Lower Growth, Large Gaps

Economic output remains stubbornly low around the world and is expected to grow only modestly for the foreseeable future.

This challenging environment, and the uncertainty it brings to the financial markets and related investment returns, threatens to widen already-large gaps between what investors need to reach long-term goals and how much they actually accumulate.

Sluggish growth presents two additional possible risks to those planning for retirement, college or other long-term objectives.

First, portfolios could grow more slowly as tepid return expectations are realized, forcing investors to consider increasing contributions, extending time horizons or settling for less.

Second, more frequent bouts of volatility in an uncertain economy could drive investors out of risk assets and into shorter-term holdings with even lower return potential.

Consider the retirement savings gap as an example. Today, two out of three U.S. workers have saved less than $50,000 for their retirements,* which are likely to become longer and costlier. This means retirees will either need to rely more on entitlements, such as Social Security, or require higher investment income, both of which might not be satisfactory or sustainable.

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* Employee Benefit Research Institute, 2016 Retirement Confidence Survey.
Could Global Growth Be Weaker Than Forecast?

After briefly accelerating in the wake of the global financial crisis and the Great Recession, economic growth worldwide has fallen back below its long-term average of 3.5%, due primarily to weakness among advanced economies.

The International Monetary Fund (IMF) projects growth to return to more normal levels in the coming years, albeit gradually (see Chart 1). They currently believe emerging markets like China and India will maintain a relatively high level of growth while stagnancy among advanced economies, including the U.S., Japan, the U.K. and the Eurozone, will remain a drag.

However, the IMF’s forecast may be overly optimistic. Going forward, we believe global growth may come under further downward pressure as the unprecedented confluence of today’s challenges play out.

Such challenges include diminishing returns from extraordinary monetary policy, lack of innovation, declining productivity, diminishing corporate profits and persistently low inflation.

ECONOMIC CHALLENGES PUTTING PRESSURE ON FORECASTS

A combination of lingering post-crisis issues and new obstacles are likely to keep global growth at subdued levels for the foreseeable future.

More specifically, three factors pose a challenge to the IMF’s outlook and have already helped bring down consensus forecasts for advanced and emerging economies over the past year (see Chart 2 on the right.)
THREE ECONOMIC CHALLENGES

1. **Accommodative monetary policy** provided a tailwind to economic growth in the immediate aftermath of the crisis. Since then, however, it has yielded mixed results in stimulating advanced economies, and there is now uncertainty about its future path and ultimate unwind. Many companies have also taken advantage of the current policy to fund shareholder-friendly activities instead of funding growth initiatives. The absence of fiscal policy spending, especially in the U.S., is also becoming more apparent as the benefits of monetary policy begin to wane.

2. **Business, demographic and technology cycles** are simultaneously peaking in many advanced economies. This synchronization puts additional pressure on productivity, employment and other key drivers of economic growth. For example, the aging populations in countries like the U.S., Germany and Japan are leaving fewer people in the workforce, while technology advances are creating lower demand for those workers.

3. **Structural economic changes** are also constraining forecasts and could be a larger drag on growth depending on how quickly they are resolved. For example, among advanced economies, the real economic effect of the United Kingdom leaving the European Union will not be known for years, but Brexit is widely expected to have a negative impact on the entire continent. Among emerging markets, China is in the process of transitioning its economy to be more consumer-driven and the government’s ability to orchestrate a “soft” landing remains to be seen. Other emerging nations, such as Russia, Brazil and India, are facing their own idiosyncratic challenges to growth.

These issues raise concerns for investors because lower growth is likely to translate into more uncertain financial market returns. Given today’s declining forecasts, investors may need to plan for below-trend returns and look for more company-specific growth drivers when seeking out opportunities.
A CORPORATE PROFIT RECESSION

In addition to the challenges facing global economic growth, the corporate sector is also facing some headwinds. With profit growth contracting at an aggregate level over the past several quarters, there is reason to be concerned about how this too will feed into the economic growth discussion and how the financial markets will perform going forward.

It is generally agreed that healthy corporate profits support stronger economic growth, which, in turn, results in even healthier profits as the positive feedback loop gathers momentum. Healthier profits also lead to corporate spending and hiring, which is fuel for future growth.

Considering the current low-growth environment, it should come as no surprise that profits have been shrinking since their peak in the third quarter of 2014. What investors should be mindful of is the negative feedback loop that also exists where lower corporate profits feed lower economic growth and capital spending and employment are cut, and so on.

From a financial market standpoint, even more worrisome than the declining trend in corporate profits might be the growing disconnect between corporate profits and equity market performance. Equities typically trade on earnings expectations.

Despite steadily lower profits in recent quarters, expectations for future earnings growth remain optimistic and have pushed the S&P 500 Index to trade at or near all-time highs, pushing valuations to a seven-year peak as measured by the price/earnings ratio (see Chart 3). For investors searching for growth, there will likely be more opportunities among single stocks versus buying a broader index.


