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VIEWPOINT

ASSET ALLOCATION – APRIL 2015

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Continued slow economic growth and the impact on asset allocation

There has been a good deal written about the low growth environment and associated low interest rates. Interest rates are extraordinarily low in both real and nominal terms, and the move lower has been accompanied by booming asset prices.

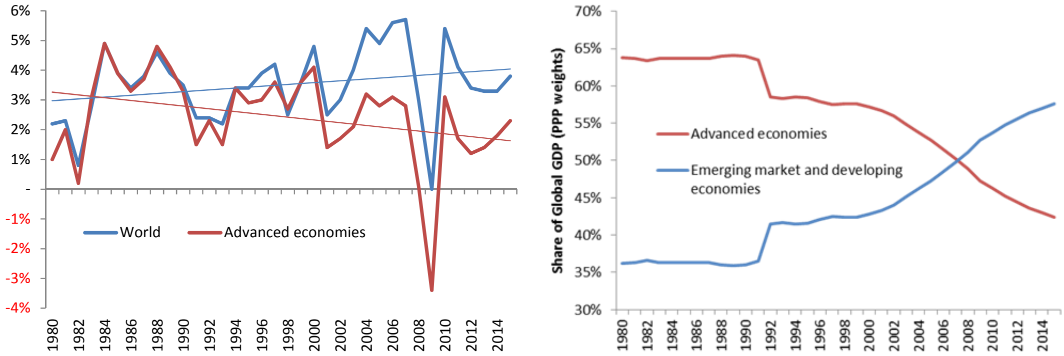
The Bank of International Settlements has been only the most prominent of the many critics warning that central banks are inflating asset prices irresponsibly and in so doing, they set the scene for likely financial instability.[1] Furthermore, the lack of inflationary boom associated with ultra-low rates in the West has prompted serious policymakers, academics and industry figures to ponder whether we have entered an era of Secular Stagnation. By contrast, I will argue that economic growth has been strong rather than subdued, and that the sustained fall in interest rates and rise in asset prices is not only consistent with this interpretation but have, furthermore, been driven not principally by central bank policy but rather by economic developments. To connect these statements we need to consider the way that the world has globalised over the past thirty years.

Asset prices are a function of two things: 1) the size of future cash flows attached to an asset; 2) the discount factor attached to these cash flows. This is a useful tautology to bear in mind when looking at the way in which changes in economic developments have affected asset prices.

Global economic growth has been strong. It has, if anything, been stronger in the period since 2000 than in the two decades preceding it (Chart 1). However, economic growth of the advanced economies – a category that includes the United States, the eurozone, Japan and the United Kingdom – has weakened over the same period. And this is despite – some would say because of – rising levels of debt as well as lower monetary policy rates that might serve to reduce future growth for present growth.[2]

[1] See Bario, Distayat & Julesius 2013 for an extremely thoughtful analysis.
[2] See Chapter 4 BIS 84th Annual Report 2014.

Charts 1 & 2: Global & Advanced Economy Economic Growth 1980-2015; Advanced and Emerging Economies Share of Global Economy 1980-2015

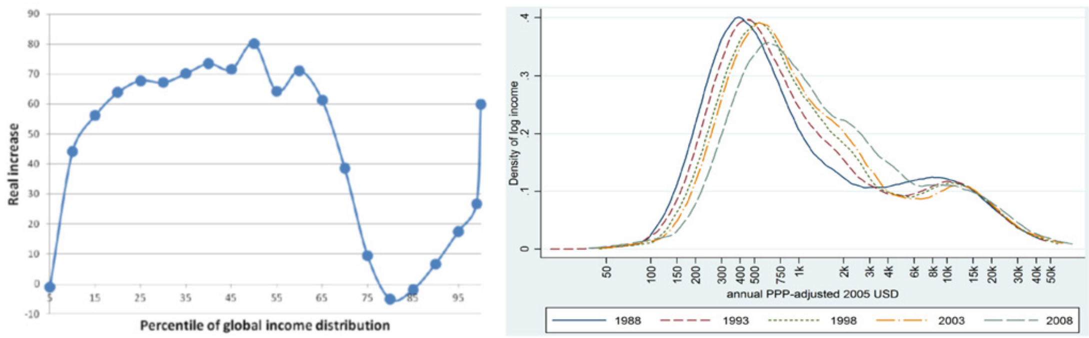


Source: IMF, March 2015.

