International investing

White paper

Investing through the global economic cycle

Key highlights

- In recent economic history, the U.S. has led the global economic cycle, followed by other developed markets and then emerging markets
- Many factors can influence how the global economic cycle evolves over time, from central bank policy and interest rates to demographics and technological innovation
- Developed and emerging markets outside of the U.S. are earlier in their expansionary stages, offering potential opportunities for investment outperformance

Summary

The U.S. has an important political and economic influence on the global stage. As the world's largest economy and most dynamic financial market, the U.S. typically leads the rest of the world through the global economic cycle and sets the pace for expansion, contraction and recovery around the world.

The **U.S. has carried much of the weight** through the current global economic expansion, but **other countries** are now **sharing more of the load**.

In this white paper, we'll explore the factors that affect the global economic climate and set the tone for the evolution of the global business cycle. We'll also look at where we are in the current global business cycle and identify potential opportunities for investors in the global markets.

U.S. leadership in the global economy is a relatively new phenomenon when viewed over hundreds of years of world history. In 1820, around 50 years into American history, the U.S. was responsible for less than one-tenth of global economic output, according to an analysis by the Economic Cycle Research Institute. Meanwhile, China and India — two countries considered "emerging" in today's global environment — accounted for nearly half of all world Gross Domestic Product (GDP) in 1820.

The balance of world economic output has constantly changed throughout history. The Industrial Revolution, starting in the 1700s in Europe and in the 1800s in the United States, triggered a significant shift in this balance; countries in Western Europe and eventually the U.S. grew to dominate the global economy.

By the 1970s the economic contributions of China and India had declined to around one-fifth of what they once were.

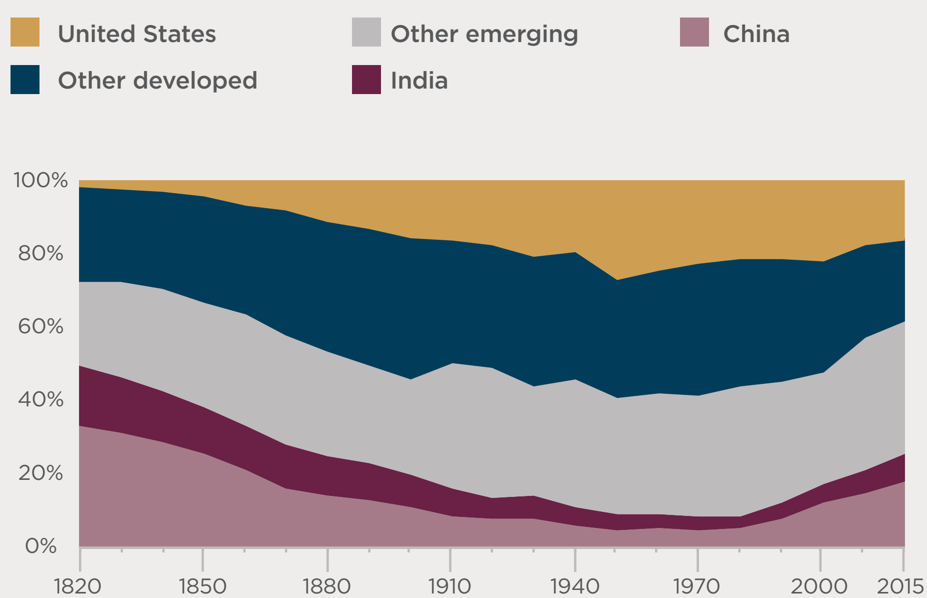
The U.S. share of global growth increased significantly in the years after World War II. Today, the U.S. remains the largest single-country contributor to world GDP. But the share of the U.S. contribution has been shrinking since the 1950s and more significantly since the 2000s, while the influence of China and India on the world economic stage (and other emerging markets as well) has grown from their recent low points.

Trends in globalization have contributed to this change, but so has the fact that China, India and many other emerging markets are today more industrialized than they were in the past and are also active participants in the current technological revolution.

More recently, the U.S. typically has led the rest of the world in the global economic cycle through periods of expansion, recession and recovery. Developed markets outside of the U.S. (e.g., Canada, the U.K., Japan and countries in Western Europe) would follow our lead, then emerging markets would follow these advanced economies. The evolution of the global economic cycle becomes a self-fulfilling progression.

