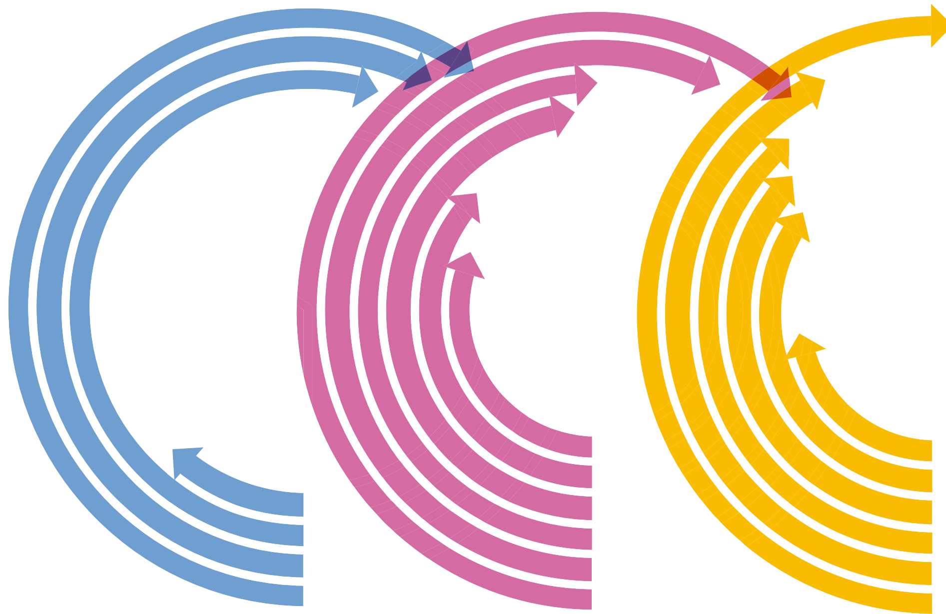
The Economist Intelligence Unit

A report from the Economist Intelligence Unit

The search for growth
Three roads to prosperity?



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1 Introduction

Institutional investors have had a bumpy ride for the last five years as policymakers scrambled to turn sinking economies around and promote growth. Governments in the US, Europe and Japan have responded in different ways to the 2008 financial crisis. Immediately following the crisis, all three reacted with a variety of monetary stimulus efforts, but they eventually diverged with different combinations of stimulus and austerity initiatives. In this mini-briefing paper, sponsored by BNY Mellon, The Economist Intelligence Unit (EIU) compares the fiscal and monetary actions taken and the results obtained thus far in these important economies. We ask institutional investors and economists about their views on these policy paths to draw out lessons learned and provide insight into what may be in store for global financial markets and what investment opportunities may arise in the year ahead.

By October 2013, Europe was showing tentative signs of recovery; investors were taking a closer look at Japan after a summer stock market sell-off; and the US housing, manufacturing and energy sectors continued to underpin the nation's economic resurgence. "I believe that the US economy, its financial system and banking industry averted a meltdown three to four years ago only by creating an unprecedented amount of liquidity," said Peter Scholla, founder of Global Investment Adviser, a US investment firm. "Today, we know

Year-on-year change in investor expectation for asset price growth since 2011
(% respondents)

Source: The Economist Intelligence Unit, January 2013 *Search for growth* survey of 730 institutional investors and executives

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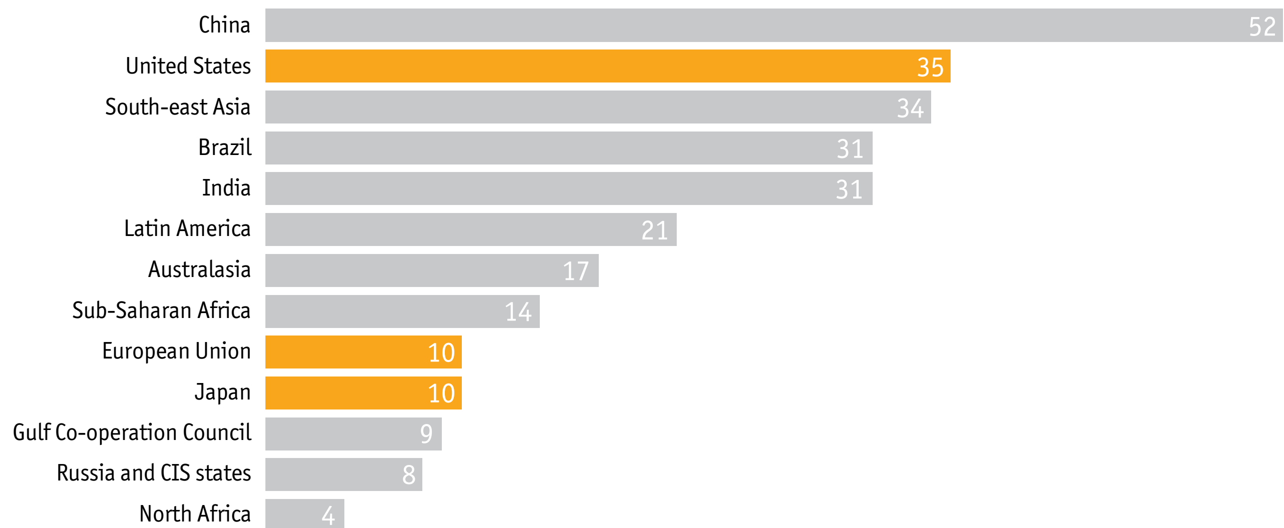
Which three countries/regions of the world do you think offer the best prospects for economic growth over the next 12 months
(% respondents)



