

Where to invest in a troubled world?



Key points

- Although the risks have increased, we remain of the view that the US and global recovery will continue. Whether there is a US double dip or not, it's clear the growth outlook in the US and other major industrialised countries will remain fragile, constrained and volatile until the imbalances of high household gearing and public sector debt are worked off.
- However there are still opportunities for investors to make decent returns by focusing on high-yield assets or assets which don't suffer from growth constraints.
- Attractive assets on one or both of these grounds are Asian and emerging market shares, Australian shares, commercial property, infrastructure and corporate debt.

Double dipper

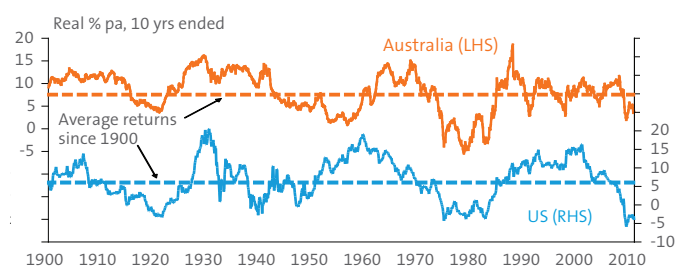
The big investment issue for the last few months has been whether there will be a double dip back into recession for the US/global economy. If yes, then government bonds are priced appropriately and share markets could fall a lot further as profit expectations are slashed. If no, then government bonds on currently very low yields are a bubble and will face a sharp rise in yields, while shares are likely to head higher. There is no doubt that recent data from the US has generally been poor. Although the August Institute for Supply Management (ISM) manufacturing conditions survey surprised on the upside, other business surveys have been weak, housing data has shown renewed weakness, retail sales have rolled back down again and jobs growth has softened. As such, it's hard to avoid the view that the risk of a return to recession in the US has increased. However, on balance we remain of the view that a double dip will be avoided because monetary conditions remain very easy, the corporate sector in the US and elsewhere is in good shape and strength in the emerging world will offset weakness in developed countries. What's more, many of the imbalances that preceded the 2008-09 recession in the US are no longer present, e.g. the household saving rate is now 6%, there is no longer a house price bubble, housing construction as a share of gross domestic product (GDP) is very low and business inventory levels are low.

Whatever the outcome, it seems likely that structural problems in major industrialised countries will result in volatility and constrained returns from traditional global assets. However there are still opportunities for investors beyond the relatively low returns from cash.

The investment world has changed

The big picture reality is that the fundamental economic and financial market backdrop has changed radically over the last decade. The 1980s and 1990s provided well above normal returns for investors as the shift from high inflation to low inflation, deregulation, easy credit, globalisation, the information technology revolution and favourable demographics all drove spectacular returns in most asset classes. For investors, the focus was on capital growth and most assets provided well above average returns, as can be seen for shares in the next chart.

Rolling 10 year US and Australian share returns



Source: Global Financial Data, AMP Capital Investors

However about a decade ago, many of these favourable themes started to fade and in some cases reverse as the broad downtrend in inflation now risks spilling over into deflation (or some would fear a renewed outbreak of inflation on the back of quantitative easing), credit conditions have tightened, many developed countries are burdened with excessive household or public-sector debt, government policy is swinging back to re-regulation and baby boomers are shifting from a focus on capital growth to income. The outcome is likely to be far more constrained returns going forward from traditional assets and greater volatility in investment returns.

This suggests that investors should focus on yield and on markets which don't suffer from the same constraints as traditional global asset classes. The easy days of the 1980s and 1990s where you could buy anything and it generally provided a good return are long gone. However, some assets still provide attractive return prospects.

Medium-term return potential

Going forward, the key for investors is to focus on assets which offer a decent income yield (i.e. the portion of return derived from dividends, rents or interest payments on bonds) and/or those assets where capital growth potential is less constrained or is more assured. The following table shows key assets by their current income yield and their growth potential on a five year horizon. Growth potential is defined as potential nominal GDP growth for shares and inflation in the case of commercial property (as commercial property rents generally increase with inflation). Capital growth is assumed to be zero in the case of bonds because if held to maturity their return is their yield.

