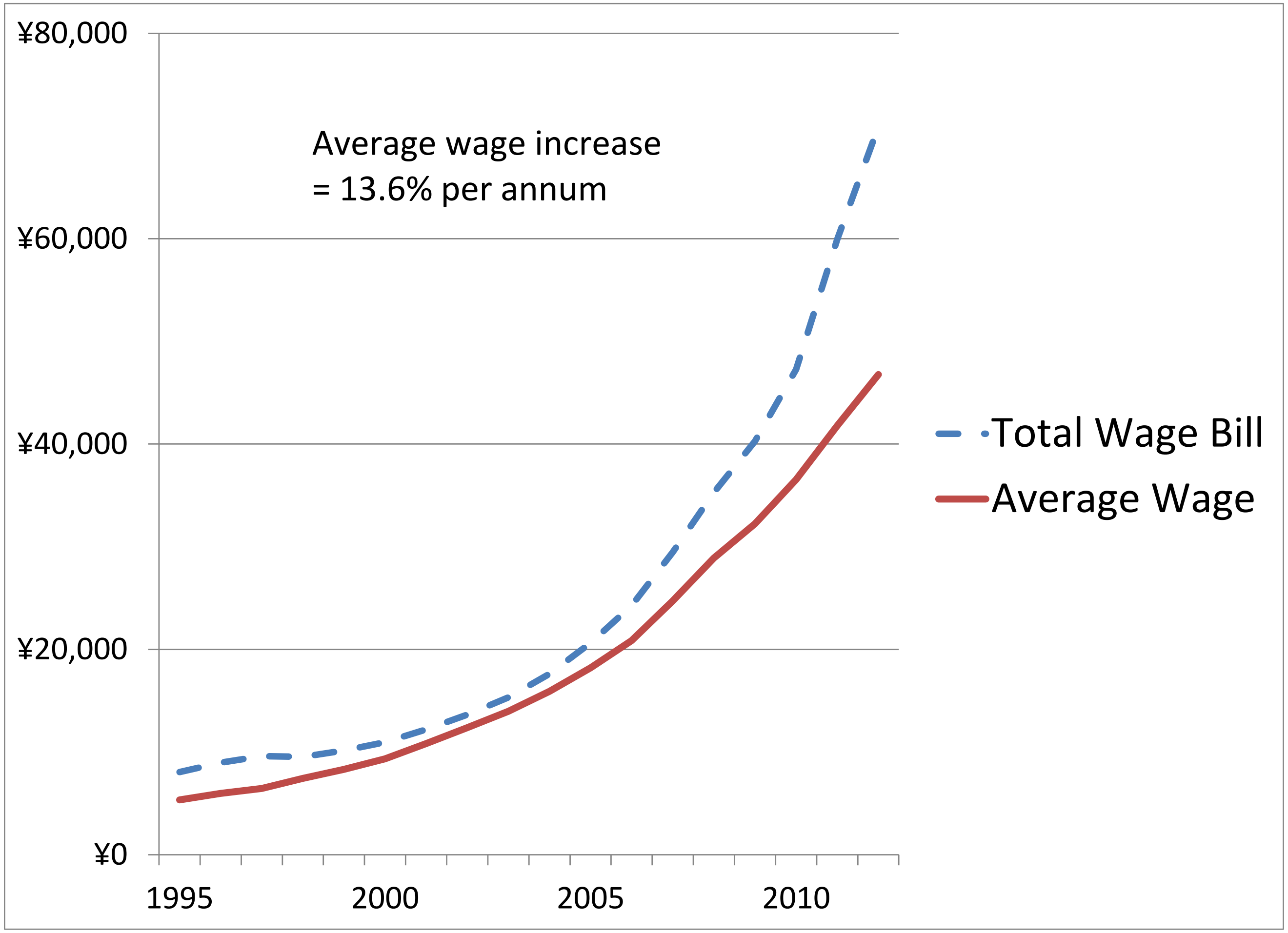
Source: China Statistical Yearbook, 2013



