Investment Implications of an Asynchronous Global Recovery

Unlike past recoveries over the last 20 years, we see the current one as highly asynchronous. Central to our thesis, we believe, is a unique set of macroeconomic factors coalescing around this recovery that are preventing it from creating the traditional virtuous cycle of improving demand in the developed markets leading to better growth conditions in the emerging markets. First, global growth is now coming from dramatically different constituents, and at the moment, it does not appear that there is enough EM consumption to offset the slowdown in DM consumption. Second, lack of wage growth in the developed markets is significantly affecting traditional consumption trajectories. Third, government spending, particularly in the developed markets, is being reined in. Fourth, productivity in both DM and EM countries appears to be waning in many instances. And finally, demographics are now challenging in many countries, which is directly affecting the rate of sustainable growth. Our bottom line: We feel strongly that the current breakdown in the traditional synchronous global recovery “investment playbook” could represent a potentially seismic shift in the way top-down macro investors think about traditional asset allocation decisions.

“...The bumps in the road just make the ride much more fun.”

ANONYMOUS
While the idea that “bumps in the road make the ride much more fun” can be applied to many aspects of life, macroeconomics is probably not one of them. In the United States, for example, 2Q14 GDP reached a robust 4.2%; in the quarter prior, however, GDP was actually negative 2.1%. Without question, we believe this type of economic “bumpiness” makes it hard for both consumers and corporations to experience the traditional economic benefits — including higher wages and business confidence — that typically boost growth during the middle to later stages of economic recoveries.

Importantly, ongoing deterrents to economic normalcy are not just a U.S. phenomenon, as we increasingly see more growth “bumpiness” outside the U.S. as well. Indeed, both India and Brazil are now running with tight monetary policy to dampen structural inflation, despite Brazil recently entering recession and India now growing at about half of its peak growth rate.

Our bottom line: We now see a global economic recovery that is highly asynchronous, with the traditional features of past periods of global growth not present in the same fashion as before. Driving our thinking is our strong belief that there is a unique set of macroeconomic factors coalescing around this recovery that is preventing it from creating the traditional virtuous cycle of improving demand in the developed markets leading to better growth conditions in the emerging markets. In the 1990s and early 2000s, by comparison, a notable acceleration in consumption by the developed economies, the U.S. in particular, boosted export activity in low-cost emerging market economies, which in turn stimulated internal demand in those same economies.

Beyond the changing economic trends we see, we also feel strongly that the breakdown in the traditional synchronous global recovery “investment playbook” could represent a potentially seismic shift in the way top-down macro investors think about traditional asset allocation decisions.

EXHIBIT 1
Developed Markets PMIs Have Rebounded Somewhat, While EM PMIs Remain Sluggish

EXHIBIT 2
EM Inflation Appears Too Hot, While DM Inflation Appears Too Cool

So what’s going on in the macroeconomic landscape that is preventing a synchronous global recovery from occurring? From what we can tell, there are — at least — five major factors that are injecting sand into the gears of the global economy. They are as follows:

1. The countries driving incremental growth in the global economy this cycle have largely nascent consumer economies. As we travel around, the lion’s share of business executives and government officials with whom we meet indicate that their countries are going to grow through increased competitiveness in their export businesses. The problem, though, is that somebody has to buy these products. In the past the United States consumer was happy to play that role. However, our global growth forecast suggests a global economy where almost 70% of total incremental global growth is now from the emerging economies, many of which lack the absolute consumption capacity — much less the access to credit — required to play the role of the world’s most important shoppers. All told, the U.S. and the European Union still have a combined consumption economy that is 3.2x the size of the collective BRICS (Brazil, Russia, India and China) consumer stories.

2. There is still no real wage growth in the developed economies at a time of increased focus on export-driven growth. The lack of real wage growth has been consistently denting the trajectory of this recovery more than many folks recognize. True, jobs are being added in the United States, but real wages in the U.S. have actually contracted since the recovery started in the second quarter of 2009. As a result, personal consumption expenditures are running at just 55% of the historical average in the U.S. Moreover, stagnation in real wage growth is occurring in markets at a time when many key inputs, including healthcare, food, and rent, are now outpacing inflation. A similar story holds true in both Europe and Japan. Making the situation even more problematic is that many countries are focused on exporting their way to growth. However, our work shows that, after rising...
3. Developed market governments are acting as drags, not catalysts, on GDP growth. After years of excessive borrowing and spending, governments are now being forced to tighten their belts. This is not new news as it was the linchpin to our original Insights piece in October 2011 (see Phase III: the Last Phase of a Bumpy Journey). However, even we underestimated how big a deal government deleveraging would be. In the U.S., for example, government spending has actually been contracting at an 1.6% annualized rate since the recovery started, compared to a positive 1.5% contribution to annual growth, on average, since 1950 (Exhibit 34). Europe is experiencing similar headwinds in this area, though the negative multiplier effect from government contraction is actually even more significant than in the United States.

