

The historically high earnings growth that we have enjoyed may be over. We believe that over the next 10 years (end 2008-2018) corporate profits globally will lag far behind the growth seen in 2003-2007 (which averaged about 20% per annum).

This paper discusses the main determinants of long-term profit growth and why these will inhibit future growth.

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insights

ING INVESTMENT MANAGEMENT

## Long term earnings growth in a lower gear

The global economy grew at an unprecedented rate in 2003-2007 and corporate earnings grew along with it. A significant factor was the acceleration in globalisation, which brought with it above-average growth in world trade, falling interest rates and soaring productivity. The introduction of new technologies was the engine of productivity growth. The penetration of computers, mobile telephones and the internet has contributed greatly to the rise in productivity in recent decades. However, in our view, the very high profit levels in this growth period are unlikely to be repeated over the next decade.

Theoretically, the main determinants of long-term profit growth are growth in output volumes and inflation. Output volume is a function of movements in labour supply on the one hand, and of productivity on the other. Many factors play a role here. Nevertheless, we expect both labour supply and productivity to come under pressure in the decade ahead.

To underpin a long-term view of economic and profit growth, a well-founded estimate of future inflation is crucial. In an era of globalisation this is particularly complicated. The smaller role played by lending due to the changes in the financial system could help keep inflation down. The less important role of globalisation combined with the expected wage rises in emerging economies could, alongside the large monetary stimulation packages, drive up inflation. These factors have consequences for the average profit growth of global equities in the next 10 years. We explore the extent to which this could be the case in various scenarios.

### The impact of globalisation

All economic developments today take place within the framework of globalisation, but it is also because of globalisation that the current credit crunch and recession are taking their toll throughout the world. Globalisation should continue to influence the global economy in the next 10 years also.

### No radical protectionist measures expected

Our long-term forecasts for worldwide corporate profit growth assume that a serious and sustained setback in globalisation will be avoided. Should the reality prove to be otherwise, it would clearly have a damaging effect on corporate profit growth. Open economies with a robust export trade (Germany, Japan, several emerging economies) would be hit particularly hard by any stringent protectionist measures.

The World Trade Organisation (WTO) is important, with reasonably well functioning international rules and a role as an independent negotiating forum. It was set up in response to the dramatic protectionist measures taken during the Great Depression of the nineteen-thirties. Those measures exacerbated the crisis; countries that were hurt by protectionism erected their own trade barriers. Because of those experiences, countries have so far refrained from going down the protectionist route. We assume that the politicians will continue to maintain a rational stance.

"The global economy must take into account higher energy and commodity prices due partly to higher demand from emerging economies."

### Biggest boost from globalisation has already happened

The liberalisation of world trade helped to make the past decades the most prosperous years in economic history. Never before had world trade tripled in only 20 years! At the current rate of economic integration, world trade can no longer act as such a powerful engine of economic (and profit) growth. The effect of the emerging economies on the global economy is also becoming more mixed.

Imports from emerging markets are still cheap, but will not continue to get cheaper (as they did in past decades). Output costs in those countries have a tendency to rise, due to higher labour costs, for example. Former Federal Reserve chairman Alan Greenspan, in his autobiography *The Age of Turbulence: Adventures in a New World*, points out that the downward price pressure due to imports from China and other emerging economies is diminishing. Approximately half of China's 800 million workers are in urban areas with a very competitive labour market.

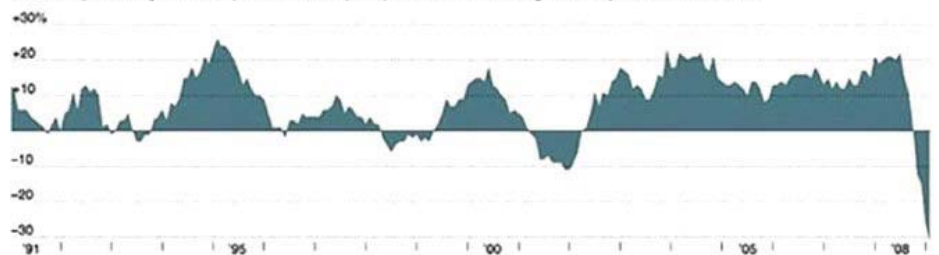
The number of new workers will gradually decline and wages will rise, along with inflation. The price of American imports from China showed a rise in the spring of 2007. China has also reported an increase in its export prices. But that is mainly because of a change in the composition of its exports where it is increasing its exports of more expensive products. Nor are wage costs the only factor. The fact that China is imposing more regulations, concerning health and safety standards, for example, will also eventually push up costs.