What we have witnessed is a change in the composition of global growth, which looks like a trend decline only from the perspective of the introspective developed market observer. Chart 2 shows how this transition has developed over the past thirty-five years – an extraordinary time in the global economy during which we saw the fall of the Berlin Wall, barriers in the global trading system torn down, and the associated rise of China.

Real income gains amongst the world's poor have been startling: more people have moved out of poverty more quickly than at any time in human history. But while the world economy has grown markedly, the gains of globalisation have not been shared with uniformity. Chart 3 shows the distributional developments using household level data constructed by the World Bank. Four features are striking: firstly the biggest winners have been the 'global middle' which is largely accounted for by China's meteoric rise; secondly, the very top of the income spectrum has done almost as well as the global middle; thirdly, there is a hard core of poverty that has not been touched by globalisation at the very bottom of the income spectrum; fourthly, and most interestingly, there is a large section of people who are well-off in global terms who have largely not participated in global growth over the past twenty years. That section is populated largely by the Western lower middle and working classes.

Charts 3 & 4: Change in real income 1988-2008 at various percentiles of global income distribution (2005 PPP USD); global distribution of income over time – logarithmic scale, population-weighted



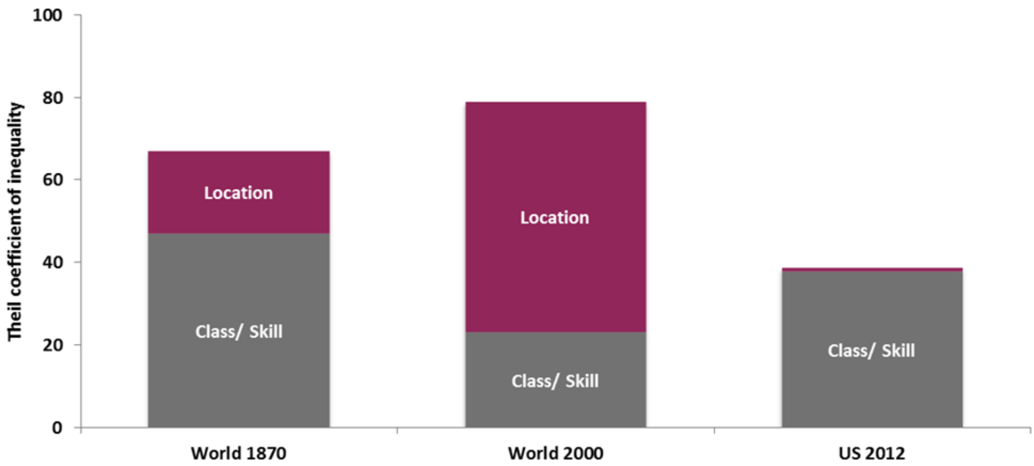
Source: Milanovic (2012); Lakner & Milanovic (2013).

Why have Western lower middle and working classes been left behind? I would suggest that it is part of the global labour market arbitrage/convergence trade that has fuelled income developments at the top and the middle of the income distribution. Marxist-Leninists would call this section of the global population the ‘Labour Aristocracy’: these are people who probably don’t feel well-off in their home countries.[3]

This convergence trade can be seen clearly in Chart 4. It shows a rolling avalanche of labour supply over the 20 years to 2008 – and the extraordinary move out of poverty on the part of developing country populations, with the modal real income per household increasing from just under $400 per annum to just under $700 per annum. Under globalisation, location becomes less relevant to household income, while skills and endowments become more important. When is this convergence trade over? If we need to wait until people’s incomes are associated with their skills we probably have a long way to go.

In the Nineteenth Century dying of hunger was not the preserve of those in the less developed world. You could do it anywhere. Karl Marx’s *Das Capital*, the first volume of which was first published in 1867, resonated with people in a way that it doesn’t today. This was because class/ endowment largely determined your place in the global income hierarchy; location was less important.