4. Productivity is actually declining in many EM and DM countries. As we detail below, many high profile EM countries have seen notable declines in their productivity in recent years. In Brazil, for example, from 2003 to 2013 real wages rose by a full 27% in local currency, but labor productivity contracted by 8% cumulatively over the same period (Exhibit 43). A major issue, we believe, is that these countries did not invest enough in fixed investment, infrastructure in particular, as was the case during the China “growth miracle” at the turn of the century. Within the developed economies, productivity has also sagged of late. All told, real GDP per employee in the developed markets increased just 0.7% on average during 2012-2013, compared to developed market GDP growth per employee of closer to 2%, on average, before the financial crisis.

5. Less favorable demographics are challenging many key economies. If demographics are indeed destiny, then investors now need to start paying closer attention than before. In the United States, for example, the outlook for working-age population growth has fallen to 0.3% over the next five years versus 1.1% in the prior recovery. Without question, this decline presents a headwind to growth. Demographic trends in Europe, which collectively accounts for 24% of total global GDP, are even more concerning. Even China, which has accounted for one-third of incremental global growth so far this recovery, is now seeing a decline in its working-age population of five million people annually, which is essentially the equivalent of a Singapore every year. All told, aggregate global working-age population growth is expected to be just 0.2% on a GDP-weighted basis over the next five years versus 0.5% for the previous five years.

So, given what we now see as a structural inability for the global economy to deliver a synchronous recovery, we are increasingly confident that a dramatically differentiated investment toolkit may be required. First, we now think that investors must increasingly focus on investment opportunities in a country and/or sector where a clear competitive advantage can be built to drive above-average growth and profits. In Spain, for example, we believe the labor situation is unique. Specifically, a more flexible labor force is not only allowing Spain to add jobs at a distinctly lower GDP growth rate than in the past but also to meaningfully increase its export economy as a percentage of its GDP. All told, Spanish exports as a percentage of GDP should reach about 35% in 2014 versus 29% in 2000 (Exhibit 44). As we detail below, a similar story holds true in Vietnam on the export front. All told, Vietnam has seen its exports increase to a sizeable 83.9% of GDP in 2013 from 55.0% of GDP in 2000 (Exhibit 45).

Second, we currently favor reform-focused countries, particularly those where there is already sizeable internal demand. At the moment, India, Indonesia and Mexico all appear to fit this bill. Importantly, in addition to more pro-growth governmental policies, we also think that the central banks in these countries are doing a better job of managing inflation than in the past.

Third, we think that investors with patient capital should consider increasing their allocation towards countries with attractive demographic profiles – and hence, faster potential growth. This migration towards higher growth, less developed investment arenas is likely to be filled with challenging issues such as illiquidity, corruption and ease of doing business, all of which should all be considered. That said, if we are right about the composition and trajectory of global growth, then we believe more nascent markets such as Africa and the Middle East should now be considered.

Fourth, we think this slowdown, particularly on the emerging markets side, is going to create ample restructuring opportunities for investment managers that can help corporations navigate a slower and bumpier economic growth environment. Already, many banks in EM are now overweight with bad corporate credit. So, we see a growing role for private lenders and restructuring professionals to step in and provide value-added capital to struggling corporations – and the financial institutions that traditionally serve them – across a variety of sectors in the global economy.

Finally, if we are right that the global economy is recovering in a non-synchronous matter, then interest rates have the potential to stay lower than normal for longer, particularly in developed economies. Interest rate curves therefore should flatten, and central bank policy could rest at a much lower equilibrium than has been the historical average.

DETAILS

In the following section we detail the macro headwinds or “speed bumps” that we see preventing a synchronous global recovery from occurring.

Speed Bump #1: The countries driving incremental growth in the global economy this cycle have largely nascent consumer economies

At the risk of oversimplifying, we currently see a breakdown in the traditional relationship between producer nations and consumer nations. In the past the story was much simpler: U.S. consumers – and often their European counterparts – would buy cheap goods...
produced in emerging markets. This consumer/producer relationship worked especially well during the 1990s and 2000s. In fact, it worked so well that it became the ignition switch that helped fuel strong global growth, particularly when 1) credit in the developed markets was flowing easy; and 2) goods could be produced at significant discounts in the emerging markets, China in particular.

