Ravi Menon: Seeking decent returns in an era of sub-par growth

Speech by Mr Ravi Menon, Managing Director of the Monetary Authority of Singapore, at the Sovereign Investor Institute Government Funds Roundtable, Singapore, 6 November 2014.

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Distinguished guests, ladies and gentlemen, good morning.

The global conjuncture

The major economies of the world are at an inflection point.

In the US, the era of quantitative easing has come to an end. Next year, for the first time in eight years, we are likely to see a hike in the Fed funds rate.

- The good news is that monetary policy normalisation will occur in the context of a strengthening US economy.
- The bad news is that for financial markets conditioned by persistently easy monetary conditions over the last six years, there is considerable uncertainty over the pace and extent of interest rate normalisation.
- The Federal Reserve has done as best as it can in communicating its approach through forward guidance. But there is many a slip between cup and lip that could to lead to disorderly market adjustments.

In the Eurozone, there is tension between restoring public debt to a sustainable trajectory and supporting a faltering economy.

- The ECB has committed to expand the size of its balance sheet by increasing asset purchases, while an active debate rages in Brussels on the appropriate balance between reducing fiscal deficits and supporting growth.

In Japan, the impact of the first arrow of monetary stimulus is at risk of being blunted by the recent consumption tax hike.

- The Bank of Japan has just announced a further expansion in stimulus – an open-ended asset purchase at a rate of about 15% of GDP a year until the inflation target of 2% is met.
- Meanwhile, the third arrow remains largely in its quiver.

In China, the challenge is to strike a delicate balance between implementing the reforms necessary for long-term sustainability while supporting short-term growth and stabilising the property market.

- The reform agenda that emerged out of the Third Plenum offers a credible and comprehensive blueprint for the way forward.
- The leadership is keenly aware of what needs to be done and is committed.
- But significant execution risks remain.

In India, there is a new government in place committed to improving the business environment for investment and building the infrastructure necessary for a strong manufacturing sector.

- But India needs to accomplish this while taming inflation and reducing its fiscal deficit, not to mention recalibrating the dynamic between the centre and the states that is critical for reforms to take root.

Reverting to mean or different this time?

The weak and uneven global recovery post-Crisis has raised concerns about the pace of future economic growth and what it means for returns on investments. Despite ultra-accommodative monetary policy, most advanced economies have not attained so-called escape velocity.

- The legacies of the financial crisis – in the form of debt overhangs – continue to exert a drag.
- The structural deficiencies in the major economies, such as under-investment, cast a dark cloud on future potential growth.

But one thing that ultra-low interest rates over the past six years have clearly done is to depress returns, particularly in fixed income assets.

- US bond returns since 2009 has averaged 2.3% p.a. compared to returns of 5.8% p.a. over the past 20 years.

This has contributed to a more challenging investing environment for government funds – namely pension funds, sovereign wealth funds, and central banks – many of which have significant allocations to developed market fixed income instruments.

Mean reversion is a key tenet of investment theory – the expectation is that as interest rates normalise, returns should revert to pre-crisis levels. But the cliché that this time is different could well be true. Secular trends weigh on future economic growth, and consequently the real return on investment.

Drivers of future economic growth

What are the prospects for future economic growth? There are, in my view, four key drivers of long-term growth: ***deleveraging, demographics, productivity***, and ***energy***. Let me elaborate on each of them.

First, ***deleveraging***. Global balance sheets need to undergo significant adjustments. This is a structural issue that will take time to address.

- For about 20 years preceding the Global Financial Crisis, there had been a significant build-up of debt in the advanced economies.
- This period – often called the Great Moderation – could just as well have been called the Great Leveraging.

Household debt grew rapidly in the US and Europe after 2000, driven by low interest rates and compression in risk spreads. It has come down a little since the Crisis, more so in the US than in Europe, but has still some way to go in both economies.

But what little private sector deleveraging has occurred has been offset by public sector re-leveraging. In the aftermath of the Crisis, public sector debt has ballooned as a result of financial sector bailouts and the effects of automatic fiscal stabilisers as economic growth decelerated.

- Government gross debt in the US and Eurozone increased from about two-thirds of GDP in 2007 to about 100% this year

At the same time, leverage ratios have risen sharply in some emerging market economies in recent years as borrowers took advantage of the abnormally low interest rate environment.

- Total debt in emerging market economies rose from 115% of GDP in 2008 to 150% of GDP in 2013.

Thus, rather than falling, debt-to-GDP at the global level has continued to rise.

- Global total debt (excluding the financial sector) rose by 38 percentage points between 2008 and last year, to reach some 212% of global GDP.
- Only the financial sector has undergone substantial deleveraging to-date.

Essentially, the process of deleveraging remains incomplete. The world as a whole has lived beyond its means. It must now work off these past excesses. The gradual unwinding of the debt build-up in both the private and public sectors will have a dampening effect on economic growth in the advanced economies for several years.

The second driver of growth is ***demographics***. Slowing population growth and rapid ageing are the most daunting headwinds buffeting the global economy over the next 10–20 years. In fact, demographic trends will negatively impact virtually all of the world's major economies, both advanced and emerging.

- In the US, UK, and France, annualised labour force growth will be barely positive over the next two decades.
- In Japan and Germany, the labour force is expected to shrink, subtracting from GDP growth.
- The most dramatic decline will be in China. Labour force contribution to GDP growth will swing from a positive 1.5 percentage points over the last 20 years to virtually zero over the next 20 years, with much of the decline occurring in the immediate future.

But demographic decline is not universal. Many emerging market economies – India and South-east Asia, for example – will continue to have favourable demographics that will support growth.