What does this economic history show to investors? Primarily, it's important to recognize that economic growth and leadership are not static; like the picture shown in the graph below, the global economy is a mix of influential forces that are always in motion. Understanding how these forces shape the global economic cycle can help investors get positioned for return opportunities as growth ebbs and flows around the world.

Percentage of Global GDP 1820-2015



Source: The Maddison-Project, http://www.ggdc.net/maddison/maddison-project/home.htm, for data from 1820-2010. World Economics for 2015 data.

A primer on the global economy

Looking at the U.S. economic cycle through a domestic-only lens can present a two-dimensional view of investment opportunities. It can be helpful to see how different components of the U.S. economy work to drive the domestic economy, but the narrow view excludes the significant influence that global forces have on the U.S. and vice versa.

If the domestic economic cycle is two-dimensional, the global economic cycle is three-dimensional. There is a greater degree of interdependence in the global economic cycle, among different countries and different economic forces. In a global economy, the trading of goods and services among different countries helps economies move through their own cycles of expansion and contraction.

Among countries, the trend in recent history (at least going back to the 1950s) is for the U.S. to lead the rest of the world in driving economic growth and expansion. Strength in the U.S. economy typically makes other developed markets more attractive for investment. The increase in global business activity eventually drives demand for raw materials and commodities, which tends to help the economies of emerging markets.

As U.S. economic activity picks up, inflation increases and interest rates rise. Stronger U.S. growth relative to the rest of the world tends to increase the value of the U.S. dollar; the pickup in business activity makes U.S. assets more attractive to international investors and drives greater demand for U.S. dollars.

Similarly, a number of significant factors, from governmental policies to market forces, also interplay to shape how the global economic cycle evolves. These include central bank policies, interest rates, current account balances, currency markets and commodity prices. Typically, a confluence of factors starts the economic cycle transition from an expansion to a recession, and vice versa.

What forces influence the global cycle?

Central bank monetary policy

Central banks focus primarily on their home country economics with an eye toward the global effects of their policies.

Interest rates

Interest rates offer investors a window to a country's economic activity and potential investment opportunities.

Currency markets

Currency markets can affect a country's imports and exports, and by extension influence the global economic cycle.

Central bank monetary policy

In most countries, the central bank is responsible for keeping the economy on an even keel as the business cycle evolves, using the primary tool at their disposal — intrabank interest rates — to affect economic growth, control inflation and promote employment.

The efforts of central banks focus first on the economic cycle in their home countries. For example, the Federal Reserve may tighten monetary policy to cool off an overheating U.S. expansion while the Bank of Japan works in the opposite direction to jump-start an economy in recession. In a global economy, where countries trade goods and exchange currencies and investors seek return opportunities, central bank actions will have ripple effects in other markets. This can make a central banker's job more difficult. Central banks in larger developed economies, such as the U.S., the U.K., Japan and the European Union, have historically enacted policy changes within the context of global economic growth. In this way, central banks typically are in concert on the direction of policy.

There are occasions when central bank monetary policies may diverge, particularly when local economic issues take greater precedence over global objectives. The recovery from the global financial crisis has been one of those occasions; the Federal Reserve led the way in setting accommodative monetary policies, including low interest rates and asset purchases ("quantitative easing"), before European and Japanese central banks did so. The Fed has since changed course to adopt a more restrictive monetary policy (by raising rates) while the European Central Bank and the Bank of Japan remain in accommodative mode (by keeping rates low).

Interest rates

%

Central bank policies have wide-ranging effects within an economy. For example, when the Fed hikes rates, businesses typically pay more to borrow from the investment markets and consumers often pay higher interest rates on mortgages, auto loans and credit card balances. Central banks cannot control interest rates beyond their intrabank target rates. Other factors influence the direction of consumer interest rates and longer-term rates for government and corporate borrowing, but central bank decisions do hold a lot of sway in credit and lending markets.

When central banks raise rates from low levels, it typically indicates favorable conditions in the overall economy: Business activity is accelerating; companies make more money and add staff; workers can find jobs easily and earn more income; and consumers spend their higher income on goods and services, which keeps business activity going.

