Transcript

Better conversations. Better outcomes.

Episode 1.17 - Five-year outlook: Slow and steady wins the race

Jon Adams - We've really talked a lot in our team at least about kind of the folly of thinking that you have a better sense of political outcome than the overall market and also that you're going to be able to predict market outcomes based on those political events. I think that's the main part of the reason why we look at kind of a longer term and try not to get too caught up in short-term noise because these things are very difficult to predict.

Ben Jones - Welcome to Better conversations. Better outcomes. presented by BMO Global Asset Management. I'm Ben Jones.

Matt Smith - And I'm Matt Smith. Each episode will explore topics relevant to today's trusted advisors, interviewing experts and investigating the world of wealth advising from every angle. We'll also provide actionable ideas designed to improve outcomes for advisors and their clients.

Ben Jones - To learn more, visit us at bmogam.com/betterconversations. Thanks for joining us.

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Ben Jones - Today our episode's a bit different. We're zooming out to take a look at the big picture. We're exploring global financial markets, global political and economic events and how these events could influence your client's portfolios in the years ahead.

Matt Smith - Every year for the past several years, BMO Global Asset Management has hosted an annual Global Investment Forum. The Forum brings together BMO's international investment leaders and strategists as well as select outside experts to discuss and debate our five year outlook for global economies and capital markets. At the end of each Forum, we publish our five year outlook perspective as a document that highlights the possible scenarios we see happening in global trends as well as themes we see for economic and political environments for the years ahead. I sat down in late November of 2016 with Jon Adams, a senior investment strategist on BMO's multi asset solutions team. Jon participated in this year's event and talked about what was discussed at the Forum and its goals. If you want to read along, a link to this year's five year outlook paper can be found at bmogam.com/betterconversations.

Jon Adams - It's really senior investors from all over the world attend the Forum, typically about 20 to 25 investors in total. Those folks are from the U.S., from Canada and from Europe. So we were in London this year. We were in Toronto last year and Chicago the prior year. But really the idea with the Global Investors Forum is to discuss themes that will impact markets over the next three to five years and what we do is we formulate three scenarios - a base case, an upside and a downside scenario. We try to assign probabilities to those scenarios over the next three to five years. This happens over the course of a couple of days and we have a number of speakers who come in and talk about these various themes. The speakers comprise of chief economists, investment managers, academics. They're both internal and external speakers, and really the goal of the Forum overall is to come up with our five year outlook document which really summarizes what was discussed at the Forum as far as the themes that we discussed and the probabilities. I think this year we came up with four really interesting, really important themes that we're looking at over the next three to five years.

Matt Smith - Before we dive into the five year outlook published after this year's Forum, I want to quickly review the scenarios put forth during the 2015 Forum in Toronto. The base case, which we called *Firing On All Cylinders*, and put at a 60% probability, included a U.S.- led broadening of economic growth. We also anticipated a decline in energy prices that we thought would be supported for global consumption.

Ben Jones - Jon spoke about what he thinks BMO got right and how they outlook from the 2015 Forum turned out versus reality. First there was the idea that there would be U.S.- led economic expansion, and this turned out to be true. With an increased pickup in government spending as well. Growth, however, was slow and steady. In terms of what we got wrong, global consumers did not respond to a decline in energy prices as much as we had originally thought, and prices for crude oil have actually been stronger than we thought they were going to be. Therefore without declines in energy prices, we did not see a corresponding increase in consumer spending patterns.

Matt Smith - This all leads us to one of the central points we'll get to later in the episode, but it's important to state now as sort of a disclaimer. We can't predict the financial markets for how political and economic environments will impact them. So taking a diversified longer term view is important. Now we dive into what our outlook is for the coming five years.

Matt Smith - Let's fast forward then to this year's Forum, which occurred late September 2016. Can you talk about the scenarios that the group came up with out of this year's Forum?

