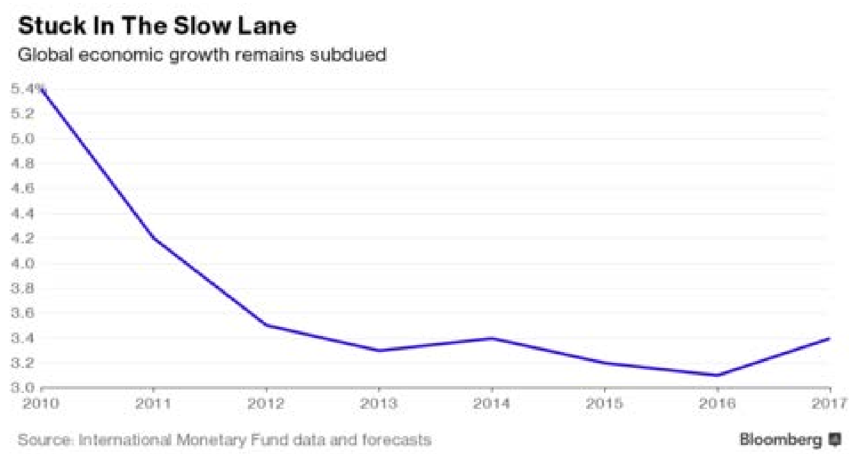
Investing in a Low Growth-High Debt World

The world economy continues to slow as policy makers attempt to find additional ways in which to stimulate the economy, while simultaneously remaining committed to the existing accommodative monetary policies. The global economy is likely to grow by approximately 3% this year, a far cry from the over 5% achieved in 2010 (chart 1).

Chart 1



The low, or in many cases negative, interest rates do keep the economy afloat, but just barely. Many experts have urged for fiscal measures to complement existing monetary policies in order to stimulate the economy. However, this might be hard to achieve given how high developed world debt levels are today. Both public and non-public debt in the developed world has grown to approximately 265% of GDP (see chart 2). According to the below chart, the rising overall debt levels are primarily due to the public sector, which began its ascent after the great recession of 2008. Private sector debt as a percentage of GDP has actually come down as businesses have remained cautious throughout the same period. The high public debt levels leave very few tools in the hands of policy makers to revive growth. This low growth, high debt, low interest rate world presents a unique challenge to an asset allocator.

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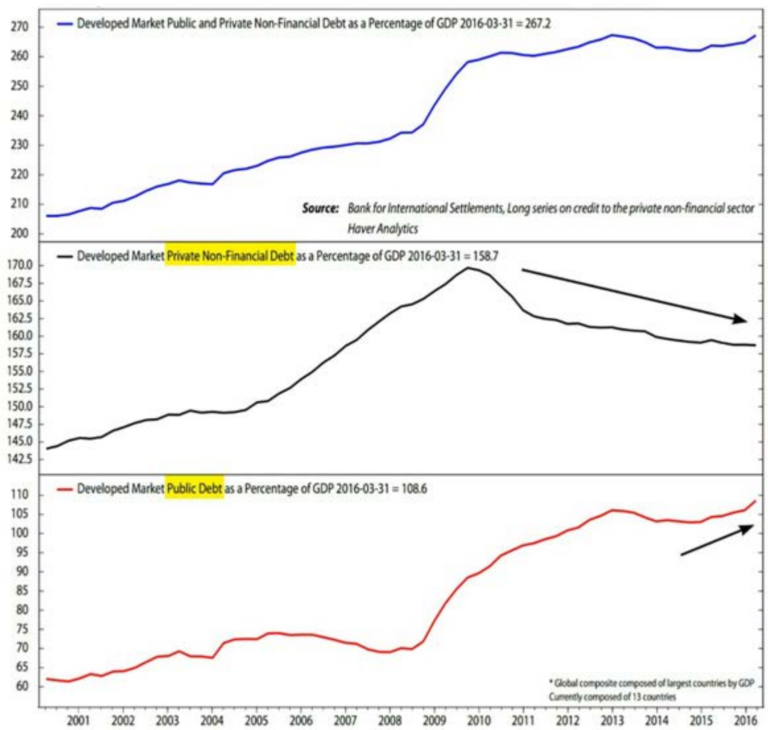
Chart 2



At Lynx we believe the answer, while not easy, is to look more closely at the various constituents of the global economy and then at individual asset classes in order to uncover less obvious and highly fruitful areas of investment. One such opportunity resides in the emerging world.