Central bank policy and interest rates should be viewed in context of the local economy and its place in the wider global economy. A central bank may tighten monetary policy and increase interest rates to cool down an overheating economy. Or a central bank may relax monetary policy and lower interest rates to jump-start an economy.

For investors, interest rates become an important gauge of economic activity and indicate potential investment opportunities. In an expanding economy, higher corporate earnings attract investors, not only from domestic markets but international markets as well. Moreover, higher interest rates in government and corporate lending markets can make yields on bonds more attractive.

Currency markets

Investors looking beyond their domestic market for investment opportunities typically must purchase assets in local currency. That introduces currency markets and exchange rates into the global economic cycle.

A country that is attracting investment from foreign investors, either because of economic expansion, greater business activity or higher interest rates, will typically see the value of their currency rise. A stronger currency is good news for anyone holding that currency: Businesses and consumers may find greater purchasing power when buying foreign assets or imported goods. A manufacturer in the country may not be as happy to see the currency rise, because it makes their goods more expensive in markets where the currency is relatively weaker.

The rise and fall of relative currency valuations influence trade between countries, and by extension the global economic cycle. This dynamic is behind the trend of U.S. economic leadership; a stronger U.S. dollar relative to another country's currency makes that country's products and investments more attractive to U.S. consumers and investors. But while the American public may see a stronger dollar as a positive for the country (perhaps more on a psychological level), American-based businesses may take the opposite view because a strong dollar hurts their ability to trade with the rest of the world.

A current view of the global cycle

More recent economic history, over the past 30 years, has been relatively placid compared to other economic periods, even with the significant upheaval caused by the global financial crisis. The past 30 years have been marked by declining economic volatility; changes in the business cycle have been less violent in recent years, due in part to the greater interdependence among countries for trade and investment and a more active role assumed by central banks in managing the economic cycle.

Businesses and governments around the world look to their countries' central banks to act as a "circuit breaker," warding off potential economic calamity with more conventional interest rate policies and less conventional "quantitative easing" policies of asset purchases. These accommodative "easy money" policies may have helped avoid a significant global economic downturn in the years since the financial crisis. More controversially, the intervention of global central banks in asset markets has distorted market forces that typically create bull and bear markets.

The globalization of trade has also emerged as an influential force in the current economic cycle. While trade across borders has long been a feature of the global economy, advances in technology and transportation in recent decades have dramatically altered the dynamics of trade among different nations. Goods now travel faster between countries thousands of miles apart, often in a matter of days. Services travel even faster, usually in a matter of seconds. Think of how easy it is today for a consumer in the U.S. to contact a customer service representative in India.

Real GDP growth in the U.S. is **expected to remain**

above 2%

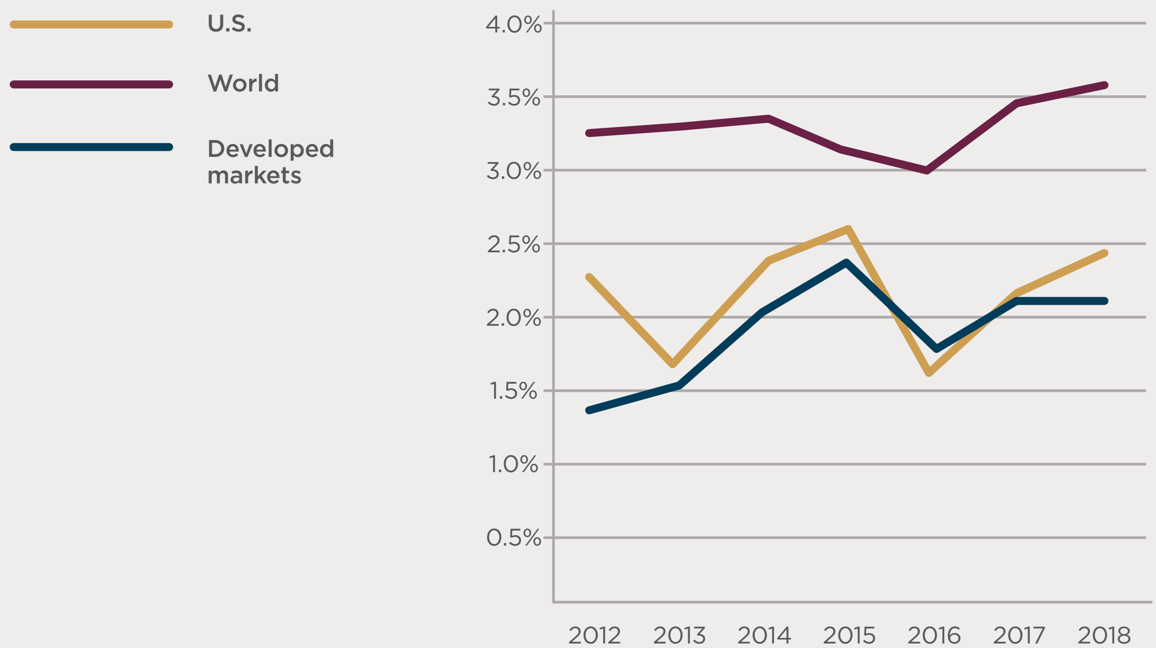
on an annual basis in coming years, **among the strongest** of global developed economies.

