Getting the "Big Picture Call" Right: Ten Defining Issues for the Teens Decade

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EXECUTIVE SUMMARY

Our profession devotes a great deal of time to pondering the future. And for good reason. The right "big picture call" about the forward course of economic conditions and capital market values confers a substantial portfolio performance advantage.

The benefits of identifying the correct "big picture call" have been striking so far in the early 21st century. On a naïve market-weighted allocation from January 1, 2000 to January 31, 2014, global equities (0.42%) and global bonds (5.41%) combined to produce a mediocre composite average annual return of just 2.68% as shown in Figure 1. But astute, big-picture aware portfolio managers could have done much better.

A real estate-inspired economic trough looks highly unlikely in this decade.

The equity valuation excesses of the late 1990s' dot.com era were rinsed from the financial system during 2000–2002. A reduction in equity allocation, especially to the tech sector, in the late 1990s, followed by a reversal to a higher equity exposure in late 2002 would have rewarded portfolios.

So too, the systemic overindulgence in financial leverage peaked in 2008 and is still rightsizing in 2014. These systemic purifications ultimately will be recalled as therapeutic and as having laid the foundation for a sounder global financial system. For asset managers, a pre-2007 reduction in portfolio exposure to equities, credit, and real estate securities and a subsequent switch back in early 2009 generally would have made for handsome relative portfolio returns.

Of course, such perfect portfolio allocation agility is easier to portray in hindsight than to achieve through foresight. In a forecasting field already crowded with bias errors, the two most common mistakes in forging asset class return expectations are the tendency to extrapolate the immediate past into the future and to become inordinately influenced by the headlines of the moment. Accordingly, a real estate-inspired economic trough like 2007-2009 looks highly unlikely in this decade. And Fed "tapering" of U.S. Treasury bond purchases, to conclude in 2014, will not figure in the economic discourse of the late Teens.

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The most adept pension funds balance attention to current events with their obligation to meet the long-term needs of their beneficiaries. This difficult process can be facilitated by the simplification of global financial system scenarios into a concise set of pivotal issues that define the "big picture call."

To illustrate this process, we suggest the following ten issues that in our view likely will define the paths of key capital market parameters and hence pension fund returns over the balance of this decade.

When and how does the next U.S. recession arise?

FIRST, when and how does the next U.S. recession arise? The longevity and magnitude of this unfolding global and U.S. economic expansion (about to celebrate its fifth anniversary in June 2014) will become an increasing concern as the end of this decade approaches. Although many pension plan sponsors refrain from high-frequency timing tactics, a late-business cycle portfolio rotation from risky to less-risky asset classes likely will prove beneficial before 2020 in our opinion.

SECOND, the normalization of monetary and fiscal policies without mishap by advanced economies would imply the defeat of deflation, the suppression of inflation, the resuscitation of corporate animal spirits, and the attainment of more vigorous global economic growth. This happy scenario would support extended economic growth, equity valuation advances, just a modest increase in interest rates, moderate housing value appreciation, alternative asset class attractiveness, and stable commodity values. Although likely to be realized over the long run, chances are high of a zig-zag trail rather than a linear path in the Teens in our opinion.

THIRD, the vast regulatory revamp of the global financial system, aimed at systemic risk mitigation, may bring unintended consequences along with its hopeful advantages. For example, volatility may run higher than in past business cycles while liquidity remains scarce, which could influence investor allocation and security selection preferences.

FOURTH, after nearly four decades of blistering economic growth, China has commenced a deceleration from a 7%-10%+ velocity to sub-7%. After 2014, Chinese transition to more internally-based consumption, stepped-up environmental remediation, and full currency convertibility could alter global capital market flows and curb world economic growth, especially for EM economies. Key commodities, like copper, may wind up with lower prices.

FIFTH, although emerging market (EM) economies likely will converge in the long run to advanced economy (AE) status, EM and AE business cycles are asynchronous. In turn, the budding economic recoveries in Europe and Japan in the mid-Teens could be restrained by EM economic slack. This would also chill enthusiasm for frontier markets like sub-Saharan Africa.

SIXTH, from a widely entertained "twilight thesis" a decade ago, U.S. hydrocarbon production has been soaring thanks to the fracking revolution. The apparent global abundance of fossil fuels will aid consumers and energy-intensive industries. This will help corral inflation and promote economic growth. Like the early-to-mid 1980s, energy producers and the commodity asset class may suffer from lower energy prices.

SEVENTH, the power of demographics will intensify as boomers retire in record numbers throughout advanced economies. This likely will occasion a shift into more defensive financial products like bonds. As the world economic system becomes more open, human capital migration also will increase along with associated capital flows like remittances.

EIGHTH, the comparative dormancy of geopolitical risk hopefully persists far into the 21st century. But history does not reassure, as Russia's incursion into Ukraine shows.

NINTH, a kind of Moore's Law guides innovation. The rate of technological change appears to be quickening in the early 21st century. Thanks to the pursuit of "big data," markets have never been as richly informed. Technological progress breeds new products and new methods. Financial markets largely will be beneficiaries.

