Making sense of the future

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ABSTRACT

Everyone knows the saying, "you can't see the wood for the trees", and yet when investing it is all too easy to get hung up on the details and miss the big picture. For example, whether the Fed continues to raise interest rates or not will have little impact on anyone's retirement outcome. In contrast large scale changes, such as the aging of the global population, are often ignored although they could have important implications for positioning portfolios for the future. The focus of investors tends to be almost exclusively on easy to see, but often unimportant, short-term factors at the expense of the mistier, but more important, long-term themes.

INTRODUCTION

It is clear that the global economic and investment landscapes are in a continuous state of change. The countries, industries and companies that are the most successful at any time rarely remain so for the long term. Companies which on the basis of their size make up stock market indices change frequently. For example, only 54 per cent of the companies in the S&P/ASX 50 index at the start of 2000 remain in the index today. The economic success of countries and regions fluctuates too. Japan was at one time envied for its rapid growth and its efficient manufacturers were both feared and admired. While the US economy trebled in size between 1952 and 1991, by 1991 Japanese GNP was not three but 13 times its 1952 level. At its peak, anyone predicting the demise of Japan would have received little attention, and yet Japan's miracle ended in the early 1990s as it commenced a 15 year long slump.

It is not only the fortunes of countries and companies that fluctuate – the whole structure of industry across the globe is subject to significant change. The typical evolution of developed world countries involved manufacturing growth waning and giving way to growth in services and the development of new service industries. Information technology in particular has taken centre stage. This growth leadership too will no doubt prove to be transitory. A new industry leader will emerge, perhaps due to advances in new areas such as robotics, non-fossil fuel energy or nanotechnology. Some of today's largest companies will adapt to the changing environment, while others will not survive. Will the global leaders in the telecommunications industry still be there in 20 years time, for instance? Given the rate of change in their industry, quite possibly not.

There are clearly a variety of paths which the world can take over the next 20 years. This matters to investors. We cannot assume that the future will be like the past, and we should prepare for the possibility that it will not. Change, however, need not be viewed negatively. On one hand change creates risk that portfolio performance will fall below expectations; on the other hand it creates opportunity for investors to potentially exploit and generate higher returns. This paper considers the potential for generating insights into the future and looks at some of the factors that may shape the next 20 years.

FORECASTING THE FUTURE

If insight into the nature of prospective change can be acquired this should permit improved positioning of portfolios to achieve investor objectives. For example, knowing that Japan would enter an extended slump would have been very useful. It would have assisted those managers concerned about a sharemarket bubble to stick to their guns (in the face of booming share prices) and maintain an underweight position.

There are basically two ways to develop insight into the future: knowing what no one else does, or having an ability to better interpret what everyone knows. Knowing something that no one else knows would certainly be useful (assuming it did not contravene insider trading rules), but this is unfortunately not realistic (particularly given advances in information technology). Instead insight into the future must rely on figuring out the implications of what everyone knows, earlier than the market in general – or at least factoring it into your strategy faster than the market. This is an important point. The short-term performance focus of many investors means that the market can ignore even glaring mis-valuations or underlying economic problems for an extraordinarily long period of time. As investment guru Bill Gross recently commented, the ability to position the portfolio for the future at present "depends not so much on what Aristotle Onassis would claim as knowing something 'nobody else knows'. Rather it depends on knowing something that the investment markets, economists and a future Fed Chairman alike are slowly but surely coming to believe and by weighting strategy significantly in that direction" (*Investment Outlook – Secrets*, William H Gross, managing director, PIMCO, December 2005).

Lags in the factoring in of new information may lie in the need for a lot of evidence to change accepted views. Behavioural finance research has highlighted the psychological tendency for accepted views to change slowly This can mean that there are lags before new information is factored into asset prices, and this can create opportunity. This "anchoring" of views arises from over reliance on past information and may lead to mis-pricing of assets as investors extrapolate past trends.

However, exploiting these lags requires insight – it is very difficult to make accurate predictions. Accurate predictions over the short term are generally impossible because of the vagaries of emotionally driven decision making. Over the longer term these swings in investor optimism and pessimism wash out, but a new element becomes arguably more important – the influence of unforseen circumstances. Unpredictable elements have a nasty way of upsetting even the most careful analysis.

But while the flow of short-term data (such as changes in interest rates and information about company earnings) is factored into markets lightning fast, longer-term structural changes (changing demographics and global warming are prime examples) and risks not experienced for a long time (eg persistent rising inflation) can be ignored for a surprisingly long time. At times it almost seems to be a case of don't know and don't care. The present seems far more important and it's hard to figure out the consequences of most structural shifts. For investors, either things are too good now to worry about future risks – fear of being left behind in the short term sometimes makes it easy to ignore the unsustainability of market behaviour – or things are too uncertain to consider future positives. In fact some economists seem to take a pessimistic view regardless of what's happening – either things are so good that something has to go wrong soon, or things are so bad that it can only get worse! Little wonder that economics carries the tag of "dismal science".