Source: International Monetary Fund, "World Economic Outlook Update" July 2017.

As the world's largest economy, the U.S. remains a significant contributor to global economic growth. In coming years, real GDP growth in the U.S. is expected to remain above 2% on an annual basis — among the strongest of developed economies. Still, this is a modest pace of economic growth relative to the U.S. historical average.

While U.S. GDP growth has been sluggish in recent years, other developed countries have picked up a greater share of global growth — and the trend is expected to spread to emerging economies. This is an encouraging development, indicative of a strong and healthy global economic cycle in which expansion continues in many countries.

Real GDP growth



Source: FactSet Research Systems.

Where is the current global economic cycle most vulnerable? Among the biggest factors that could potentially weaken the current pace of growth, especially in developed markets, are demographic trends. Many advanced economies are facing a growing burden of aging populations as people live longer and fewer children are born. In many of these countries, financial support pledged to older citizens is overburdening governments and increasing budget deficits. Many businesses are facing similar increased costs, in the form of obligations to provide financial and health insurance benefits to former and retired employees in their pension plans.

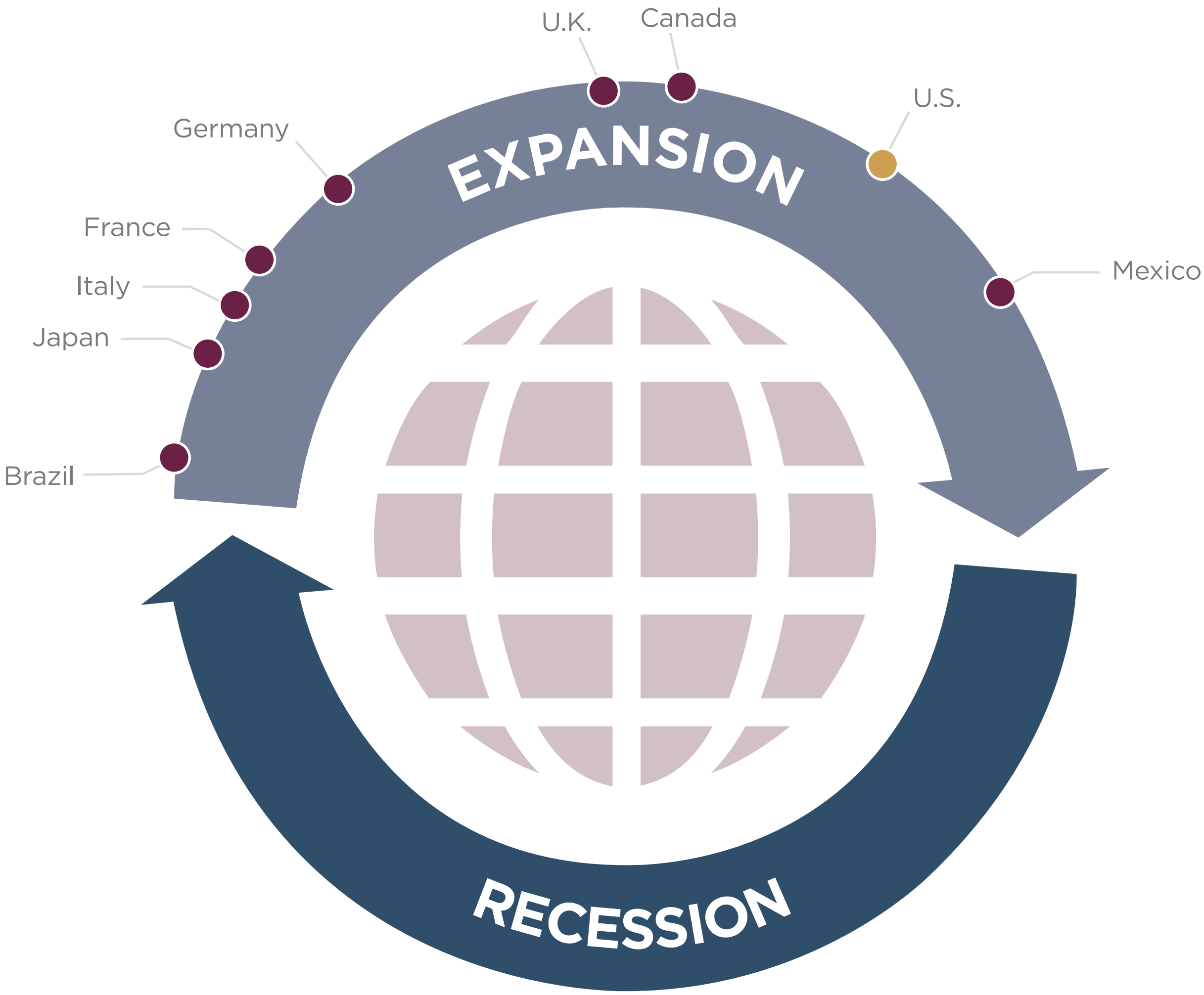
Ideally, a growing economy would provide enough tax revenue to cover these obligations to older citizens through business growth, higher productivity and increased consumer spending. But these demographic challenges are squeezing many advanced economies in another way as well: While the population of older citizens and retired workers is growing, the working-age population is shrinking.

> Many advanced economies are facing ***a growing burden*** of ***aging populations*** as people live longer and fewer children are born.

Having a greater share of nonworking citizens does not contribute to economic growth, either through consumption or taxation of earnings, and they also can increase the burden on governments providing benefits and other resources to citizens outside of the workforce.

