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Bestuurders Conferentie

CAPITAL GROUP[SM]

De mogelijke consequenties van economische scenario's
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IPFOS Bestuurders
Conferentie in Huizen

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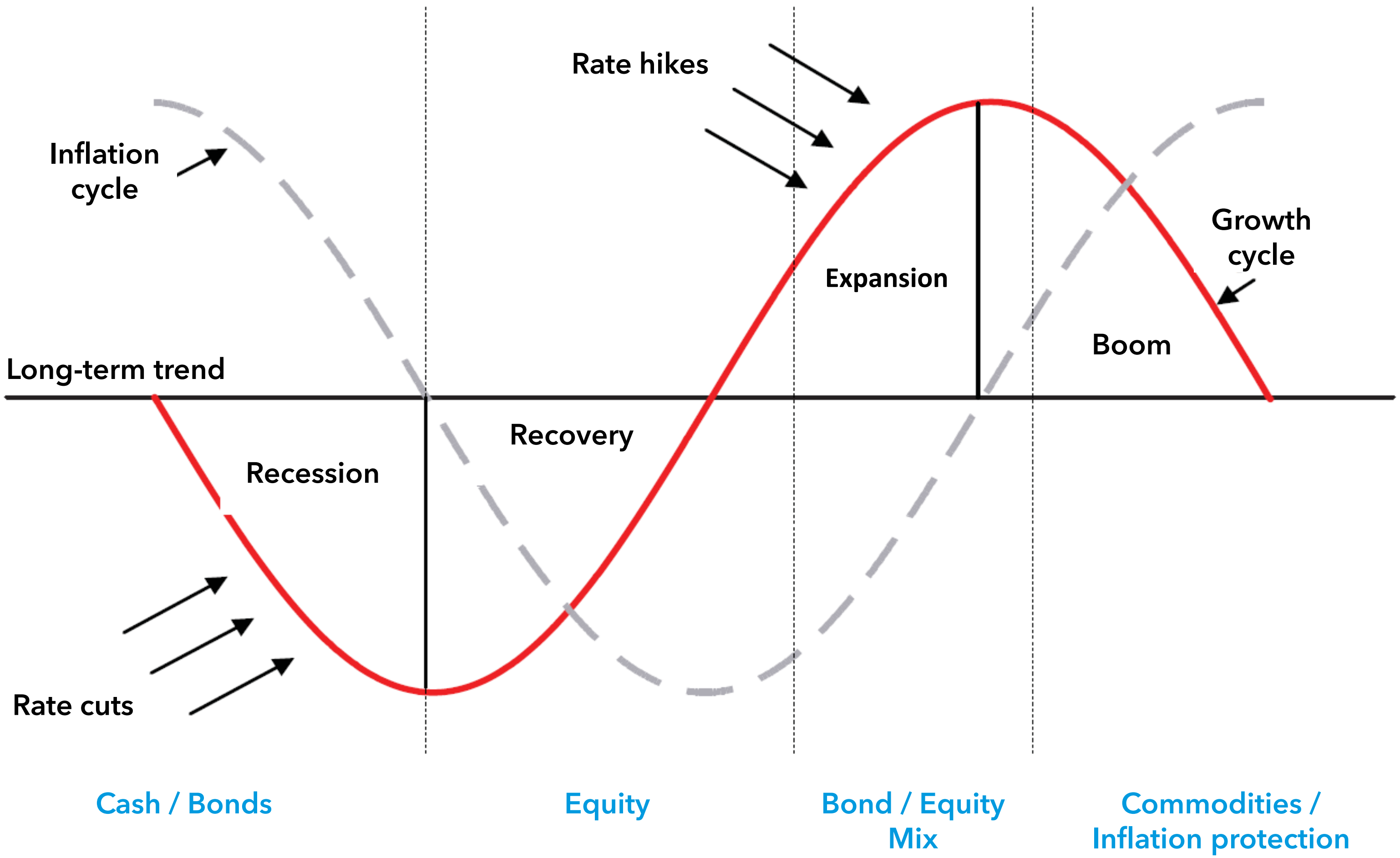
2 April 2015

Macroeconomic scenarios and investment implications

Macroeconomic scenarios and investment implications

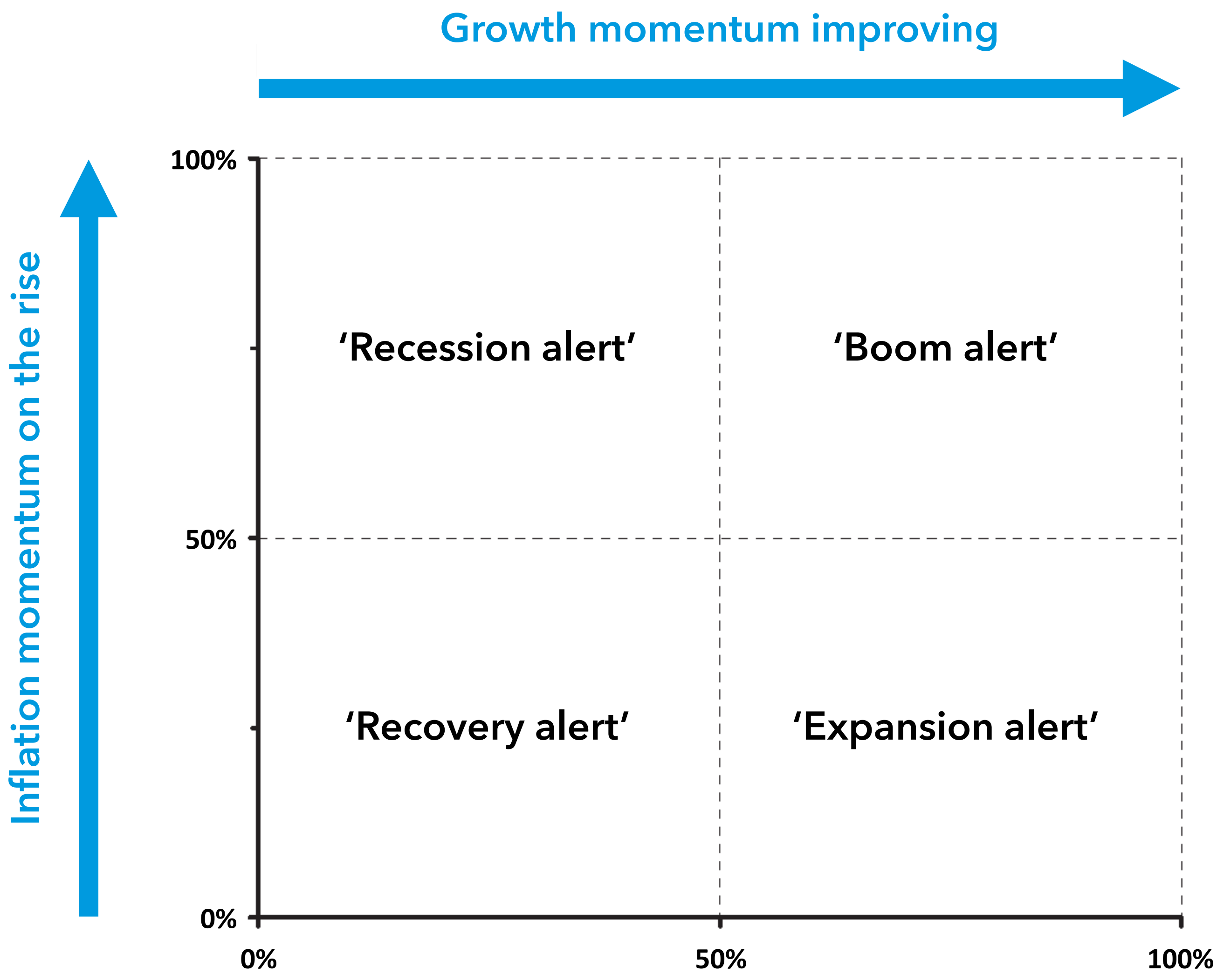
- The economic backdrop has a powerful influence on asset returns
- But care must be taken to differentiate between cyclical and secular views
  - Cyclical drives tactical asset allocation
  - Secular drives strategic asset allocation

