Medium-term economic and financial market outlook

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Not enough transformational innovations

In the 1990s, and to an extent in the 2000s, productivity growth was high. This was largely driven by the mass adoption of transformative technologies (i.e. the internet and mobile communication) and large-scale technology transfers to emerging economies, supported by booming commodity markets in the 2000s. Conversely, productivity growth in recent years has been strikingly low. This trend is consistent with healthy improvements seen in a number of labor markets (e.g. USA, U.K.), despite muted economic growth.

While the financial sector is now certainly more strictly regulated than before the financial crisis, we do not find enough evidence to blame slow productivity gains on a generally more demanding regulatory environment. Although there may be reasons for productivity shortfalls in certain regions (depressed labor markets in the eurozone, nationalistic policies in Brazil or Russia), these are insufficient to explain the global shortfall. More compelling is the argument, that slow growth reduces the need to grow production capacity and to replace aged equipment with newer, productivity-enhancing plant and machinery.

For the world economy as a whole, the most probable scenario remains that a lack of break-through innovation and transformative technologies will contribute to a comparatively low potential rate of growth at least well into the next decade.

Labor productivity (growth p.a., %)

	1991-2000	2001-2010	2011-2020	2021-2030
Western Europe	**2.1**	**1.4**	**0.7**	**0.7**
Germany	2.8	1.6	1.1	1.1
France	1.8	1.3	0.7	0.7
Italy	1.6	0.3	0.2	0.2
Spain	1.2	0.7	1.1	1.1
United Kingdom	2.6	1.8	0.4	0.4
Switzerland	1.0	1.8	0.2	0.2
Emerging Europe	**0.7**	**4.9**	**2.0**	**2.0**
United States	**1.8**	**2.2**	**0.5**	**0.5**
Latin America	**1.5**	**1.5**	**0.8**	**0.8**
Brazil	1.8	1.8	0.2	0.2
Japan	**2.0**	**1.6**	**1.0**	**1.0**
Asia (excl. Japan)	**4.4**	**6.0**	**8.0**	**8.0**
China	5.1	8.1	10.7	10.7
India	4.1	6.0	5.1	5.1
Indonesia	2.7	2.7	4.1	4.1
World	**2.1**	**2.4**	**2.8**	**2.8**

Period averages (data exclude severe recession years 2008-2009). Forecasts from 2011 onwards based on available data starting in 2011. China data based on Conference Board estimates. Source: Conference Board, own calculations

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Labor markets: A normal business cycle

Even in a slow-growth environment, business cycles, in many aspects, do not differ much from those in the past. Both in the euro area and the USA, the unemployment rate has fallen at a fairly normal pace in recent years (in the euro area since at least 2013, when the debt crisis ceased to be a drag).

Given these labor market trends, it is fairly obvious, that any further stimulus measures, whether central bank easing or more government spending, are currently not required.

With respect to inflation, we do not see lower growth potential materially altering the dynamics. We therefore expect inflation to rise, albeit modestly, once full employment is established. While the U.S. economy is nearly there, full employment in the eurozone is still a number of years away.

Source: Eurostat

Source: Bureau of Labor Statistics

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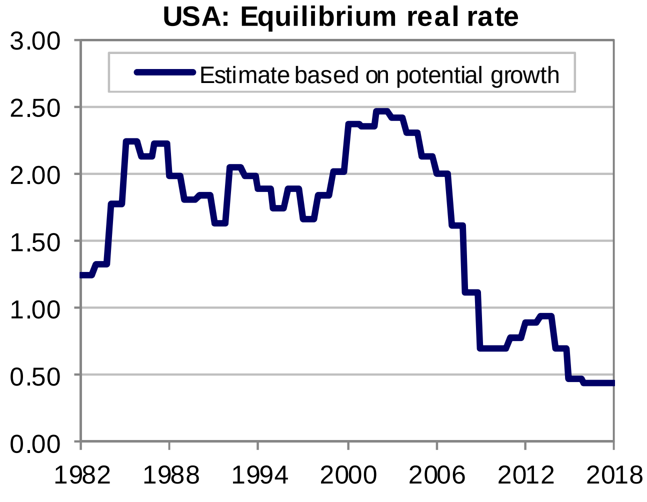
Interest rates: Structurally lower