While many advanced economies, through government and central bank policies, seek to stimulate economic growth and therefore boost employment, another trend threatens to undercut these efforts: the drive toward automation. Many economists see automation as the primary cause of job losses and the growth of non-working populations, not only in advanced economies but in emerging market economies as well.

Automation tends to contribute to the trend of increasing economic growth through improved productivity, but it may also mask an underlying problem of widespread, long-term unemployment in a country's working population. While economic growth may continue on a global level, on a national level the drag of a large nonworking population would likely increase the burden of government debt and could eventually slow economic growth.



As of January 2018
Source: Nationwide Economics

Investing through the global cycle

As we mentioned earlier in this white paper, the U.S. has often led the rest of the world in the global economic cycle, through periods of expansion, contraction and recovery. The current cycle has not been much different; the U.S. economy emerged faster out of the gate following the previous recession, during the global financial crisis. Growth in other developed markets lagged, as it did in emerging markets. That is, until more recently.

A look at the current global economic cycle shows that nearly every economy — in particular the major developed market economies — is in an expansionary phase. This is a welcome sign. For many of the years after the financial crisis, the U.S. has borne much of the weight of the global economy while other countries waited for growth to develop. Now, the weight is being spread more evenly; the U.S. continues to carry its share, but now the rest of the world is stepping up to do the same. That should help the current expansion phase of the global economic cycle to continue.

Investors who **look beyond their domestic borders** may find **better opportunities** for investment return.

As global growth becomes more evenly distributed and economies outside of the U.S. see an acceleration of growth, investors who look beyond the domestic borders may find better opportunities for investment return. How long can this expansion continue? Let's look at a snapshot of developed and emerging markets to find potential answers.