Today, however, the story is much more complicated, as growth appears to be coming from places with fairly nascent consumer economies. Just consider that China accounts for about one-third of total incremental global growth these days, though its consumer economy is only 35% of GDP versus 70% in the United States (Exhibit 3). Throw in the rest of its emerging market peers, and total EM economies now account for almost 70% of total annual global growth, with much of this growth coming from commodity and infrastructure-related growth initiatives.

EXHIBIT 3
China and Other Emerging Markets Will Make Up Nearly 70% of Global Growth in 2014

EXHIBIT 4
The U.S. Consumer Has Retrenched Since the Financial Crisis, So Now EM Consumption Must Drive Growth. However, Is this Achievable?

However, when we look at global consumer spending patterns in absolute terms, we get a wildly different story than the aforementioned one about incremental global growth coming predominantly from the emerging markets. As Exhibit 7 shows, the U.S. and European consumption economies in absolute terms still dwarf those of the emerging economies, the BRICs in particular. All told, U.S. and European consumption is still 3.2x the size of the collective BRIC consumption economy. So while the EM consumer story is a dynamic and compelling one, it is still in its early stages.
EM Economies Will Overtake DM Economies in the Coming Years…

<table>
<thead>
<tr>
<th>THE WORLD’S LARGEST ECONOMIES ($ TRILLION)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2010 GDP</td>
</tr>
<tr>
<td>----------</td>
</tr>
<tr>
<td>1 U.S.</td>
</tr>
<tr>
<td>2 CHINA</td>
</tr>
<tr>
<td>3 JAPAN</td>
</tr>
<tr>
<td>4 INDIA</td>
</tr>
<tr>
<td>5 GERMANY</td>
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<tr>
<td>6 RUSSIA</td>
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<tr>
<td>7 BRAZIL</td>
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<tr>
<td>8 U.K.</td>
</tr>
<tr>
<td>9 ITALY</td>
</tr>
<tr>
<td>10 FRANCE</td>
</tr>
</tbody>
</table>


Importantly, overall consumer spending trends in developed markets are quite sluggish these days. In fact, personal consumption growth in the United States during this recovery has expanded at just 3.7% on a nominal basis and 2.0% on a real basis versus 7.1% and 3.7%, respectively, on average since 1950. As such, personal consumption growth is now running at just 55% of the level achieved during the average economic recovery cycle since 1950. As part of this slower growth profile in the U.S., consumers have also been deleveraging. Not surprisingly, this credit downsizing affects overall buying power as well. All told, as Exhibit 8 shows, overall household debt as a percentage of GDP has fallen to 77% as at Q14 from 96% in 2007, while household debt to disposable income is now just 100%, down sharply from 127% in 2007. While these trends are positive for the long term, they obviously reduce short-term to medium-term growth of consumption spending.

U.S. Consumers Are Deleveraging, Which Is Adversely Affecting Demand

The former virtuous cycle of DM consumption and EM exports has become somewhat of a vicious cycle.
We See Few Offsets to Slowing DM Consumption as Many EMs Have Yet to Increase Their Leverage Profiles

Similar to the situation in the United States, Japan and Europe have large consumption economies that are growing only modestly these days. As Exhibit 10 shows, real personal consumption in Japan has expanded at just a 1.1% growth rate, or only 48% of its pre-financial crisis historical annualized growth rate. Meanwhile, in Europe consumption growth trends are even more sluggish. Indeed, as Exhibit 11 shows, real personal consumption has actually contracted by 0.1% since 2009, compared to an historical annualized growth rate of 2.0% from 1995-2008.

Our bottom line is that the virtuous cycle that previously existed between producing nations and consuming nations is no longer working as it did in the past. In particular, we now see diminished buying power from the developed economies at a time when the emerging markets, China in particular, are not yet positioned to take up the slack on the consumption front. This downdraft is also occurring at a time when 1) real wages in emerging markets are soaring, which makes many EM countries less competitive on the export front (Exhibit 12); and 2) consumers in the developed markets are eschewing their traditional playbook of a “lever up and spend” mentality for the first time in years. As such, the former virtuous cycle of growing DM consumption of EM exports has now become somewhat of a vicious cycle of DM austerity and EM export headwinds (Exhibit 14).

Global trade is no longer the growth engine it once was.
Real Wages in Emerging Markets Are Soaring, Which Is Affecting Export Competitiveness

**Exhibit 12**

2014 Real Wages, % Increase, Y/y

<table>
<thead>
<tr>
<th>Country</th>
<th>2014 Real Wages, % Increase, Y/y</th>
</tr>
</thead>
<tbody>
<tr>
<td>Taiwan</td>
<td>0.7</td>
</tr>
<tr>
<td>Brazil</td>
<td>0.9</td>
</tr>
<tr>
<td>Mexico</td>
<td>1.7</td>
</tr>
<tr>
<td>Korea</td>
<td>2.0</td>
</tr>
<tr>
<td>Chile</td>
<td>3.1</td>
</tr>
<tr>
<td>Singapore</td>
<td>7.3</td>
</tr>
<tr>
<td>Indonesia</td>
<td>8.4</td>
</tr>
</tbody>
</table>


China’s Exports Have Seen a Dramatic Slowdown

**Exhibit 13**

China: Monthly Exports Y/y

- May-10: 48.3%
- Feb-14: -18.1%
- Jul-14: 14.5%
- Jul-14: 3.7%

Data as at July 31, 2014. Source: China Customs, Haver Analytics.