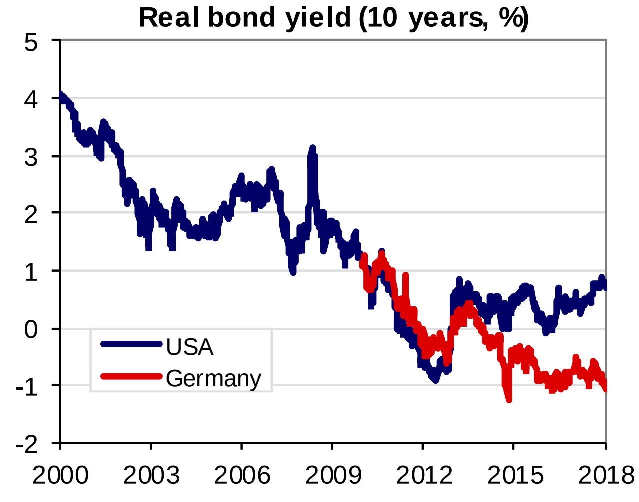
While there is no obvious link between the cyclical behavior of an economy and its growth potential, the latter is a key driver of interest rates.

Our analysis suggests (the San Francisco Fed has reached similar conclusions), that the level of real short-term interest rates compatible with current economic growth potential is close to zero, both in the eurozone and the USA. Before the 2008 financial crisis this rate was 2% or higher in the USA and around 1.5% the eurozone.

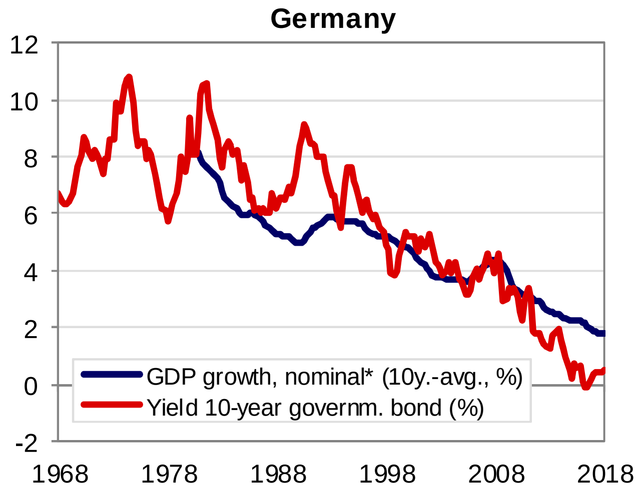
If growth potential remains at the current level in the long run, which is our baseline scenario, interest rates will remain at a structurally lower level for an extended period.



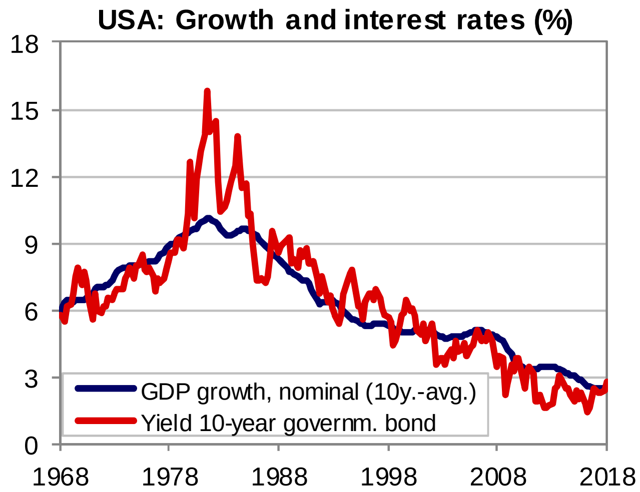
Source: Conference Board, own calc.



Source: Index provider



*Eurozone after 1998. Source: Index provider, own calc.

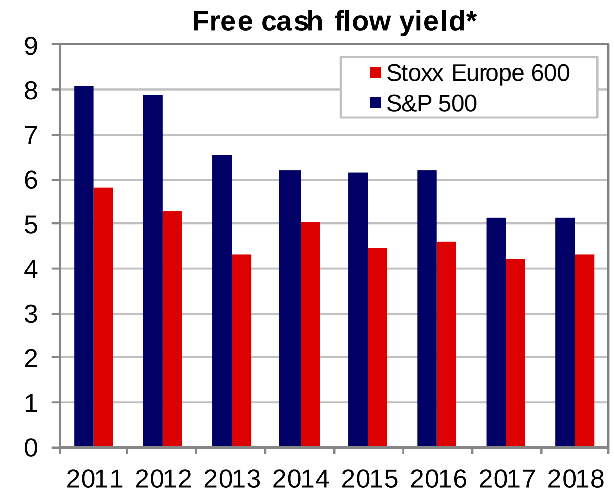


Source: Index provider, own calc.