Developed markets: Central banks provide direction

In the previous section, we discussed the gradual adoption of accommodative monetary policies among the major developed markets' central banks, including the Federal Reserve, the European Central Bank (ECB) and the Bank of Japan (BoJ). A primary reason for U.S. economic leadership out of the Great Recession was Federal Reserve policy. In addition to lowering interest rates, the Fed rolled out its "quantitative easing" (QE) asset purchase program earlier than other central banks did. By buying bonds on the open market, the Fed provided a necessary backstop for the U.S. economy as it regained its footing after the financial crisis.

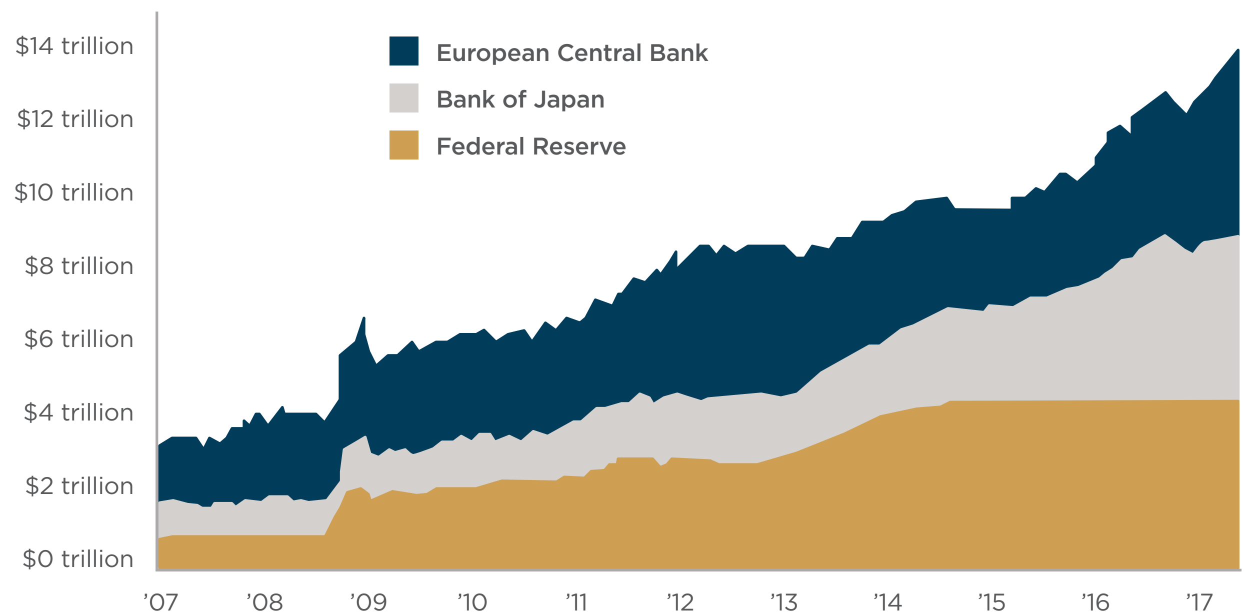
In the process, the Fed's balance sheet swelled significantly — to over $4 trillion — by 2014.

The ECB and BoJ eventually expanded their QE programs. The ECB's expansion occurred in 2012, partly as a response to the European sovereign debt crisis that threatened the eurozone economies of Greece, Spain, Portugal and Ireland. The Bank of Japan's QE program started in 2014, around the time the Fed called a halt to its asset purchase program.

A combined look at the balance sheet expansion of all three central banks shows total assets growing to more than $12 trillion as of 2017. Much of the recent purchases have come from the ECB and BoJ; these central banks have maintained accommodative monetary policies after the Fed began tightening rates in the U.S. starting in December 2015. "Easy money" brightened the prospects for economic growth and investment return in these countries.

When the pace of growth accelerates in these countries, it is expected these central banks will follow the Fed and remove "easy money" monetary accommodation. This process has recently started in the U.K. and Europe; in June 2017, the Bank of England signaled the possibility of higher rates coming in the near term, while ECB president Mario Draghi floated the idea of tapering the European Central Bank's quantitative easing program.