Chart 5: Level and composition of inequality in 1870 and 2000: World (disaggregated by countries) and the United States (disaggregated by States)



Source: Milanovic (2012), Hisnanick & Rogers (2007), Columbia Threadneedle Investments March 2015.

Things have changed, and radically so (Chart 5). The main determinant of your income at the beginning of the twenty first century is the country in which you were born. The huge ‘citizen’s premium’, enjoyed by citizens of rich countries, has been more recently challenged by globalisation, particularly since the fall of the Iron Curtain and advent of China to the global trading system. Understanding the importance of this challenge is central to understanding asset price and debt stock developments over the past thirty-five years and taking a view as to where we are on the journey to globalisation is crucial if we are to peer into the future.

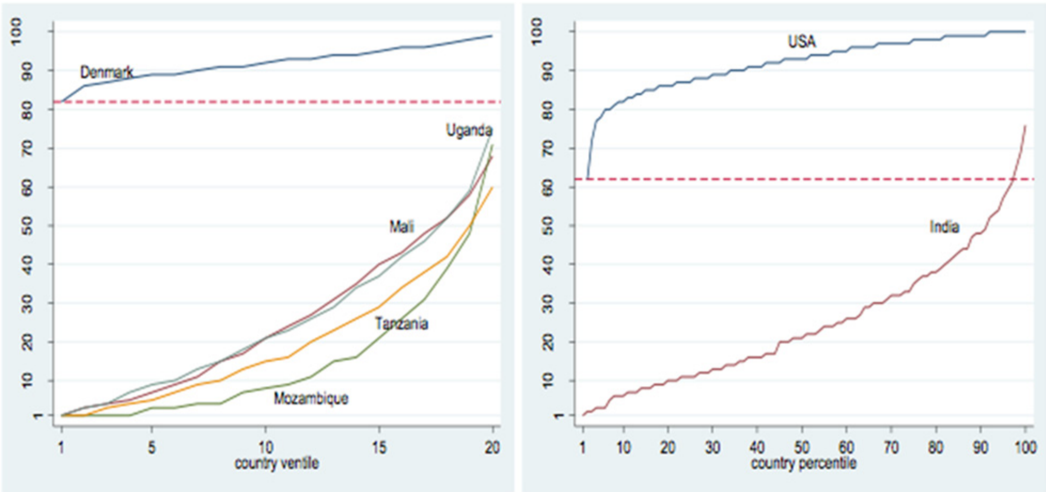
How might the future world look if this were to continue? Let’s compare the World in 2000 to the US in 2012. The US is typically thought of as a very unequal place – and it’s true that the Gini and Theil coefficients of inequality are higher in the US than almost anywhere else in the developed world. But compared to the world at large, the US has very low levels of inequality.

[3] Lenin (2010) being the classical example.

Within the US there are rich states and poor states. But in disaggregating the Theil coefficient of inequality we can see that location plays a very small role in your likely level of US household income. Things like inheritance (broadly defined), and the skills you acquire are much more important. If globalisation is to succeed, the world should look a lot more like the United States – and the mission to make it so is an amazing one.

The future could look, politics permitting, a lot like America, but we are a long way from getting there. A couple of quick examples: the poorest Danes are better off than the richest sub-Saharan Africans; most of India's higher earners earn less than the minimum wage in the United States (Charts 6 and 7). This becomes tested in a globalised world.

Charts 6 & 7: Denmark vs Selected African Country household income ventiles; United States vs India household income percentiles



Source: Milanovic (2011).

In a globalised world the vestiges of geography are being challenged, leaving developed countries with a quandary: should they drop the safety nets that they have spent decades constructing to ensure domestic harmony and allow wages to collapse at the bottom of their own income distributions, or should they invest more in education to equip their populations to be the middle and upper management of the globalised world? It could be argued that the cosmopolitanism of globalisation attacks the State's communitarian *raison d'être*, and that the increase in government debt and political heat around economic immigration is the result. As income inequality in the West has increased so the role of the State has changed: in 1980 a median quintile US household would be paying twice the amount of federal taxes as they received in transfers, but by 2010 this ratio had reversed.