But now wages are rising rapidly

Wage Increases in China

Source: China Statistical Yearbook, 2013

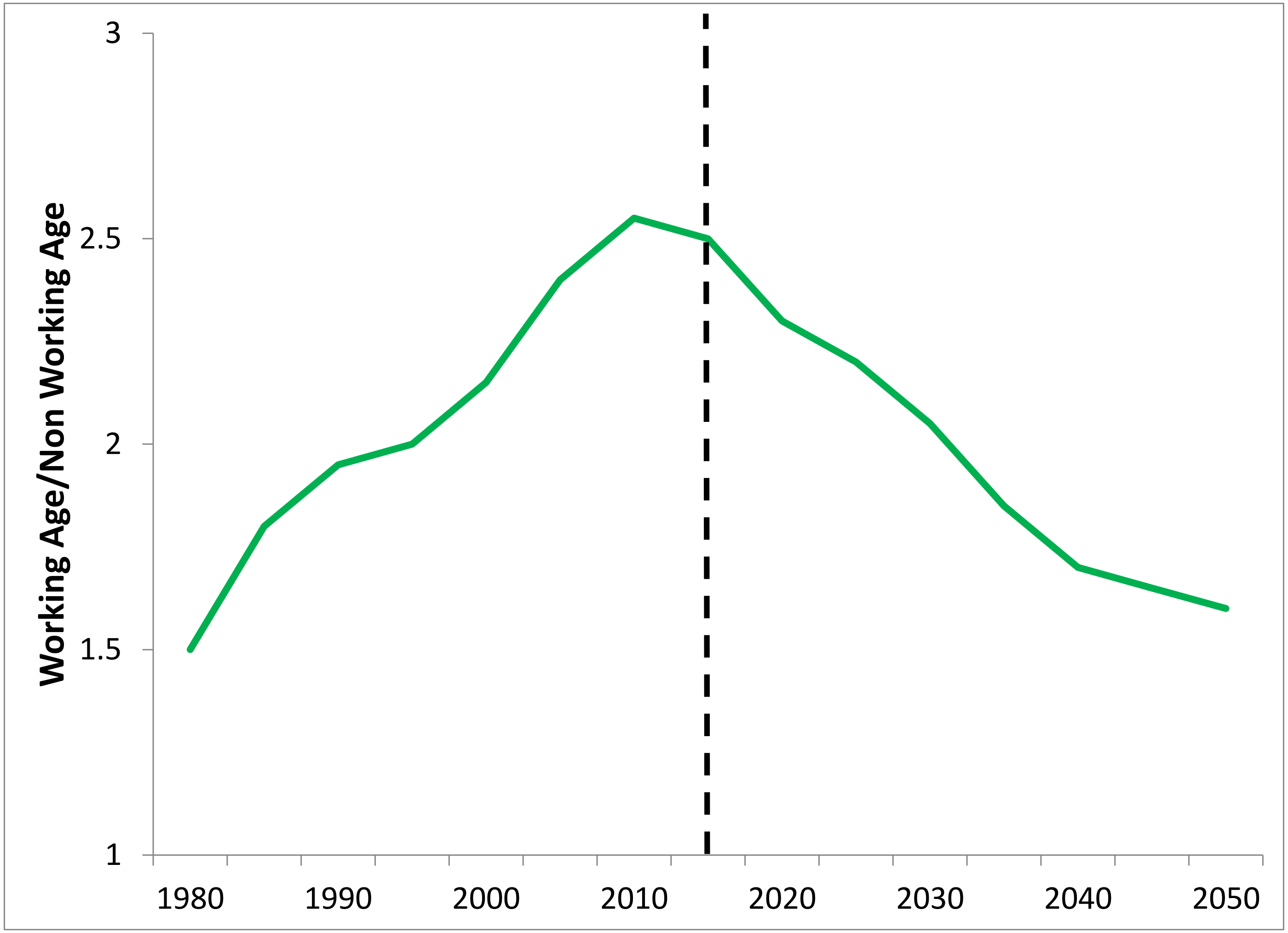


Will China slow down?