Jon Adams - The core scenario that we came up with was called *Slow and Steady Wins the Race*. I would say it's kind of a continuation on that theme from last year as far as firing on more than one cylinder. But basically the assumptions behind the base case are that we'll get continued marginal improvements in global economic growth. I think importantly that fiscal and monetary policy will work together. We've talked a lot about it over the last couple of years, about monetary policy and how much monetary policy has been able to do to stimulate economic growth and inflation. But we think that we're getting toward the end of the time where monetary policy can do too much more. We've kind of reached the limits there and might need to rely more on fiscal policy going forward. So to the extent that those two pieces, fiscal and monetary policy can work together, we think that will be supportive of global growth going forward.

Matt Smith - And you brought up a really important point for our listeners, which is what our Investment Forum does is they're considering these factors globally, so it's not just the Fed, our U.S. monetary policy governing body. They may tighten here, but that may not be the case globally and our team looks at these factors all over the world, not just in the U.S.

Jon Adams - Right, yeah, I think that's why it's very important to get a global perspective. I think we have noticed that with respect to monetary policy views, but I would say especially this year with respect to political policy because it's really helpful to get a very diverse group together with a number of different opinions. I would say our European colleagues, for example, really thought there was a much higher probability of populism spreading I think than our U.S. and Canadian colleagues. It was very interesting, especially with the U.S. election. It seemed like the folks in Europe really thought it was a foregone conclusion that Donald Trump would be elected in the U.S. and that was at a time when he was still poling at relatively low levels. So I think that was an interesting part of the discussion because of Brexit, what happened at the U.K. in the end of June. I think getting that perspective from our colleagues in Europe was really very helpful to us.

Matt Smith - On that topic, just within the last six months, we've had Brexit. We've had Donald Trump being elected in the United States, but that may be just be, like you said, the beginning of a trend. We have several elections coming up in Europe. I don't know if you want to talk about those, but there's at least three that I know of in the coming year that could be similar versions of Brexit and a Trump victory that is evidence of this populism spreading. Can you talk briefly on that?

Jon Adams - Yes, I think that's kind of the main part of our down side scenario.

Matt Smith - Okay.

Jon Adams - So our core scenario was a 70% probability. The down side scenario, which we assessed at 20% probability was entitled *Power to the People*, and really the assumptions behind that is that populism does spread and you get a decline in trade and globalization and that leads to slower growth globally. We really have seen a peak in global trade and globalization in general. A few years ago, we really peaked in global trade and haven't recovered back to those levels. So I do think that is a real risk. To your point, Matt, there are a number of very important elections in Europe over the next year, starting with the -- there's an Italian referendum in early December which will be I think probably before this podcast might be released, but that's an important point. There's also an Austrian election that same day, December 4th.

Ben Jones - Just jumping in here with a quick update on the recent results from the Italian referendum and Austrian election that Jon mentioned here. It was a mixed bag for populist causes. Austria rejected a populist candidate and elected a pro-European president while Italy's prime minister says he'll resign after his referendum was struck down in a wave of populism. Okay, back to Jon.

Jon Adams - And I think more importantly we have French and German elections next year that will probably tell us -- give us some indication of whether this populism movement will spread and increase in momentum. I think it's more likely it'll spread in France just because there's such an unpopular president currently and a much more credible alternative as far as the more populist party. I think in Germany we're less worried about that election as there's not as much of a credible challenger in Germany. Those will definitely be important dates over the next year. We've really talked a lot about how political policy is going to continue to drive our views over the next one to three years. We focused mainly, almost exclusively, on monetary policy over the past couple of years, but really I think that fiscal and political policy will really come much more to the fore in coming years.

Matt Smith - Okay, so your core scenario, which you gave a 70% probability is this *Slow and Steady Wins the Race*. You just talked about the down side scenario, which you gave a 20% probability, this rise of populism, *Power to the People*. Then there's a third scenario, your upside scenario, which is you gave a 10% probability. Can you talk a little bit about that scenario?

Jon Adams - Sure, yeah, we entitled that scenario *All Pulling Together*, and the idea there is that collectivism really triumphs and wins the day and we get centralized policies that are successful at stimulating global growth. An example of that is fiscal policy turning simulative for the global economy as a whole and perhaps that's just what the economy needs right now. I think there are a lot of skeptics as far as what can be done as far as centralized policy globally. I think that's part of the reason we assigned a relatively low probability to that scenario. But if you did get those types of policies, that should nudge up inflation, should improve global growth and perhaps in that scenario, we kind of move away from this so-called fear of globalization, more back toward a more coordinated global economy.

