Steven Wieting

Slow growth: what it means for returns

Slowing world population growth and sluggish trade trends point to sustained low interest rates and modest equity returns over the long run. Such conditions call for greater selectivity in investments.

A debate is raging among economists over what’s been termed “secular stagnation.” Just why is growth so slow when so much has been done to revive it or has enough actually been done? As a case study in policy impact, continental Europe was far slower to ease monetary policy than the U.S. or the U.K., and there’s been a notable difference in immediate growth outcomes (we are referring to growth that can be explained by cyclical rather than structural factors – figures 1-2.) But even in the U.S. and U.K., the pace of economic recovery has still trailed behind recoveries of the past, particularly when factoring in the scope of the economic contraction in 2008-09.

In emerging market (EM) economies, far less scathed by the financial crisis, growth has fared better, but has still disappointed expectations as anyone who can recall the impressive expansion of Brazil, Russia, India and China in the five years to 2007 would attest.

EM growth measures are dominated by China, which is slowing down its rate of capital investment, a key ingredient of future growth. Away from China, a slower pace of global integration – as measured by cross-border trade flows – seems to be holding back the pace of economic growth. Dependence on slower-growing developed markets is part of this.

Through extensive historical research, Economists Carmen Reinhart and Kenneth Rogoff showed that financial crises cause severe and longer-lasting periods of economic weakness. Yet the full brunt of the financial crisis was felt more than six years ago, and the world is still suffering from slow growth. The banking crisis doesn’t explain it all.

U.S. Cyclical vs Structural Recovery

In the past, we’ve studied so-called “hysteresis” effects on labor markets. The notion is that long spells of unemployment make it more difficult for some workers ever to regain full employment as their skills become obsolete and they lose critical contacts in their industry. This would suggest a higher period of trend unemployment, and a higher inflation rate at any given level of unemployment.

It seems this hysteresis effect is having some impact upon growth but it is far from the whole explanation for the slow recovery. To the extent that it is impacting labor markets in the U.S., this is by way of reduced participation rather than weak hiring. It is therefore lowering the unemployment rate rather than keeping it high. Meanwhile, the U.S. Federal Reserve, through its...
Figure 1. Labor Demand Diverges

 Sources: BLS, ECB, and Citi Private Bank as of 1Q 2015. Note: Data are indexed (1Q 2005=100). Note: Data indexing is a way to make comparisons of different time series by setting them equal at a common starting point and then examining their divergence over time. Indexed data allows an observer to quickly compare rates of growth for variables with different starting levels.

Figure 2. Labor Supply Doesn’t

 Sources: BLS, ECB, and Citi Private Bank as of 1Q 2015. Note: Data are indexed (1Q 2005=100). Note: Data indexing is a way to make comparisons of different time series by setting them equal at a common starting point and then examining their divergence over time. Indexed data allows an observer to quickly compare rates of growth for variables with different starting levels.
actions, appears to be actively betting on a labor-supply recovery once labor markets tighten sharply.

This is where our concerns lie. Unlike the pace of GDP growth, there has been nothing slow about the tightening of U.S. labor markets. Unemployment has fallen from 10% to 5.4% with the rate of improvement just as fast as during recovery periods in which economic growth was rapid - figure 3.

Whether temporary or more permanent, the message is clear: the trend pace of U.S. economic growth - the rate that balances growth in labor demand and supply - has been effectively very slow. In a complete reversal of the pattern of the 1990s expansion, U.S. economic forecasts in recent years have been routinely revised down rather than up - figure 4.

Figure 3. Rebounding Employment, Crawling Growth

Figure 4. The Age of Disappointment
The surprisingly slow growth rate of the U.S. labor force has been driven by prime-aged workers. It pre-dates a demographic-led slowdown that is still expected. It has also so far responded little to a record high level of unfilled job openings – figure 5. Combined with a moderate rate of investment in business capital – figure 6 - the sources of potential economic growth in the U.S. have been slow and not clearly due to any lack of demand. In fact, while previous worker productivity gains were strong and these gains accrued to corporate profits, the current modest pace of wage growth seems to largely match what would be expected from an economy with a slow growth trend.

Source: Bureau of Labor Statistics, as of Apr 2015

Source: Bureau of Economic Analysis, annual data as of 2014.
Is it “Financial Repression” When Growth is So Slow?