With the lower middle class and working class in the West comparatively left behind, income inequality in the West has risen. This has in turn informed the politics of protest, and fuelled interest in works such as Thomas Piketty's *Capital in the Twenty First Century* – a work that takes an introspective Western perspective in which inequality is increasing rather than a global perspective in which inequality has begun to fall. It furthermore mistakes recent returns to asset-holders as proof of structurally high discount rates rather, as we will now see, as a function of falling discount rates.[4]

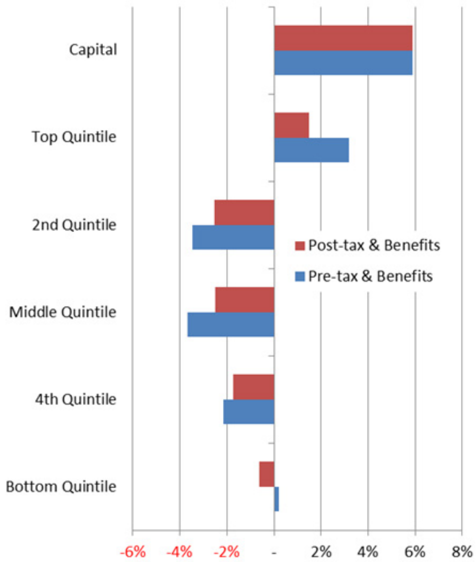
[4] This debunking of Piketty was first laid out in relation to housing in Bonnet, Bono, Chappelle, & Wasmer (2014).

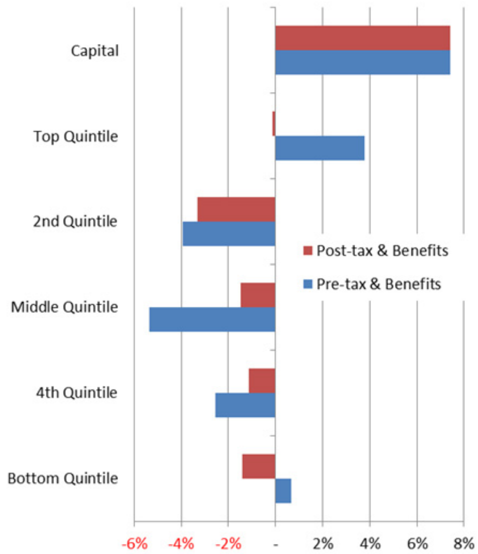
Asset market implications

The globalisation story to date has had two huge implications for asset markets. The first is in relation to how firms have responded to these changes. This is well known, informing pretty much every stock analyst report written in the past thirty years, so will not be covered here. The second is about the impact on the real rate of interest. This is less well understood, but much more important for asset allocators.

As central bankers have frequently reminded us, the neutral real interest rate is set by the economy, not by the central bank.[5] The globalisation of the economy and labour market convergence trade has been associated with a collapse in labour power in the West. When labour had power, the marginal costs of labour were high. As such there was a big incentive to invest in capital to substitute labour for capital, and this brought the cost of capital higher. As labour lost power, wage pressures in the West collapsed.[6] This led to a falling labour share of GDP, and this has been especially the case away from the top 20% of Western households (Charts 8 & 9).[7] With lower labour costs, a reserve army of global workers whose size grew as trade barriers dropped and emerging countries developed [8], companies have increasingly been incentivised to substitute capital for labour, reducing the requirement for capital, and bringing the cost of capital lower in the West.

Charts 8 & 9: Change in US (LHS) and UK (RHS) share of GDP, split by capital and labour income quintile 1980-2010





Source: Bank of England, Congressional Budget Office, Office of National Statistics and Columbia Threadneedle Investments, March 2015.

We have just outlined an argument that suggests that equilibrium interest rates would fall over

[5] See, for instance, Broadbent 2014 and Bernanke 2015 on the Wicksellian rate of interest in a contemporary setting.

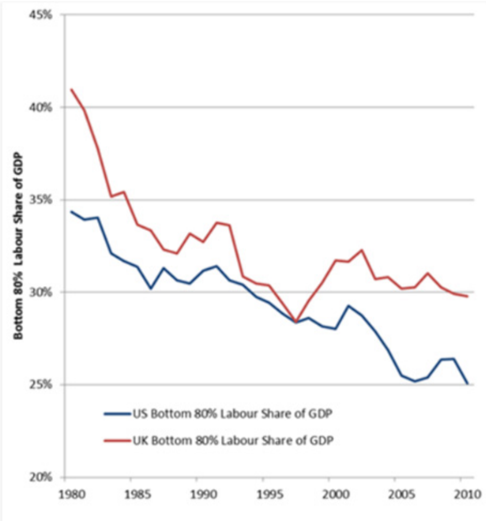
[6] Goodhart and Erfurth, 2014.

