Perspectives

February 2018

DAS FAMILY OFFICE

SHARING OUR PASSION FOR INVESTMENTS

Long Term Capital Market Assumptions in a different economic landscape.

Summary

- The 2017 rise in risky asset valuations were accompanied by strong growth in earnings for the same period.

  Looking ahead, long-term average returns from equity and credit assets are likely to be more modest as earnings flat line, or possibly decline, as a result of two key structural changes in both developed and developing economies viz. demographics and productivity.

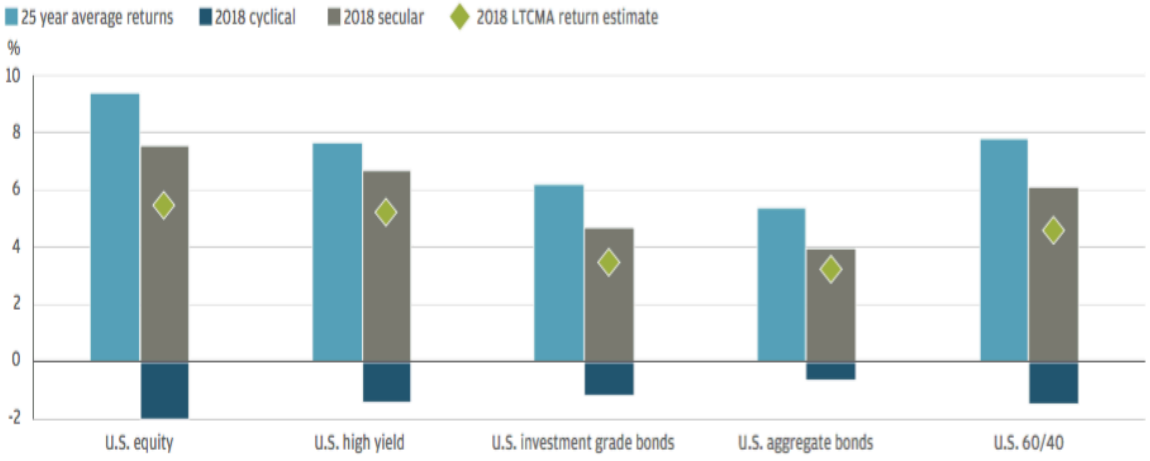
- Demographic trends and changing labour force productivity profiles have implications for corporate earnings in the 21st century's knowledge economy as compared with the manufacturing economy of the 20th century.

- 2018 should offer smart investors opportunities to profit from the higher volatility in market prices with active allocations instead of keeping portfolio positions in equity and credit allocations relatively static as markets gyrate. To be well rewarded, this warrants a focus on careful intra-sector and regional selection over broad based allocations.

Long term asset return expectations vs 25-year average returns

The 10- to- 15year aggregate forecasts for global growth are unchanged this year, with developed markets at 1.5% p.a. and emerging markets at 4.5% p.a.

EXHIBIT 1: HISTORICAL 25-YEAR AVERAGE RETURNS FOR KEY ASSETS AND THIS YEAR'S ESTIMATES, SPLIT INTO THEIR SECULAR (EQUILIBRIUM) AND CYCLICAL COMPONENTS



Source: Bloomberg, Datastream, J.P. Morgan Asset Management Multi-Asset Solutions; data as of September 30, 2017.

Key information sources: Bloomberg, JPM Morgan Asset Management public website

At this stage in the economic cycle, within the scope of structural economic developments, these two secular factors are important because:

1. **Demographics:**
   Since 2010, the steady trend of population aging has shaved half a point (0.5%) off the estimates of trend GDP in developed economies.

   Aging populations in mature, as well as, newly developed economies pose a challenge to the nominal global growth dynamic that we got used to in the last 70 years in two ways viz.

   a. Rising levels of accumulated wealth & savings as people live longer; resulting in very different consumption patterns with rising demand for healthcare, leisure and asset management but slower demand for housing and transportation;
   b. Lower fiscal revenues for governments from a lower personal tax base as the labour participation rate declines

2. **Labour force Productivity:**
   Integrated software systems and internet connectivity retrenches workers in simple or repetitive knowledge work but increases demand for workers with scarce technological and computing skills This results in a more skewed and muted impact of wage inflation on aggregate inflation readings.