We also favor countries where there are political and central bank initiatives often working together to drive broader reform and growth.

DM Belt-Tightening Has Become a Headwind to Trade-Driven EM Growth

**Exhibit 14**

EM Exports, % of GDP (Left Axis)

DM Gross Savings, % of GDP (Right Axis, Inverted)

Data as at April 8, 2014. Source: IMF, Haver Analytics.

Speed Bump #2: There is still no real wage growth in the developed economies at a time of increased focus on export-driven growth

If an investor wanted to be optimistic about the outlook for growth these days, there is plenty to which he or she could point. As of the end of August, for example, the United States was adding more jobs to the economy than at any time since 1999, which was a pretty heady time in the global growth scene. Moreover, as Exhibit 16 shows, lending has just started to accelerate meaningfully. That’s the good news.

2014 Is on Pace to Be the Strongest Year for Job Generation Since 1999

**Exhibit 15**

U.S. Monthly Average Nonfarm Payrolls (000s)

U.S. Loan Growth Has Accelerated Meaningfully in Recent Months

The bad news is that, even with strong lending, more jobs and record net worth in the United States, there remains no real wage growth. As one can see in Exhibits 17-18, U.S. employees have not enjoyed any economic benefits relative to either higher inflation and/or higher corporate profits since the recession ended in 2009. This lack of real wage growth in developed markets is significant because it is badly denting the ability of consumers to get ahead, feel confident, and spend more.

Since 2000, U.S. Real Wage Growth Has Averaged Only 0.4% Year-Over-Year

Beyond sluggish wage growth, we also see other factors at work that we believe should give global growth bulls reason to pause. Specifically, recent increases in inflation, including higher food prices, higher rental prices, and higher medical costs are now more than offsetting any annual improvement that an employee might see (Exhibits 19-21). So, unlike in the past, when inflation was often driven by robust wage growth (Exhibit 22), the inflation uptick this cycle is actually linked to areas of the economy that are acting as long-term deterrents to consumer spending.

Food Prices Have Jumped, Driven by Meat Prices (Beef & Pork Supplies Are Quite Tight)
Landlord Pricing Power Continues to Build, as New Housing Supply Remains Scarce

U.S. Rent CPI, Trailing Three Months @ Annualized Rate


Medical Inflation Is Reaccelerating, Post the Obamacare-Driven Dip

U.S. Medical Care CPI, Trailing Three Months @ Annualized Rate


In Europe, a similar story of lackluster wage growth and “bad” inflation inputs are playing out too. As Exhibit 25 shows, energy costs are higher in Europe than in either the U.S. or China. With Russia and Ukraine now at odds, this situation has the real potential to get worse, not better, in our view. Meanwhile, with both the public and private sectors repositioning themselves to be more efficient and competitive, downward pressure on wages remains significant. As such, one can see in Exhibits 23-24 that real wages are now stagnating — and even falling in many instances — throughout Europe, a trend that is unlikely to reverse soon.

This lack of real wage growth in developed markets is significant because it is badly denting the ability of consumers to get ahead, feel confident and spend more.
Both Nominal and Real Wages in Spain Have Declined Significantly

**Exhibit 23**

Spain: Unit Labor Cost (SWDA, 2005=100)


Except for the Jump Due to Reunification, German Wage Growth Has Remained Sluggish

**Exhibit 24**

German Real Wage Growth (%)

Data as at December 31, 2013. Source: Deutsche Bundesbank, Haver Analytics.

Real Wages in Japan Have Actually Declined Since Abe Took Over

**Exhibit 26**

Japan: Real Wages Y/y (%)


Japan too is dealing with “bad” inflation. As Exhibit 26 shows, real wages in Japan have plummeted in recent quarters. While a weak yen helps to stimulate growth in exports, it also leads to higher input prices, including fuel costs. As such, after adjusting for inflation, Japanese workers are actually now earning less than they did when Prime Minister Shinzo Abe took control of the political reins.
No doubt, policymakers around the developed world are aware of the headwinds consumers face, but in many cases their hope is to make “lemonade out of lemons” by framing stagnant wages in terms of increased global competitiveness that will help boost net exports. Some countries will no doubt be successful (as mentioned above, we are positive about Spanish and Vietnamese exports), but what is logical for a particular single country cannot be logical for every country. Why not? Because somewhere, a consumer should stand ready to buy what a worker produces for export. But with little wage growth and a higher cost of living, the ability to make that purchase has gotten harder – not easier – since the recovery began.