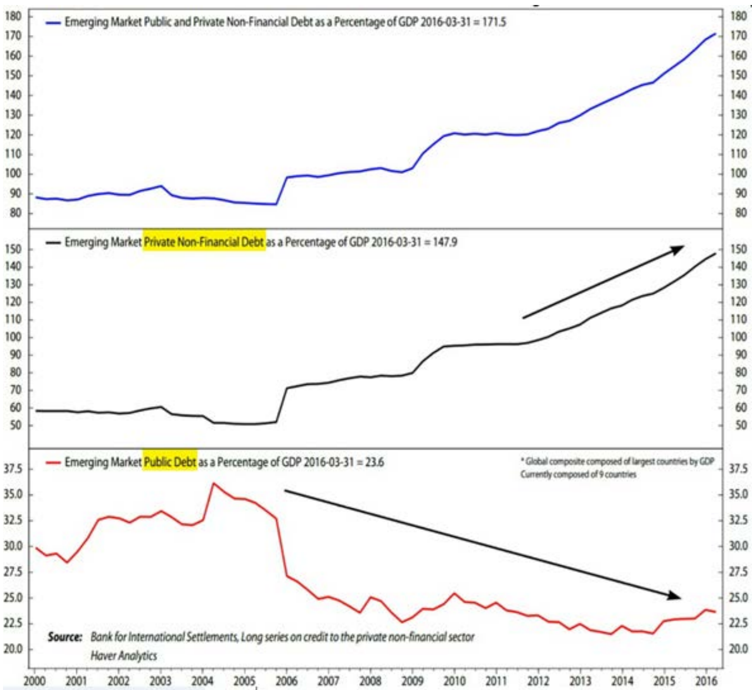
We are of the opinion that emerging markets, especially those in Asia, should do well in this environment. According to the IMF, the GDP forecast by region suggests that the strongest growth exists among emerging countries, particularly in Asia (chart 3). Not only do emerging markets have stronger growth, they also have lower levels of debt. As chart 4 indicates, the trend among emerging markets has been essentially the opposite of that seen among developed countries. Though overall debt in the emerging markets has risen as a percentage of GDP, it is primarily due to the private sector, while its public sector debt has remained relatively steady at 24% of GDP. Lower public debt in the emerging markets gives policy makers in these countries more choices, choices that their counterparts in the developed world cannot afford.

Chart 3

(Percent change, unless noted otherwise)