- China also confronts an ***aging problem*** almost as bad as in Japan, Germany and Italy.
- Consider United Nations projections through 2050.

China's Working Age Population Relative to Non-Working Age Population

Source: United Nations



Will China slow down?

- ***China is beginning to slow down.***
  - That’s bad news for everyone.
  - China has been the growth engine for the world.
- ***With China slowing, two other BRICs are in even worse shape, Brazil and Russia.***

Three of the BRICs have slowed down

Economic forecasts for emerging markets

Source: IMF, July 2016

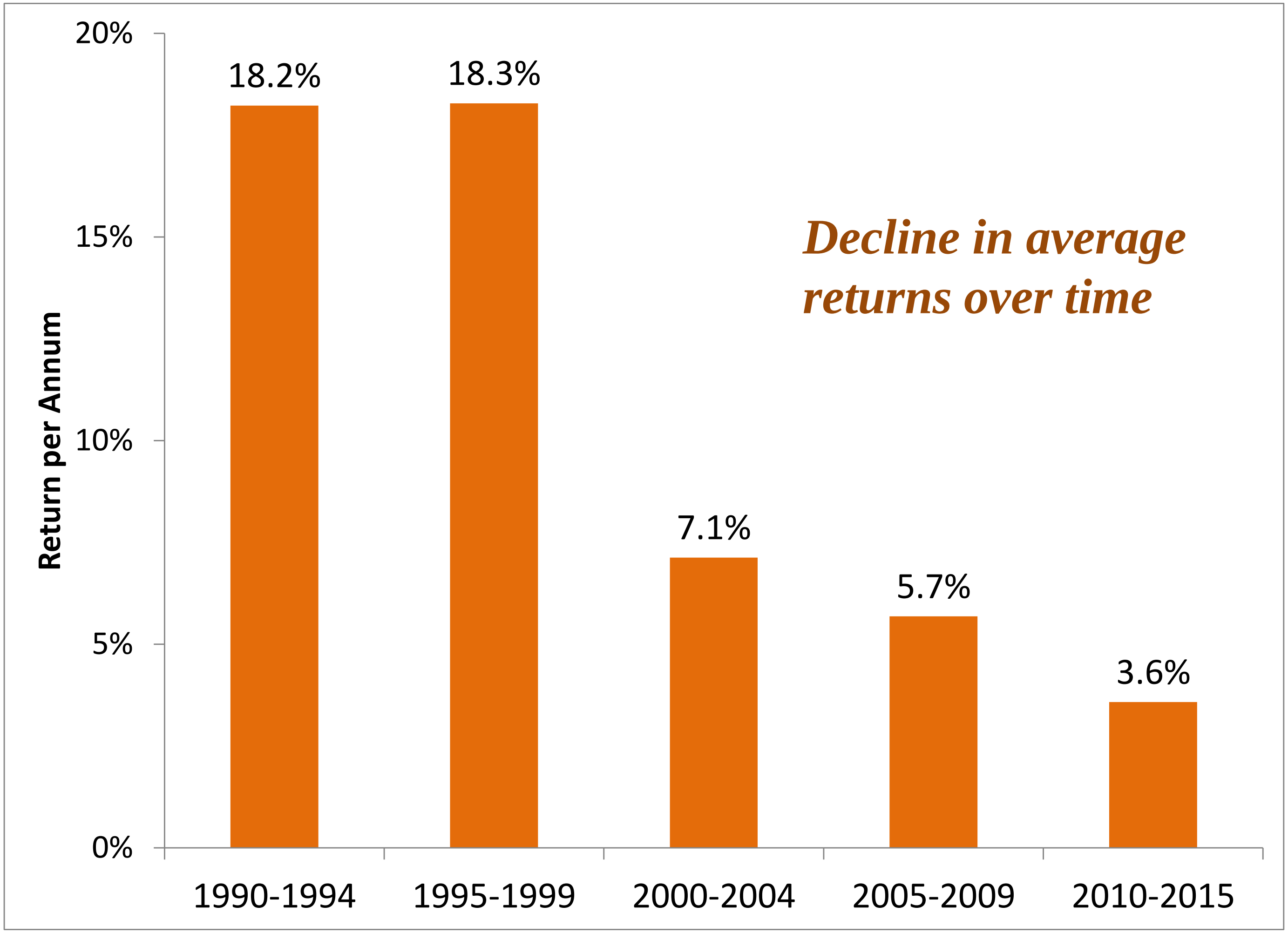
	2015	2016f	2017f
China	6.9%	6.6%	6.2%
India	7.6%	7.5%	7.4%
Brazil	***-3.8%***	***-3.3%***	0.5%
Russia	***-3.7%***	***-1.2%***	1.0%