Matt Smith - I'm interested if we just bring it back to the U.S. for just a minute. You're part of a multi asset strategy team that considers both strategic and dynamic asset allocation for some of our multi asset funds and our clients who rely on us for asset allocation advice. So how do you in the multi asset strategy team consider this information? How does it inform your asset allocation decisions?

Jon Adams - It does inform our view in the longer term. On our team we really take more of a medium to long-term perspective and we think that's part of what differentiates us from a lot of our competitors who are much more focused on shorter term issues, but I think this Forum is really valuable to kind of take us away from the daily noise that we see in markets and really to kind of consider these bigger picture, broader issues and their impact on portfolios. I would say the most, I think, relevant in the shorter term type of theme from the Forum this year was the rise of populism. That's already impacted our portfolios to some extent, especially as we look at our view on U.S. equities, for example versus international equities. I think that the populism, that policy component of our process is really driving things to a large extend right now.

Ben Jones - So the three scenarios laid out in the five year outlook are the core scenario called *Slow and Steady Wins the Race*, and this has been assigned a 70% probability. Then there's the down side scenario, called *Power to the People* at a 20% probability, and the up side scenario, called *All Pulling Together*, assigned a 10% probability. These three scenarios were informed by four themes that really rose to the top of the discussion during this year's Forum. Let's talk about each of these themes in detail, starting with populism, one that we've already brought up earlier in this episode.

Jon Adams - What we talked about in terms of populism is the risk, the unexpected has really become kind of commonplace over the last few months here. And to your point earlier, Matt, we've had Brexit. We've had Donald Trump elected here in the U.S. We have German and French elections next year and I think importantly the polls, the betting markets really failed to pick up the momentum behind this populist movement. They assigned a very low probability on Brexit and a very low probability on a Trump victory in the U.S. and both of those came to fruition. So I think there is some skepticism, I would say, of both polls and betting markets going forward, that maybe they're not picking up this sentiment in the overall populace. One of the questions we asked at the Forum was really why are people so angry? I think this theme has been kind of underappreciated. I think the most important factor globally is that we've seen this kind of stagnation in real incomes. In the U.S. for example, real incomes adjusted for inflation haven't risen in about the last 30 plus years, so folks are upset about that and don't think that the folks in power have really done enough to address those issues. There are also a number of other issues that impact the populism theme as well. It's increasing inequality. I think that's true on a global basis. It's the fact that globalization has really created winners and losers, and a lot of folks who were employed in manufacturing jobs, for example, have lost their jobs and those jobs probably are not coming back. Then declining support for open immigration. I think that kind of goes hand in glove with that globalization theme in general, some skepticism of immigration, what if that's hurting domestic economies, those kinds of ideas. And then finally, just the perception that the political system favors elites and it doesn't represent the common person. I think we've seen that played out most in the U.S. election recently where folks that have traditionally voted Democratic voted Republican in this election because of that kind of skepticism and that perception that the political elites were not looking out for the common person.

Matt Smith - Like you said, the polls got both Brexit and the Trump victory wrong up to the day before, and now what's interesting is I think the markets probably got wrong the anticipated reaction to those results. Really the predominant prediction prior to the U.S. election, that if Donald Trump wins, the market's going to go down 3%, 5%, 7%. We had the same thing with Brexit. If Brexit passes, if the exit passes, the markets are going to tank. With Brexit, it did, but days later it rebounded. So the populism trend, it's here, it's real, it's been happening. It might continue. Are you surprised with the reactions of the capital markets to these -- at least these first two major populism elections?

