The Perspectives Podcast
A World Apart
Episode Five

with
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Candace: It's been a decade since the financial crisis pushed the United States and much of the world into a deep economic slump. Since then, the road to recovery has been grueling and fitful for most countries. Now, 10 years on, the U.S. is looking like an economic powerhouse, while the rest of the world seems, in the last two years, to have lost much of its momentum. Today, we're going to take a trip around the world to look at why that is.

We'll look at some important global trends like demographic shifts that could offer promising opportunities. We'll also talk about how a global perspective could be an important part of any portfolio.

You're listening to the perspectives podcast. I'm Candace Browning, head of BofA Merrill Lynch Global Research, and with me is Michael Hartnett, chief investment strategist for BofA Merrill Lynch Global Research.

Michael: Hi, Candace.

Candace: And Chris Hyzy, Chief Investment Officer for Merrill Lynch and U.S. Trust.

Chris: Hello, Candace.

Candace: Michael and Chris, for a while, the U.S. and the world were recovering together, but then things started to diverge. So, how is the world doing compared to the U.S.?

Michael: Well, it's not doing as well as the U.S., and that's a little bit of a change from five to seven years ago because if you think about the global financial crisis, you know, the U.S. came out of it at a snail's pace. Europe, the same, Japan, the same. They were all saddled with the problems of the real estate market, the banking sector, and it was China and the emerging markets that for the first time ever, basically lead the world into recovery in the 2009 to 2011, 12 period. And then, Chinese growth peaked. It's been decelerating ever since. Whereas the U.S. has picked up.

Michael: I think, the crucial thing that happened in the U.S. is they did sort out the banks, and they did sort out the real estate. And that's really kept Europe and Japan behind. They haven't been able to, keep pace with the U.S. because they've still got this, you know, this banking sector, and real estate markets that haven't really fully recovered. And then the Chinese just couldn't keep growing at 12%. And so, you know, what you're left in 2018 is a very sort of unipolar world really. It's been a, a year of big, big U.S. decoupling in terms of growth, but also in terms of markets.

Chris: Yeah, and I would say, Candace, the only other part of the world that seems to be in this performance enhancing growth world, or at least trying to get there is Japan. So, Japan and Europe have also decoupled, and the emerging markets, which are still under pressure from higher rates, - basically higher material costs in general, but lower oil now should help a little bit, and the strong dollar.

Candace: So, let's delve into each area of the world in a little bit more detail. What challenges are countries in Europe facing that other parts of the world aren't?

Chris: There's quite a few problems that are still uncertain. And I think the biggest one is, is their largest trading partner in the world is China. And as China slows down, that has an enormous impact on Europe's overall growth curve. So, that's number one. Number two, there really doesn't appear to be a political or banking union in Europe. And that doesn't allow a fiscal response when monetary policy is actually changing, and starting to try to get back to normal.

You're starting to see some effects overall of the refugee situation as well. It's an inordinate tax on some of the economies, and if you think about it, the Euro really hasn't performed at a level that would allow their export market to pick up for what their domestic economies haven't been able to produce.

Michael: Yeah, I mean, I think that's, that's right. I mean, the most pressing issue for the European Union right now is the situation with regards to Italy.

Newsclip: EU Commissioner Pierre Moscovici has again warned Italy that it must keep its national debt under control… *(News clip from 09/21/2018).*

Michael: You have, you know, a very, very large economy in Europe that looks as though it's going to find it very, very difficult to repay its bills going forward without a dramatic decline in interest rates. And this makes the fiscal situation in Italy look more and more, you know, dangerous.

Europe's had negative rates for the best part of one or two years, and it still can't grow. And that tells you that it's got some real deep structural issues. I mean, they could be political, they could be social, but you know, a lot of it is demographic, and the plain fact of the matter is that you've got something like 27 interest rates, and, and one currency. You know, I mean, it's just not (laughs), it's not, it's not a union. I mean, that can't persist indefinitely

Candace: So, you've talked about some of the structural issues within the European Union, and you hit a little bit on demographics.

Michael: Mm.

Candace: But can you give us some more details on some of Europe's demographic challenges?

Michael: Yeah, I mean, Europe, unfortunately, is following Japan pretty closely in terms of its demographic path. Whether it's Italy, Ireland, you already have seen their working population's growth just come to, come to an end. And the rest of the block, particularly Germany, is going to follow pretty quickly. So if you don't have working population growth, then it's very difficult to have economic growth. Unless those people are incredibly productive.