Source: The Economist Intelligence Unit, January 2013 *Search for growth* survey of 730 institutional investors and executives

that America's strategy has worked. Japan is now following America's lead but the Europeans are far more cautious. Eventually, the European Central Bank will have to expand its balance sheet as well," he said.

Consistent with the findings from the EIU's January 2013 *Search for growth* survey of 730 institutional investors, sponsored by BNY Mellon, global investors remain bullish on the US and on China—despite forecasts that the Asian powerhouse's GDP growth could slow to between 6% and 8% a year. Overall, investor sentiment remains upbeat amidst global financial market volatility and developing markets' vulnerability to the US Federal Reserve's tightening of credit. At the start of the year, the majority of global investors expected global growth, choosing the US as the number one region for investment growth in 2013 while ranking China number one for economic growth. However, they expressed caution about the new policy shift in Japan and were pessimistic about Europe's prospects for economic recovery and asset price growth. ■

Who took the survey?

The survey questioned 730 executives worldwide. The respondents were based primarily in North America (29%), Asia-Pacific (29%), and Western Europe (26%), with the rest from the Middle East and Africa, Latin America and Eastern Europe. While the largest number of respondents came from the US (22%), 7% came from the UK and Canada, 5% from India, and 4% from each of the following countries: Australia, Brazil, China, Germany, South Korea, Japan and the United Arab Emirates. In total, investors and executives from 73 countries responded to the survey.

In terms of seniority, 52% were at the "C-suite" level, 23% at the director level and 26% at the managerial level. With respect to the size of the organisation, 50% were from companies with revenue of more than $500m per year, and 50% were from companies reporting less than $500m in annual revenue. The overwhelming majority (73%) of respondents came from the financial industry, with 11% from retail banking, 10% from asset management, and 9% from diversified banking institutions. Corporate banking, private equity/venture capital, financial services consulting and non-life insurance each represent 8% of respondents. A lesser number of responses were spread across other sub-sectors—such as wealth management, life insurance, real estate/leasing, broker-dealer and hedge funds. ■

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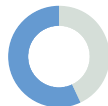
2 The US: taking the *easing* path

At the end of the third quarter of 2013, US manufacturing had grown for the third straight month, car sales were strong, housing prices were rising and manufacturing employment was on the upswing. The US economic turnaround is largely attributable to the Federal Reserve's (the Fed's) unconventional policy of pumping billions of dollars of liquidity into the global financial system since the beginning of the financial crisis.

The Fed's aggressive policy began in 2007 when the central bank began cutting official interest rates from 5.25% to 2% in a little more than eight months to ward off recession. Then, in September 2008, with Lehman Brothers' bankruptcy, the Fed injected massive amounts of credit into the economy by lending to banks, thereby doubling the monetary base in about four months. In March 2009, the Fed announced the first of its quantitative easing programmes (known as QE), which bought $1.75trn in mortgage-backed securities and longer-term bonds. QE1 was followed by QE2, where the Fed spent an additional $1trn on long-term securities while selling short-term securities. This policy was dubbed "operation twist". Finally, in September 2012, the Fed began QE3, spending close to $1trn to date on buying mortgage-backed securities and long-term bonds. The Fed is now considering reducing and eventually ending its

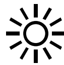
730 institutional investors from around the world judge the likelihood and impact on their portfolios of a series of scenarios including the one pertaining to the US below:

US manufacturing is revived by cheaper input costs (namely energy and labour).