[7] It is interesting to note that three-quarters of the gain in share of GDP from top decile earners in the UK and about half of the gain in GDP share of GDP from top quintile earners in the US is redistributed down the income spectrum. Pre-distribution real income of the median US household is almost flat, but after the impacts of taxes and benefit changes are felt it is up nicely: participation in US economic growth for the masses has largely been manufactured by the State, somewhat in contradiction to the traditional narrative.

[8] In terms of education standards, governance systems, infrastructure etc.

the past thirty-five years. And indeed, the fall in labour's share of GDP has accompanied the fall in the real cost of capital (Charts 10 & 11).

Charts 10 & 11: US & UK bottom 80% labour share of GDP 1980-2010; 10-year US Treasury and 10-year Gilt minus respective 12-month changes in Core Consumer Price Indices



Source: Columbia Threadneedle Investments and Bloomberg, March 2015.

The fall in the neutral real rate of interest in the West has been textbook. It does not signify Secular Stagnation in economic growth rates, but instead the loss of labour power.

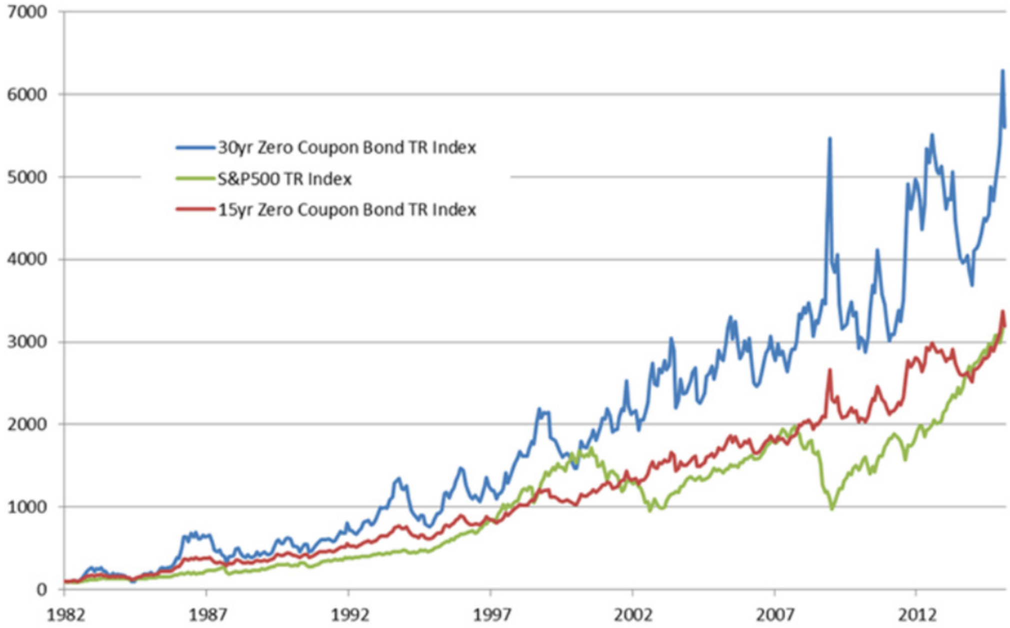
At the start of this viewpoint we stated that asset prices are a function of:

1. The level of future cash flows attached to an asset
2. The discount factor attached to these cash flows

As the neutral real rate of interest has fallen, so the present value of future promised cash flows goes up in value.

The blue line in Chart 12 shows the total returns associated with investing in 30-year zero-coupon US Treasury bonds, the red line shows the total returns from investing in 15-year zero-coupon US Treasury bonds, and the green line shows the total returns from investing in S&P 500 index. Over the past thirty-five years assets have rallied largely in accordance with their sensitivity to changes in the real rate of interest.