The macro cycle and the investment cycle



Source: Capital Group

The G7 macro cycle indicator – defining the cycles



x axis: growth momentum indicator; y axis: inflation momentum indicator

Asset class real returns over the cycle

	Asset returns				
	Cash	Government bonds[1]	Corporate bonds[2]	Equities[3]	Commodities[3]
Recession alert	2.7%	5.2%	1.8%	-9.4%	-17.4%
Recovery alert	1.1%	1.7%	7.3%	15.0%	3.6%
Expansion alert	2.0%	11.0%	6.6%	12.7%	4.2%
Boom alert	0.3%	4.3%	1.5%	4.1%	7.4%
Average return	1.5%	5.6%	4.3%	5.6%	-0.5%

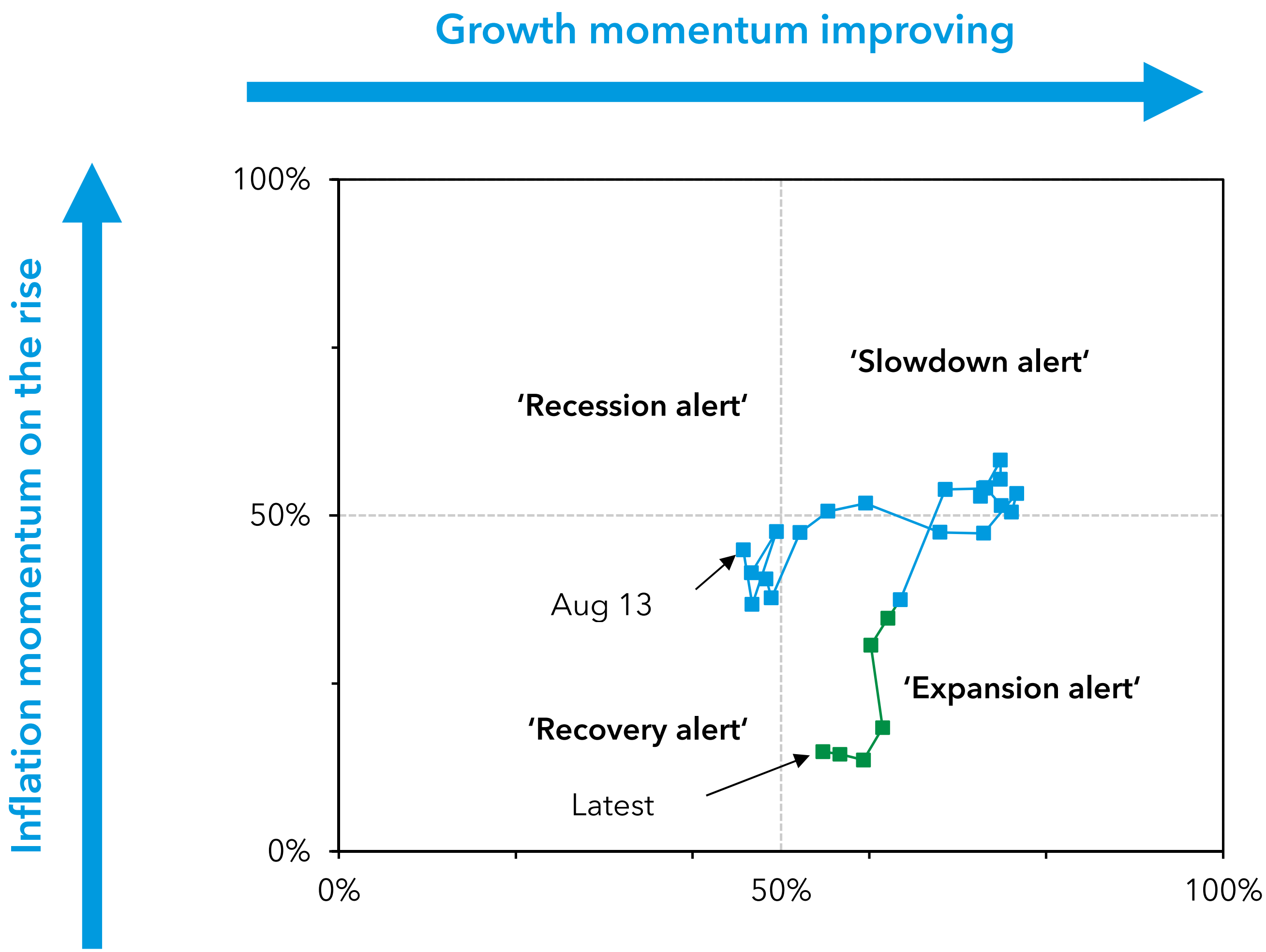
Note: Figures show annualised average US$ returns in real terms using the US 10-year government bond index, Barclays global corporate bond data, MSCI world equities total return data, GSCI total return for commodities and 3-month Treasury Bills for cash. Data deflated using G7 CPI series

1. Dec 1979 for US government bond index
2. Data from January 1973 to December 2014
3. Data from January 1970 to December 2014

Sources: Capital Group, Datastream, Barclays

Global balanced fund allocation

The G7 macro cycle indicator (MCI)

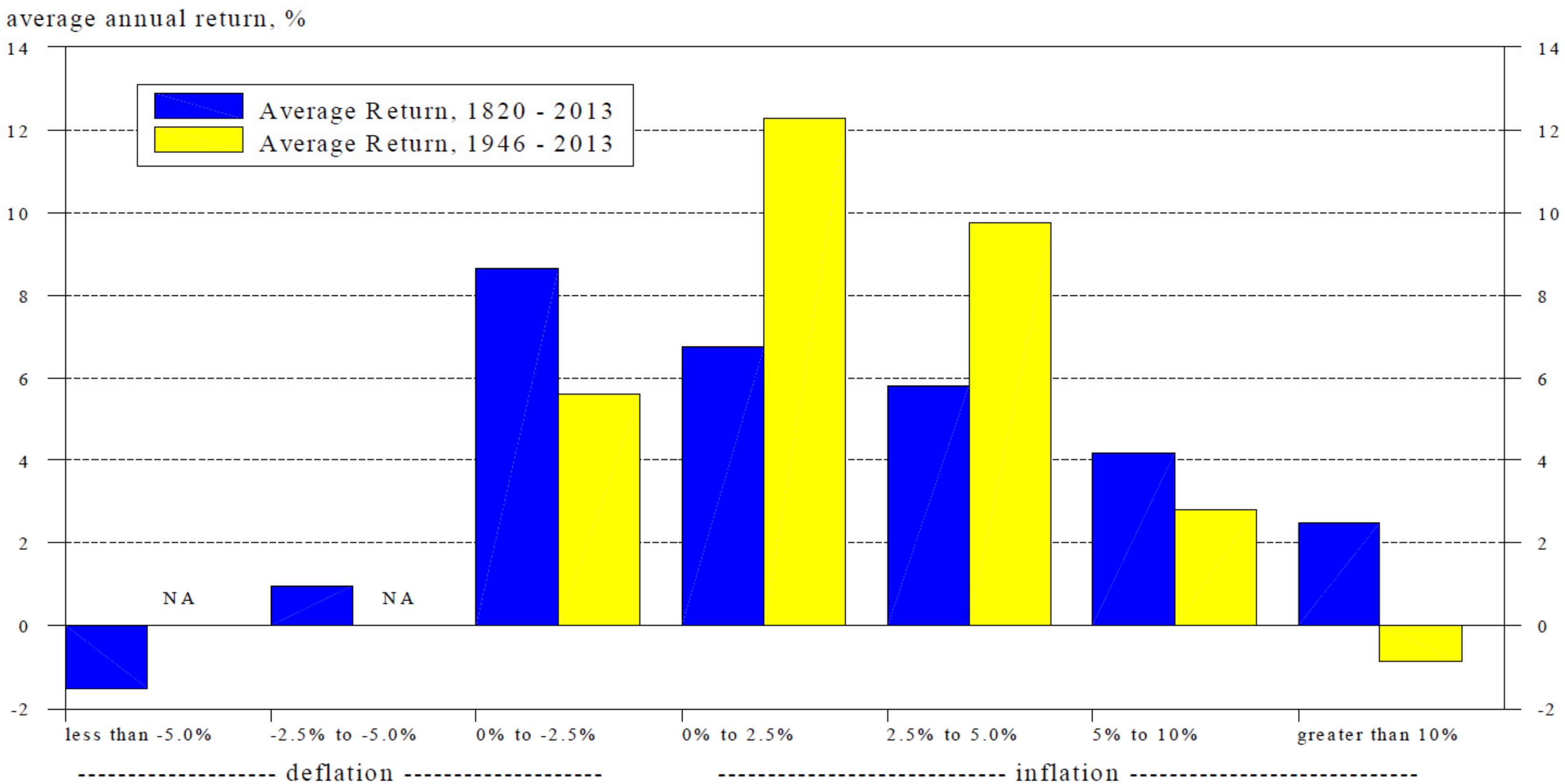


1. These are predicted results
x axis: growth momentum indicator; y axis: inflation momentum indicator. Source: Capital Group