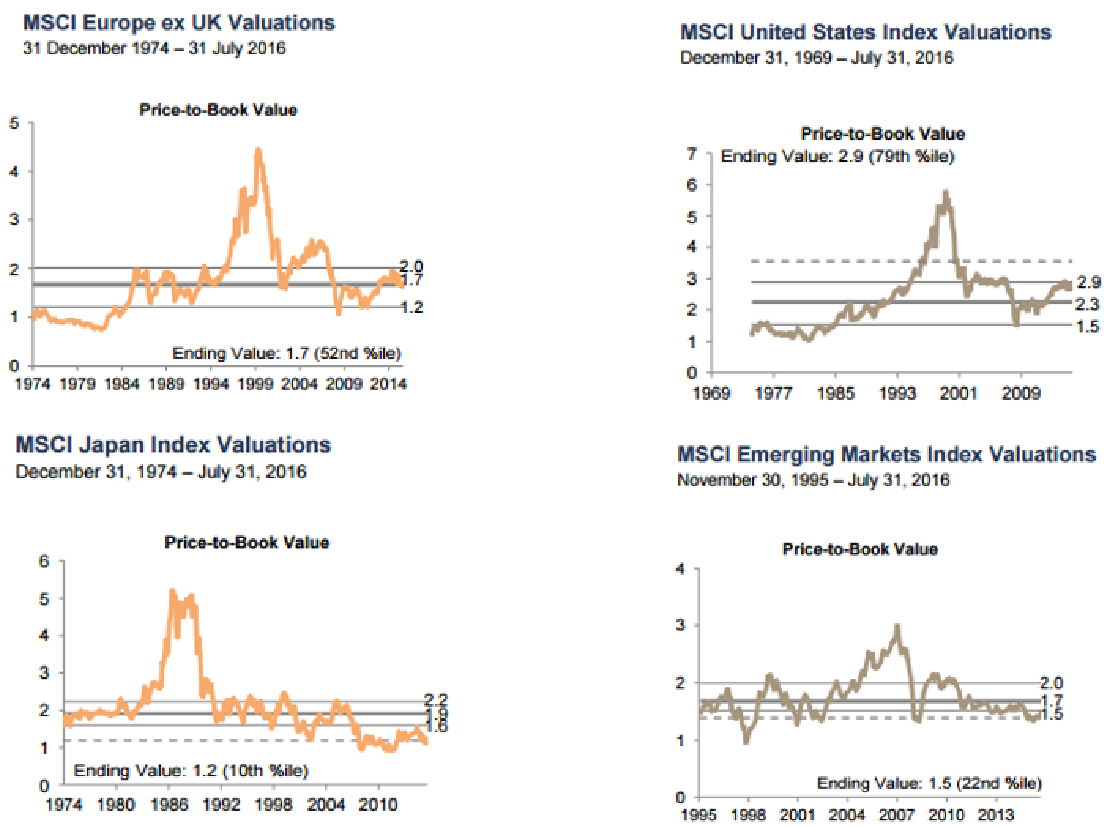
		Projections		Difference from January 2016 *WEO Update*[1]		Difference from October 2015 WEO[1]	
	2015	2016	2017	2016	2017	2016	2017
World Output	**3.1**	**3.2**	**3.5**	**–0.2**	**–0.1**	**–0.4**	**–0.3**
Advanced Economies	**1.9**	**1.9**	**2.0**	**–0.2**	**–0.1**	**–0.3**	**–0.2**
United States	2.4	2.4	2.5	–0.2	–0.1	–0.4	–0.3
Euro Area	1.6	1.5	1.6	–0.2	–0.1	–0.1	–0.1
Germany	1.5	1.5	1.6	–0.2	–0.1	–0.1	0.1
France	1.1	1.1	1.3	–0.2	–0.2	–0.4	–0.3
Italy	0.8	1.0	1.1	–0.3	–0.1	–0.3	–0.1
Spain	3.2	2.6	2.3	–0.1	0.0	0.1	0.1
Japan	0.5	0.5	–0.1	–0.5	–0.4	–0.5	–0.5
United Kingdom	2.2	1.9	2.2	–0.3	0.0	–0.3	0.0
Canada	1.2	1.5	1.9	–0.2	–0.2	–0.2	–0.5
Other Advanced Economies[2]	2.0	2.1	2.4	–0.3	–0.4	–0.6	–0.5
Emerging Market and Developing Economies	**4.0**	**4.1**	**4.6**	**–0.2**	**–0.1**	**–0.4**	**–0.3**
Commonwealth of Independent States	–2.8	–1.1	1.3	–1.1	–0.4	–1.6	–0.7
Russia	–3.7	–1.8	0.8	–0.8	–0.2	–1.2	–0.2
Excluding Russia	–0.6	0.9	2.3	–1.4	–0.9	–1.9	–1.7
Emerging and Developing Asia	6.6	6.4	6.3	0.1	0.1	0.0	0.0
China	6.9	6.5	6.2	0.2	0.2	0.2	0.2
India[3]	7.3	7.5	7.5	0.0	0.0	0.0	0.0
ASEAN-5[4]	4.7	4.8	5.1	0.0	0.0	–0.1	–0.2
Emerging and Developing Europe	3.5	3.5	3.3	0.4	–0.1	0.5	–0.1
Latin America and the Caribbean	–0.1	–0.5	1.5	–0.2	–0.1	–1.3	–0.8
Brazil	–3.8	–3.8	0.0	–0.3	0.0	–2.8	–2.3
Mexico	2.5	2.4	2.6	–0.2	–0.3	–0.4	–0.5
Middle East, North Africa, Afghanistan, and Pakistan	2.5	3.1	3.5	–0.5	–0.1	–0.8	–0.6
Saudi Arabia	3.4	1.2	1.9	0.0	0.0	–1.0	–1.0
Sub-Saharan Africa	3.4	3.0	4.0	–1.0	–0.7	–1.3	–0.9
Nigeria	2.7	2.3	3.5	–1.8	–0.7	–2.0	–1.0
South Africa	1.3	0.6	1.2	–0.1	–0.6	–0.7	–0.9
Memorandum							
European Union	2.0	1.8	1.9	–0.2	–0.1	–0.1	–0.1
Low-Income Developing Countries	4.5	4.7	5.5	–0.9	–0.4	–1.1	–0.6
Middle East and North Africa	2.3	2.9	3.3	–0.6	–0.2	–0.9	–0.8
World Growth Based on Market Exchange Rates	2.4	2.5	2.9	–0.2	–0.1	–0.5	–0.3
World Trade Volume (goods and services)	**2.8**	**3.1**	**3.8**	**–0.3**	**–0.3**	**–1.0**	**–0.8**
Imports							
Advanced Economies	4.3	3.4	4.1	–0.3	0.0	–0.8	–0.4
Emerging Market and Developing Economies	0.5	3.0	3.7	–0.4	–0.6	–1.4	–1.7
Exports							
Advanced Economies	3.4	2.5	3.5	–0.4	–0.1	–0.9	–0.4
Emerging Market and Developing Economies	1.7	3.8	3.9	0.0	–0.5	–1.0	–1.4
Commodity Prices (U.S. dollars)							
Oil[5]	–47.2	–31.6	17.9	–14.0	3.0	–29.2	7.8
Nonfuel (average based on world commodity export weights)	–17.5	–9.4	–0.7	0.1	–1.1	–4.3	–1.0
Consumer Prices							
Advanced Economies	0.3	0.7	1.5	–0.4	–0.2	–0.5	–0.2
Emerging Market and Developing Economies[6]	4.7	4.5	4.2	0.2	0.1	0.2	0.0
London Interbank Offered Rate (percent)							
On U.S. Dollar Deposits (six month)	0.5	0.9	1.5	–0.3	–0.7	–0.3	–0.7
On Euro Deposits (three month)	0.0	–0.3	–0.4	0.0	–0.2	–0.3	–0.5
On Japanese Yen Deposits (six month)	0.1	–0.1	–0.3	–0.2	–0.4	–0.2	–0.5