57% think this scenario is very or quite likely.

68% think this scenario will have a **positive impact.**



26% think this scenario will have **no impact.**

7% think this scenario will have a **negative impact.**

Source: The Economist Intelligence Unit, January 2013 *Search for growth* survey of 730 institutional investors and executives

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bond buying programme—the uncertainty has kept global investors on their toes. In addition to unconventional bond buying policies, the Fed has also promised to keep official short-term interest rates low for the foreseeable future. Meanwhile, as a result of political wrangling and budget stalemates in Congress, the federal government has had no choice but to implement a programme of austerity. After using an initial spending package of $700bn in 2008 and then smaller packages related to job creation, the federal government has tightened fiscal policy since 2010.

Is the US policy approach that combined monetary expansion and fiscal contraction to be credited with sustained economic growth? While the US economy has returned to growth, the growth rate is lacklustre and employment figures remain weak. Indeed, two opposing views have been expressed on today's US economy. One view, espoused by some large institutional investors such as Pimco's Bill Gross, is that the US will remain stuck in weak growth for another five to seven years and returns on equities and bonds will be disappointing. An opposing view, which seems to be gaining ground, is that growth in the energy sector, high-tech manufacturing and a recovery in housing are creating the conditions for sustained economic growth that will continue to gain momentum over the next few years. "The view I call 'brilliant pessimism' hasn't been paying off," said Bill Smead, chief investment officer of US-based Smead Capital Management. "Many big institutional investors are overweight in bonds and underweight in equities and have been missing the big rally in the market," he said.

The strong US stock market has helped allay investor uncertainty. US equities are now favourites of global investors, helping to make stockholders feel wealthier and spend more. In addition, the recovery under way in home prices is creating a mild wealth effect. The wealth effect from stocks and housing is expected to continue as the Fed has promised to hold official interest rates low for some time.

As the housing, manufacturing and energy sectors continue to grow, consumer sentiment and spending have picked up—although jobs growth remains sluggish and continues to drag on the recovery. Moreover, investors still worry about how monetary and fiscal policy will affect growth. In addition, tight fiscal policy and continuing budget cuts are putting a drag on growth. What remains uncertain is whether the growth momentum under way in housing, manufacturing and energy will be enough to withstand the headwinds from tighter monetary policy as the Fed tapers QE3 and federal government spending cuts begin to be felt. The federal government shutdown that began in October and the impending 2014 deadline to raise the debt ceiling also have the potential to create turmoil in the financial markets. "Provided that the October 17 deadline is met," said Steffen Bassler, chief executive officer of the Swiss investment firm Allegra Partners, "we would expect more solid investments in the US as we believe the US dollar is undervalued, and that's what we're hearing from our clients." ■

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3 Europe: A dead-end street?

Signs of a pick up in manufacturing in Italy and Spain, stabilisation of manufacturing in France and stronger economic growth in Germany have fuelled hopes that the worst could be over for Europe. Optimism was reflected in stock market rallies in August and September and greater consumer and business confidence throughout the region. "The good news is that Europe is stable," claims Allegra Partners' Mr Bassler who is based in Zurich. "I am pretty positive on Europe. The economies of Germany, the UK, France and Switzerland are growing. And the German elections are a good sign for the stability of the euro."

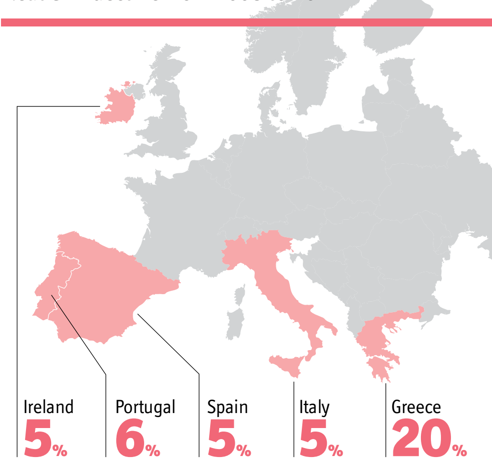
Still, the prevailing view among global investors remains that the European region has much work ahead and a recovery will require more stimulus from the European Central Bank while Spain, Portugal and Italy, among others, need to reduce budget deficits further.

Europe first turned to austerity in response to a growing sovereign debt crisis in the region. In the wake of the 2008 financial crisis, European governments stabilised the financial sector by bailing out banks and other financial institutions. As a result, governments assumed private sector debt and suddenly found themselves saddled with massive and growing public debt. For example, Greece's public debt levels peaked in 2011 at 180% of GDP.