But more secular trends can have powerful influences…

What causes inflation and where might it be headed in the US?

The price return on the S&P 500 in different inflation environments
1820 – 2013 and 1946 – 2013



Sources: Ibbotson, Global Financial Data

Investment game

Start with €100m in assets

Four economic scenarios

- Strong growth, low inflation (Yellen)
- Weak growth, low inflation (Stagnation)
- Weak growth, rising inflation (Stagflation)
- Strong growth, rising inflation (Capital)

Five asset classes

- Global equities
- Global bonds
- Cash
- Real estate
- Commodities

Asset allocation

- Choose which combination of at least three asset classes will perform the best in each scenario

Restrictions

- Invest a maximum of 40% in any one asset class
- Investments for each scenario must add up to 100%

Four secular economic scenarios

1. Strong growth, low inflation (Yellen)
2. Weak growth, low inflation (Stagnation)
3. Weak growth, rising inflation (Stagflation)
4. Strong growth, rising inflation (Capital)

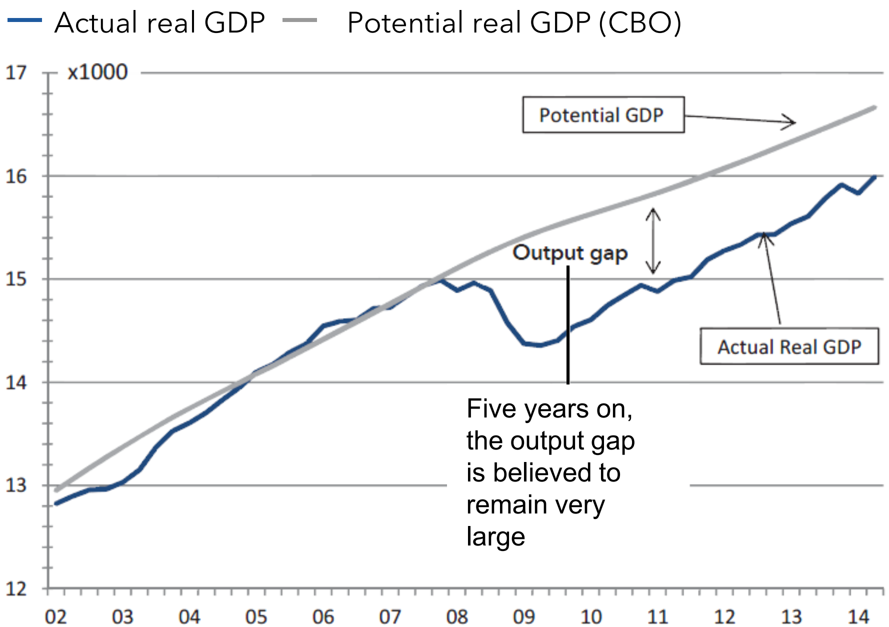
Scenario 1: Strong growth with low inflation (Yellen)

Proponent	Janet Yellen Chair of the Federal Reserve
Evidence cited	Economy has plenty of spare capacity Plenty of slack in the labour market
Financial indicators	Strong accelerating GDP growth Buoyant corporate profits Stable interest rates
What if she's wrong?	Wages start to rise Growth stays subdued

The Yellen View: Growth accelerates, low inflation

Potential GDP didn't decline during the global financial crisis

US – Actual and potential real GDP
Billions of 2009 Dollars, Q2 14



Significant excess capacity in the labour market and muted wage growth

US – Under-employment rate* (U6) Jul 14

* Total unemployed + all marg. attached workers + total employed part-time for economic reasons, % labour force

Sources: Thomson Reuters Datastream, ABV

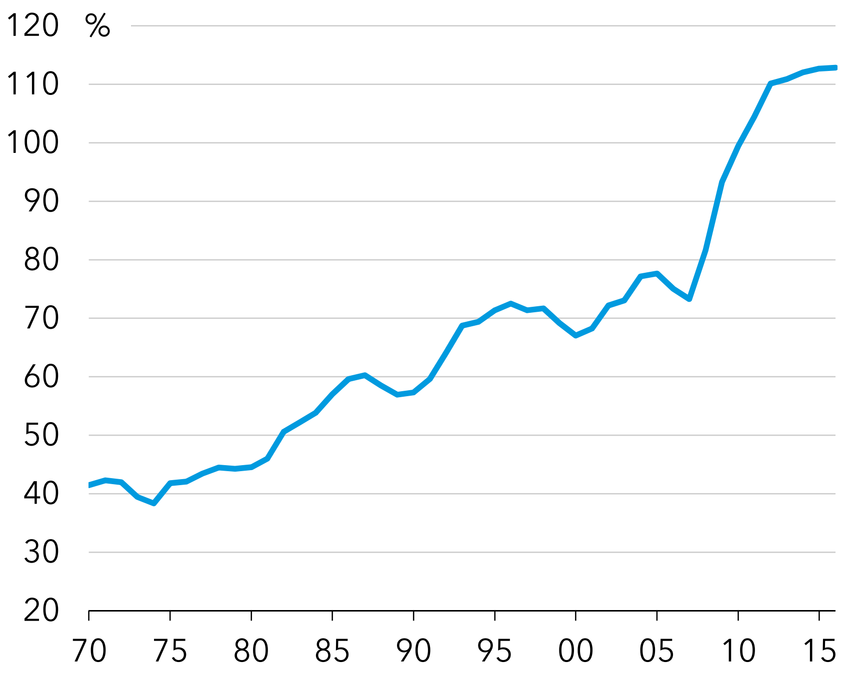
Scenario 2: Weak growth with low inflation (Stagnation)

Proponent	Bill Gross (Ex Pimco)
Evidence cited	Slow recovery in developed economies from the Global Financial Crisis Slowing emerging market economies Weak commodity prices
Financial indicators	Slow growth in corporate profits Stable / falling interest rates Weak emerging market economies
What if he's wrong?	Employment growth accelerates Capital spending strengthens strongly Small company confidence improves (NFIB, Tankan)