As noted, a demographic slowdown in labor-force growth in the U.S. is on the way. But in fact, this trend is highly global - figure 7. Among other things, this means that the interest rate one would expect to balance global demand and supply will be lower than in periods of more rapid potential economic growth.

In a report we once titled Learn to Love Work we anticipated that this slowdown in populations historically deemed “working age” - coupled with heightened longevity - would produce a feedback effect on financial market returns. The impact would induce later retirement ages, perhaps as a result of both policy measures and individual choice. Reduced interest income would likely be a part of that financial feedback effect. In addition, what is sometimes called “financial repression” by central banks - keeping cash interest rates at historically low levels - may persist for reasons that are justified and long-lasting.

Notably, interest rates in markets including the U.S., Germany, and a few other countries, appear unusually low even accounting for slower potential economic growth rates. This provides an ongoing incentive for investors to reallocate to higher-risk, income-producing assets like equities.

So what are the risks to such a portfolio shift? Savers and investors currently accept a negative return after inflation on most low-risk bank deposits. In many markets, they accept yields near that level for high duration government bonds. Amid such high fixed-income valuations, why would valuations not be high in equity markets, with future returns correspondingly low?

Blessed With Low Expectations

The expectation of low returns does indeed appear to be embedded in stock and bond prices. As figure 8 shows, the real yield on long-term U.S. Treasuries is a meagre 0.4% annually for 10 years. This is directly observable in the inflation-linked bond market (TIPS) yield. Despite having no calculations in common, our arithmetic estimate of the long-term real corporate earnings growth rate implied in the S&P 500’s price closely matches this level, both currently and throughout history.

What does this mean? Growth expectations in the U.S. and global stock market are not high at all if one accepts that nominal long-term returns are going to be around 6% per annum in U.S. dollar returns, consistent with low bond yields.

If, however, markets are confused about the message of low bond yields, and assume that all of the historic return in equities can be achieved and that bond yields are simply a complete mispricing of a growth rate that will be as strong as in the past, then valuation issues would abound. Discarding the notion that bond markets are completely wrong, capitalizing equity cash flows at an interest rate that is one percentage point higher in yield without commensurately faster economic growth, the negative impact on equity values is 25%. As noted, we believe low return expectations abound, and investors are not simply
confused in their return outlook. Further study of this issue, however, seems worthwhile.

Finally, the case for longer-term growth is far from shut. Emerging markets are not homogenous or entirely dependent on growth in developed economies. In the U.S. and other developed markets, policies that can incentivize economic growth potential can be devised\(^\text{i}\). Giving up hope is particularly un-American. And as figure 9 shows, the U.S. has recovered before from surprisingly weak growth, even when the sources aren’t merely cyclical.

At the same time, the somber evidence hinting at persistent slow growth suggests greater discrimination in investments will be needed ahead. As interest rates and other return opportunities have fallen, there’s reason to fear that investors will extrapolate a mere business cycle recovery too far when structural growth limitations will eventually limit it. We believe sorting out the truly enduring growth opportunities will be particularly important in the years ahead (please see Seek Alpha with Secular Growth.)

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\(^i\) Authors: Steven Wieting, Shawn Snyder, August 30, 2010, Citi Global Markets.

**Figure 8. Bonds and equities both pricing in slow economic growth**

<table>
<thead>
<tr>
<th>Implied Real Trend EPS</th>
<th>Growth Rate of S&amp;P 500</th>
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<tr>
<td>CBO Estimate of Real Potential GDP Growth</td>
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<tr>
<td>TIPS Real Yield</td>
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Source: Citi Private Bank, Federal Reserve Board, Congressional Budget Office, Standard & Poor’s, Moody’s through May 2015.

The Standard & Poor’s 500 Index is a capitalization-weighted index that includes a representative sample of 500 leading companies in leading industries of the U.S. economy. Although the S&P 500 focuses on the large cap segment of the market, with over 80% coverage of U.S. equities, it is also an ideal proxy for the total market.

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**Figure 9. Weaker-Than-Expected Growth Is Not Impossible to Reverse**

| Labor Force Deficit |

Source: Congressional Budget Office, as of 9 Jun 2015
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