The global economy must also take account of higher energy and commodity prices, due particularly to structurally high demand from the emerging economies for oil, copper and other feed stocks. These feed stocks are in relatively limited supply. Structurally higher energy and commodity prices are negative on balance for the global economy, partly because they push up inflation.

Another factor of globalisation – the liberalisation of capital movements – contributed a good deal to the prosperity of the past decades, via downward pressure on interest rates. The free movement of capital will keep interest rates down in future, but no longer to the same extent as in the past 30 years, when the sharp falls in interest rates propelled the global economy. These robust effects will not be repeated, since interest rates are already at a very low level.

### World Trade Shrinks

Year-over-year change in total exports from 15 major exporters. Data are through February 2009, in U.S. dollars.



Source : John Mauldin. Year-over-year change in total exports from 15 major exporting countries (1991-02/2009)

## A changing financial system

Given the severe consequences of the credit crunch (including the banks and the financial system), it is important that globalisation is in a form that allows it to contribute to a more balanced global economy. For this, it is crucial that good progress is made through international co-operation.

Awareness of the need for this is growing, demonstrated by the formation of the G20. The G20 is an extension of the G8, which is influential in the west, but not in Brazil or India. The expansion of G8 to 20 members has enhanced its legitimacy. The World Trade Organisation (WTO) is also more legitimate than it used to be now that China is a member.

According to WTO Director-General Pascal Lamy, the financial sector is one of the least regulated on the planet and the credit crunch arose because of the black hole in the international system of financial governance. When the financial crisis broke, the whole world was affected. The idea is gaining ground in the financial world that to achieve stable, cross-border financial institutions better regulation is necessary, such as international supervision, for example. The call for smaller and sounder financial institutions will probably ultimately receive some response.

### Deleveraging depresses economic growth

High leverage contributed to the rapid economic (and profit) growth in 2003-2007. The ultimate consequence of this indebtedness – the credit crunch – makes it clear that this debt must now be reduced. Consumers, particularly in the US and other Anglo Saxon countries have also run up considerable personal debt.

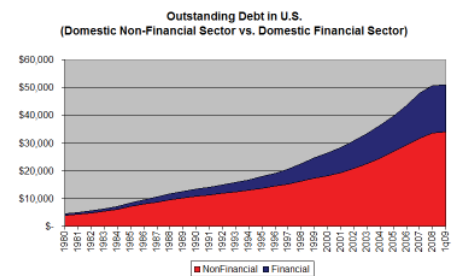
The balance sheets of western banks and other financial institutions (including hedge funds) are too highly leveraged. That is obvious now that the risks have increased and the size of the debt has become a problem. That debt was able to escalate off the balance sheets of financial institutions because of the so-called shadow or alternative banking system. The fact that American banks took a lot of risks is nothing new. The US financial system was highly leveraged between the sixties and the mid eighties. Then it was the mainstream banks that took many risks in relation to their capital base. That period has now ended with a series of bankruptcies among the savings and loan associations.

Since then commercial banks in the US have been more circumspect in their lending. The reason why the risks in the American (and western) financial system increased dramatically was because of instruments that allowed the banks and other financial service providers to keep debt/risks off the balance sheet. Securitisation, for example, enabled loans and risks to be sold on to other parties. Furthermore, by making massive use of derivatives, the risks could be offloaded.

Research by Brender and Pisani ("*Globalised Finance and its Collapse*") estimate that because of this an alternative banking system worth around US\$14,200 billion grew up in the US in mid 2007. This exceeds the US\$11,300 billion in credit/loans that the commercial deposit banks and savings and loan associations had on their balance sheets for the same year. Brender and Pisani estimate only the credit risks in the alternative banking system. Although they make clear that their figures are only an approximation, they nevertheless give a good indication of the spectacular size of the shadow system.

Based on data from the Federal Reserve, Hedge Fund Research and their own computations, Brender and Pisani estimate that the traditional and alternative banking systems in the US together make up approximately 180% of US gross domestic product (still only 100% in 1990). In 1990-2007, the traditional banking system stabilised at 60% to 70% of American gross domestic product. The increase in leverage was clearly concentrated in the alternative banking system.

