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Global recovery will be subdued says AMP Capital economists

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The forces shaping the global outlook—both those operating over the short term and those operating over the long term—point to subdued growth for 2016 and a gradual recovery thereafter, as well as to downside risks. These forces include some new possible shocks; ongoing realignment; demographics and the evolution of productivity growth; as well as non-economic factors, such as geopolitical and political uncertainty. The subdued recovery also plays a role in explaining the weakness in global trade and persistently low inflation. In this article, we explore the medium-term return potential from major assets and the implications for investors.

The forecast: Medium-term returns will remain sluggish

Combining the return projections for each asset indicates that the implied return for a diversified growth mix of assets is 6.4% p.a. We anticipate that growth will pick up from 2017 onward, on account of the gradual normalisation of macroeconomic conditions in several emerging markets experiencing deep recessions and the increasing weight of fast-growing countries in developing economics.

The downside risks to our medium-term return projections are referred to endlessly by financial commentators: namely that the world is plunged into another recession or that investment yields are pushed up to more normal levels causing large capital losses. The upside risks are (always) less obvious but could occur if global growth improves but inflation remains low, which could see a continuing search for yield further pushing up capital values.

Several themes are allowed for in our projections: slower growth in household debt; the backlash against economic rationalist policies of globalisation, deregulation and small government; rising geopolitical tensions; aging and slowing populations; low commodity prices; technological innovation and automation; the Asian ascendancy and China's growing middle class; rising environmental awareness; and the energy revolution. Most of these themes are constraining nominal growth and hence investor returns. However, technological innovation is positive for profits and some of these themes point to inflation bottoming.

Implications for investors

In this environment, investors should have reasonable return expectations. A dynamic approach to asset allocation may be a way to enhance returns when the return potential from investment markets is constrained. The combination of low investment yields and constrained GDP growth and low inflation means investors should focus on assets providing decent sustainable income as they provide confidence regarding future returns.

7 investment trends to watch

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1. **Sugar and obesity: a risk to earnings**
   Sugar is emerging as one of the most prominent investment risks for the global food and beverage industry. Science has linked high sugar consumption to obesity and Type 2 diabetes at a time when obesity rates are rising and healthcare costs for governments are growing. A long-term trend toward health and wellness is already limiting the growth profile of companies manufacturing and selling products with high sugar content.
2. **Disruption: technology with the potential to upend mature industries**
   In 2017, we expect the next generation of disruptive technologies to deliver the first waves of impact. A few industries in particular will see technology change the way they do business, namely manufacturing (automated vehicles/driverless cars), finance (Blockchain) and retail (online retail moving offline).
3. **Climate change: momentum on renewables will continue**
   The private sector is proactively preparing for a renewables-centric and climate change-resilient world. The continued focus on renewables and energy security will ensure that electricity prices and energy will remain heated discussions globally in 2017. This is likely to add to short term uncertainty for investors as well as utility and fossil fuel companies in the medium term.
4. **Corporate governance: CEO pay and persistence of bonuses**
   The spotlight on executive pay is firmly on bonuses and long-term incentives. With increased investor focus on the components of executive pay and whether or not the hurdles that determine vesting reward stretch performance, executive pay will be a key issue for investors in 2017.
5. **Social licence to operate**
   Key in 2017 will be the remuneration structures financial services firms have in place for front-line sales staff. If there are sales incentives for those who sell to customers, the structure of these incentives will be scrutinised as well as the presence of safeguards to ensure that customers are sold products that are in their best interests, irrespective of internal sales targets.
6. **Supply chain scrutiny broadens beyond the garment sector (electronics, food and agriculture sectors)**
   Globally, some of the largest retailers and manufacturers are only just starting to audit their lengthy supply chains in response to growing scrutiny that is unlikely to abate. Ultimately, a lack of control over a supply chain raises the risk of business interruption and reputational damage and investor awareness of this issue is important.
7. **Food and agriculture: human resistance to antibiotics**
   Recent scientific studies have linked human resistance to some types of antibiotics to their use in meat production. Reduced use of antibiotics by factory farmers will change cost structures and may lead to price rises for consumers. Consumption patterns may therefore also change, affecting the growth and profitability of listed food and agricultural companies globally.