A good example of predictions from a dismal economist comes from the late 1800s, when Thomas Malthus predicted that population growth would eventually lead to a decline in wage rates and stagnation, which would potentially be followed by starvation and population collapse. Fortunately this prediction proved wrong. He missed a number of important factors in his discussion on population, specifically technological advance.

A similarly gloomy prediction came in 1972 when a global think tank, the Club of Rome, published their report on the *Limits to Growth*. This group's prediction was that within 100 years the supply of resources would run out triggering a collapse of the economic system and population decline. This publication should have focused attention on the likely future trend to the more efficient use of resources and identification of alternative resources. But the authors failed to consider the implications of the basic mechanism of the operation of free market economies – the price system. As resources become scarce, prices rise which provides an incentive to reduce consumption by increasing efficiency and finding alternative materials. This adjustment process was illustrated not long after the publication of *Limits to Growth* as the oil price shocks hit the western world, which led to a rapid rise in energy efficiency and triggered a search for alternative power sources.

CAN FORECASTING BE USEFUL?

All this might suggest that forecasting the future is a fruitless task. Certainly it is pointless to try and identify a single scenario that will describe the future. Betting on one scenario is fraught with risk, and very likely to be wrong – particularly where forecasts involve the picking of specific winners. For example, predicting the winning home video format (Betamax or VHS) was extremely difficult. However, predicting the impact of home video players on cinemas was arguably easier. Useful forecasting needs to seek out the most obvious insights, and recognise what is unknowable.

Behavioural finance is generating some insights which may help make sense of the future. It has been suggested that most mistakes are due to either self-deception, misinterpretation of data or emotion (fear and greed). Self-deception can result in an inability to distinguish between skill and luck, and a tendency to over-confidence and over-optimism can result. Avoiding these behavioural mistakes requires that we structure thought and decision making processes to ensure (as far as possible) objectivity.

For example, it is easy to get attached to a particular view and become selective in the assessment of, and slow to respond to, new information. A decision making process without behaviour biases must be objective and unbiased in the way in which information is assessed and decisions made. An important rule of thumb is that no matter how compelling an argument, there is always at least one credible alternative scenario. The implication is that the only sensible way to consider the future is via a range of possible outcomes or scenarios. Only a multiple scenarios approach can be sufficiently robust in positioning investment strategy appropriately for the future.

Behavioural finance research and the lessons of the past suggest that meaningful forecasting requires:

- All available information be considered in an unbiased and objective manner.
- Avoidance of over-confidence by recognising that there is always considerable uncertainty about the future.
- A range of alternative potential futures or scenarios is recognised.
- That the possible emergence of currently unforseen elements be contemplated.

WHAT DOES THE FUTURE HOLD?

The sorts of factors that shape the future will be many and varied. Some of them we are aware of now, though we cannot be sure exactly how economies and markets will be affected. Others we have no information about, though we still have the ability to speculate. The future path for investment markets depends not just on what happens but also on how this compares with what markets are expecting – it is necessary to understand both what investors collectively believe about the future and what might surprise or disappoint.

An important fundamental belief is in the inexorability of economic progress. As little as 200 years ago the vast majority of people were poor and had little control of the forces of nature. We are now not only far more numerous but we also expect that more of us will become increasingly better off and that we are generally in reasonable control of the forces of nature (other than the most extreme weather events). This has been the expectation (for those in developed countries) for a comparatively short period of human history. If assumptions as fundamental as this were tested, there would be important implications for markets. If, for example, the frequency of extreme weather events continues to rise or there is a terrorist event (a nuclear event in the US, for example) which shakes the foundations of western society, then a variety of risk premia would likely increase.

Most of the factors influencing the future are far less radical than this. They will tend to centre on economic, social, demographic and political issues and associated trends in consumption, production and investment. Some of the factors likely to help shape the future are discussed below.

The global economy

Changes to the economic order are nothing new, but can nonetheless have implications for portfolio positioning. One of the most widely accepted views about the next 10 to 20 years is that China will emerge as not only a clear driver of global growth, but possibly as the world's largest economy.

> "In 2026 China will be number one in the world in terms of purchasing power parity, at just over a fifth of the world economy. America will be number two and India number three, although a bit of a way behind"
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> **— Daniel Franklin, editor, "The World in 2006",** *The Economist*

Although growth is creating social tension in China (particularly among the displaced poor), a huge unemployed labour force of 150 million peasants plus millions more underemployed in the cities makes continued growth a political imperative. Progress looks inevitable but will probably not be smooth. Two immediate challenges include the opening up of the banking system and avoidance of trade friction with the US. The former is vital to underpin long-term development of a capitalist system, and the latter essential to help ensure a smooth growth path.