Consequently, global trade is no longer the growth engine it once was. See Exhibit 27 for details, but after rising rapidly from 1986-2008, global exports are now stagnant as a percentage of global GDP. This lack of growth is a big deal, particularly as it is occurring at a time when more and more countries are looking to fix their economic imbalances through increased exports.

EXHIBIT 27
The Big Headwind: Global Trade Is No Longer the Growth Engine It Was in the Past

Our bigger picture view is that the lack of real wage growth in the developed markets represents a major deterrent to global growth. Indeed, even with monthly job growth in the U.S. now solidly above 200,000 and net worth at record levels, developed market consumers are not buying enough goods to fuel the virtuous global growth cycle that often occurred in prior recoveries. Moreover, because of higher input costs in healthcare, shelter, and food, many consumers in the developed markets are actually falling behind on a net basis. As such, even with rising asset prices, many consumers remain less inclined to increase purchases and/or take business risks than they were during prior synchronous recoveries.

EXHIBIT 28
...And It Is Impacting Global Growth at a Time When Countries Are Trying to Export Their Way Out of Domestic Imbalances

Our bigger picture view is that the lack of real wage growth in the developed markets represents a major deterrent to global growth. Indeed, even with monthly job growth in the U.S. now solidly above 200,000 and net worth at record levels, developed market consumers are not buying enough goods to fuel the virtuous global growth cycle that often occurred in prior recoveries. Moreover, because of higher input costs in healthcare, shelter, and food, many consumers in the developed markets are actually falling behind on a net basis. As such, even with rising asset prices, many consumers remain less inclined to increase purchases and/or take business risks than they were during prior synchronous recoveries.

Speed Bump #3: There is a less favorable demographic outlook

While my formal economics training pales in comparison to that of many folks on my team, I did learn enough at the University of Virginia and the Wharton School of Business to fully appreciate that – besides productivity – population growth is a critical input to forecasting long-term GDP growth.

To be sure, demographic stories rarely make the cover of tabloids like the *New York Post* or London’s *Daily Mail*, but the truth is that demographics are having a significant impact on GDP growth. In the United States, for example, working-age population growth is expected to be just 0.3% annually over the next five years. This contribution is down substantially from the 1.1% annual growth in the U.S. working-age population during the economic expansion from 2002-2007. Given annual GDP growth that has only been 1.3% on average since 2009 and is expected to grow only 2.7% per year in the coming five years, this downturn in demographic growth is substantial (Exhibit 29).
A Broad-Based Decline in Demographic Trends Is Now Affecting Global Growth in Many Instances

Importantly though, this story is not specific to just the United States. As one can see in the World Bank’s estimates in Exhibit 30, major global markets such as China, the Eurozone (Germany in particular), and Japan are all expected to see reductions in the sizes of their labor forces. The net effect is that aggregate global growth will fall to a paltry 0.2% on a GDP-weighted average basis over the next five years versus 0.5% for the previous five years.

Our bottom line is that the virtuous cycle that previously existed between producing nations and consuming nations is no longer working properly.
A related point, illustrated in Exhibit 31, is that there is almost nowhere to hide from this trend of declining demographics, as the phenomenon of the retiring baby boom generation is pervasive. Indeed, of the 50+ economies we surveyed, there were only four where the World Bank expects any acceleration at all in working-age population growth over the next five years versus the past five years. Moreover, those accelerations are strikingly modest, being on the order of just 10-20 basis points.

Importantly, many of the most blessed demographic countries shown in Exhibit 30 display important investor challenges. In fact, according to the American Enterprise Institute, the triumvirate of sub-Saharan Africa, Pakistan, and Bangladesh could generate nearly half of the world’s growth in working-age manpower over the next two decades. This outlook is significant for investors as many frontier markets have nascent capital markets with limited liquidity and breadth, while others are often heavily linked to commodity prices and related activities. Moreover, as Exhibit 33 shows, many of these countries can be tough places to do business.