   Currently, the beneficiaries of these higher wages are a disproportionately smaller percentage of the overall population and likely to remain so for at least another 10 years until working age population skill levels are revised to match demand for more knowledge and computing skills

Our 2018 assumptions anticipate slow real GDP growth globally; neither global growth assumptions nor the emerging market-developed market growth gap has changed from last year

EXHIBIT 2: MACROECONOMIC ASSUMPTIONS (%)

	2018 assumptions		2017 assumptions		Change (percentage points)	
	Real GDP	Core inflation	Real GDP	Core inflation	Real GDP	Core inflation
DEVELOPED MARKETS	1.50	1.75	1.50	1.75	0.00	0.00
U.S.	1.75	2.25	1.75	2.25	0.00	0.00
Eurozone	1.50	1.50	1.25	1.50	0.25	0.00
UK	1.25	2.00	1.25	2.00	0.00	0.00
Japan	0.50	1.00	0.50	1.00	0.00	0.00
Australia	2.00	2.25	2.25	2.25	-0.25	0.00
Canada	1.50	1.75	1.50	1.75	0.00	0.00
Sweden	1.75	1.75	1.75	1.25	0.00	0.50
Switzerland	1.25	0.75	1.50	0.75	-0.25	0.00
EMERGING MARKETS*	4.50	3.50	4.50	3.75	0.00	-0.25
Brazil	3.00	5.00	2.75	5.25	0.25	-0.25
China	5.00	2.75	5.25	3.00	-0.25	-0.25
India	7.00	5.00	7.00	5.00	0.00	0.00
Russia	1.50	5.50	2.25	5.50	-0.75	0.00
GLOBAL	2.50	2.50	2.50	2.50	0.00	0.00

Source: J.P. Morgan Asset Management; estimates as of September 30, 2017.
* Emerging markets aggregate derived from 9-country sample.

Looking ahead

1. Implications for Corporate Earnings trends

From 2016 to date, the global economy has had a period of superbly synchronized growth as Europe and Japan escaped recessionary conditions. Confidence in the emerging economies' ability to capitalize on this growth momentum was fueled by low nominal market yields that ran below inflation levels. So far, so good….

Whilst many patterns and trends should stay their recent course, the protracted length of this business cycle is likely to result in the secular factors of demographics and labour dynamics asserting greater influence near term returns and long-term investment decisions.

1. Corporate sector earnings will diverge meaningfully from the averages, as some sectors are better positioned vis – a-vis changing consumption patterns.
2. Operating margins and corporate debt levels are likely to trend lower as wage inflation and the cost of capital rises.

As wage inflation rises, albeit skewed in favour of a smaller segment of the population, there are meaningful differences in impact on the global economy.

1. Global Consumption comprises about 65% of global economic GDP, on average.
   Changing trends herein matter:
   a. Aggregate consumption of basic consumer goods (staples) trends will track at or below GDP growth levels, whereas business services and products that require differentiated intellectual property like healthcare and discretionary consumption will see stronger demand and hence, higher nominal growth relative to GDP
   b. Higher capex into automated processes to drive operational productivity will keep net margins at consumer staples (food, household and apparel) under pressure until a sector consolidation sieves out inefficient segments to allow for more oligopolistic market structure.

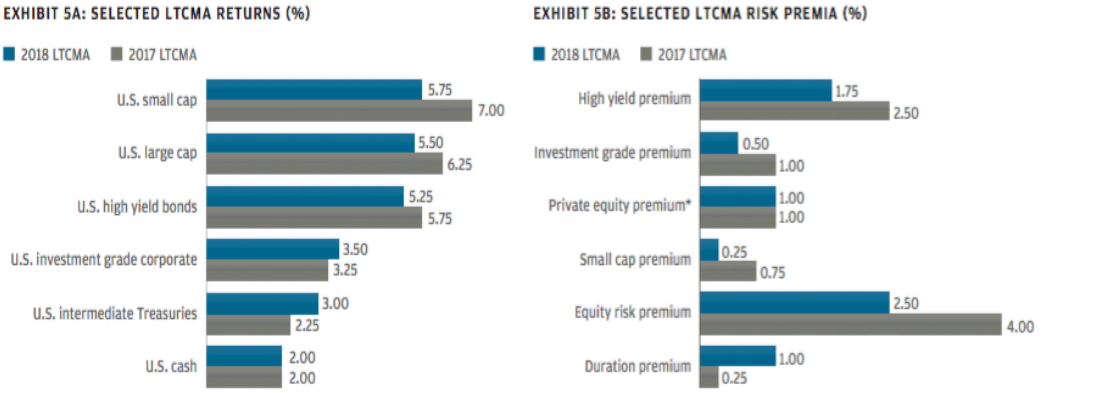
2. Policies emphasizing energy efficiency and resource conservation can result in lower net margins for energy producer and distributors as incremental capex responds to this impetus.