Chart 4



As discussed, emerging markets have both growth and low debt levels, thus the question then becomes, should investors increase their allocations to these markets? We believe the answer to this question is yes, at least based on valuations. At this point, we don't think the positive environment in emerging markets has been priced into the capital markets yet, and we attribute this to investor concern and caution around both the uncertainty in China, as well as the Federal Reserve interest rate policy. According to chart 5, emerging markets are trading at extremely cheap valuations based on the historical price to book ratio. The emerging market equity valuation is the cheapest we have seen in many years. The next question is then, how best to seek exposure to the asset class. The answer, of course, is contingent on an investor's liquidity needs, risk tolerance and return objectives. An investor looking for yield, albeit with some volatility, can invest in sovereign debt of emerging markets using open ended or closed end mutual funds. Templeton Emerging Market Bond Fund (Ticker: TEI), is a closed end fund an investor might consider. This fund is managed by an experienced and highly regarded team. It currently trades at an over 10% discount and offers slightly more than a 7% yield. Unlike most closed end funds, TEI is not levered, which would suggest less volatile as compared to other closed end funds in this category (please note, some of Lynx's client portfolios hold this investment). As always we strongly encourage investors to do their own due diligence before investing.

Chart 5



In summary, while the developed world appears to have tepid growth and high levels of debt, emerging markets are better positioned for growth. For those investors who have a longer term investment prospective and are willing to accept short term volatility, the cheaper valuations in emerging markets provide an attractive investment opportunity today.

Date: October, 2016