The European nations that implemented austerity as a means to bring down national debt included Greece, Ireland, Italy, Portugal, Spain and France. Their modus operandi was to make severe cutbacks in government spending across the board, including such areas as government operations, defence, social welfare and health. In 2012, France elected a new government under President Francois Hollande. While he continued with austerity measures, he raised taxes on the wealthy in addition to implementing further government spending cuts. Germany and Austria, having escaped sovereign debt crises, were exceptions in the region and pursued moderate fiscal stimulus policies.

The short-term effects of austerity have been socially devastating. Joblessness, which was high

GDP
Real GDP decline from 2008 to 2012



Source: International Monetary Fund (IMF).

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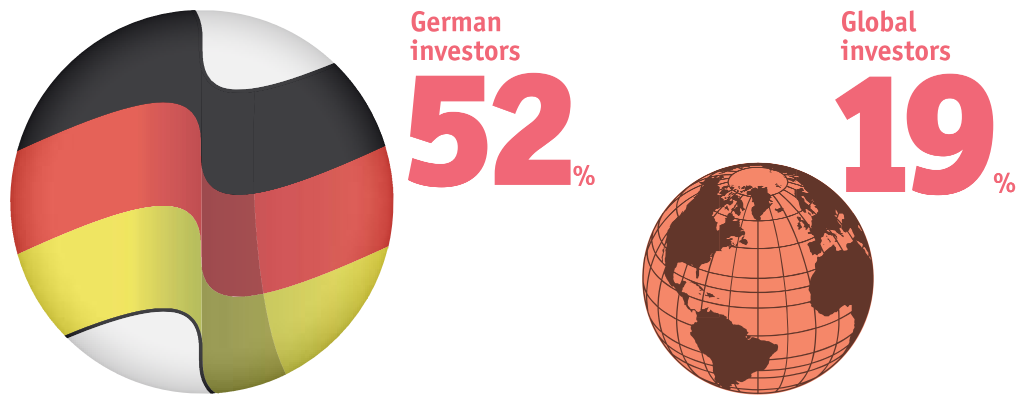
In January 2013, **German investors** expressed more optimism about the prospects for asset price growth in Europe this year than their global peers.



Source: The Economist Intelligence Unit, January 2013 *Search for growth* survey of 730 institutional investors and executives

before the crisis, became even worse. Greece and Spain have unemployment in the range of 25%; unemployment in the Eurozone is stuck around 12%. Making up lost ground from spending cuts introduced over the past few years is a Herculean task. According to a study from the IMF, after Greece introduced severe cost-cutting, its real GDP plummeted by 20% from 2008 to 2012. Portugal's spending cuts led to a 6% decline in real GDP over the same period, while Spain, Ireland and Italy all experienced 5% declines after turning to austerity. Making up those gaps in real GDP will not be done easily or quickly. France, second only to Germany in economic might, is showing signs of stabilising but business and consumer confidence remains anaemic.

The severe economic losses have added to rising income inequality in the region. Global investors are already very concerned about the economic implications of rising inequality in developed nations. A staggering 65% of investors who participated in the EIU's January survey agree that rising income disparities pose a threat to global capitalism. Record-high youth unemployment and anti-austerity protests have already fuelled growing violence and social unrest throughout Greece, Spain, Portugal and Italy. If these states' economies don't grow fast enough, global investors fear that social and political turmoil could undermine the region's chances for renewed prosperity. ■

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4 Japan: a short sprint or a race to the end?

"Abenomics", a stimulus plan on steroids proposed by Shinzo Abe, Japan's prime minister, has been in effect for close to one year now. The Keynesian-inspired plan takes a three-pronged approach to restore the Japanese economy through monetary, fiscal, and structural policies. It includes a stimulus package worth $210bn, of which half is devoted to infrastructure spending. The Bank of Japan has also doubled its inflation target to 2%. The goal is to increase GDP growth to around 2%, create 600,000 jobs and reduce national debt (which stands at more than 200% of GDP). "There's a lot of political coherence in Japan now that hasn't existed in a very long time," said Eric Lascelles, chief economist, RBC Global Asset Management, Canada. "That's allowed aggressive policy action."

The initial enthusiasm for Japan's policy shift seemed to wane over the summer as investors wondered whether Japan's outsized economic growth could be sustained. It is still too soon to judge whether the current policy approach will lift Japan out of its two-decade-long deflation era for good or whether the boost will be fleeting. Top investment houses in Japan hosted high-level investment conferences during September to convince global institutional investors that a lasting recovery was under way and to increase their investments in Japan. Japan's government also appears to recognise that, to achieve sustainable results, spending must be balanced by revenue, as evidenced by an October announcement of an imminent sales tax increase.