The impact of higher sovereign debt

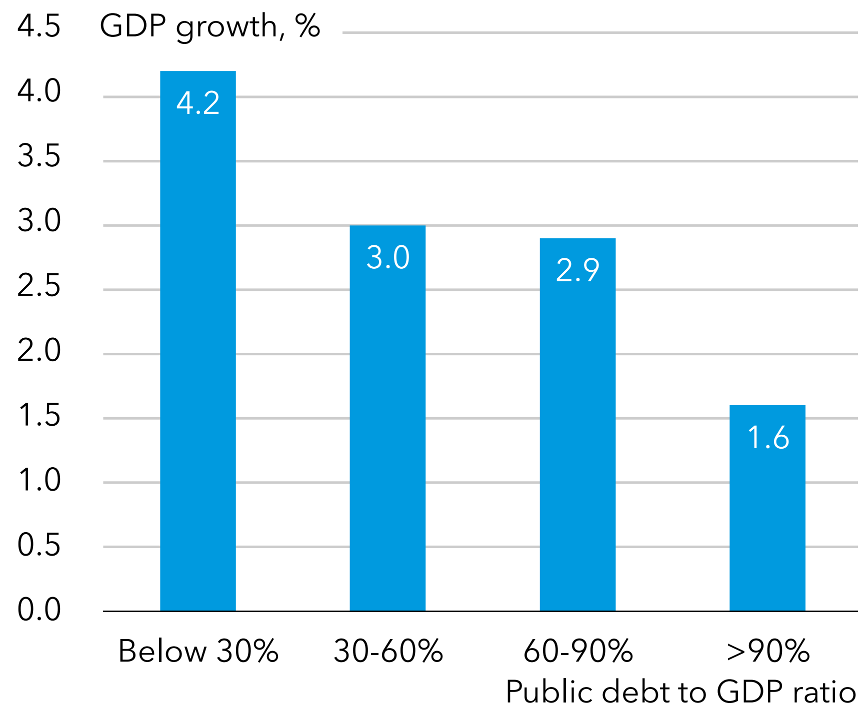
Sovereign debt has been rising

OECD sovereign debt as a % of GDP (1969–2016)[1]



Growth has been lower at higher debt levels

Median real GDP growth for OECD nations at various levels of public debt[2]



1. Data for 2014, 2015 and 2016 based on November 2014 estimates. Source: OECD
2. Source: Reinhart and Rogoff

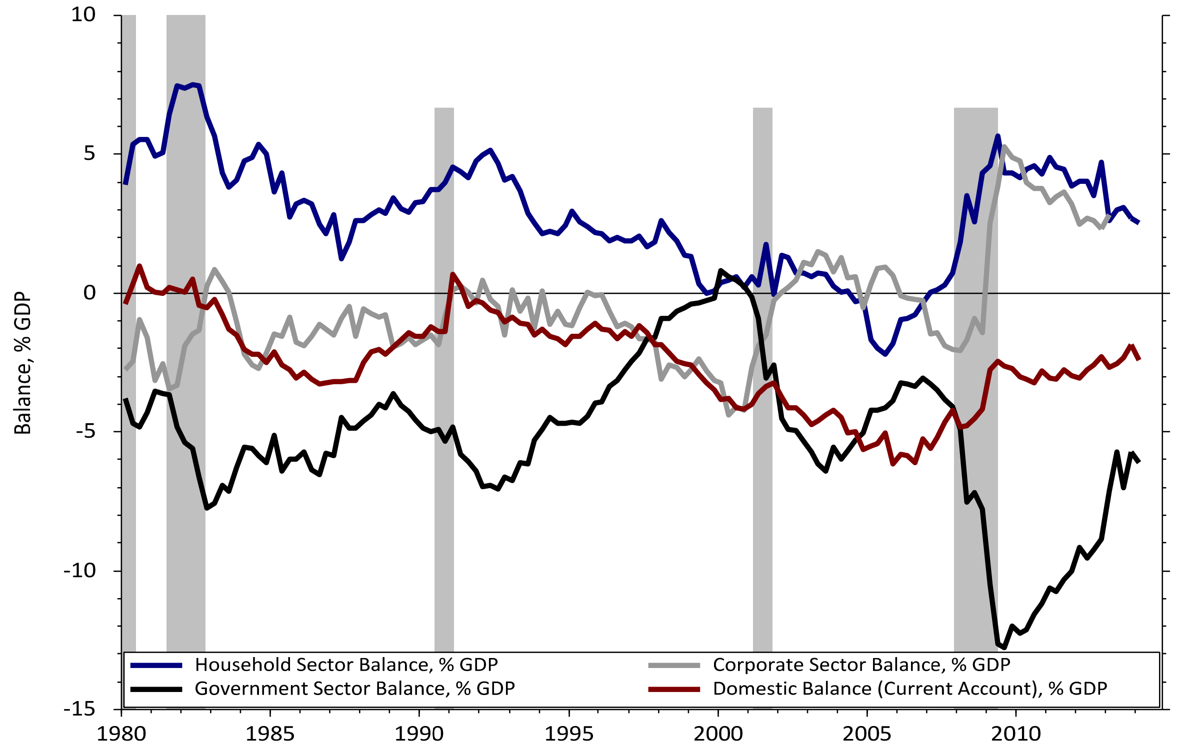
The Stagnation View: Weak growth, low inflation

This scenario assumes that the US deleveraging process has further to go

This assumes lower productivity growth, lack of investment and continued rise in savings

- US households and non-financial corporations maintain/extend significant savings surpluses
  - This depresses investment and consumption growth
- Fiscal consolidation continues
- The US external adjustment has further to go

US financial balance by sector



Household balance: Income – Spending + depreciation – Residential investment
Corporate balance: Retained earnings + Depreciation and other allowances – Business fixed investment – Inventories
Government balance: Federal, state and local savings – Investment

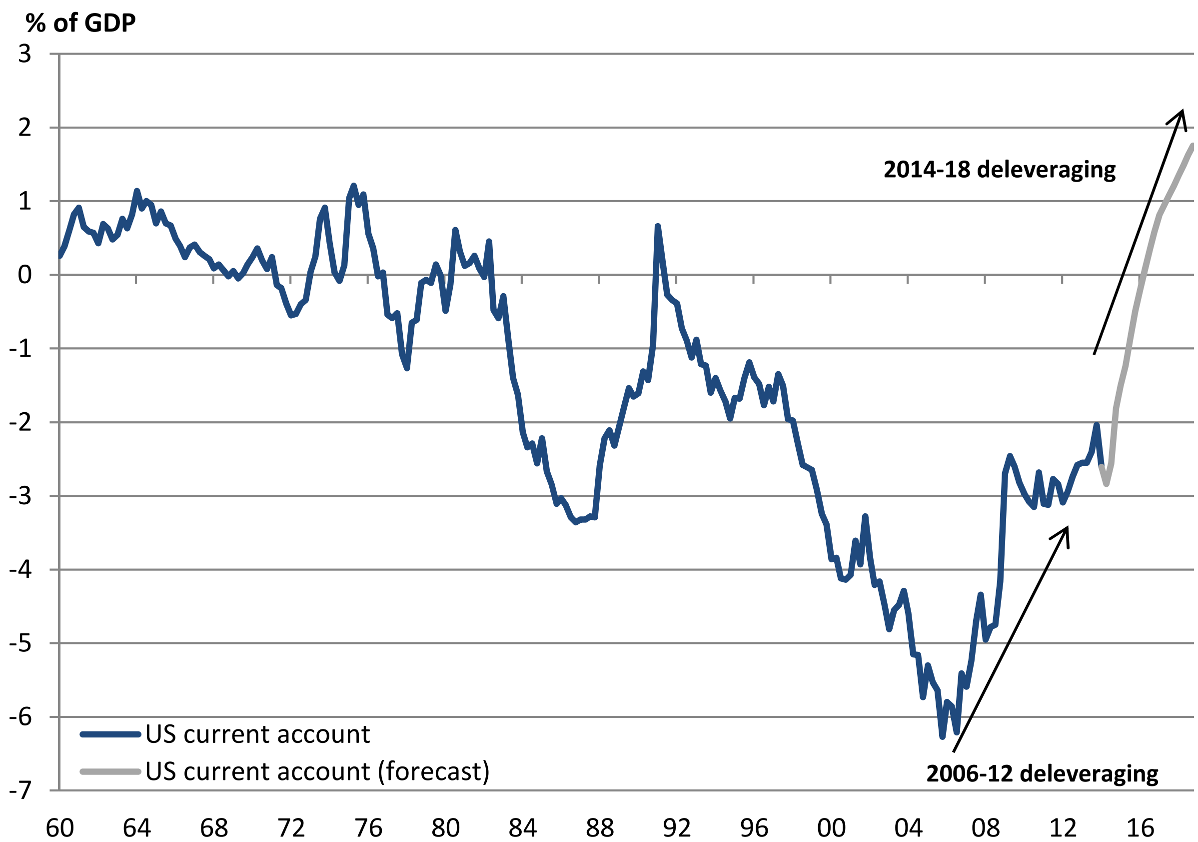
As at 31 March 2014
Sources: Thomson Reuters Datastream, ABV