Jon Adams - Yes, that's a great question. I think we all have been surprised by the market movements in response to these events and we really talked a lot on our team at least about kind of the folly of thinking that you have a better sense of political outcomes than the overall market and then that also you're going to be able to predict market outcomes based on those political events. I think that's a main part of the reason why as a team we look at kind of the longer term and try not to get too caught up in short-term noise because these things are very difficult to predict. I think that the highest confidence view among fund managers going into the election was that, to your point, Matt, that if Trump wins, that equities would sell off. I think there was some disagreement as far as the impact on bonds. Some people argued that it would be supportive of treasuries, for example, due to kind of a risk off type of sentiment, flight to quality. We've actually seen the opposite with bond yields rising significantly over the last couple of weeks. Then on the U.S. dollar, another example, we've seen some pretty incredible strength in the dollar over the last couple of weeks, and I think that was also a consensus view, was that if Trump won, the dollar would actually sell off. People would worry kind of about the store of value in the U.S. dollar. So I would say definitely some surprising market outcomes. I think to me at least, something that's been very interesting is that kind of post Brexit, post-election in the U.S., you saw equities rally in the U.K. pretty sharply. We've seen equities rally in the U.S. pretty sharply. I think some very different themes as far as why that's happening. In the U.K., I think most of the move is really due to Sterling weakness, just weakness in the currency that was supporting multi-national companies, supporting exporters, that really I think helped U.K. equities. We've seen the exact opposite in the U.S. We've seen a pretty sharp dollar strengthening, but also U.S. equities rallying. So clearly equities are rising for a different reason here in the U.S., and I think on the expectation that we'll get more policies oriented around growth, oriented around inflation, and might actually kind of turn inward also as far as economic policy, which could be supportive of both a stronger dollar and stronger equities.

Matt Smith - After populism, the next thing discussing the outlook is the theme of productivity.

Jon Adams - I think another important scene, Matt, that we've talked about on the Investment Forum is really the idea of productivity and trying to figure out why productivity has been so stubbornly low, really, for the last few years. Productivity's notoriously probably the hardest piece of economic data to predict. We seem to kind of go in cycles of productivity as a global economy. In the 1990s, for example, productivity was very, very high. And then ever since, for the last 15 years or so, we've seen relatively low levels of productivity.

Matt Smith - And Jon, so -- sorry to interrupt, but when you say productivity, for our listeners' sake, this is the year-over-year change in productivity. So these are productivity increases the way we measure worker output. We're pretty much -- looking at it over the last five years, on average, we're pretty much flat. So to me, the data is telling us we've had a little bit of productivity gain, but, on average, pretty much flat. And prior to that, we were having 3% or 4% or 5% average productivity gains for periods of time.

Jon Adams - Right, right. Yeah, I think that's an important point, just that what we're looking at here is just output per hour. It has been stubbornly low over the past few years. We do kind of move in these various cycles. The 90s cycle was really driven by new technology, driven by the Internet. That really allowed workers to become more efficient. We've really slowed here in the last few years as we've kind of maybe gotten to the end of those gains from technology. But I would say this is a very different issue. I don't think we had, necessarily, a great outcome as far as expectations on what we expect as far as productivity. But I wanted to maybe outline two different kind of schools of thought on productivity then maybe highlight the issue.

Matt Smith - Sure.

Jon Adams - So you have kind of -- you have two different schools of thought. You have -- the first school of thought, really, would say that the economic growth -- and this is Robert Gordon at Northwestern University is really kind of the, I would say, main proponent behind this theory. He's a noted expert on productivity in general. But his view is really that the growth that we saw -- the economic growth that we saw from 1870 to 1970, for example, was really a one-time event. And that's not going to return. His main view is that the IT revolution that we've seen over the past 20 to 30 years, his view is that that's much less important than a lot of the other great inventions that powered economic growth in the previous hundred years. And those are ideas like electricity, internal combustion engine, modern communication, etc. And so the view there is that there'll be slowing technological progress because we've kind of reached the limits of truly transformational innovation. And also, the view is that there are some headwinds to growth globally, some that we touched on in populism, for example, rising inequality, a plateau in education levels. A lot of the productivity in the last 50 years or so was driven by folks kind of -- more people going to college, more people getting advanced degrees than in the past. We might be reaching a plateau there as far as education levels. And then also the idea of unfavorable demographics putting downward support on productivity. So I would say that's kind of the pessimistic scenario to productivity. The optimistic scenario would really outline the idea that there are a lot of technological advances that we've seen in the last 10 years or so, and that they're getting close to reaching their tipping points. So the kind of second machine age is really kind of the idea here that we're going to get exponential and digital and combinatorial power as far as technological advances, that machines are going to work together, machine learning, automation, 3D printing, all these factors. The technology's there, but there's just kind of this period that we need to use to learn from the technology that we have and put into practice so that the technology can work with other technologies.