Chart 12: 15-year, 30-year zero-coupon US Treasury bond total returns versus S&P 500 index total returns, 1982-2015



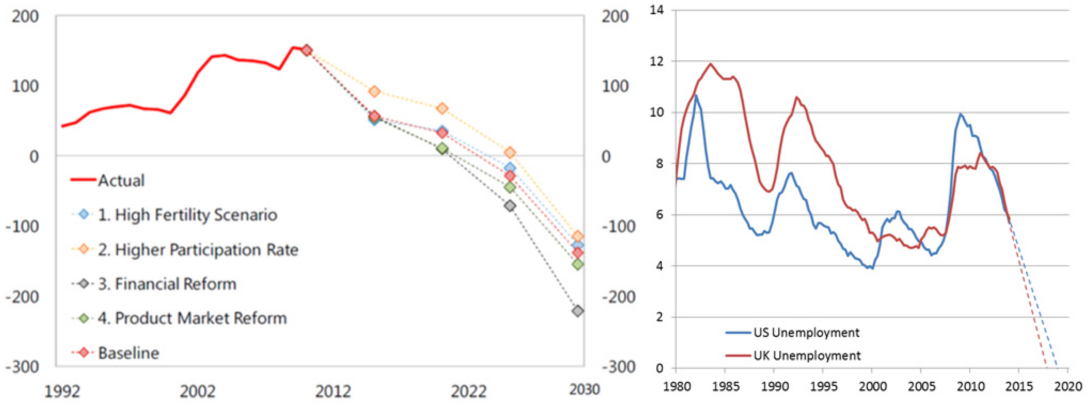
Source: Columbia Threadneedle Investments and Bloomberg, March 2015. Past performance is not a guide to future performance.

The negative asset market implications of slow economic growth in the West have been less important than the positive asset market implications of weak labour pricing power. That sentence is so important it is worth repeating: **the negative asset market implications of slow economic growth in the West have been less important than the positive asset market implications of weak labour pricing power**.

Under this thesis, what happens next to labour pricing power becomes extremely important. If labour market globalisation has so far been largely a China story, let's look at some IMF forecasts for surplus labour. The IMF believes that demographics and the emptying of cheap mobile rural labour are due to lead to labour shortages in around five years (Chart 13). So we're not there yet.

China does not make up the rest of the world. But the supply of cheap labour from the rest of the world into the global trading system is dependent upon governance – the delivery of higher education standards, the introduction of market-based economics, and the delivery of trade openness. It is unlikely to be a straight line.

Charts 13 & 14: IMF Scenarios for China surplus labour (millions); United States and United Kingdom unemployment rates 1980-2015 (and projected on last 12 month trends)



Source: Das & N'Diaye (2013), Columbia Threadneedle Investments and Bloomberg, March 2015.

Even if structurally, the rise of China and emergence of the world has fundamentally changed the bargaining power of labour in the West, cyclically, labour's bargaining power is likely to still be a function of labour scarcity.

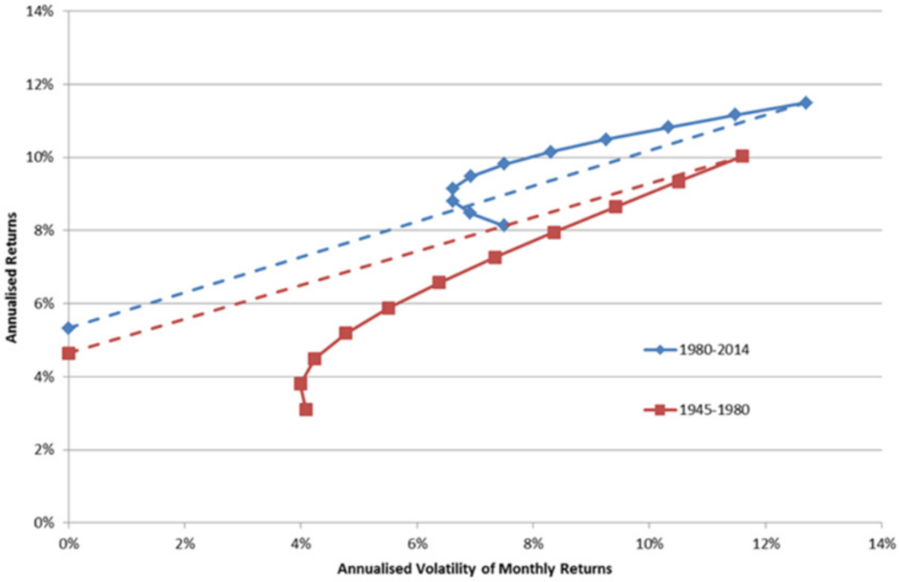
It is hard to call a turn in the pricing power of labour, and there has been no real wage response to date. But it is unlikely that we will need to wait until unemployment rates reach zero percent, and on current trajectories, they are on course to hit zero in the US and the UK by 2020 (Chart 14).