B. Diversifying into alternative investments

- **Hedge funds**:
- Surely hedge funds provide an escape from the low returns offered by U.S. stock and bonds.
- Let's consider how well they have performed in the last 15 years.

Hedge Fund Returns – Too Many Cooks Spoiling the Returns?

HFRI Fund Weighted Hedge Fund Index



Diversifying into alternative investments

- **Hedge funds**:
- The increasingly poor performance of hedge funds in last 15 years is perhaps expected.
- After all, the space has been flooded by the influx of new funds. Are there that many arbitrage opportunities to keep 10,000 managers in business?

Diversifying into alternative investments

- **Real Estate**:
  - Over last 20+ years as well as over the last 40+ years, real estate has outperformed U.S. equity.
  - Look at REIT index relative to the S&P 500

Table 12-1 NAREIT and stock returns compared

	Average Return	Standard deviation
<u>1972-2015</u>		
NAREIT	12.0%	17.1%
S&P 500	10.3%	15.2%
<u>1992-2015</u>		
NAREIT	11.2%	19.1%
S&P 500	9.0%	14.4%
Sources: NAREIT and Standard and Poor's.		

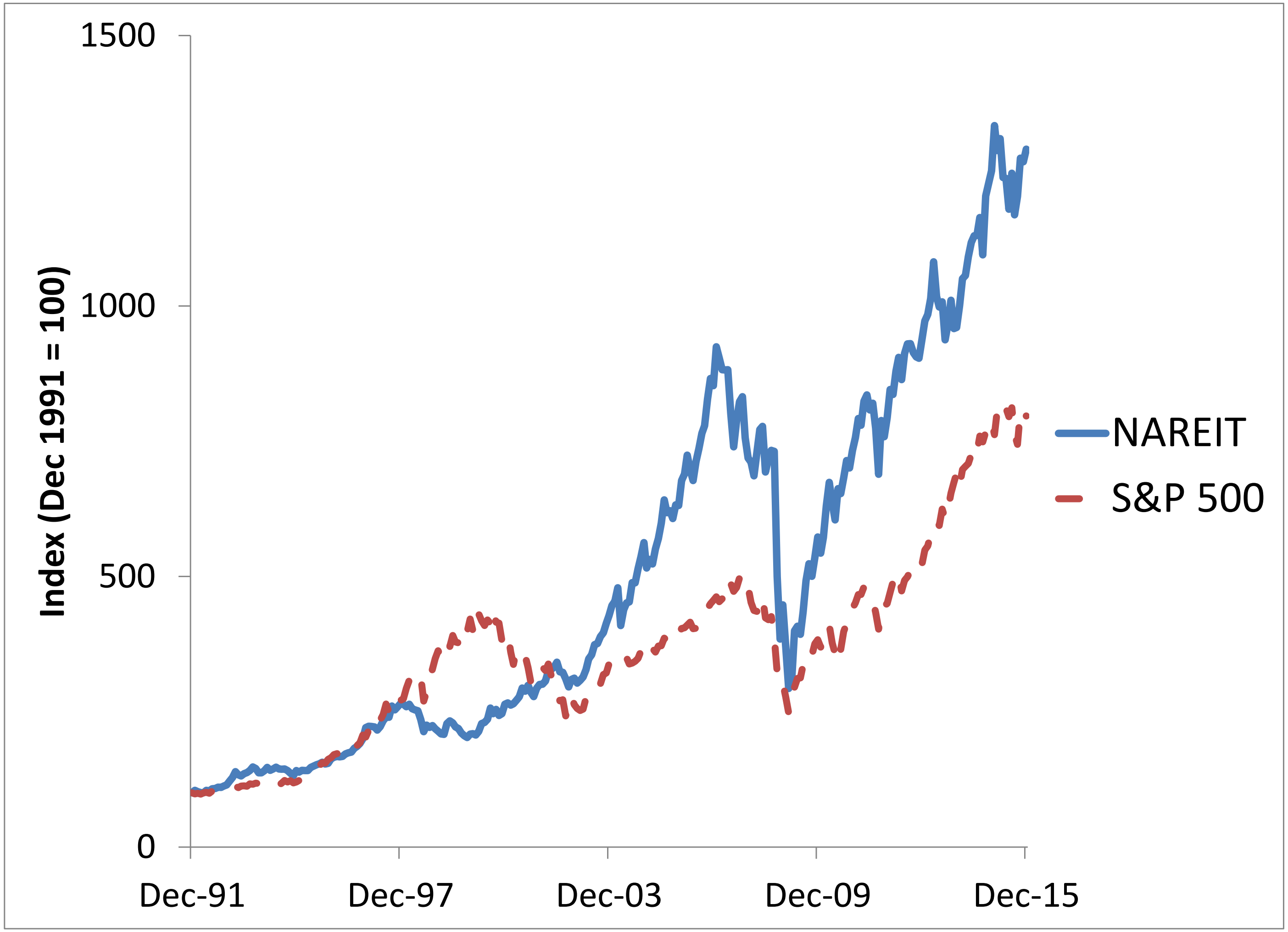
Diversifying into alternative investments

- **<u>Two caveats about real estate</u>**:
  1. ***Real estate is as cyclically sensitive as stocks are.***
     – It’s true that in the 2000-2001 recession, real estate did not fall with stocks.
     – But in the financial crisis, the drop in REITs (65%) was more severe than in stocks (50%).
  2. ***Current values in real estate (“Cap rates”) are high.*** It’s not a great time to add to this sector.
     – On other hand, the outlook is not great in any sector.