Matt Smith - Yeah, and I've even heard people further on that end of the spectrum of this topic. People like Elon Musk saying, well, we're going to get to the point where automation is going to cause the loss of jobs to the point where we have to have serious discussion about universal income. And so it's interesting. You've outlined two ends of the spectrum. Maybe we've maxed out on the major productivity innovations and then others feels like, well, maybe we're in a pause period and another wave's coming that could greatly automate and increase productivity of workers.

Jon Adams - That actually flows very well into -- if I could, another theme that we discussed. And to your point on universal income, Matt, we had really an expert at the forefront of this automation technological change from the Oxford School, a professor named Carl Frey. And he actually discussed that idea of universal income as maybe kind of the ending point to all this potential automation and technological change that if we aren't able to replace the human jobs that the machines are taking, that we might need to provide some type of universal income for people to kind of account for that loss of jobs, loss of income.

Matt Smith - Is this an idea that we're going to talk about for the next 50 years and it's just always that thing in the future? Or is this really something that we'll have meaningful dialogue about in the next decade?

Jon Adams - I think that we will have meaningful dialogue about this in the next decade. I think we're getting close to a number of jobs being displaced by technology. And it's probably a longer-term theme. But yeah, I do think this is something that we'll be talking about quite a bit not only in the next five years, which is the scope of the Investor's Forum, but probably the next kind of one to three years also.

Matt Smith - Yeah. And just for our listeners' sake, there was a vote in Switzerland earlier this year floating this idea that they would try universal income. This is an idea where every citizen would receive -- and it wouldn't be means-tested -- a certain amount of money every year. That got voted down, but what's interesting is the idea was popular enough to get all the way to a vote.

Jon Adams - Yeah, I think that this would have been kind of crazy to talk about in the U.S. maybe a couple of years ago. But now I think there's more talk about it. You have the Switzerlands of the world and the Norways of the world that have looked at these ideas. In the past, I think it was probably considered much more of a socialist type of idea. But I think it will be considered more and more as far as U.S. policy. But I think this was, really, to me, the most fascinating theme of the Forum was really this idea of the global implications of automation and technological change. And it's not only the jobs that'll be susceptible to automation or the impact on productivity. But it's really also the impact on policy in general. We might need to rethink the entire kind of pacts that citizens have with governments globally, that universal income could be one of those components. But you have seen wage growth, pretty anemic on a global scale. And to the extent that you get technology kind of increasing in importance, that should also put kind of downward pressure on wages globally. So I do think that there are really some very important potential policy implications from this automation and from this technological change.

Ben Jones - We've covered three of the themes laid out in the five-year outlook: populism, productivity, and the global implications of technology shifts. Before we move on to the last one, I want to just remind listeners that there's a much more in-depth discussion to these themes that can be found in the five-year outlook paper. We just recently released it and it has a number of exhibits that you may want to use when discussing these themes with your clients. You can find a link to the paper at bmogam.com/betterconversations.

Matt Smith - Really an interesting topic, the implications of automation because it's counterintuitive right? I mean, even the U.S. presidential election, an important theme was creating jobs. And that's always been an important part of elections, both at the local level and the federal level. And now we're talking about issues that might actually dramatically decrease jobs. And how are we, as a society, as governments going to deal with those loss of jobs? And the answers aren't always negative, right? It could just lead us to a different way of organizing our economy. And like we said, universal income could be an element of that.

Jon Adams - Yeah, right. And the idea of the -- there would be a rise in jobs, that kind of work along with the technology as well. But, yeah, I think something that's important to note, as well, is that maybe this should be met with some degree of skepticism, also. We've kind of heard these arguments a number of different times throughout history, that technology's going to kind of take over and eliminate jobs globally. And that hasn't really happened to any large extent. In fact, I think technology in the past has actually increased jobs, despite predictions of kind of gloom and doom. So while I think that there is definitely a lot behind this argument of automation and kind of putting pressure on, I would say, kind of certain sectors in particular like office, administrative support for example, I do think that we need to meet this with a fair bit of skepticism just because kind of previous predictions of technology taking away jobs have really proven incorrect to a large degree.

