Investment Insights

BNY MELLON
WEALTH MANAGEMENT

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Uneven global growth: What will it mean for central bank policy, the markets and investing?

The global economy seems to have lost some momentum. While the U.S. is showing signs of improving economic fundamentals, the same cannot be said for other corners of the world. The Eurozone and Japan are struggling to generate positive growth, while the economy in China is softening. In fact, concern about slower economic activity fueled an upsurge in market volatility this fall, as investors worried whether central banks would be able to navigate the slowdown and if ongoing geopolitical tensions would disrupt the recovery.

While uneven growth and inflation expectations will lead to less synchronized policies among central banks, we expect that the global economy will continue to grow at a moderate and sustainable pace. However, divergent growth trends are impacting currencies, interest rates and equity markets. Thus, it will be important to have the right strategies to maneuver through a changing environment, take advantage of opportunities being created and protect portfolios against potential risks.

U.S. Accelerates and Growth Abroad Slows

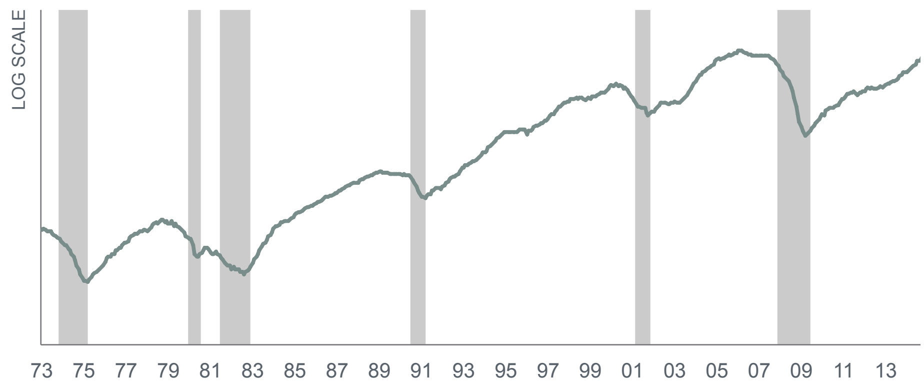
The uneven pace of global growth is becoming more apparent with the U.S. clearly leading the developed world. Since 2010, U.S. real gross domestic product (GDP) growth has averaged 2% to 2.5% annually, but evidence is mounting that the economy is accelerating. Third quarter economic growth showed an expansion at an annualized pace of 3.9%, following a second quarter upwardly revised reading of 4.6%. Manufacturing indexes are pointing higher, inflation remains low, the unemployment rate has declined and consumer confidence has risen all year. Thus, as illustrated in Exhibit 1, leading economic indicators confirm that the U.S. economy is on firmer ground than many other markets.

These positive trends are in marked contrast with those in Europe and Japan. Europe narrowly avoided falling into its third recession since the financial crisis after the region delivered modest growth of 0.2% for the third quarter. Europe is also plagued with low inflation and an elevated unemployment rate of 11.5% as of October. The ongoing geopolitical concerns resulting from the Russia/Ukraine conflict have stabilized somewhat, but the corresponding sanctions have damaged sentiment, likely delayed investment and exacerbated the growth slowdown. Japan's economy is in technical recession after GDP shrank in the third quarter, defying expectations for growth. Although Europe and Japan have been challenged with uneven growth, we expect both economies will begin to deliver modest but consistent growth as their central banks continue to develop plans to stimulate growth.

Economic growth in the emerging world varies significantly by country. Growth continues to slow in Latin America, especially in Brazil, where the economy remains particularly weak. In China, the economy is transitioning to a slower pace, clearly impacting other emerging markets, especially commodity-producing countries such as Australia, New Zealand and South Africa. Although this global recovery has been below trend, it should continue at a moderate pace and pick up to about 3.0% in 2015. Downside risks include ongoing geopolitical tensions or a misstep by policymakers, but we do not expect these risks to derail the global recovery. Global growth will likely be below trend, but could produce a long expansion because it will keep inflation at bay and delay many developed countries' central banks from tightening.

Exhibit 1

Leading Economic Indicators



Source: The Conference Board/Bloomberg L.P. As of 10/31/14.

Implications of Diverging Monetary Policy

While monetary policies in major developed economies have been generally accommodative since the financial crisis—a factor that has helped keep rates low—they are beginning to diverge. While the Federal Reserve (Fed) is getting ready to tighten, for instance, the European Central Bank (ECB) and the Bank of Japan (BOJ) have taken additional steps to stimulate growth. The ECB has already launched a host of stimulus measures to reverse disinflation, including cutting interest rates to record lows and purchasing covered bonds and asset-backed securities. ECB leaders have even dropped hints that it could be in the market for its own government bond-buying program. The BOJ recently expanded its already massive stimulus in an effort to reenergize a fragile recovery and stoke inflation, and Prime Minister Shinzo Abe decided to postpone the next sales tax increase. Furthermore, China cut interest rates for the first time in two years in an effort to spur slowing growth that has been weighed down by heavy debt burdens in the corporate and property sectors.