And it's not to say that Europeans are not productive, but it would be much easier for the market to believe that they would be productive if there was this massive disruption via technology within those economies. I mean, the U.S. has a tech sector that's, I don't know, $6 trillion. You look at the tech sector in, in Europe, it's probably less than half a trillion, if that.

Candace: Okay, so let's switch from Europe to Asia.

Candace: Japan and China recently announced an important change in their trade relationship.

Newsclip: Increasing uncertainties in the two countries respective ties with the United States are pushing Japan and China closer. Shinzo Abe worries about United States declining presence in the region, while President Xi Jinping hopes that Japan can help ease the impact of China’s escalating trade war with the United States. (*News clip from 10/26/2018*).

Candace: So, why is that important to those two countries and the rest of the world?

Michael: Asia's important and it might come as a surprise to hear, it arguably is the most important. If you actually look at the latest figures, the global economy is 85 trillion dollars and Asia is 30 trillion of it. North America is 25 trillion and Europe's 20 trillion. So Asia's the biggest region on the planet in terms of its economy. If they are shifting to a much more sort of free trade environment, that's got some major sort of, you know, obviously geopolitical ramifications in terms of GDP and earnings growth over the next 10, 15 years.

I mean, the strike against Asia has always been, it's much less shareholder friendly and there's much more barriers to trade and all that sort of stuff. So, if they're liberalizing and they truly mean it, and it's with regards to capital. It's with regards to the labor, it's with regards to goods and services. That's a big, big deal. And it's going to give Asia a big advantage over the next 20 years.

Chris: Yeah, I think Michael threw the dart right into the bull's-eye in terms of GDP, earnings, trade, labor, and the relationship that China is trying to build with Japan, while they're kind of moving away from the U.S., or at least the U.S. is pushing them away. And at the same time, they're trying to create a domestic economy and remove themselves from being the low cost manufacturer to the world, export all the time.

If they want to control their own ability to create a powerhouse around technology, that is China, they're going to need another partner that's not an emerging nation to move that forward in a quicker way, and perhaps Japan is that one.

Michael: Mm-hmm (affirmative).

Candace: We've spent a lot of time talking about Asia and Europe. What about Latin America?

Michael: Latin America obviously is a region in terms of its GDP is much smaller compared to North America or in Europe, and, and Asia, but you know, it's still very relevant. Often it's, you know, very good barometer of whether the world's getting better or worse. When we've seen Latin America boom it's often when their interest rates are going down and the commodity prices are going up, and when Latin America tends to have problems it's when interest rates are going up, and commodity prices are going down.

Which if political changes in Latin America can lead to, you know, governments that can reduce interest rates, and if the Chinese economy ends up being stronger than people expect, and they continue to support commodity prices, then Latin America will be a good place to have your money.

Candace: So, how all these dynamics that we've been talking about really affect us in the United States? I mean, we're a pretty large domestic economy.

Michael: Yeah.

Candace: Does, does all of this really matter for us in the U.S.?

Michael: I think over the long term, of course it matters. U.S. corporations have a lot of exposure overseas. I can't remember what the number is. Chris, something like 40% of U.S. earnings…

Chris: Mm-hmm (affirmative) close to 45.

Michael: … 40, 45 come from overseas. So yeah, sure. I mean, the GDP you don't care about what happens overseas. But if you're an investor in the stock market, and 45% of your earnings come from overseas, you better be interested in what's going on overseas.

Candace: So, in terms of some of the big trends that are affecting the world. I mean, Michael, you've done a lot of work on demographics-

Chris: Mm-hmm (affirmative).

Candace: Aging of some populations, the explosion of youth in other areas of the world, the rise of the global middle class. And if we fast forward 10 years, and we extrapolate out some of these demographic trends, what do you see happening?

Michael: Outside of the U.S., I mean, clearly places like India, the continent of Africa, places like Nigeria, Egypt, the demographic stories there are really incredibly powerful. Not just that, you know, there's lots of people that can buy goods and services there. But I think in terms of human capital and the quality of human capital, you know, I wouldn't underestimate that as something that can be very, very positive going forward from the emerging markets.

But the other one is, is just that you are seeing, you know, a big aging of the population in the major areas of Japan, China and, and Europe. I mean, Japan's interesting because they just haven't got enough people.