Demographics is not destiny. This brings us to the third driver of growth – ***productivity***. Human ingenuity to coax higher production out of scarce resources has overcome past demographic challenges. This can be achieved either through more intensive use of existing technology or through breakthroughs in new technology. But there is considerable uncertainty about the prognosis for productivity growth.

On the pessimistic side of the debate is the notion of technological stasis.

- Robert Gordon has presented the most well-known articulation of this view.
- The thesis is that most of the truly important innovations (such as the steam engine, electricity, and modern sanitation) have already been fully utilised, while newer inventions (for example, digital technology) do not seem to have as much transformative impact.
- It is not that there is a dearth of innovations today – on the contrary, there are many. It is just that they have not had as much impact on productivity as earlier innovations.

Techno-optimists, however, believe that we are on the cusp of a new wave of technological breakthroughs that will greatly raise the economy's productive capacity.

- The story of genomics, robotics, artificial intelligence, and 3D printing is only starting to unfold.

Moreover, the world does not comprise of the advanced economies alone. Regardless of what happens to technological advances at the frontier, emerging market economies have considerable scope to raise productivity by simply catching up to the existing state of play at the frontier.

Given their low levels of productivity relative to the frontier (as represented by US productivity), emerging market economies have enormous scope to raise productivity through capital deepening and adoption of existing technology and modern production methods.

- In China, for instance, despite substantial gains in the last two decades, the productivity level is only about 15% that of the US.
- In Indonesia and the Philippines, it is only about 10% that in the US
- With the right policies, these economies can sustain good rates of productivity growth for a few more decades.

A fourth factor impacting long-term economic growth is ***energy***. Some of the world's largest economies – the US, Japan, China, and India – are also among the largest net importers of oil. Cheaper and more plentiful energy is akin to a supply-side boost to these economies.

- The shale gas revolution in the US has markedly reduced its dependence on energy imports and helped to boost industrial competitiveness as energy costs stabilise at a lower level.
- It would be unwise to extrapolate too much from the recent fall in oil prices of over 25% (between July and October this year). But a gentle secular decline in the real price of oil is not an unrealistic assumption that, if true, should be a boon to global economic growth.

To sum up the impact of the four key drivers of growth, deleveraging and demographics are quite unambiguously a dampener while energy appears a benign force. The long term trend for productivity is hard to predict. But even assuming a generally optimistic prognosis for productivity, it is quite likely that global growth in the next 20 years is likely to be lower than in the last 20. This means that returns from financial investments are also likely to be lower in the next 20 than in the last 20.

Safeguarding long-term returns

The modest outlook for long-term economic growth presents a major challenge for government funds to close the widening gap between their financing needs and investment returns.

- On the liabilities side, population ageing in the advanced economies will increase pension claims and place a heavier burden on social services such as healthcare.
- On the assets side, slowing global economic growth will constrain investment returns.

There are three ways to narrow this mismatch between trends in assets and liabilities:

- The first is to reduce financing needs by lowering social expenditures or increasing fiscal revenues. Both are politically difficult to do.
- The second is to reach for yield by taking on various combinations of higher leverage, longer duration, and greater credit and liquidity risks. But the public perception and character of government funds limit their scope for aggressive risk-taking.
- The third way is to expand the investment portfolio to include new asset classes and new geographies for consistent and uncorrelated return streams. This option, while not easy, probably offers the best way forward.

Consider new asset classes. Many government funds are increasing their allocation to non-traditional assets such as real estate, infrastructure, and even private equity.

- Australian and Canadian pension funds have been pioneers in infrastructure investing, from as early as the 1990s.

- Norway's Government Pension Fund Global plans to increase its real estate investments to as much as 5% of its assets, with a corresponding decrease in its bond holdings.
- CalPers has been increasing its allocation to private equity and real assets, including real estate and infrastructure.

Next, new geographies. Over the last 20 years, government funds have steadily reduced their home bias in their equity holdings, investing in markets outside their own country. The big shift in portfolio allocation in recent years has been to emerging markets. If long-term growth prospects for emerging markets are superior to advanced economies, it seems to make sense to increase the strategic allocation to these markets, beyond what is dictated by market capitalisation.

The challenge is in finding ways to translate the superior growth performance of emerging market economies into asset returns, given the limited depth of their capital markets. One way is to perhaps invest in advanced economy corporates with significant exposure and presence in emerging markets.

- Market research shows that equity investments in certain advanced economy companies with significant emerging market exposure can indeed enhance portfolio performance.

Local presence to serve global interests

Even so, there is no substitute for direct investment in emerging market assets. But to understand the performance and risk characteristics of each market requires access to specialist knowledge of political systems, macroeconomic trends, currency conditions, and regulatory and legal frameworks in these countries.

Singapore offers a compelling value proposition for government funds seeking a vantage point from which to build knowledge, insights, and partnerships in Emerging Asia. As a premier asset management centre, Singapore offers global funds a gateway to investing in Asia.

Asset managers are drawn to Singapore's strong global and regional links and their growing presence reinforces these links and at the same time enhances the larger financial eco-system of banks, insurance companies, and the supporting networks of legal, accounting, and technological expertise.

The growth in assets under management has in turn helped to draw in more sell-side products, including traditional and alternative assets like real estate and private equity, as well as a wide range of capabilities.

Several government funds have set up offices in Singapore to support their research and investments in Asia. They include:

- ICPRC;
- Norges Bank Investment Management;
- the Swiss National Bank; and
- La Caisse de dépôt et placement du Québec.

Conclusion

Managing money for the long-term is one of the most difficult of human endeavours. For those of us who manage government funds, we also owe a duty of care and responsibility to future generations – to sustain decent returns at an acceptable level of risk in an era of sub-par growth.

A wise man once said, “In investing money, the amount of interest you want should depend on whether you want to eat well or sleep well.”

I wish you fruitful discussions over the next two days as you explore how to do both. Thank you.