The Stagnation View: Weak growth, low inflation

The flipside of deleveraging is an improvement in the US current account

Significant implications for the US external sector

- Another round of deleveraging will involve the US current account improving further
- The implied current account reversal is 4.5pp over 5 years



As at 30 June 2014
Source: Haver & MiGEM simulations

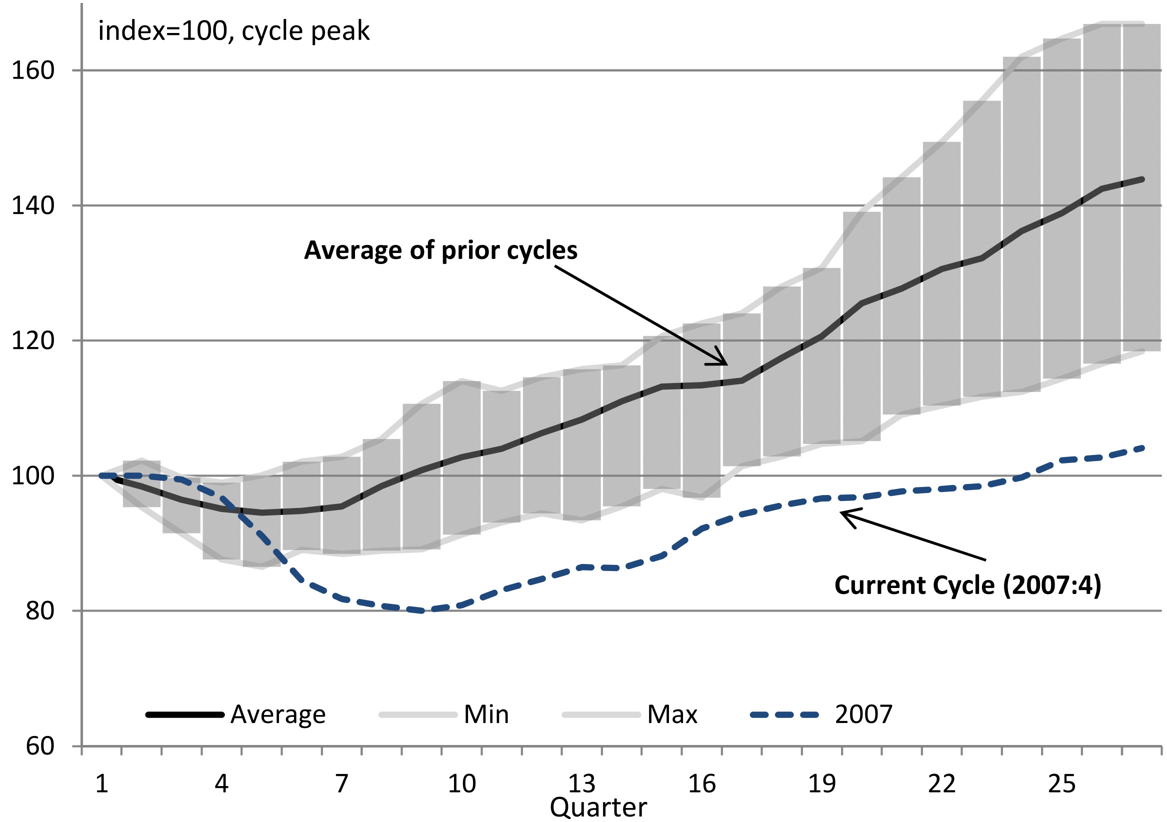
The Stagnation View: Weak growth, low inflation

Fixed investment growth would continue to remain sub-par

This scenario assumes growth in investment remains in the mid-single digits

- The US recovery from the Global Financial Crisis has been exceptionally weak
- A slow rebound in non-residential investment is one factor
- Capex growth in this scenario is assumed to remain low going forward

US real private non-residential fixed investment



As at 30 June 2014. Source: Haver

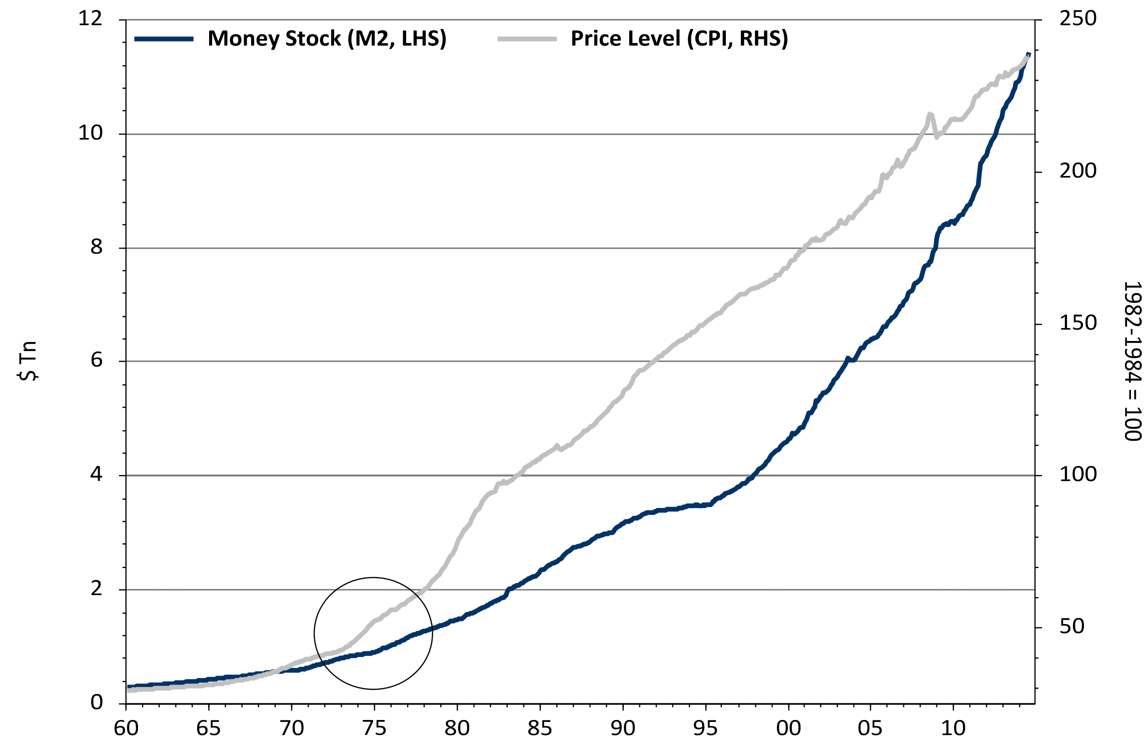
Scenario 3: Weak growth, rising inflation (Stagflation)

Proponent	Monetarists
Evidence cited	Central bank balance sheets Asset price inflation
Financial indicators	Rising inflation expectation Weak productivity growth
What if they are wrong?	Strong employment growth Stable inflation expectations

The Stagflation View: Weak growth, rising inflation

In this scenario, one has to assume rising inflation expectations and lower productivity growth

- In this scenario inflation is caused by 'bad' monetary policy
  - Monetary policy stays 'too loose for too long' (the Fed is slow to react to inflationary pressures)
  - Inflation expectations rise significantly
- This scenario assumes that productivity grows at a permanently lower rate, causing stagnation