What this means for portfolio construction

If discount rates will be rising rather than falling in coming years, what does this mean for stocks and bonds?

If earnings are strong, the cash flows that are important to asset class pricing will be supportive, although the discount rate tailwinds will turn to headwinds. In an environment in which there are rising (Wicksellian) interest rates, and the starting points for yields is low, it is conceivable that cash will dominate as the efficient frontier becomes less curvaceous: returns to duration may be negative and at such low yields they stop providing portfolio insurance.

Chart 15: Ex-post efficient frontiers between government bonds and equities, and average cash rates, 1945-1980 and 1980-2014

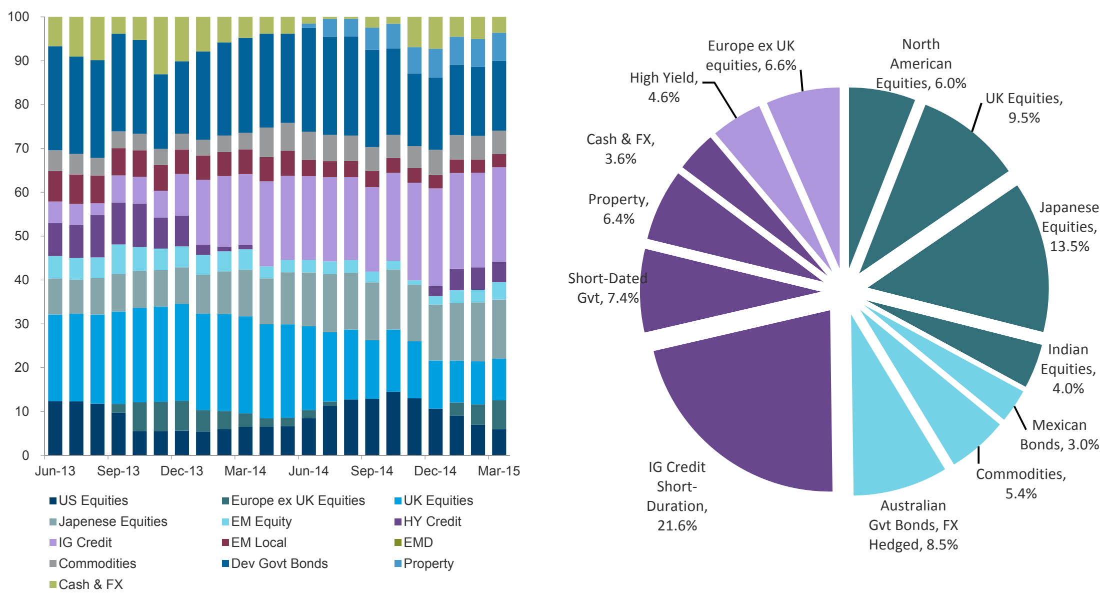


Source: Columbia Threadneedle Investments and Bloomberg, March 2015.

This was the case in the post-war period leading up to 1980 – a time during which labour power was rising in the West (Chart 15).

It is for this reason that we have espoused duration as a strategic position in the Dynamic Real Return Fund, and rotated across asset classes as the valuation case for each asset class has varied. A snapshot of the positioning as well as an evolution of the historic asset allocation is shown in Charts 16 & 17.

Charts 16-17: Threadneedle Dynamic Real Return Fund Historic Asset Allocation and End-March 2015 Asset Allocation



Source: Columbia Threadneedle Investments as at 31 March 2015.

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