What are the results of Abenomics thus far? The yen has depreciated substantially against the US dollar, encouraging renewed confidence in Japanese manufacturing and exports. The yen's depreciation, which began last November, has led to a rise in corporate earnings and wages, helping to boost private consumption. Gains in the stock market earlier this year also helped by providing a wealth effect. Japanese industrial production, business and consumer confidence, business investment and corporate profits have all started to recover. For the first three months of 2013, the Japanese economy grew at an annualised rate of 4.1%, faster than any of the Group of Seven (G-7) leading economies, and by 3.8% in the second quarter. Sustained strong growth in the second quarter is an encouraging sign for investors that the benefits realised from the government's stimulus programme can be sustained. "Japan has delivered on its fiscal and monetary policy promises," said Mr Lascelles. "The last area is structural reform and we'll have to wait and see on that."

Global investors like Peter Scholla expect the excitement in Japan to continue for another 6-12 months and then wane. The challenge for Japanese officials will be to convince global investors that

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the government will pull out all stops to deliver results. The consequences of failure are too great to imagine. If the government spends billions of dollars without generating sustainable higher growth, debt will grow even more and Japan will be punished with higher interest rates—thus creating a vicious circle of ever-growing debt and lower growth. Abenomics, in many ways, is risking it all. If Japan succeeds, the rewards will be great. If it fails, there's no telling how bad things could get. ■

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5 Conclusion

The three different roads towards prosperity all lead to one destination: global financial markets. Global investment is the litmus test for how well fiscal and monetary policies are working. At any time, the global investor consensus can change suddenly and dramatically as new and unexpected events occur. This year, however, many of the key findings from our January survey of 730 institutional investors are still holding up as we enter the last quarter.

Global investors still view the US as the number one investment destination in the world. "As to future growth, our clients' (and my own) money is on the USA," said Mr Scholla. "Consumer and investor confidence in America is likely to improve further in 2013 to 2015, making America a preferred place for global capital. Once optimism about America's future returns, and once capital flows back into the US, it will be two, perhaps three, happy years. I expect GDP to grow at 2% above the annual rate of inflation."

As the Fed tapers its bond buying programme, bonds are expected to be increasingly unattractive in comparison with equities. Smead Capital Management's Bill Smead expects equities to

The three roads

The US economic turnaround is largely attributable to the Federal Reserve's (the Fed's) unconventional policy of pumping billions of dollars of liquidity into the global financial system since the beginning of the financial crisis. The government has also introduced significant spending cuts as a result of political wrangling and budget stalemates in Congress.

Europe turned to austerity in response to a sovereign debt crisis in the region, stabilising its financial sector by bailing out banks and other financial institutions. Saddled with massive public debt, across the board spending cuts were implemented and led to devastating short-term effects.

"Abenomics", a stimulus plan carried out by Shinzo Abe, Japan's prime minister, aims to increase GDP growth to around 2%, create 600,000 jobs and reduce the national debt. Short-term results have been positive but doubts remain about the long-term sustainability of the upswing.

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outperform as big institutions—caught underweight in stocks and overweight in bonds—begin to shift their holdings. At the start of 2013, Mr Smead observed that the bulk of endowments invested only 15% in US long-term equities. The rest of their portfolio was in bonds, commodities and emerging market assets. As emerging markets have been sold off in anticipation of the Fed's QE3 tapering, and US bond yields have risen, these investments will underperform stocks. "They invested assets based on the meagre growth view, the inability to get unemployment down and work down our debt," said Mr Smead. "But they are starting to regret it." Mr Smead expects the bond market to start to unwind decades of gains. "The next 30 years in the bond market will be the reverse of the last 30 years. Long-term bonds will be at 6% or 7% at the end of that. But it will be slow death."

Finally, China is still at the top of global investors' portfolios, although there are more questions and less exuberance about the Asian giant's prospects. Fears of problems in China's banking industry, a lack of transparency throughout the economy and slower growth than in recent years have combined to give investors pause. "China is still quite attractive," said Mr Scholla, "but if investors have to select between a better-managed, more predictable USA and a still-uncertain China, they will select the slower growing USA for their capital."

There is a partial verdict on post-crisis economic policy. In the eyes of global investors, the US has performed the best while the jury is still out on Europe and Japan. No doubt the year ahead will reveal more. ■

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