PERENNIAL VALUE MANAGEMENT

Perennial Perspective

The two BIGGEST questions

Brian Thomas

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Answering the two biggest questions affecting markets for the next five years and beyond: **why** do we have such sluggish World growth and **why** is there so much middle class "angst" in the developed World?

Why are these such big questions for investors?

If we are indeed stuck in some kind of prolonged economic stupor then interest rates will remain lower for longer and whilst this will partly justify property and share prices above long term averages, this lack of economic growth will continue to see tepid growth in company earnings. If on the other hand we are eventually to bounce back to a "normal" cycle, then demand and earnings will grow although most economists predict that inflation and therefore rates will remain subdued compared to previous cycles.

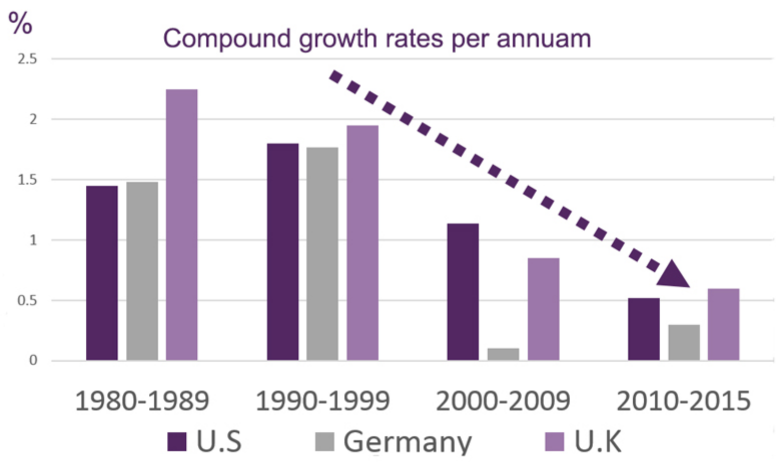
The other big question is more political in that it relates to the future voting intentions and Government policies (based on Brexit and the popularity of Trump) that could see the recent trends to free trade, open borders and globalisation suffer major setbacks (or U-turns in the extreme). Share market returns have been driven, not so much by Governments, but by global value chains selling into a globalised market fed by the internet.

Snail-paced growth

Despite massive Quantitative Easing (QE) and negative policy interest rates, economic growth is un-inspiring around the World.

The below chart shows the massive deceleration in compound GDP growth rates per employed person in the US, UK and Germany over the last four decades, even more surprising considering the 2000's included the GFC.

Chart 1. Real GDP per Employed Person



Source: IMF. World Economic Outlook Database. SED.

So what gives?

This has puzzled many leading economists with Harvard Professor, Gregory Mankiw and others suggesting some reasons as to why growth is so slow which I've summarised below:

Why is growth so slow?	Our Comment
1. **Method of measurement** – Gross Domestic Product (GDP), the generally accepted measure of growth,is a poor measure of the increasing quality of our lives and the things we consume and doesn't fully capture the benefits of the digital economy.	This newsletter has commented this issue previously (www.perennial.net.au/news - Deflecting deflation, Reflating Oil and Pumping Productivity) It is a key factor but is unlikely to be the major cause.
2. **Secular stagnation** – excess saving compared to investment brought on by ageing populations and the internet economy providing less need for traditional capital investments.	Larry Summers (Former Treasury Secretary in the Clinton Administration and one of America's leading economists) makes some important points on this issue.
3. **Bad Government policy** – Government stimulus post GFC followed by tax increases (e.g. US) and fiscal constraint to reign in rising Government debt.	Coupled with a lack of Government infrastructure spending this appears to be a large factor.
4. **Slower innovation** – does the digital revolution really compare to the past inventions of electricity, internal combustion engines etc.?	Personally I discount this one, particularly given the mass, global market the internet has created.

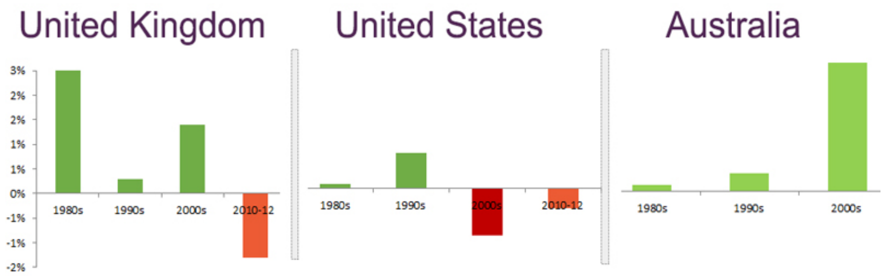
5. **Massive debt overhang**, both private and public debt is at record levels in most large economies.	Debt used for productive investments is good for an economy and there is considerable debate on what is "bad" debt and where we are at in the deleveraging cycle post the GFC. Certainly private debt in Australia is high compared to the rest of the developed world.
6. **Unproductive investment and crony capitalism** leading to an essential "mis-spending" of the massive influx of capital from QE programs ,particularly in emerging markets (Furman and Blundell-Wignall)	Similar to number two above, but coming from a different perspective on why there is excess effective savings, particularly given the poor Return on Equity on many capital investments.

It is clear from the above that there is not one answer but a combination of all of the above factors impacting the rate of growth, however an appreciation of the key arguments will help us understand how this could unfold in the next 5 years and beyond.

Middle class angst?

It's obvious from Chart 1 that GDP per employed person is falling and we all know that wages growth is next to non-existent however the next part of the question is, "who is benefitting from the spoils of the growth that is occurring?". Some believe in the so called "trickle-down" effect where inequality is just a feature of capitalism where entrepreneurs make the "pie" bigger for everyone. However economist Joseph Stiglitz and others are now saying that inequality is an important issue as "we need to focus not on what is happening on average – as GDP leads us to do – but on how the economy is performing for a typical citizen". The charts below, taken from a report on inequality by the Chifley Research Centre, show the growth in average income for the bottom 90% of people in the UK, US and Australia and perhaps goes some way to explaining Brexit and the Trump phenomenon. The last bar of the charts shows that in the UK and US the growth in income accruing to the bottom 90% of the population has not only fallen but dived into negative. Australia by comparison is performing relatively well, with the chart showing that Australia's average real income growth for those outside the top 10% growing substantially thus illustrating one reason Australia is such a great place to live!

Chart 2. Average real income growth of those outside the top 10%, by decade



Source: Perennial 2016, The World Top Incomes Database: http://topincomes.g-mond.parisschoolofeconomics.eu

Bottom 90 percent average income, Accessed July 2015.

Red colour indicates less than a full decade of data available.

All in all, these two issues provide some interesting food for thought.

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This article is an extract from Perspective.

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