India is also developing rapidly. It is a nuclear power but not yet a superpower. It is growing fast (7–8 per cent per annum) and over the next 20 to 40 years it should become a very important economic power. Huge inequities remain in India and for many rural poor life has become worse rather than better over the past 20 years. However, there is important progress taking place and not just in terms of economics. Importantly, peace has strong popular support in both India and Pakistan. Both governments appear prepared, though are struggling, to solve the Kashmir dispute and to increase economic and other ties. If this is successful it will remove an important source of regional instability.

Our conditioned expectation that economic progress will continue makes it easier to believe that Japan, which is still the world's second largest economy, will resume "normal" economic growth. Koizumi has struggled to get his economic reform program approved. In the end he forced an election and won a spectacular victory that has now put him in a very strong position. Analysts and economists are increasingly optimistic (despite a slower than hoped for reform agenda). If they manage to avoid a policy mistake (in particular, raising taxes or interest rates too soon), the decade and a half long slump may be at or close to an end. While Japan is tackling some of its difficult structural problems, Europe is taking a different tack – it is growing by acquisition. In 2004 it added 10 new members, and more are to come. Countries which are poorer and with whom there are greater cultural differences are progressively joining the EU and converting to the euro. The outcome of this experiment is uncertain. Some predict the eventual demise of the euro, particularly following the rejection of the proposed constitution by a number of member countries during 2005. Further tension seems inevitable as the union tries to digest its more divergent new members.

While China may eventually exceed the US as an economic power, the US should not be underestimated. It remains the most efficient, flexible and innovative economy in the world. The problems for the US are probably more in the political than the economic arena. The two sides of politics are extremely polarised – each sees the other as at best misguided. Following Hurricane Katrina, President Bush's standing with the US population plunged. While increasing numbers have been growing dissatisfied with the handling of Iraq, following the Katrina episode Bush is no longer seen as decisive, strong and reliable. This is important given the difficult issues to be resolved – for example, the administration has been described as "fiscal incompetents" (Robert Guest, Washington correspondent, *The Economist*).

Both the US current account deficit (CAD) and fiscal deficit are growing and appear set to continue on that path. Spending has been boosted by a number of influences: Katrina-related spending, a close to insolvent social security system (the pay-as-you-go state pensions program in which workers pay for retirees), the spiralling costs of Medicaid (public health care for the poor) and Medicare (public health care for the over 65s) and recent tax cuts may now be made permanent. The US has only been able to keep spending at these levels without a US dollar collapse because the world has been willing to fund the CAD. If this does not continue a very different scenario may emerge.

Ironically, protectionist pressure from the US on China to reduce its exports may push them to revalue their currency (perhaps by 10 per cent or more). If this occurs, US dollar weakness, tighter liquidity, more volatility, higher bond yields (though this may reverse if an economic slowdown is triggered) and higher risk premiums may result. To many (perhaps pessimistic) economists such an adverse outcome looks hard to avoid. They are hopefully underestimating the ability of the global economy to adjust and correct the imbalances in a relatively benign manner.

Coupled with these risks is a potential housing market bubble in the Anglo economies. British economist Roger Bootle (of Capital Economics) believes the US housing market has become "simply the biggest bubble in financial history" ("One Economist's Yin and Yang", *Business Week,* 6 December 2005).

Clearly there are a range of factors driving change in the global economy. Over 20 years or more it seems likely that a number of emerging economies will expand substantially and may change the economic order. Assessing the implications of these trends for portfolio positioning is not, however, simple and the economic environment needs to be considered in conjunction with other factors, for example the inter-play of economics and demographic factors.

Baby boomers start to turn 60

Demographic trends are one of the most predictable variables, but it was not all that long ago that we were all concerned about the global population explosion. All that has changed, and the worry now is that populations (especially in the developed world) are set to shrink. With the oldest baby boomers turning 60 next year, these concerns are receiving more attention. Sixty is an important age because in OECD countries this is the age at which many withdraw from the labour force. A smaller labour force means (other things being equal) lower economic growth (and sharemarket returns) and pressure on public finances due to lower tax revenue and higher spending.

Adverse effects on economic growth are far from certain (other things are unlikely to be equal). If labour is in relatively short supply then its price will tend to be bid up which increases the incentive to introduce labour saving innovation and encourages those not in the labour force to seek work. Also (as already noted) the developing world has huge reserves of labour.