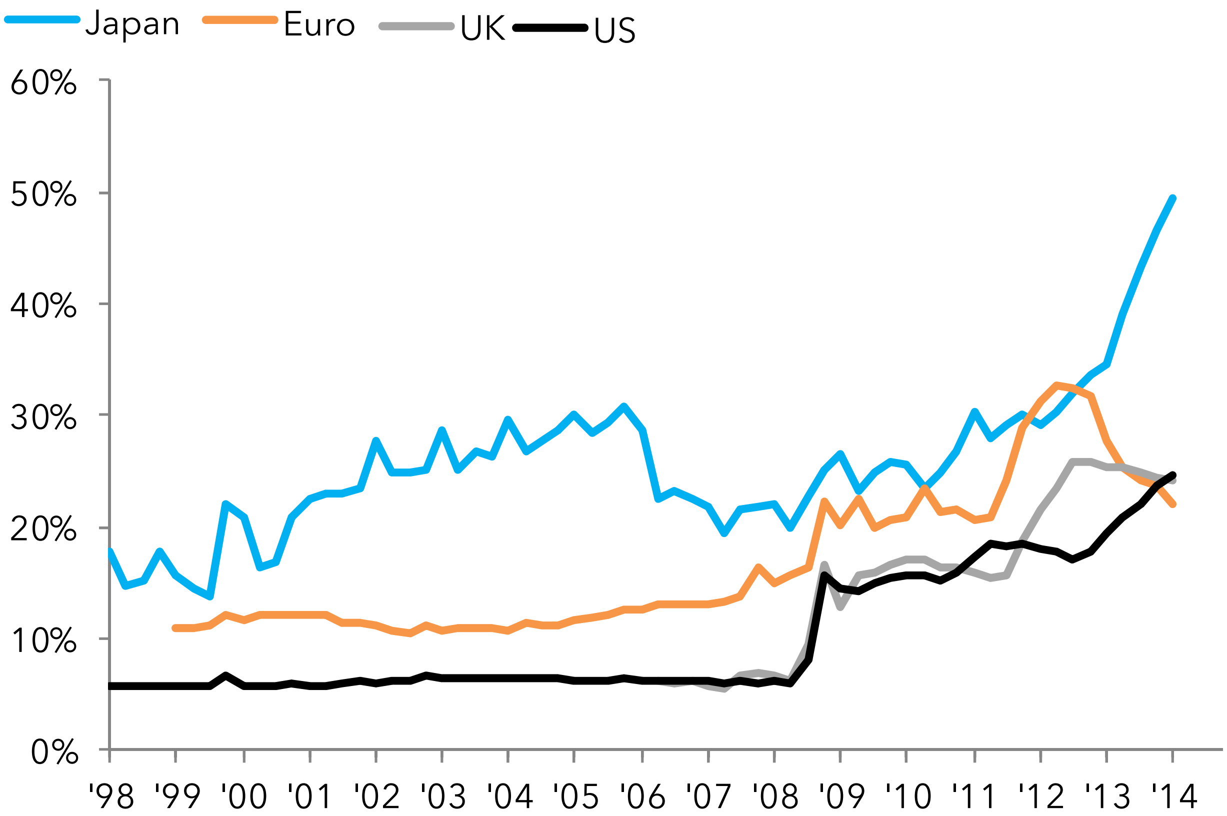


As at 30 September 2014
Sources: Thomson Reuters Datastream, ABV, Capital Group

Central bank balance sheets

Central bank assets as % of nominal GDP

FRB, BOJ, ECB and BOE



As at 30 March 2014
Sources: FRB, ECB, BOJ, BOE, Bloomberg

Scenario 4: Strong growth, rising inflation (the Capital view)

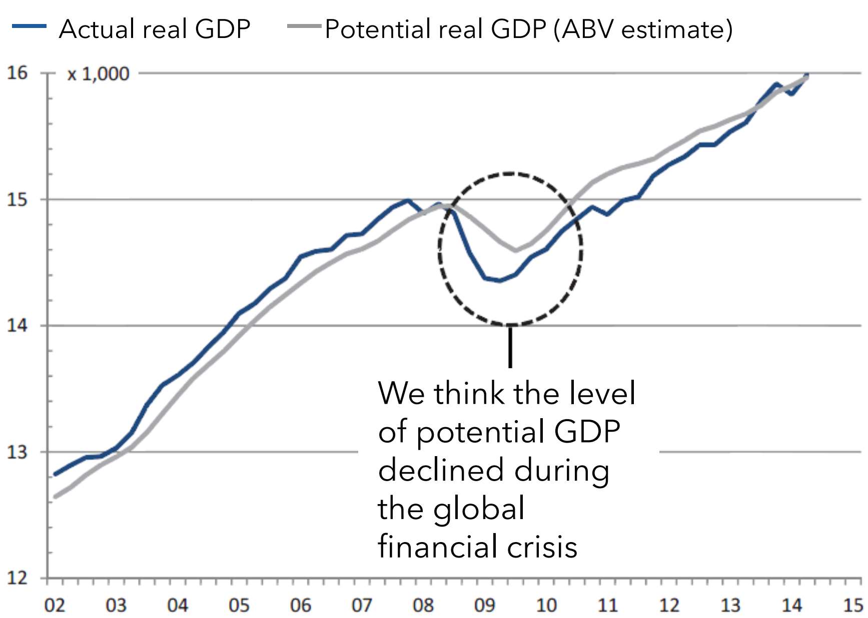
Proponents	Capital Group (CSR[1])
Evidence cited	Improving labour market conditions Rising small company confidence Financial deleveraging ending
Financial indicators	Accelerating corporate profits Tightening monetary policy Rising bond yields Strong dollar
What if we are wrong?	Wages don't accelerate Credit growth remains low Capital spending stays subdued

1. CSR refers to Capital Strategy Research

The Capital view: US growth and inflation accelerates

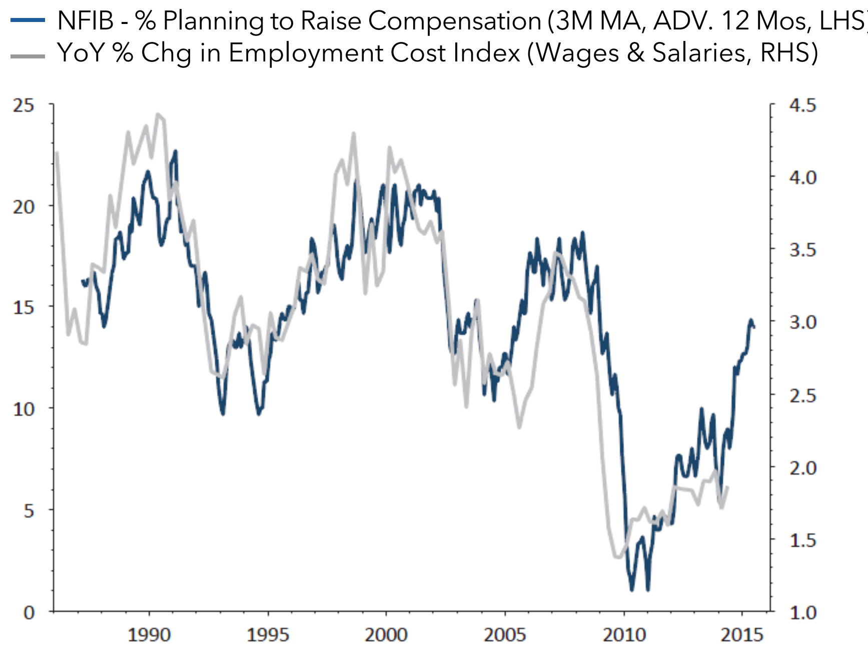
There is not a lot of slack currently in the US economy

US – Actual and potential real GDP
Billions of 2009 Dollars, June 2014[1]



Little spare capacity left, inflation and wage pressures building

US NFIB Compensation Plans and Employment Cost Index
July 2014[2]