"The debt mountain of American and European banks is so high in comparison with their capital base, that reducing it will put downward pressure on economic growth for some years."



Source: U.S. Federal Reserve - Flow of Funds, U.S. Bureau Economic Analysis



"The amounts of money that governments are now spending is nothing compared with what they will spend in coming decades in connection with the ageing population."

According to Nassim Nicolas Taleb and Mark Spitznagel, the global economy is weighed down with debt. They think that debt as a ratio of gross domestic product has approximately tripled in approximately 30 years (Financial Times 14 July 2009). Some of this debt is toxic, partly because of its link (via securitisation and derivatives) to the collapse of house prices in the US Sub Prime sector and also because of the severe recession. The European Central Bank expects that banks in the euro zone will have had to write off approximately €280 billion by the end of 2010.

To sum up, the debt mountain of American and European banks is so high in comparison with their capital base that reducing it will put downward pressure on economic growth and thus on corporate profit growth for some years. The sector must reduce its debts, but it also has to cope with stricter regulation of its business practices. So it can no longer be the powerful engine of economic growth that it used to be.

We expect that banks will have to operate with a bigger capital base and will find it harder to launch new products in the market. The alternative banking system is expected to be regulated in some way. All this means is that there will no repeat of the very strong growth that the financial sector experienced in 2003-2007. Even once the economy recovers, growth will still have to contend with pitfalls. Western and Japanese governments will need to trim their soaring budget deficits. Their economies will then be hit by tax rises and cutbacks.

### The demographic trend depresses economic growth

One of the main determinants of the economic growth of a region is population growth. Growth in the working population is particularly important to increased long-term economic activity. Thus any decline in the workforce will have a depressing effect on growth. We have already seen this happen in Japan, where the workforce has shrunk. Europe will have to contend with a similar situation in the years ahead, as will many other countries around the globe.

The problem of a shrinking population and workforce is generally only mentioned in a western or Japanese context. In the long term, however, the ageing problem will not be confined to the mature economies. In Asia too, demographic trends will eventually move downward in some countries, such as China. On the other hand India is, according to projections by the United Nations, one of the countries that will contribute the most to population growth in future decades (until 2050).

The ageing population will be a problem in Europe and Japan in the next 10 years. The birth rate in the US fluctuates around the level necessary (2.1 per woman) to maintain the population, but this is boosted by the traditionally high rate of immigration. The conclusion is that growth in the active working population of the emerging economies will contribute to higher economic growth in those countries than in the mature economies over the next 10 years.

In any case, the International Monetary Fund (IMF) has already warned that the amount of money that governments are now spending on combating the economic crisis is nothing compared with what they will have to spend in the coming decades in connection with the ageing population.

Working population (15-64 years) as % of total population (millions)								
	2010		2020		2030		2040	
	millions	%	millions	%	millions	%	millions	%
Europe	500	68.3	479	65.4	453	62.7	426	60.3
North America	235	67.1	248	64.8	255	62.2	265	61.6
Latin America	385	65.4	435	67.4	463	67.2	472	65.7
Asia	2,796	67.1	3,106	67.2	3,318	67.5	3,393	66.2
of which China	973	71.9	996	69.6	983	67.2	916	63.0
India	780	64.3	916	67.0	1,021	68.8	1,088	69.6
Japan	81	64.2	74	59.9	68	58.4	59	53.8
Australia/New Zealand	17	67.1	18	64.5	19	61.8	19	60.3
Africa	581	56.3	743	58.3	937	61.5	1,134	64.1

Source: UN 2009

## A new complex situation, so greater uncertainty

Global economic processes are becoming ever more closely entwined. This greater complexity also means more uncertainty for investors.

We have seen that the accumulation of debt in the US (some of which is of poor quality) has affected almost every region. This debt needs to be reduced over a number of years, particularly in the US. This will create more than usual uncertainty about the trend of effective demand. Governments and central banks are currently pursuing an extremely accommodating policy.

The unorthodox policy of the American Federal Reserve, in particular, is contributing to the great uncertainty. The present quantitative easing, i.e. printing extra money, could, if reversal is mistimed, lead to a period of escalating inflation. Besides this, the reduction – once the economy recovers – in the mountain of government debt will depress growth for years.