Matt Smith - Right, right. Sometimes, we can't predict the effects. We might be able to see these long-term secular trends coming, whether it's market reactions, whether it's votes of the people, whether it's impact on specific industries or sectors. Sometimes those impacts are very, very difficult to predict. And it really supports one of our main themes, which is this is why you stay diversified in your portfolio, so you have a strategic vision, you have a long-term vision, and you stay consistent with those strategic views and not react to a lot of the short-term noise. Now, what's the fourth theme that the Forum talked about?

Jon Adams - Sure, yeah. The fourth theme that we discussed was the outlook for energy markets. And as I mentioned earlier, uh, it seemed like the conversations that we had a year ago all began with depending on the price of oil. I really think this is no longer a significant driving factor in markets today than it was a year ago. But I would say our base case here is that oil, for example, remains range-bound in this $40 to $60 per barrel range. And we also had the idea that really Asia remains the key kind of marginal contributor to energy demand growth globally. It's difficult for us to see much of a catalyst for energy prices to go significantly higher, absent, of course, a supply disruption, which is always possible. But demand for energy is slowing, growing very slowly. So we think there's not as much risk of having upside surprise going forward as far as energy prices. One final point in the energy theme is the fact that, really, the commodity price recovery that we've seen over the last six months to a year is really all about perspective. If you look at a shorter-term chart, it seems like a very sharp increase. But if you look at a longer-term chart on commodities globally, where we peaked kind of in 2008, we're still quite a bit below that peak level in commodities. So I think we need to take the most recent increase and really put it in perspective there.

Matt Smith - So, Jon, just to be clear, are you saying that we're downplaying the effect of energy prices going forward because there's multiple factors, both on the supply side and the demand side that that will moderate prices over the long-term? Or is it that, regardless of where that price goes, the price of energy is less important going forward in the global economy?

Jon Adams - Yeah, I think it's probably more the former. We just don't think it's as interesting as it was a year ago. We think there's a very low growth in demand. There's abundant supply of the majority of commodities. We've seen rampant growth out of China over the last 20 years. Clearly, that's slowing. So we, really, I would say, would put a lower probability on the possibility of an upside surprise as far as energy prices. It's probably not going to be a spike in demand. I think, if anything, it would be some sort of supply disruption that could put upward pressure on energy prices.

Matt Smith - The Five-year outlook paper covers these topics in detail. But keep in mind, these perspectives aren't always predictors of what will actually happen in the markets in the future. Therefore, it’s important to keep a diversified and long-term view. Jon leaves us with his thoughts on the importance of the annual Global Investment Forum.

Jon Adams - It's just really showcasing that we have the knowledge, we have the investor talent globally to get all these folks together in a room from all around the world with diverse perspectives, with diversity of opinion, and really to kind of get away from our day to day looking at the screens and focusing on what are we going to be talking about in three to five years? What's really going to be driving markets over that timeframe? And then trying to get out ahead of it and actually position ourselves to benefit from those themes over the next few years.

Ben Jones - Thank you for sharing your time and insights during the episode, Jon. And thanks to our listeners for your continued support of our program. You can find a link to the outlook paper and other episodes of the show at bmogam.com/betterconversations.

Matt Smith - This episode was produced by the team at BMO, which includes Pat Bordak, Gayle Gibson, and Matt Perry, and the team at Freedom Podcasting, which includes Jonah Geil-Neufeld and Annie Fassler.

Ben Jones - Thanks for listening to Better conversations. Better outcomes. This podcast is presented by BMO Global Asset Management. To learn more about what BMO can do for you, go to bmogam.com/betterconversations.

Matt Smith - We hope you found something of value in today's episode, and if you did, we encourage you to subscribe to the show and leave us a rating and review on iTunes. And of course, the greatest compliment of all is if you tell your friends and coworkers to tune in. Until next time, I'm Matt Smith.

Ben Jones - And I'm Ben Jones. From all of us at BMO Global Asset Management, hoping you have a productive and wonderful week.

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