EXHIBIT 32
The Fastest Growing Populations Are Now in Africa and the Middle East

Looking at the big picture, global growth is losing its “bird in the hand” as demographic forces are now reaching a point where they contribute increasingly little to GDP growth. Without question, this slowdown represents a major change over previous recoveries, and we view it as a headwind that may still be under-appreciated by many in the investment community. To be sure, there are still countries with compelling demographic profiles, but many of them require a higher cost of capital and improved skill sets for generating returns. The bottom line is that the demographic slowdown suggests that many traditional developed economies will now need to rely on increased productivity and/or a change in immigration policies just to maintain past growth rates. This transition certainly is possible, but it is likely to be – at a minimum – bumpier than in the past, and it will take place at a time when heavy social expenditures are already weighing on many economies.

Speed Bump #4: Government contribution to GDP is now much diminished

“A government big enough to give you everything you want is big enough to take away everything you have.” Attributed to Thomas Jefferson

Well, I am not sure even Thomas Jefferson could have anticipated what is going on with the role of government in the developed markets in recent years, but I am sure he would certainly find it as remarkable as we do. Just consider that the Fed now has a $4 trillion balance sheet, the U.S. government now has $17.7 trillion in outstanding debt, and government spending has topped out around a lofty 40% of U.S. GDP (which looks low only relative to Europe, where the equivalent number is 50%). However, because of fiscal...
austerity, the contribution to economic growth of U.S. government spending has actually turned negative. In fact, since this recovery began, the U.S. government has contracted by 1.6% on average each year versus its historical average of expanding by 1.5% on an annual basis. One can see this in Exhibit 34.

**EXHIBIT 34**

Relative to History, U.S. Government Consumption Is Lagging

![Graph showing U.S. Annualized Real GDP Growth (%)](image)

- Post 1950 Average
- Post 1980 Average
- Current Recovery

Real GDP Real PCE Real Investment Real Government Real Exports


**EXHIBIT 35**

A Similar Story Is True on the Job Front, As Government Downsizing Has Affected Employment Trends

![Graph showing U.S. Cumulative Payroll Growth (thousands)](image)

- Post 1950 Average
- Post 1980 Average
- Current Recovery

Total Private Govt

Data as at June 30, 2014. Source: Federal Reserve Board, Haver Analytics.

**EXHIBIT 36**

Fiscal Austerity in the United States Has Significantly Affected U.S. GDP Growth

<table>
<thead>
<tr>
<th>Year</th>
<th>United States: Fiscal Expansion/(Consolidation), % of GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>2011</td>
<td>-1.4</td>
</tr>
<tr>
<td>2012</td>
<td>-0.9</td>
</tr>
<tr>
<td>2013e</td>
<td>-2.0</td>
</tr>
<tr>
<td>2014e</td>
<td>-0.7</td>
</tr>
</tbody>
</table>


**EXHIBIT 37**

A Similar Story Holds True in Europe

<table>
<thead>
<tr>
<th>Year</th>
<th>Euro Area: Fiscal Expansion/(Consolidation), % of GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>2011</td>
<td>-1.0</td>
</tr>
<tr>
<td>2012</td>
<td>-1.4</td>
</tr>
<tr>
<td>2013e</td>
<td>-1.0</td>
</tr>
<tr>
<td>2014e</td>
<td>-0.5</td>
</tr>
</tbody>
</table>

Measured as change in general government underlying primary balance, adjusted for cycle and one-offs. Data as at December 31, 2013. Source: OECD Economic Outlook 94 Database.

Europe, too, has seen a notable change in the impact of government on its economic growth. Indeed, as one can see in Exhibit 37, fiscal austerity has been a significant drag on GDP, though – to the surprise of many – it has actually been less of an economic thorn in the side in Europe than in the United States. What has been more problematic in Europe, however, has been the fiscal multiplier effect. Specifically, whereas in the past, a one-percentage point con-
traction in the fiscal deficit traditionally led to a 50-60 basis point contraction in Europe’s GDP, in this cycle the “multiplier effect” has been much more damaging. As Exhibit 38 shows, it has been much closer to 1.5%, a nearly 3x increase.

EXHIBIT 38
Austerity Has Been Particularly Biting to European Economic Growth

Separately, while Japan’s growth has benefitted in the short term from Abenomics, the medium-to-long-term picture remains quite cloudy. In particular, the country’s fiscal deficit, which reached a whopping 9.3% in 2013, is a major concern. From our vantage point, the present deficit – coupled with gross debt of 244% of GDP – is unsustainable without some belt-tightening by the Japanese government in the quarters ahead9.

Looking ahead, we fully acknowledge that the government drag in the United States and Europe should begin to subside in the coming quarters. However, leverage in many countries is still at high levels (Exhibit 39), and we believe this will affect future growth rates as well as respective governments’ abilities to use tax dollars for forward-looking productive investments. Moreover, with social benefits such as healthcare starting to cost more due to a rapidly aging population, governments will have to look for new and innovative ways to avoid crowding out private sector growth in the years ahead. Japan, too, could see some growth relief in the near term, but the structural debt challenges it and the other developed economies face over the next few years are likely to lead to a smaller role for government spending, and hence, reduce overall global GDP growth.