The Fed, on the other hand, has finished tapering its quantitative easing program and has been communicating its intentions to begin interest rate normalization in 2015. With weakness abroad, we believe the Fed will be patient and rely on reported economic data as it evaluates whether to increase the federal funds rate. Thus, given our expectation that the U.S. economy will continue to accelerate, we expect the Fed will likely begin raising rates by mid-2015.

We anticipate that many global central banks will need to remain accommodative next year and we have already started to see the impact of diverging monetary policies. The dollar has strengthened against major currencies, global rates remain extremely low and commodity prices have fallen. Thus, given our expectations for stronger growth in the U.S. and gradually tighter monetary policy, investors should be positioned to take advantage of dollar strength, be prepared for a slow increase in rates and manage against a pickup in volatility.

A Home Country Bias in Equities

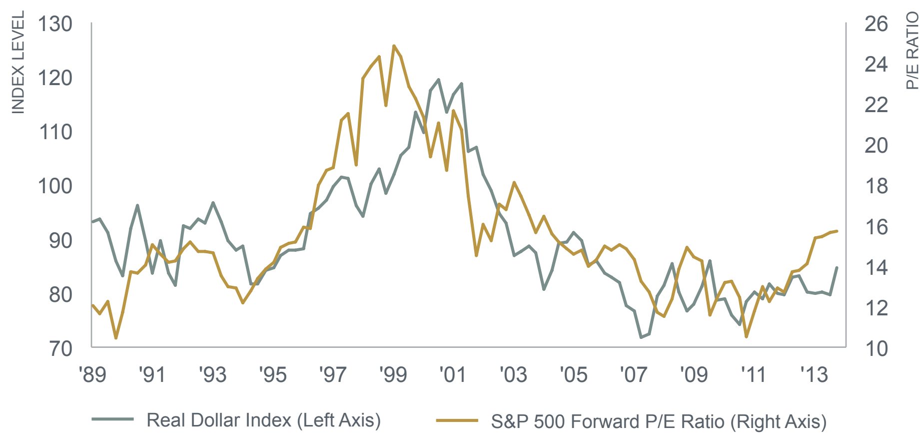
In light of our confidence in the strength of the U.S. economy, expectations for continued dollar strength and solid corporate balance sheets, we favor U.S. equities. Despite concern that a slowdown in Europe and falling oil prices will negatively impact corporate profits, we expect earnings growth to pick up modestly from 2014's projected pace of 8%. For 2015, we expect an annual earnings growth rate of 8% to 10%, which translates into an operating earnings per share range of $125 to $130.

The stronger dollar should benefit domestic-focused companies, while multinational commodity companies, such as energy and materials, will be more negatively impacted. These companies' products are traded in dollars and thus, foreign buyers may demand less when prices rise in local currencies. U.S. companies with large multinational operations may also experience some earnings pressure from currency translation losses due to a strong dollar. On a positive note, a rising dollar and falling commodities prices imply a decline in inflation expectations. A modest inflationary environment historically has supported higher multiples for stocks, as illustrated in Exhibit 2. Also, consumer sectors could benefit as households pay less at the gas pump and have more discretionary income to spend.

Exhibit 2

Implications of a Stronger Dollar

Real Dollar Index vs. S&P 500 Forward P/E Ratio



As of 9/30/14. Source: StrategasRP.

In addition, U.S. companies have ample cash available for share buybacks, strategic acquisitions and dividends. In periods of market volatility, there is an opportunity to increase buybacks when stocks decline. Cash can be used to fund strategic acquisitions and increase dividend payouts, which are still historically low.

While global diversification is important within portfolio construction, we are more cautious on international equities given growth concerns and the impact of dollar strength. As a result, country and bottom-up security selection will be increasingly critical moving forward in order to identify opportunities in both developed international and emerging markets. Where possible, hedging strategies also may help to minimize the impact of fluctuations in currency values.

Manage Bonds Thoughtfully

Low global rates in countries such as Germany and Japan and geopolitical turmoil kept U.S. interest rates lower than most industry experts anticipated in 2014. After hitting 3% early in the year, interest rates as measured by the 10-year Treasury were down around 2.18% as of the end of November. Now that the Fed has ended its bond-buying program, interest rates should begin to move gradually higher as the U.S. economy continues to strengthen, barring any major flare-up in geopolitical tensions or economic news disappointments.