Total assets on central bank balance sheets (Combined Fed, BoJ, ECB)

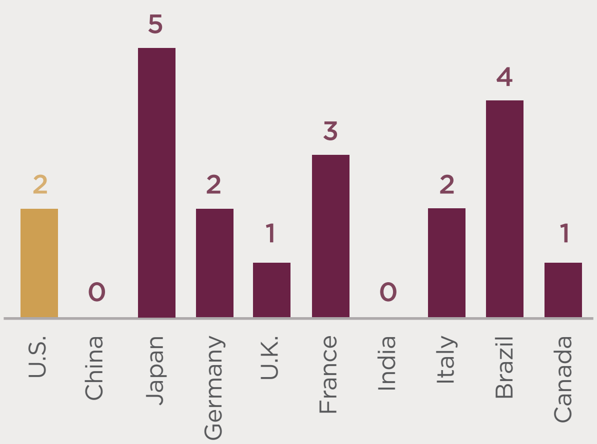


Source: Strategas Research Partners

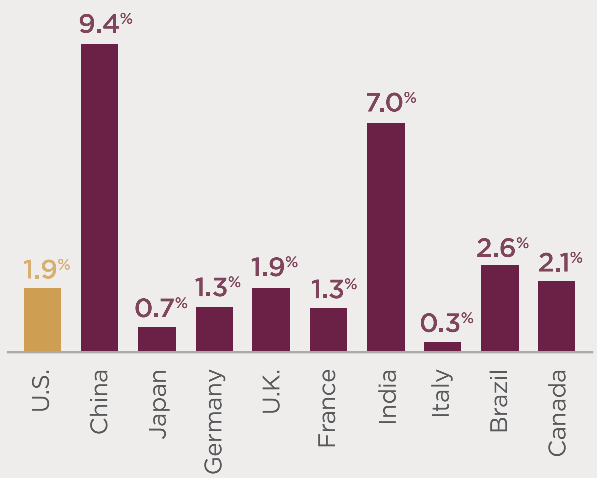
Emerging markets: demographics at work

The four largest global emerging markets — Brazil, Russia, India and China — are at very different places in terms of their economic cycles. Brazil has emerged from a recession as oil prices have steadily moved higher.
China and India, however, have been among the strongest economies on the global stage since 2000, outpacing the G-7 major industrial economies. Both countries have reaped the benefits of a growing labor force and expanding middle class driving greater consumer spending and business activity. In India, the last recession was more than 20 years ago; in China, nearly 30 years ago (see chart below).
In both China and India, the pace of growth can be expected to fluctuate, especially as their economies become more integrated into the global marketplace and the growth cycle approaches maturity. Recent economic data shows growth in both countries is slowing down as of late. With their structural advantages helping to continue expansion, investment opportunities in both countries should remain attractive.

Recessions since 2000



Average yearly real GDP growth 2000-2016



Sources: Economic Cycle Research Institute, Bloomberg

Exploring global investment ideas

Many investors display a "home bias" in their portfolios, overweighting investments from their home country and missing opportunities that can be found beyond U.S. borders. For example, U.S. investors prefer to buy stocks of U.S. companies they recognize by name. This tendency affects investors in other countries, too.
A review of a portfolio allocation by country can be useful in identifying the need for additional diversification, especially when this review is done in conjunction with a risk tolerance assessment.

Many investors display a ***"home bias"*** in their portfolios

Investors should be cognizant of the unique risks that come with investing in international markets, in particular political, currency and information-access risks that may be different when exploring opportunities in various countries. Investors should allocate a portion of the portfolio to international investments only when global investing aligns with their long-term goals and only at a level that would be suitable for their risk tolerance.

An understanding of the forces at work in the global economic cycle can help investors better assess how opportunities in international markets may be able to meet their investment objectives.

Key takeaways

1

An allocation to international investments in both developed and emerging markets can be appropriate for many investors, depending on their risk profile.

2

View opportunities in international markets in perspective of where various countries are in the global economic cycle.

3

News on economic developments (e.g., central bank policy) can be short term in nature, so maintain a long-term, "big picture" view of global opportunities.

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