3. The sectors to benefit most in the next 3-7 years are likely to be
   a. Industrial manufacturers in medium and light weight automation (not just robotics!)
   b. Integrated hardware and software systems (not just artificial intelligence!)
   c. Software technology and telecom (yes, even telecom…)

2. Implications Investment Return Expectations

Lower long-term growth estimates have lowered equilibrium returns for most asset classes compared with the last 25 years

Cyclical pressures are weighing on returns for long-term equity and riskier credit, while higher starting yields push bond returns modestly higher



Source: J.P. Morgan Asset Management, estimates as of September 30, 2016 and September 30, 2017.

* Private equity premium assumptions are our alpha assumptions for private equity.

A. Equities

A perceived robust real economic context should support equity return expectations, were it not for the far higher market multiples and a lower starting point for earnings yields

A few key factors now contribute to the sudden change in investor perception and recent rise in risky asset price volatility for 2018

1. Heightened risk awareness about the higher levels of debt that took advantage of the declining trend in nominal cost of capital especially in the developed world since 2003.
A de-leveraging would reduce the net returns on capital enjoyed so far.

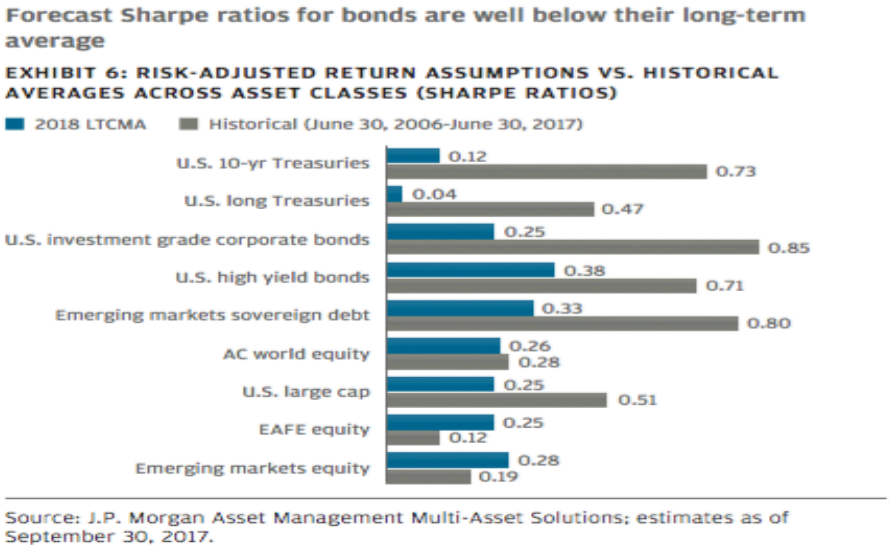
2. Sharply higher asset values were not accompanied by meaningful consumer or producer inflation… thus far. This may be about to change as higher inflation raises the nominal cost of capital.

3. The negative impact of US deficit spending on the US Dollar and its corresponding implications for global export earnings for Asia and Europe.

B. Fixed Income

The forecast return for G4 sovereign bonds are slightly improved this year, credit continues to offer a decent pickup in returns even though prevailing spread levels are tighter than estimates of fair value.

Risk-adjusted returns for fixed income assets now stand at the low end of their typical ranges. In an absolute term, U.S. large cap sharp ratios are below the average of the last 10 years, while EAFE and EM equity Sharpe ratios are above their 10-year average.



Asset Allocation Implications

Our portfolios are positioned taking into account these dynamics and the opportunities they present. We expect to continue rebalancing our allocations to capitalize gains thereto as well.