Thus, investors still are faced with low yields and the prospect of rising interest rates that, even when modest, can cause the value of bonds to decline. It is prudent, therefore, to thoughtfully balance fixed income investments. Investors should continue to benefit from a well-diversified portfolio of core U.S. investment grade municipal, corporate and government securities. Higher yielding sectors, such as high yield and dollar-denominated emerging market bonds, can offer a hedge against an eventual increase in rates. However, investors should be cautious about reaching too much for yield, as spreads have tightened.

Given the waning of a 30-year bond bull market, investors should look beyond traditional fixed income strategies and thoughtfully incorporate diversifying, alternative investment strategies which have the potential to deliver positive returns during periods of rising interest rates. Examples of these strategies include absolute return, managed futures and other opportunistic credit strategies. Absolute return strategies can provide a return stream less correlated to fixed income amid rising rates, while managed futures can capitalize on any trend, such as rising rates. Investors can further diversify their core fixed income exposure through opportunistic credit strategies, such as global credit strategies in sub-investment grade and distressed credit markets. By incorporating a wider range of investment strategies, investors will be better prepared for a gradually normalizing interest rate environment.

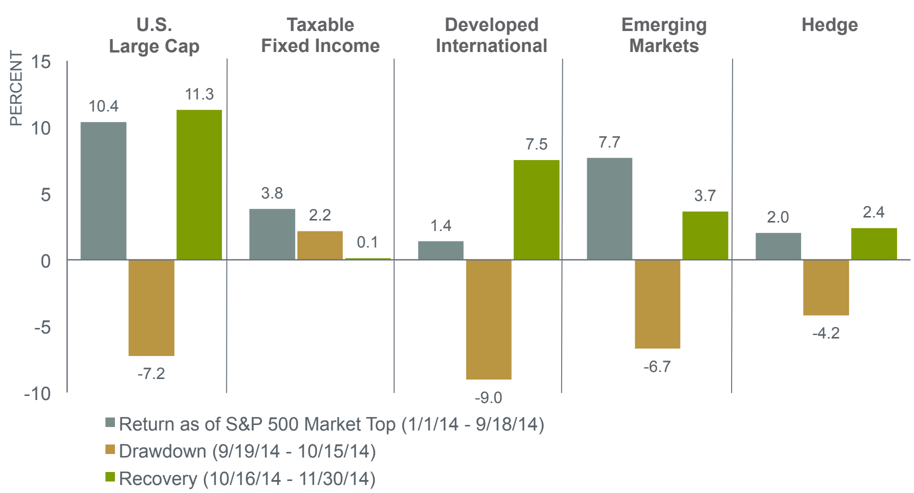
Manage Volatility with Lower Correlated Investments

Historically, diversifiers or lower correlated investments enable investors to mitigate risk within a well-diversified portfolio. Often these types of strategies are used to help smooth portfolio volatility, provide downside protection and deliver less correlated sources of return. Diversifiers can serve investors well in the face of market challenges.

Consider the recent period of volatility from mid-September to mid-October 2014. Long-short equity hedge funds and other diversifiers, including managed futures and absolute return investments, outperformed the broader equity markets and provided downside protection. During that period, the S&P 500 market declined over 7%, the HFRX Global Hedge index was down only 4% (Exhibit 3). Although hedge funds have had some challenging short-term periods, hedge funds have performed in line with the S&P 500 with significantly less volatility over longer periods.

Exhibit 3

Volatility Returns



As of 11/30/14 unless noted otherwise.
Indices used: Large Cap: S&P 500; Taxable Fixed Income: Barclays Capital U.S. Aggregate; Developed International: MSCI EAFE (Net); Emerging Markets: MSCI EMF; Hedge: HFRX Global Hedge Index.
Sources: Bloomberg L.P. and Morningstar. Past performance is not indicative of future performance.

Managed futures solutions have also done well during periods of market swings. These trend-following strategies seek positive returns by capturing momentum across a wide variety of investments, providing portfolios with a diversified source of return. For instance, managers who focus on energy and commodities are benefiting from the recent downward price trend through a combination of long and short positions.

Although we continue to have positive expectations for equities over other asset classes for the next 12 to 18 months, volatility may be more prevalent. Thus, it is important to incorporate diversifiers that are less correlated to traditional asset classes in order to help smooth out any bumps along the way.

Forward Focus

Markets are transitioning. Global growth is uneven, monetary policy is diverging and volatility is on the rise from low levels. Investors will need to consider the potential impact of this shifting market environment across asset classes. An active investing approach will be critical—one that identifies important portfolio adjustments as needed, uncovers new opportunities and manages against risks. By focusing on what's ahead and staying active in the management of their wealth, investors will be able to navigate change and successfully reach their goals.