Newsclip: Newly released statistics show that Japan's population is continuing to shrink. The ministry of Health, Labor and Welfare announced June 2nd that the country's birth rate plummeted to a historic low last year … (*News clip from 06/05/2017).*

Michael: So, I think that the technology and the way that that comes into, you know, making people be able to work for longer, or actually take over the skills of people that want to retire, that's going to be a big, big deal going forward in those three major areas.

Chris: The other aspect when you see GDP growth around the world, there are many points in history that you can point out to that as female labor participation goes up in the workforce, it's a direct correlation with higher GDP growth. And you're seeing that across the emerging markets now as well. It's early days, but it's going to take a while to play out. And that is additive to the world's growth curve.

Michael: Yeah, I mean, that's a, that's a big deal.

Chris: It's huge.

Michael: I do think it's a big deal.

Chris: And we've seen it in the advanced economies decades ago, and now we're starting to see it in, in the emerging economies. We even saw it in Japan a few decades back. So there is a huge growth curve in education, the growth of the labor force, and then the advent of robotics and other things to push this growth curve forward.

Candace: So, clearly there are some long term opportunities in certain parts of the world. What would you recommend that an investor do? I mean, is there a risk in having only U.S. investments in your portfolio?

Michael: Certainly from the fixed income side, I'd say that's unquestionably true because the rest of the world owns the U.S. bond market (laughing), or owns a very large, I mean, almost 45% of U.S. Treasuries are now owned overseas. If the Chinese, the Japanese, the European suddenly say, "Actually, we're not interested in owning, or financing your budget deficit," then yields are going to go up, and, or the dollar is going to go down. So I think to me, I mean, Chris can make a comment on, on the equity exposure here. But certainly I think that, you know, you've got some very nice yields now in the U.S. across the curve. Certainly relative to, to Europe and Japan.

Chris: Yeah, and on the equity side, for the long term investor, the investor that has patience, the investor that understands volatility overseas is higher, and the investor that will allow long-term growth ideas to evolve, investing overseas particularly in the emerging economies for the long-term investor at attractive discounts to the historical valuations, like they are right now, is very important.

And it's very important to create that growth that the U.S. from time to time may not have there for you, depending on what part of the cycle they're in. So, long-term investors, volatility can be your friend. And from the standpoint of diversification, it means diversifying the opportunities to grow your portfolio as well. And that is from time to time overseas.

Michael: And don't forget that some of those U.S. companies that you own, as we mentioned before, I mean, they're going to be exposed to the overseas cycle. So, you think about safe ways to play overseas exposure, I mean, one is to just make sure you have a nice chunk of U.S. multinationals in your portfolios that go up and down, you know, with the global economy. I mean, that's one way of doing it. Exchange Traded Funds, otherwise known as ETFs is another way you can do it because you can get exposure to certain markets in a very diversified way via an ETF.

Candace: Okay, well, given all that we've been discussing today, this strong growth in the United States, but, still real opportunities outside the United States in the very long term, what would be your number one takeaway that you'd like to leave our listeners with in terms of investing and the world?

Michael: Well, mine would simply be that Japan, China, Europe, all of those markets are still 20, 30% from their all-time highs. You know, that means that you have to prospectively look forward as an investor and see where your best risk reward is. So I think that looking into 2019, 20, and beyond, it's actually not a bad time to be looking at opportunities overseas.

You really just have to question whether A, the developed markets can get their act together with growth and interest rates because if growth and interest rates start going up in Europe and Japan, there's fantastic opportunities there. Or you just want to say, "No, I want to stay with where the population growth is, the tech opportunities, and that veers you much more towards the emerging markets.

Chris: And I'll always go back to the phrase that says, "Diversification works the most when you need it the most." Markets work off of relative change, for the most part. The relative growth outlook. Is it going up? Is it going down? Is it faster or slower? It's the rate of change that matters a lot. And the emerging markets and the rest of the world outside of the U.S., what they've done for people lately is produce uninspiring results.

And if that starts to turn the other way, while the U.S. begins to slow down to a more normal rate of growth, then the attractiveness of assets overseas becomes higher. And that's why we think, at this stage of the cycle, it's important to raise your level of diversification, increase your exposure to higher quality investments overall, and when you're looking for long term growth, go for the areas that have been unjustly pushed down to levels that have become very attractive for the long term investor.

Candace: Thank you, Chris. Thank you, Michael. You've been listening to the Perspectives podcast. My co-hosts are Michael Hartnett and Chris Hyzy. I'm Candace Browning.

For further insights, listen to other episodes in the Perspectives podcast series. Thanks for listening.

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