Speed Bump #5: There has been a fall in productivity in several key EM and DM countries

Though emerging markets continue to grow faster than developed markets, the slowing pace of their growth has surprised many folks in recent years. Nowhere is this downshifting more visible than in the BRIC countries. One can see the magnitude of the declines in countries like Brazil, India, and China in Exhibit 40. So, what’s going on? Our travels and our research lead us to several conclusions. On the one hand, our research shows that productivity growth in China has moderated as the pace of urbanization has slowed (Exhibit 41). On the other hand, we link India and Brazil’s slowdown to failure to leverage the China growth dividend to reinvest in their core infrastructure. Beyond creating growth bottlenecks, lack of infrastructure investment has led to higher inflation. As a result, central bank policy in both India and Brazil is tight at a time when growth is slow. Without question, we think that central bankers in these countries are being forced to dampen demand until supply-side solutions can be implemented to boost growth without stoking higher inflation. Importantly, this strategy requires long-term patience as infrastructure bottlenecks take years, not months, to correct.

Given this “bumpy” macro backdrop, we think a different investment toolkit may be required.

9 Data as at June 30, 2014. Source: BOJ, Haver Analytics.
Looking ahead, there is the potential for some notable changes in productivity. According to the IMF, India, Brazil, and Europe are likely to see the biggest changes in non-labor contribution to growth over the coming five years. We agree on India, given its new administration and central bank head, but we remain much less confident on Brazil. Our visits to Brazil lead us to believe that lack of spending on infrastructure can’t be addressed overnight, and as such, we expect productivity to remain an issue.

**EXHIBIT 42**

We Worry the IMF Projections for Non-Labor Contribution to Growth Appear Too High in Places Like Brazil

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By comparison, we are more optimistic than the IMF on Mexico, as our research indicates that President Peña-Nieto’s reforms could lead to lower energy prices, more fixed investment, and strong exports. In Europe, we have somewhat of a mixed opinion. On the one hand, we think productivity should rise in Spain as labor reform is leading to a more flexible workforce. On the other hand, we think countries like Italy are likely to remain challenged from a productivity standpoint.

Investment implications of a non-synchronous global recovery

So with all this going on in the global macro environment, what are investors supposed to do? We still see a lot of compelling investment opportunities, but we do think that a more targeted approach is required now than was necessary in past cycles. First, we think that determining which countries are actually succeeding in the export game through more competitive wages, technological innovation, and improvements in industry expertise is hugely important in analyzing both macro and micro opportunities. At the moment, our research and our local presence in the various regions where KKR operates lead us to believe that both Vietnam and Spain are unique export stories worthy of investor consideration.

**EXHIBIT 44**

Spanish Exports Have Become a Key Driver of Economic Growth


Second, we think investors should think more about countries where internal demand is likely sustainable. Put another way, investors should consider focusing more heavily on countries where consumption growth in emerging markets depends less on economic rebalancing/deleveraging and more on just increasing GDP per capita. In concert with these criteria, we also think finding countries that are undergoing a central bank and/or political leadership changes are worth considering. At the moment, India, Mexico and Indonesia largely fit these profiles.

Third, we believe that investors should consider allocating a little more of their risk-seeking resources to countries that are enjoying demographic tailwinds. No doubt, the country risk premium for doing business in Ethiopia, for example, is dramatically different than that for doing business in the United States or Europe, but if investments are priced correctly, with the proper amount of running room on the liquidity front, there could be outsized returns in many instances. Importantly, not all frontier market-type investments need to be concentrated in just corporate equity positions, in our view. Rather, our observations from recent travels in Africa, Asia, and Latin America all underscored that there are significant opportunities in real estate, infrastructure, and energy for investment firms with industry expertise, a local presence, and patient capital.

Fourth, in today’s slower growth environment we believe investors must consider allocating more to the new opportunities “emerging” in several developing markets. Many of them relate to corporate restructurings and deleveraging stories. In many instances, banks are now carrying too much bad corporate credit and, as such, there is a growing role for private lenders and restructuring professionals to step in and provide value-added capital to struggling corporations across a variety of sectors.

In many instances these deals are large and complicated, requiring not only expertise in financial engineering but also in operational
capability. This insight is important, we believe, because many investment managers in emerging markets are currently set up to do public investing and/or private equity, but not the restructurings, recaps, and deleveragings that we think are needed. As a result, we think many firms, particularly in the alternative space, will be forced to overhaul their model. In particular, we think the ability to move up and down the capital structure and provide corporate partners with value-added financial and operational expertise, will go from being a luxury offering to becoming a prerequisite for success in the new era of EM investing we now envision.