The Price-to-Earnings Ratio or P/E ratio is a ratio for valuing a company or index that measures its current share price relative to its per-share earnings.
Back in 2010, market observers noted that the Federal Reserve’s (The “Fed”) unprecedented monetary policies, including the flood of liquidity into the economy through record low interest rates and multiple quantitative easing programs, would bring about runaway inflation and monetary crisis. While inflation expectations touched nearly 3% in 2012, they have since trended lower and remain below the Fed’s 2% target (see Chart 4).

What’s driving inflation expectations lower? In a normal economic expansion, inflation rises when demand for products and services outpaces the supply of those items and, therefore, pushes prices higher.

In the current environment, however, demand has yet to materialize, in spite of the Fed’s best efforts. Furthermore, on the supply side, commodities have undergone a sizable correction over the past year, relieving pressure on input prices while, despite the positive trends in employment, wage inflation has held relatively steady. In short, a reasonable conclusion is that the market has adopted the “lower-for-longer” economic growth narrative and does not consider the Fed’s current policies as effective as they previously were in driving economic growth in the near future.

Despite today’s low inflation expectations, investors should not be complacent. While the headline numbers might appear benign, under the surface, the prices for certain essential services, such as healthcare, housing and education, all are rising at a relatively fast pace. Investors will need to account for this “lurking” inflation as they build their investment objectives.

Source: Federal Reserve Bank of St. Louis as of August 26, 2016. This series is a measure of expected inflation (on average) over the five-year period that begins five years from the date pulled.
**Investment Considerations**

Given this low-growth environment, advisors will be challenged to find sustainable growth to help build investors’ portfolios or narrow their savings gaps. The investment strategies that proved successful over the past seven years of recovery may no longer be optimal going forward. Clients will need to overcome their natural biases, expand opportunity sets and consider strategies better suited for today’s realities.

**CONSIDER ACTIVE OVER PASSIVE STRATEGIES**

Today’s market landscape represents fertile ground for active security pickers. An environment of low growth and heightened volatility represents one of the times when active management can and should outperform passive indexing, especially on a risk-adjusted basis.

**CHART 5**

**NEGATIVE-YIELDING BONDS OUTSTANDING ACROSS THE GLOBE**

- Japan
- Germany
- France
- Switzerland
- Sweden
- Netherlands
- Austria
- U.S.
- Denmark
- U.K.
- Spain
- Italy
- Belgium
- Canada
- Luxembourg
- China
- Taiwan
- Finland
- Norway

Source: Bloomberg and BNY Mellon, as of October 13, 2016.

We are currently seeing a wide dispersion of returns between growth and value equity styles and also across market sectors. Instead of buying an entire index — including the most volatile and unrewarding areas — opportunistic managers can target higher-quality companies with longer-term return potential.

Active management can also play a crucial role within the fixed income investing. Given over $16 trillion in negative-yielding bonds outstanding across the globe, active managers that are flexible and nimble enough to pick through the universe to identify the bright spots in the market can help deliver returns for investors.
EXPAND YOUR OPPORTUNITY SET

Growth factors can differ across both sectors and countries. Since these trends can sometimes pull portfolio returns in different directions, choose a skilled manager who has the experience to identify opportunities wherever they may be found, including outside of the United States.

As of the end of 2015, over half of the world’s equity market capitalization was found outside the United States (see Chart 6), and often in countries with relatively stronger economic and corporate growth prospects. Thoughtful exposure to a diversified basket of international and emerging market equities can be a critical component to long-term risk and return objectives.

BACK TO BASICS

Active strategies that focus on company fundamentals, such as strong balance sheets, low leverage, reliable cash flows and steady or increasing dividend payments, may be able to help investors overcome a broader economic slowdown.

The ability of active managers to invest selectively can be an advantage over a broad index, which doesn’t differentiate between the good and the bad.

Consider strategies that deliver relatively consistent returns over time and map directly to client objectives and challenges.

We believe active equity strategies that rely on fundamental research to identify quality opportunities can help a portfolio grow over time and boost investors as they try to meet long-term goals.

Conclusion

Navigating today’s environment starts with a clear understanding of why economic growth is slowing – with factors ranging from maturing cycles to emerging market divergence, declining corporate profits to falling inflation expectations. Even more important, however, is recognizing how to position portfolios during this time.

Simply allocating assets across passive index strategies is not enough to generate strong returns and bridge savings gaps. With U.S. equity valuations high and rates likely to rise, investors need to take advantage of active security selection as well as accommodative monetary policy and attractive opportunities beyond our borders.
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RISKS

All investments contain risk and may lose value. Equities are subject to market, market sector, market liquidity, issuer, and investment style risks to varying degrees. Small and midsized company stocks tend to be more volatile and less liquid than larger company stocks as these companies are less established and more volatile earnings histories. Investing in foreign denominated and/or domiciled securities involves special risks, including changes in currency exchange rates, political, economic, and social instability, limited company information, differing auditing and legal standards, and less market liquidity. These risks generally are greater with emerging market countries.

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