Central banks may be expected to take a more critical stance towards excessive market movements. The US Fed, too, will no longer automatically assume that the market can resolve its problems without too much damage. We expect that central banks will no longer direct their policies solely at keeping down inflation in the real economy, but also at limiting inflation in the financial economy, such as bubbles in the housing market. A stricter monetary policy may ensue, with a concomitant risk of downward pressure on economic growth.

The expected shift of economic power away from the US to China, India and other emerging economies may also increase political tensions and thus uncertainty. Taking all the factors into consideration, we believe we will experience wider economic fluctuations and faster swings in financial markets than we have generally seen in the past 20 to 30 years.

## A study of economic scenarios

Long-term profit growth is largely determined by growth in output volume and the possible price rise or inflation. Some scenarios have been drawn up in order to get an idea of what is facing investors in the somewhat distant future. As mentioned, the picture for inflation is particularly uncertain and will depend partly on monetary policy. Given the high degree of uncertainty, we are considering several possible outcomes. We note that the US has the most data available, so we have based our projections on historical American figures, going back to 1980.

### Scenario 1: Economic boom and controllable inflation

In this scenario, there is robust growth in the global economy and slightly higher inflation than in recent decades – say 3% real growth and 3% inflation. Such a situation would benefit the advancement of globalisation, investment and technological innovation. Slightly higher, but controlled, inflation would help to erode the debt mountain in the US and elsewhere.

We consider this a less likely scenario for mature economies. These economies are saturated, while the American economy needs to kick the debt habit. The need to deleverage will temporarily depress consumption, which accounts for around 70% of the US economy.

We think that emerging economies have a greater chance of 4% to 5% annual growth and higher inflation. The populations of these countries are increasing and the potential growth in their domestic markets is high. They are in a situation that is inevitably accompanied by higher inflation. Inflation in emerging markets could affect global inflation through rising import prices. Moreover, demand from emerging markets could push up oil and commodity prices worldwide. These factors would not only depress global consumer demand, but also have an adverse effect on corporate profit margins.

### Economic Scenarios

	Economic Growth	Unemployment	Prices
Inflation	High	Low	High
Stagflation	Low	High	High
Stagnation	Nil/Low	High	Low

"Reversing fiscal stimuli too soon could result in a period of stagnation. However, responding too late to improving economic activity would risk runaway inflation."

### Scenario 2: Sustained stagflation

Such a scenario was seen in the western economies in the nineteen-seventies after oil prices skyrocketed. Central banks have taken many traditional and unorthodox steps to increase the liquidity of the financial system. These steps will eventually need to be reversed. Should the US Fed fail to adjust its extreme easing of monetary policy at the right time, then there is a risk that inflation will get out of hand. Even somewhat higher inflation forecasts could give rise to this, with the risk of a weaker US dollar. Low growth exacerbates the risk of protectionism and intensifies competition in the saturated mature markets.

We see a negligible risk of structural stagflation in the emerging economies, although stagflation in the mature economies could indeed depress growth in emerging markets, particularly in countries with a high dependence on exports and few opportunities to focus more on domestic growth and/or little leeway to stimulate the domestic economy.

### Scenario 3: Sustained stagnation and deflation ('Japanese scenario')

The deflationary effects of deleveraging may mean – certainly if the stimulation packages do not have the desired effect – a risk of protracted low growth, minimal inflation and possibly even structural deflation.

Japan experienced just such a situation in the nineteen-nineties (and is still not over it). Like Japan, the western economies are saturated. In such an economic climate, a massive supply of credit and low interest rates need not automatically lead to demand for credit. Investor concerns that the western economies will end up in a Japanese-type scenario may lead to a further cut in government bond yields. A period of deflation would be disastrous for public finances; as tax revenues would fall, while public spending would rise due, for example, to social security payments and other anti-poverty measures.

### Likelihood of these economic scenarios

#### Global economic boom (scenario 1) is less likely

As already mentioned, several factors will depress global economic growth in the next 10 years. Leverage must be reduced, while stricter regulation of the banks will put downward pressure on profit growth. The ageing and shrinking working population, initially in Japan and Europe, is yet another factor that will weigh on economic growth. We therefore think that a global economic boom is unlikely given the restraints on growth exercised by the afore-mentioned factors, particularly in the major economies (US, Europe, Japan).