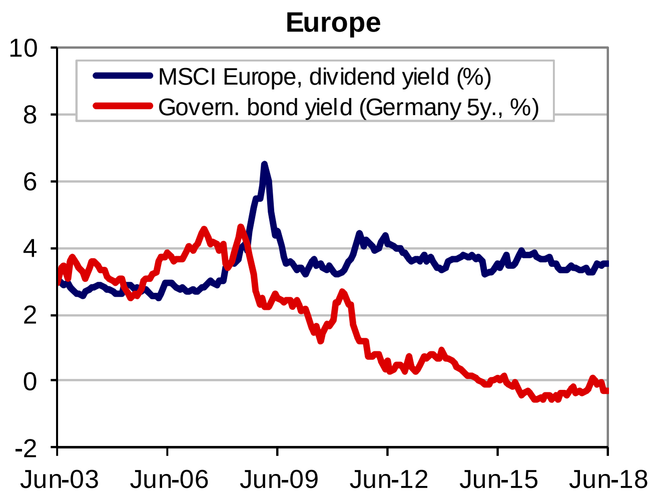
Attractive equity yields

Total returns for shareholders are comprised of dividends and capital gains, with the latter generated by retained (i.e. not paid out as dividends) earnings and their growth over time. Over long periods of time, dividends and capital gains each account for about half of total returns.

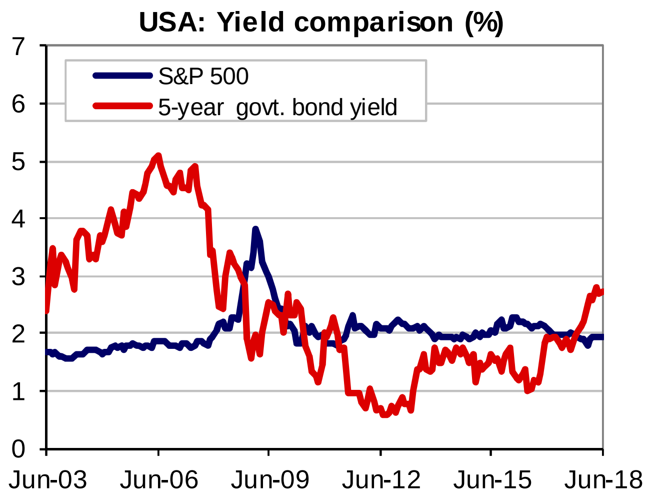
Free cash flow yields – the basis for sustainable dividends – are currently around 4%-5% in Europe and the USA. When adding 3% growth p.a. over the medium term (a conservative estimate for real economic growth plus inflation) we get to a total return of about 7%-8% p.a. This constitutes an attractive value proposition, particularly when compared to still low bonds yields.



*Key sectors. Source: Own calculations



Source: Index provider



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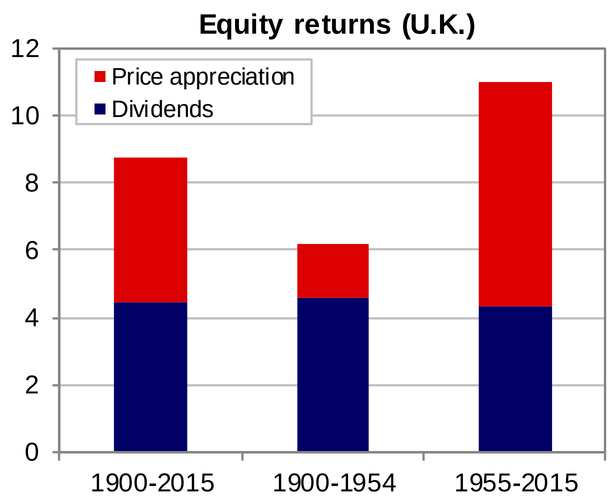

Source: Barclays

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