TENTH, the philosophy and methods of asset management will evolve. Horizon extensions to multi-year performance calibrations, the severance of allegiance to generic and even customized indices in the pursuit of absolute return maximization, increased allocation timing flexibility, and a growing preference for green, socially-responsible issuers will number among a few of the forthcoming methodological adjustments.

Fraught with old and new challenges, the second half of the Teens will unlikely be a golden age for financial asset returns rivaling the 1980s and 1990s. But compared to the opening decade of the 21st century, plan sponsors may look back favorably on the Teens. Indeed, the best working title for the next "big picture call" may be "Coping with Relative AE Prosperity."

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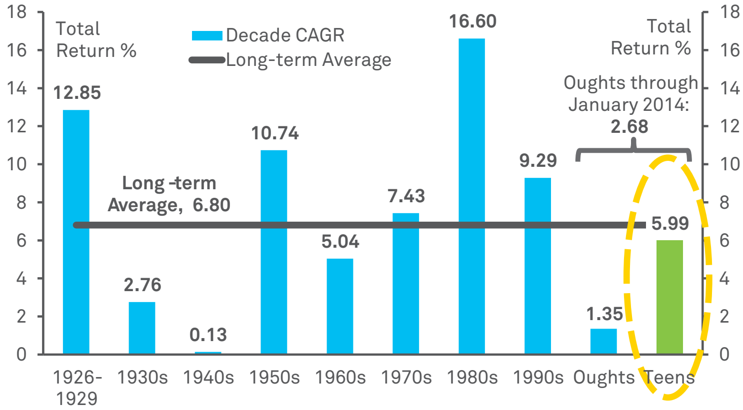
Figure 1. Global Financial Asset Returns by Decade: 1926 to January 31, 2014

NOMINAL

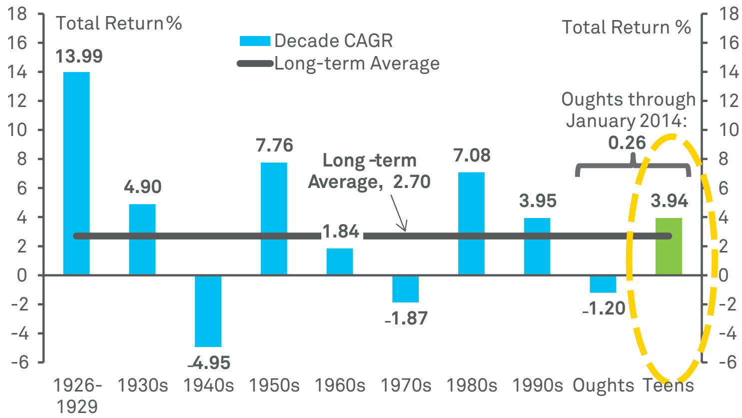


PERIODIC COMPOUND AVERAGE ANNUAL GROWTH RATES (%)

	1926 - 1999	1946 - 1999	1970 - 1999	1970s	1980s	1990s	Oughts	2010 - January 31, 2014	Oughts through January 31, 2014	Jan-14
GLOBAL EQUITY	9.64	11.19	12.11	6.96	20.77	9.09	-2.60	8.22	0.42	-3.31
GLOBAL BOND	4.78	5.48	9.07	7.16	12.02	8.08	5.84	4.39	5.41	1.38
GLOBAL FINANCIAL ASSET	7.60	8.69	11.04	7.43	16.60	9.29	1.35	5.99	2.68	-0.73

	1926 - January 31, 2014	1980 - January 31, 2014
GLOBAL EQUITY	8.11	8.61
GLOBAL BOND	4.89	8.10
GLOBAL FINANCIAL ASSET	6.80	8.55

REAL



PERIODIC COMPOUND AVERAGE ANNUAL GROWTH RATES (%)

	1926 - 1999	1946 - 1999	1970 - 1999	1970s	1980s	1990s	Oughts	2010 - January 31, 2014	Oughts through January 31, 2014	Jan-14
GLOBAL EQUITY	5.12	4.99	3.98	-2.30	10.91	3.76	-5.05	6.13	-1.94	-3.22
GLOBAL BOND	0.47	-0.40	1.16	-2.12	2.88	2.80	3.17	2.37	2.94	1.47
GLOBAL FINANCIAL ASSET	3.17	2.63	2.98	-1.87	7.08	3.95	-1.20	3.94	0.26	-0.64

	1926 - January 31, 2014	1980 - January 31, 2014
GLOBAL EQUITY	3.96	3.37
GLOBAL BOND	0.86	2.88
GLOBAL FINANCIAL ASSET	2.70	3.30

Global Financial Asset: Equally weighted average return of Global Equity and Global Bond from 1926 to 1989; market-value weighted average return from 1990 to current. Global Equity: Data provided by Global Financial Data, a provider of historical market datasets and indices as described at **www.globalfinancialdata.com**, from 1926 to 1987; MSCI-Hedged World U.S. $ Index from 1988 to current. Global Bond: Data provided by Global Financial Data from 1926 to 1986; Barclays Live from 1987 to current. Global Bond U.S.-dollar hedged after 1986; Global Equity U.S.-dollar hedged after 1987. Financial asset total return series begins in 1926; Global Equity total return except from 1988 to current.

Source: BNY Mellon using data from FactSet, Bloomberg, Global Financial Data, and Barclays Live.

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