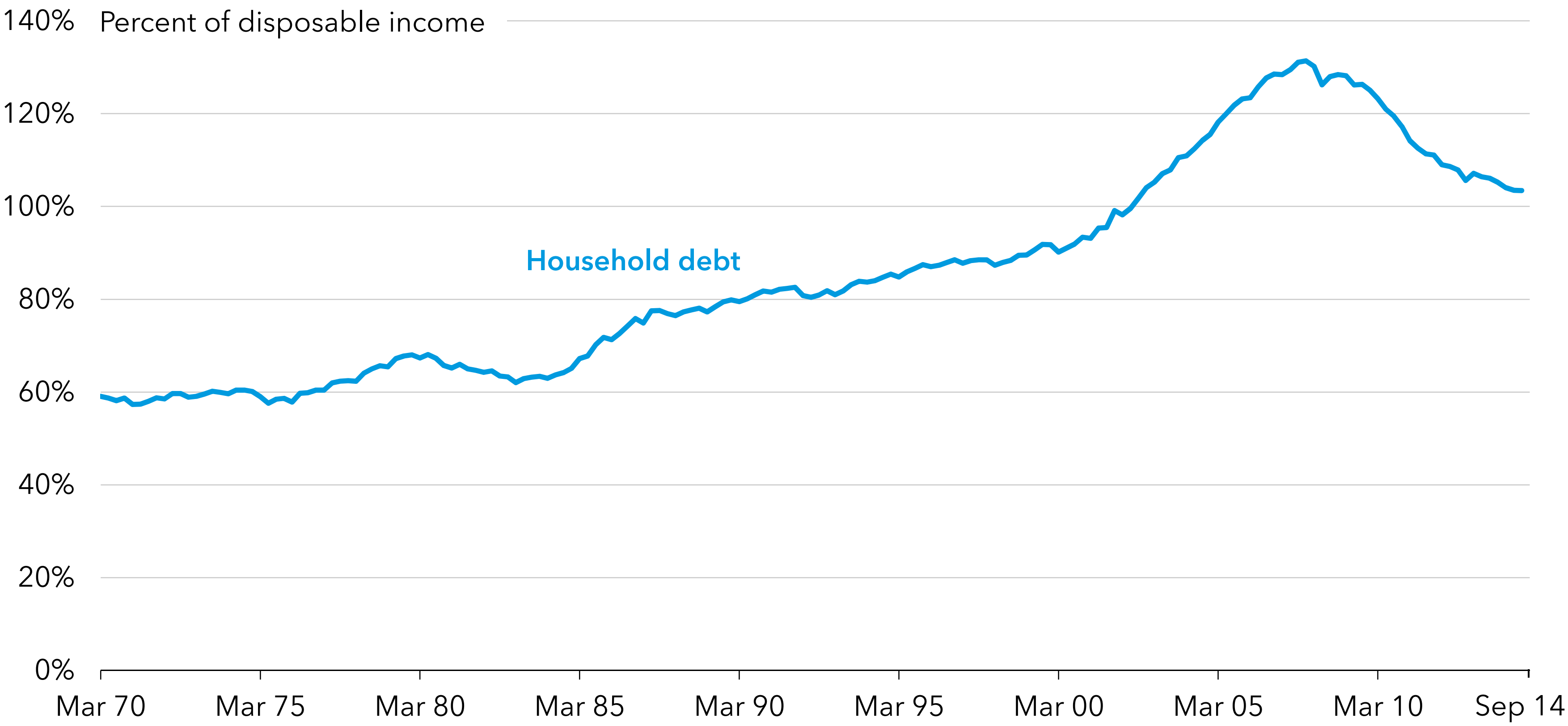


1. Sources: Thomson Reuters Datastream, ABV
2. Sources: Thomson Reuters Datastream, Deutsche Bank, ABV

Why this cycle could last a long time

US household debt relative to disposable income

31 Mar 70 – 30 Sep 14

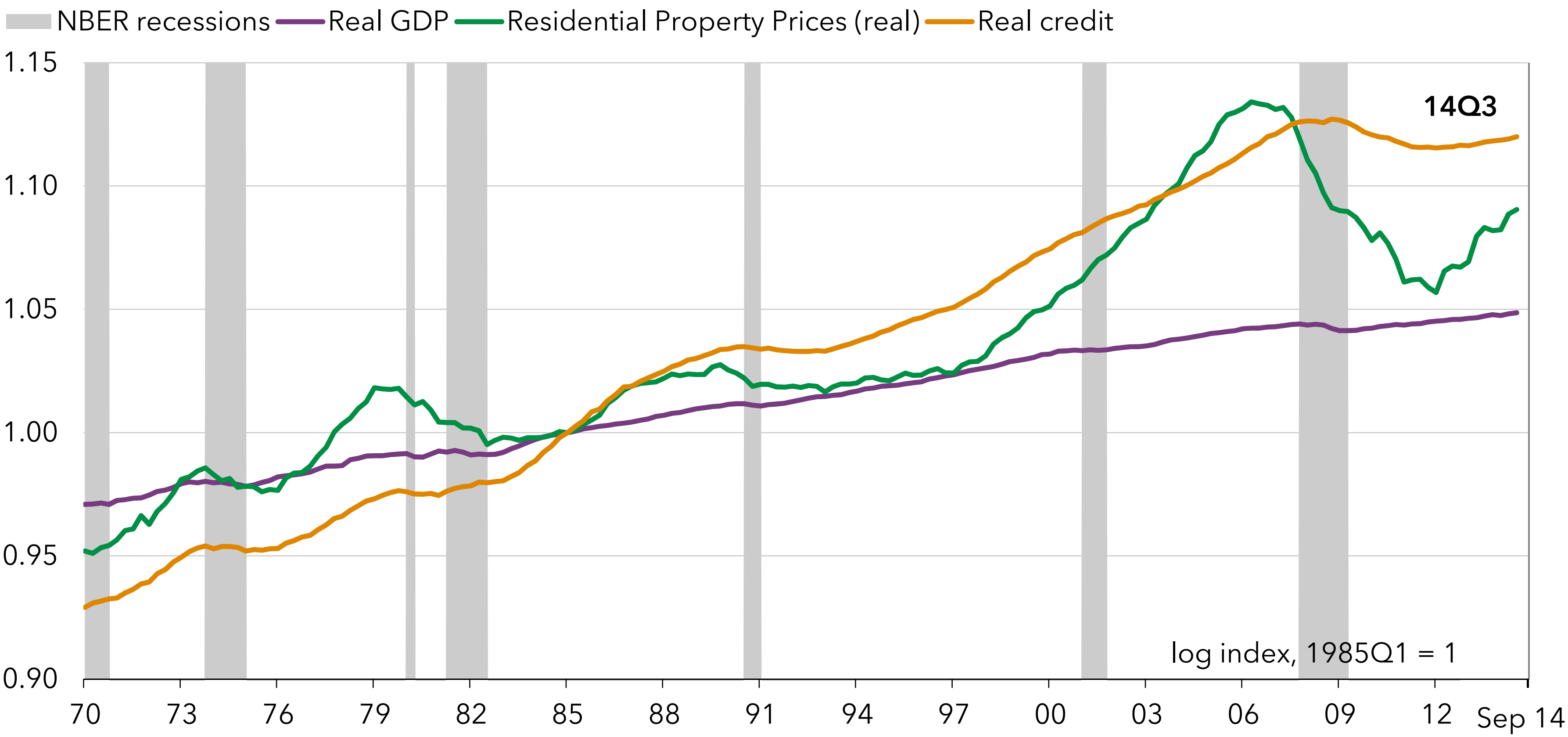


As at 30 September 2014

Sources: Capital Group analysis of data from Bank for International Settlements, National Bureau of Economic Research, and Organisation for Economic Co-operation and Development