The global economy experienced boom conditions in 2003-2007. That period also saw an enormous accumulation of debt that will have to be paid off in the years ahead. The global economy will also lack the stimulus it received in the past 20 to 30 years from the ongoing fall in interest rates. In any case, interest rates are now at a record low with no room for a much further fall. Overall, we consider there is little chance of a 'normal' sustained economic boom in the next 10 years.

#### Sustained stagflation (scenario 2) and sustained stagnation (scenario 3) are less likely

The chances of sustained stagflation and/or sustained stagnation are greater than normal, owing to the unorthodox steps that the central banks and governments have taken in recent months. The considerable fiscal and monetary stimuli will have to be reversed once there are clear signs of economic recovery. Choosing the right time to begin to do this will be difficult, but will also be crucial.

Reversing the monetary and/or fiscal stimuli too soon could mean that the global economy ends up in recession again or in a period of stagnation. Responding too late to obvious improvements in the global economy would risk runaway inflation. That could mean a situation of high inflation and minimal growth (stagflation).

Stagnation would depress corporate profits via lower turnover. The risk of deflation would then also rear its head. Looking at the various investment classes, such a situation would benefit only government bondholders, due to lower interest rates. We know from experience that in such a situation it is not only corporate profits that come under pressure, but also price/earnings ratios.

Reversing the monetary and/or fiscal stimuli too late could have serious consequences for the global economy, owing to rising inflation. Runaway inflation would increase corporate turnover, but higher costs due to pay rises and rising interest rates would put corporate profits under pressure in this situation as well. Also, government bond yields would shoot up. This situation, too, would depress equity prices.

The policymakers have so far managed to avoid stagnation and deflation. We think that they will continue to do by relentlessly pursuing an expansionary policy for as long as necessary.

The chance of stagflation after some time cannot be ruled out, given the present complex situation. But we must point out that the global economy has to contend with several deflationary influences. Deleveraging, for example, has a deflationary effect. The ageing population also affects the financial markets due to reduced savings. All in all, we expect central banks and governments to have the ability to avoid stagflation.

### What do the scenarios mean for equities and bonds?

<b>Boom</b>	- Good for equities, less so for bonds
<b>Stagflation</b>	- Less good for equities, less good for bonds
<b>Stagnation</b>	- Less good for equities, good for bonds

## Conclusion

Normal economic growth of 3% to 4% in the major economies, as seen in the past 20 to 30 years, cannot be maintained in our view, due to the restraints that are already in effect, including deleveraging and stricter regulation of the financial sector. We foresee economic growth in the western countries and Japan averaging below 2% per annum for the next ten years. Growth in the emerging economies will be appreciably higher than this at around 4.8% per annum.

To gain an impression of corporate profit growth worldwide we must first look at structural growth in the mature economies. The equity markets of those economies account for 90% of global market capitalisation. Also, western and Japanese multinationals generate a large part of their turnover in emerging markets. We estimate the annual effect of emerging markets on global profit growth at about 1%.

As already mentioned, there are several factors that could exert upward pressure on inflation. The global economy experienced a sharp fall in inflation and interest rates as from the nineteen-eighties. At the moment, we already have very low inflation and low interest rates. The relatively feeble growth in the saturated markets (US, Europe and Japan) will depress real growth, and thus possibly inflation also. The expected lower credit growth (from record highs) would likewise have a deflationary effect. However, the contraction in the working population implies upward pressure on wages. On balance, we see global inflation averaging 2% to 2.5% per annum for the next 10 years.

Our estimate for average corporate profit growth in the next 10 years is based on real economic growth (about 2% per annum), plus the emerging market effect (about 1%), plus expected global inflation (2% to 2.5%). Our estimate for average inflation is the same as the average global inflation rate for the last 30 years.

This brings our 10-year forecast for profit growth (end 2008 to end 2018) to around 5% to 5.5% per annum. That is much lower than profit growth in 2003-2007 (20%) and also appreciably less than average profit growth in the last 30 years (7.5%).

### Lower gear growth on the horizon

	Earnings Growth
<b>30 Year Average</b>	7.5% p.a.
<b>Last Bull Market (2003-07)</b>	20.0% p.a.
<b>Future Expectations (2008-18)</b>	5.0-5.5% p.a.

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