How to win from Generation Rent in the US

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If you're an American, you're much more likely to rent your home or apartment today than you were ten to twenty years ago. If Seinfeld were filmed today, Jerry would still be renting his apartment on the Upper West Side of Manhattan, rather than owning it.

A larger pool of renters is good news for companies that specialise in owning and leasing apartments. There is a group of high-quality US apartment REITs that benefit from the renting trend, and provide a good opportunity for Australian investors to gain exposure to the growth in US rentals, to generate income streams, and to achieve offshore diversification in their property portfolio.

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The influence of Millennials

Millennials now make up the largest share of the American workforce, a proportion which is set to rise to 75 per cent by 2025 and Millennials want to rent.

Millennials are marrying later in life; prefer proximity to nightlife and the workplace; seek flexibility as they switch jobs readily; and are struggling to save for down payments. These factors combined contribute to a greater tendency to rent.

As a result, there has been an increase in demand for rented apartments, particularly in what is dubbed the 'urban core': areas of high density in and around city centres.

Exposure through US apartment REITs

Broadly, this change in American dwelling habits is a positive for residential landlords. Investors can gain exposure to that upside potential through the listed institutional apartment operators.

These apartment (Real Estate Investment Trusts) REITs are generally of high quality and have seen significant consolidation in recent times – five such REITs have been acquired or have merged during the past three years alone – leaving an investible set of large, well-capitalised companies with seasoned management teams.

A more attractive through-cycle investment

Affordability challenges and demographic change have resulted in a larger share of the population living and renting in the city centre. Over the property cycle, the US apartment REITs should therefore be in a stronger position to push rents, given the larger demand base. Quality management teams with insight into the needs of Millennials will be best placed to deliver value for investors.

We believe that this subsector is a more attractive through-cycle investment because of the structural tailwinds described above.

This article was based on the 'Generation Rent: The symbiosis of apartment REITs and Millennials' whitepaper which can be downloaded here.

Don't abandon this vital asset class

AMP Capital

After the election of Donald Trump in November 2016, a surge in global yields triggered a sharp sell-off in global listed infrastructure. Global listed infrastructure fell 4 per cent that month and underperformed global equities by 12 per cent – the second worst monthly relative performance since 2002.

With the threat of further yield rises looming, it's understandable advisers and their clients would be concerned about the outlook.

Nonetheless, investors shouldn't give up on this important investment class. There are strong reasons advisers should remain faithful, and focus not on short-term market movements, but on the resilience of global listed infrastructures' underlying assets and their ability to generate visible and growing cash flows.

Bond proxies

Infrastructure companies provide owners with stable and reliable streams of cash flow, often paid out as regular dividends. That risk/reward profile is usually compared to those of other lower-risk investments such as fixed income, thus receiving the term 'bond proxies' from time to time.

The tools used to value infrastructure assets are rate sensitive, as are regulatory frameworks and contracts that are based on allowed rates of return. Infrastructure assets often have higher leverage, and higher rates can impact financing costs and ultimately cash-flow streams themselves.

Surprising resilience

What is surprising is the asset class' ability to weather rate rises over time.

November was not the first time in recent history that yields have risen, causing global listed infrastructure to underperform global equities in the short term.

However, global listed infrastructure recovered all the relative underperformance to global equities in the 12 months following these periods of increases in nominal yields.

Sector diversification

An understanding of specific characteristics of regions and sectors within the asset class can help advisers position investments to mitigate some interest rate risk.

The drivers of cash flows of a communication tower company in Italy are very different from those of an electric utility company in the US, or an airport in Australia; regulatory frameworks and contract structures vary greatly from sector to sector and from region to region.

This article was based on the Global Listed Infrastructure: Not just a bond proxy whitepaper. Click here to read the full paper.

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