This is not to say that nothing will change. Our expectations about retirement have been set during the period in which the baby boom bulge was in the labour force. A relatively low dependency ratio meant that previous retirees could enjoy earlier retirement than seen previously. However, as the boomers retire that ratio will become more adverse. In addition, better health and rising longevity means that unless the retirement age changes retirees will have a longer retirement than those in the past. The boomers are capable of working longer, and one solution to this problem is for the boomers to stay in the labour force longer. For Japan, which has particularly adverse demographics, increasing their relatively low female participation will also be important. We should expect to see further policy changes (perhaps tax incentives) to encourage more older age and female participation.

It appears fortuitous that the huge labour forces of China and India are being drawn into the global economic market at a time when developed country labour forces are starting to shrink. This not only makes the transition less painful, but will help offset potentially negative effects of shrinking labour forces on economic growth. There are likely to be other effects too. The relatively cheap emerging market labour forces should help support the living standards of developed country retirees. But developed country workers could find their real wage rates being bid down by international competition. The result might be a relatively high profit share of GDP – a positive for investors but not for workers.

An interesting question from an Australian perspective is what the implications are for resource prices. The Chinese are still at an early stage of development – they are becoming highly successful manufacturers. In time, they will be consumers too and as this happens demand for resources will follow. The implications for the resources sector depends on both the supply response and trends in efficient use of resources.

Resources – oil

While the rise in oil prices is not comparable with the shocks of the 1970s, there is a perception that we have now moved out of the low oil price era of the 1990s. Not surprisingly, many are worried about an era of expensive oil. However, while the market is tight currently, there is potential to increase production. And higher prices could trigger a more prolonged demand response than anticipated.

Chinese energy demand has been important in changing the supply-demand balance and pushing up oil prices. Demand in China has been growing fast and with it demand for oil. This has been partly as a quick fix to meet electricity demand. Electricity is 75 per cent coal based, but there has been increased reliance on diesel oil based back-up generators to keep up with demand. Oil experts report that this has resulted in a temporary demand spike. A recent UBS Energy Update (August 2005) stated that by 2007 the power deficit will disappear and oil consumption per head and relative to GDP growth will decline.

However, it is undeniable that demand from China and India is likely to mean that oil demand will be significantly higher in 20 years. Conservation measures provide an offsetting factor – and may mean the capital stock (eg cars) will become less energy intensive. The supply side will also be critical for future prices. In Russia, production growth is now slowing and this is expected to continue, due to a number of factors including geology and the rigid regulatory and tax systems, plus the fall-out from Yukos. There are also ongoing problems in Iraq and new concerns about sanctions being applied to Iran.

Despite this, there are predictions of rising global production over coming years. "The major risks to this outlook are not below ground, but above ground – in such forms as political turbulence, abrupt changes in contract terms, and controversy over fiscal terms" (*The Oil Industry Growth Challenge: Expanding Production Capacity*, Cambridge Energy Research Associates, 7 December 2005).

However, in terms of supply some analysts at least are positive. "We don't see an oil shortage, we see a very substantial build-up of capacity between now and 2015, of the order of a 20–25 per cent increase, and a lot of it in the next few years is in process, with projects that were sanctioned at lower oil prices" (Daniel Yergin, author, economic researcher and chairman of Cambridge Energy Research Associates).

There is clearly a lot of uncertainty about how recent price pressures in energy markets will translate into long-term trends. What is clear is that in the long term (ie over periods longer than 20 years) the challenge will remain to replace oil which is ultimately a finite resource with alternatives. This will require considerable technological innovation and investment – and the transition will involve both risks and opportunities.

CONCLUSION

Periods of great uncertainty produce winners and losers. The future may feel particularly uncertain now, but there have clearly been far more uncertain periods in the past. In recent history, the two world wars stand out and for the longer run of human history the environment was generally considerably more uncertain compared to the present. The uncertainties we are currently facing in relation to the global imbalance between savings and investment, housing bubbles, trade tensions between the US and China and the future of energy may prove to be highly important for broad market outcomes over the medium term. However, over a series of decades most of their effects, however disruptive in the shorter term, will most likely be shown to be transitory.

Other factors will have a more lasting effect. Barring any major catastrophe, it appears likely that over the next 20 years economic growth will continue in a manner broadly consistent with history. This includes resumption of "normal" growth in Japan, and growth in Asia and some other developing countries (assuming they avoid serious policy mistakes) being particularly strong. Ultimately this may result in the emergence of new leading economic powers, and the increasing importance of China in the global economy is a harbinger of this. Demand pressure, from a more numerous and a more wealthy global population, will increase demand pressure on global resources. However, supply responses and technological change should be spurred by emerging price and environmental pressures. This should create new opportunities and a new round of winners and losers may be influenced by the changing values of consumers. Indicators of changing priorities may perhaps be seen in the more densely populated parts of Western Europe. Arguably, with the rise of China and India coupled with ongoing technological change and a greater focus on sustainability, the next two decades will prove to be a highly positive era.