	Current Yield #	+ Growth	= Return
US equities	2.1	4.8	6.9
UK equities	3.5	4.0	7.5
European equities	3.7	3.8	7.5
Japanese equities	2.1	2.8	4.9
Asia ex Japan, equities	2.3	8.0	10.3
Emerging equities	2.7	7.0	9.4
World equities, local currencies	2.6	4.6	7.2
Aust equities	3.9 (5.1*)	5.5	9.4 (10.6*)
Unlisted commercial property	7.0	2.5	9.5
Aust REITS	6.1	2.5	8.6
Global REITS	5.3^	3.3	8.6
Unlisted infrastructure	6.0	4.0	10.0
Global listed infrastructure	5.3	5.0	10.3
Aust government bonds	4.5	0.0	4.5
Aust corporate debt	7.5	0.0	7.5
Aust cash	5.0	0.0	5.0
Diversified growth mix			8.0

Current dividend yield for shares, distribution/net rental yields for property and 5-year bond yield for bonds. ^ Assumes forward points averaging 1% point pa. * With franking credits added in. Source: AMP Capital Investors

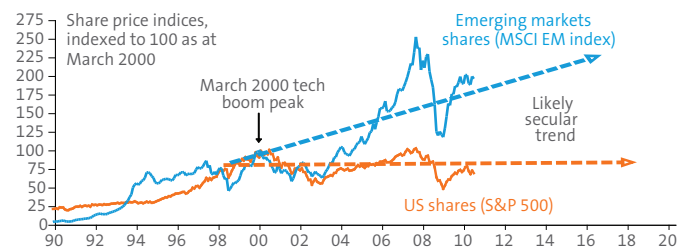
Opportunities for investors

The first thing which stands out is that projected returns for a traditional diversified mix of assets (with a 70/30% mix of growth/defensive assets) is likely to be around 8%. This sounds low, but similar projections have been around for the last seven years or so. It is also consistent with low inflation as it would imply a 5.5% real return which is the average a diversified mix would have delivered over the last century. The second stand out is the relatively low return potential from traditional global shares. They suffer from low dividend yields in the US and Japan and a constrained growth outlook given poor household balance sheets and/or high public debt levels in major developed countries. Global government bonds (not shown) also suffer from very low yields and the risk of a public debt crisis at some stage in the US, broader Europe and Japan. More importantly, the table highlights (in blue) key opportunities for investors in terms of their asset exposure. These are in:

- **Asian equities and emerging equities.** The case for Asian and emerging shares remains strong. First, they offer strong growth potential as industrialisation continues, demographics are more favourable and they lack the structural debt constraints facing the US, Europe and Japan. Second, they are less at risk of deflation than developed countries. Finally, they are trading on a similar price to earning multiple to developed countries despite their better growth potential and lower macro economic risk. In fact, while global shares have been in a secular bear market

since 2000, emerging shares have been outperforming for two decades now, including, so far, this year.

While US shares have been range bound for a decade emerging market shares have been trending up



Source: Thomas Financial, AMP Capital Investors

- **Australian equities.** So far this year, Australian equities have been relative underperformers due to interest rate tightening and worries about the slowdown in China. However, the case for Australian shares is strong based on high dividend yields, franking credits which add about 1.25% to Australia's return potential (for Australian based investors) and strong growth potential due to high population growth and trade links to high-growth Asia.
- **Commercial property.** Commercial property (unlisted or listed) looks attractive due to high yields. The net rental yield (or capitalisation rate) on a well diversified portfolio of directly held Australian property is now around 7%. With space demand and rents improving, and forced selling having run its course as real estate investment trusts have recapitalised and reduced debt, unlisted commercial property prices appear to have bottomed.
- **Infrastructure.** Similarly, infrastructure offers attractive returns based on high yields. The yield on mature unlisted infrastructure assets in developed countries, including Australia, is now running around 6%.
- **Corporate debt.** Finally, corporate debt continues to offer relatively high yields of around 7.5% and a yield differential of 250 basis points above conventional public sector bonds, which is higher than normal. Consequently, except in an extreme environment of severe recession (where the spread would blow out significantly) or surging inflation (where yields would be pushed sharply higher), they offer good return potential across most scenarios.

Conclusion

The macro economic outlook is unusually uncertain with the most likely outcome being fragile, constrained and volatile growth in major developed countries. However, this is not to say there are **no decent investment opportunities for investors. The best are likely in Asian and emerging shares, Australian shares (assuming a decent resolution to the election uncertainty), commercial property, infrastructure and corporate debt.**

Dr Shane Oliver

Head of Investment Strategy and Chief Economist
AMP Capital Investors

Contact us

If you would like to know more about how AMP Capital can help you, please visit ampcapital.com.au, or contact one of the following:

Financial Advisers Your Business Development Manager or call 1300 139 267

Private Clients Your Financial Adviser or call us on 1800 188 013

Wholesale Investors AMP Capital's Client Service Team on 1800 658 404

Important note: While every care has been taken in the preparation of this document, AMP Capital Investors Limited (ABN 59 001 777 591) (AFSL 232497) makes no representation or warranty as to the accuracy or completeness of any statement in it including, without limitation, any forecasts. Past performance is not a reliable indicator of future performance. This document has been prepared for the purpose of providing general information, without taking account of any particular investor's objectives, financial situation or needs. An investor should, before making any investment decisions, consider the appropriateness of the information in this document, and seek professional advice, having regard to the investor's objectives, financial situation and needs. This document is solely for the use of the party to whom it is provided.