Finally, a bumpier road for the global economy likely means lower interest rates for longer. We came into this year thinking 10-year yields around 3.0% were already near the high end of the range for 2014. However, even we have been surprised by the magnitude of the bond bull market so far, as U.S. 10-year yields have fallen 60bp year-to-date. There have been plenty of economic crosscurrents at work, but if we had to isolate just one factor that’s weighed most on yields, it would be the extent to which Europe has been acting as a global anchor. See Exhibit 47 below for details, but German 10-year yields have fallen fully 90 basis points in 2014 and now stand at a historic low of 1.0%. Given the ECB’s recent announcement surrounding direct market purchases, we think German yields may – at some point – fall even further in the future.

To reflect the effect of the evolving dynamics in Europe and its impact on global interest rates, we recently lowered our U.S. 10-year yield targets to 2.9% from 3.3% for year-end 2014 and to 3.5% from 3.9% for 2016 (Exhibit 49). Nonetheless, there is no change to our near-term assumptions regarding the Fed, which we continue to expect to begin hiking rates in September 2015. Instead, the key changes are in years 5-10 of our yield curve assumptions (Exhibit 50). The long end of the curve is where Europe has been exerting the most pressure on rates, a dynamic we expect will continue.
**EXHIBIT 48**

...While the U.S.-German Spread Is Near a Historic High, Which May Limit Treasury Yields From Rising Post-Tapering

**EXHIBIT 49**

We Have Lowered Our U.S. 10-year Yield Forecasts...

**EXHIBIT 50**

...Based on Lower Expectations for the Long End of the Curve

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“Key to our thinking is that there are a unique set of macroeconomic factors coalescing around this recovery that are preventing it from creating the traditional virtuous cycle of improving demand in DM leading to better growth conditions in EM.”
Conclusion

“Insanity: doing the same thing over and over and expecting different results.” Albert Einstein

If there is a single message that we think that macro folks and asset allocators can take away from this essay, we think it is that investors need to fully appreciate that to get good investment results this cycle a new approach will be required. Key to our thinking are the five “speed bumps” that we see as preventing a traditional, synchronous global recovery from occurring. We note the following:

• First, global growth is now coming from different countries than in the past. And at the moment, it does not appear that there is enough EM consumption to offset the slowdown in DM consumption.

• Second, lack of real wage growth in the developed markets is significantly affecting traditional consumption trajectories. Importantly, this headwind to growth is occurring at a time when input costs such as healthcare, food, and shelter are all climbing faster than wage increases.

• Third, government spending, particularly in the developed markets, is being reined in, and this is reducing both GDP and job growth.

• Fourth, productivity in both DM and EM countries appears to be waning in many instances. Some of this is related to China’s slowing growth, but other EM countries are also being adversely affected by lack of competitiveness, creeping technological obsolescence, and misguided fixed investment.

• Finally, demographics are now challenging in many countries, and they are directly affecting the rate of sustainable growth in those countries.

In this context, we think that investors need to modify how they pursue investment opportunities, particularly relative to past cycles. Without question, investors should brace for lower returns from both stocks and bonds. They should also brace for more political discord, as economic volatility is likely to inspire more political instability in both developed and developing economies. This inter-connectivity between economics and politics has already increased in recent years, but we believe it will continue to accelerate even faster in the quarters ahead.

Despite this somewhat unsettling macro-economic and geopolitical backdrop, we still see several significant investment trends that could yield outsized returns. For starters, we feel strongly that investors should focus more intently on markets where both the government and private sector are – in tandem – finding ways to successfully reposition a country’s economy. As we mentioned earlier, our travels lead us to believe that Spain and Vietnam are two countries that have built differentiated export economies amid volatile economic growth, though we fully acknowledge that there are certainly others worth pursuing as well.

We also favor countries where there are political and central bank initiatives often working together to drive broader reform and growth. India and Mexico both jump to the forefront of our macro research in this regard, but we are watching Indonesia closely too. Third, we are bullish on emerging credit restructuring opportunities. If we are right that China is structurally slowing amid a non-synchronous global recovery, then we believe that many companies in the emerging markets will need to restructure and/or recapitalize. Importantly, this opportunity set is emerging as many banks in the developing markets are increasingly full up with bad credits and high loan-to-deposit ratios.

Finally, given our outlook, we think interest rates will remain lower for longer, particularly in the developed markets. As such, investors are likely to continue to fuel the ongoing search for yield, which is constructive for private credit, high yield, and even growth-oriented dividend yielding stocks (see our piece Brave New World: The Yearning for Yield Across Asset Classes dated December 2011 for further details).
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