Crushed in financial crisis, but have come back fully

Figure 11-4. NAREIT and S&P 500 Returns, 1992-2015

Data Sources: Ibbotson Associates and Zephyr Database



Diversifying into alternative investments

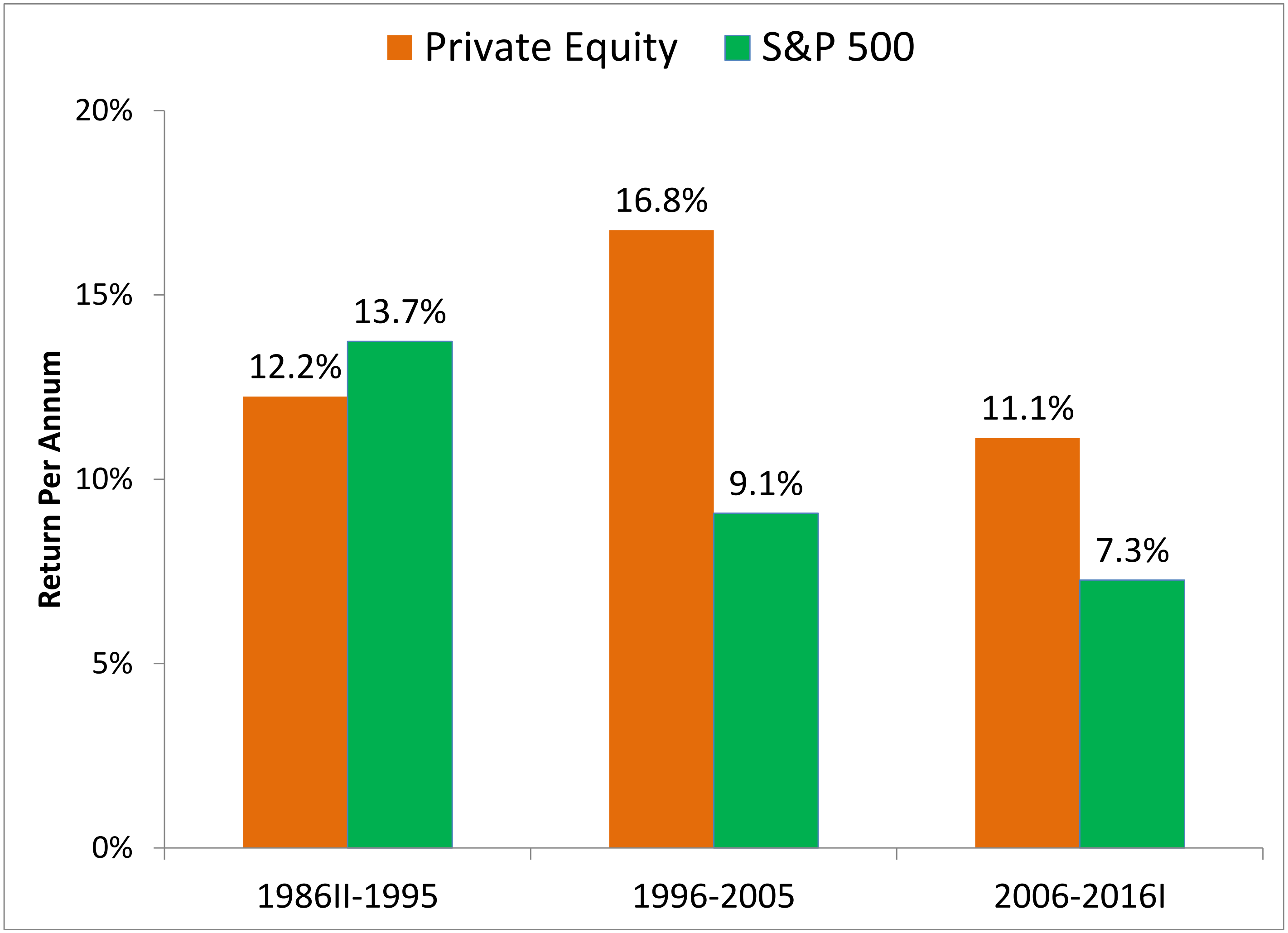
- **<u>Private equity</u>**:
  - Here we have an alternative investment that has proved itself time and again.
  - Cambridge Associates has reported its private equity series since 1986.
  - ***Returns have been consistently above those of the private equity markets.***

- My advice to endowments (and wealthy families) wealthy enough to invest in PE:

  Take advantage of excess returns to buck the New Normal in public markets

Private Equity
– Twenty Years of Superior Returns

Source: Cambridge Associates



Diversifying into alternative investments

- ***So private equity provides an alternative to the New Normal <u>only for large endowments</u> – not for the rest of us.***

The bottom line

- ***Investors face a "New Normal" of diminished returns.***
- Economic growth has slowed throughout much of the world, so ***investment returns are likely to be lower than in the past.***

My latest book published by Wiley

Investing for a Lifetime

Managing Wealth for the "New Normal"

1) *Saving and Investing*
2) *Choosing a Portfolio*
3) *Wealth Management*

Also see my website

richardcmarston.com