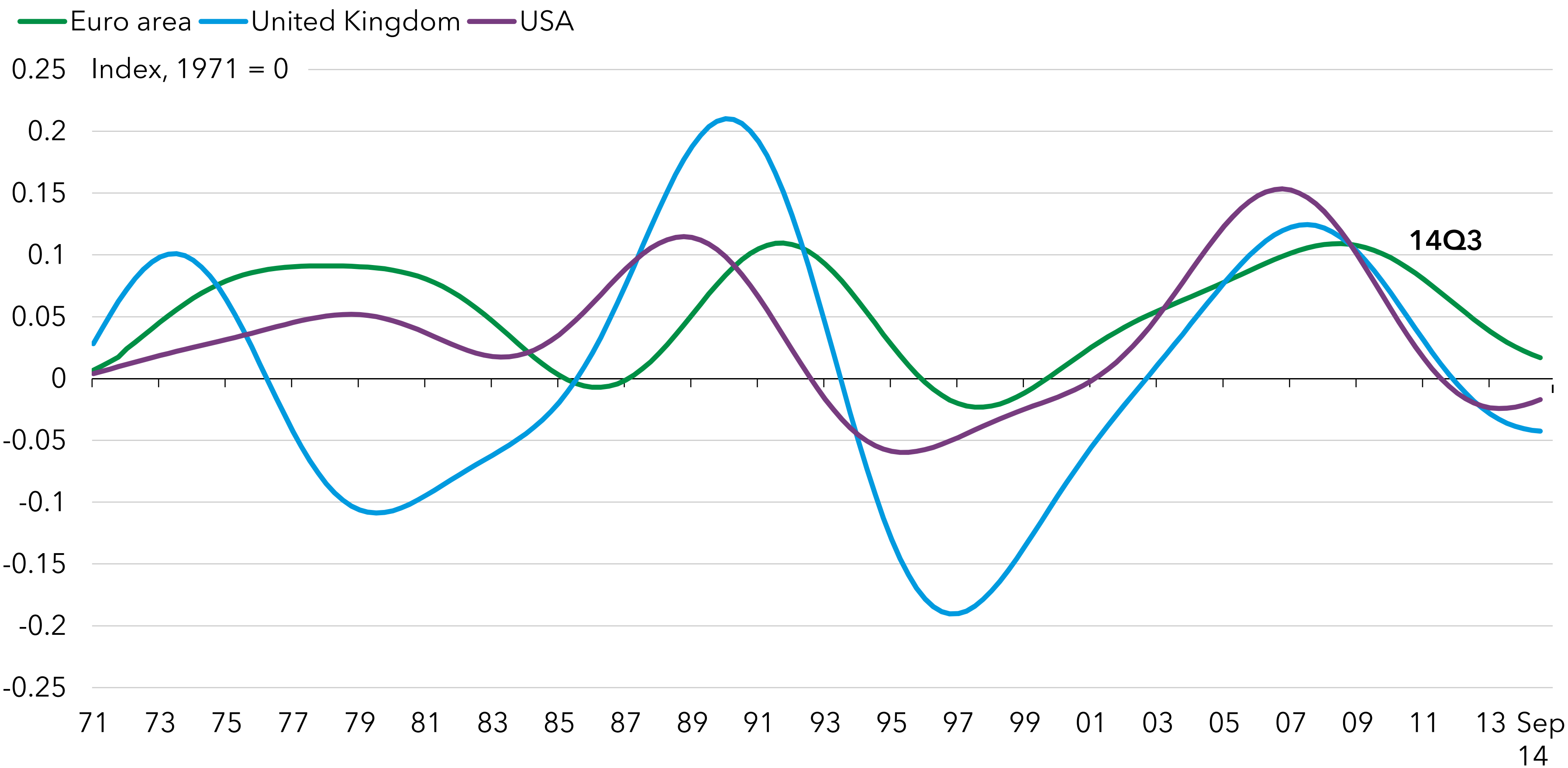
Credit growth accelerates when real housing prices are rising

The dynamics of US real GDP, residential property and credit
31 Dec 69 – 30 Sep 14



As at 30 September 2014
Real credit refers to private sector non-financial credit adjusted for inflation. Sources: Capital Group analysis of data from Bank for International Settlements, National Bureau of Economic Research, and Organisation for Economic Co-operation and Development

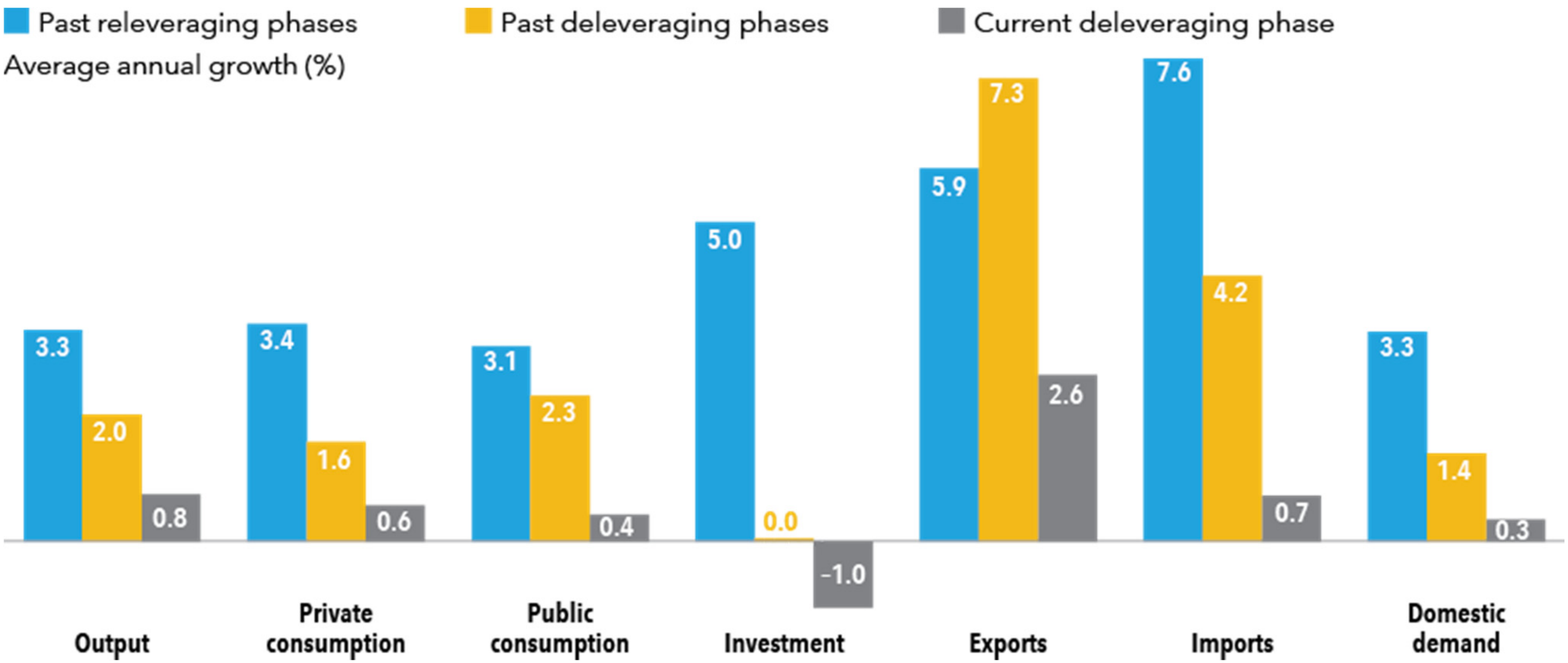
US, UK and Eurozone financial cycles



As at 30 September 2014
The financial cycle is composed of 3 variables: 1. real domestic credit (financial resources provided to the private sector by financial corporations), 2. the domestic non-financial sector credit-to-GDP ratio and 3. real property prices. The deviation from a medium-term trend is then taken for each of the 3 variables and an average is calculated.
Sources: Bank of International Settlements, Haver Analytics, OECD, Capital Group

Releveraging has a strong impact on economic growth

Macro characteristics of previous releveraging vs. deleveraging phases



Final data point as at Q4 2012. Source: Capital Group

Results

Expected asset class ranking for each scenario

	1	2	3	4	5
1. Strong growth / Low inflation	Global equities	Real estate	Commodities	Global bonds	Cash
2. Weak growth / Low inflation	Global bonds	Global equities	Cash	Real estate	Commodities
3. Weak growth Rising inflation	Cash	Commodities	Real estate	Global bonds	Global equities
4. Strong growth / Rising inflation	Global equities	Real estate	Commodities	Cash	Global bonds

Conclusions

- Cyclical scenario analysis drives tactical allocation
- Secular scenario analysis drives strategic allocation
- Perhaps the outlook is better than the consensus thinks?

Regulatory information

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Hartelijke dank voor uw aandacht