research affiliates

ARTICLE

Slow Growth: A Tale of Two Theories

May 2015

AUTHORS

Shane Shepherd

First quarter U.S. GDP numbers were recently released, and they weren't pretty. Notwithstanding our oft-cited concerns that GDP doesn't measure anything terribly useful,[1] GDP growth was a paltry 0.2% and will likely be revised into negative territory after accounting for the latest trade deficit numbers reported in early May. But this "news" is hardly new. Slow economic growth has been a staple of what PIMCO presciently described as the "New Normal" in 2008, and in the intervening seven years our economy has yet to reach what mainstream economists term "escape velocity."[2] Those who have forecast a return to better times just around the corner, instead find themselves paraphrasing Michael Corleone from *The Godfather*: "Just when I thought I was out... they pull me back in!"

But why has economic growth been so slow for so long, and how much longer should we expect it to last? Two economic stories may shed some light on the motivating forces behind current slow GDP growth and low interest rates, and as such, bear further examination. One is secular stagnation, and the other is the notion of a global savings glut.

An interesting dialogue on this subject has played out on Ben Bernanke's new blog,[3] where he recently discussed the theme of secular stagnation, put forth most prominently by Larry Summers.[4] According to this view, the New Normal is about inadequate aggregate demand, or in other words, slowing consumer spending and depressed investment levels, which are leading to slower economic growth and lower real interest rates. Summers lists six important and potentially long-lasting changes in our economy that have led to lower demand: 1) a debt overhang and lower demand for leveraged investing, 2) a declining rate of population growth, 3) increased income inequality contributing to a greater propensity to save, 4) cheaper capital goods lowering the demand for capital for activities such as business formation, 5) a pre-tax real interest rate that is possibly too high; and 6) an accumulation of reserves at central banks around the globe.

In a world of secular stagnation, the Federal Reserve may not be able to achieve a real rate of interest low enough to match the long-run equilibrium rate of interest.[5] Equally insidious is secular stagnation's feeling of permanence; the trends at fault are slow moving and likely to persist well past the standard business-cycle horizon. Deleveraging from our debt overhang—a hangover from the housing bubble now infecting many central governments—will take decades. The impact of aging demographics across the developed world is only just beginning to slow both labor force growth and productivity, and this trend will only strengthen in the coming years.[6] The technological changes brought about by the Internet and the Information

© 2022 Research Affiliates, LLC. All rights reserved. Duplication or dissemination prohibited without prior written permission. Generated on 11/22/22.

Age have created an environment that spawns start-ups with tremendous potential, founded on thousands, rather than millions, in initial capital. The remaining play in these long-term trends suggests that the New Normal is still in its early days.

Bernanke, however, suggests that the New Normal may be more temporary. He notes that secular stagnation—if purely a domestic phenomenon—could easily be overcome by allowing investment of capital overseas. Capital should naturally flow to countries offering the highest returns on investment, and the earnings from those investments should provide an economic boost in the home country. But slow economic growth is hardly isolated in the United States; it's even more powerful in Europe and the developed countries in East Asia.

Bernanke also notes the presence of a global savings glut, an excess of desired saving over desired investment that leads to lower interest rates and slower GDP growth. But he attributes this more to the economic headwinds of normal business-cycle fluctuations, rather than long-lasting structural changes in the economy. As the headwinds dissipate, he believes the New Normal will as well. Bernanke even provides a clue as to when this might happen: "When the European periphery returns to growth, which presumably will happen at some point, the collective [global savings] surplus ought to decline."[7] The secular stagnation-based outlook may seem glum, but is it any better to pin hopes for stronger U.S. growth on the economic recovery in Greece and Italy and the savings of the emerging markets?

Bernanke is, of course, quite right to emphasize the global nature of today's economic prospects; the forces that may be driving secular stagnation in the United States are perhaps even stronger in Japan and Europe. The global economy is experiencing a shortage of demand. At Research Affiliates, we believe that structural changes in most developed market countries will cause the demand shortage to persist. The primary demographic impact of an aging baby-boom generation will be slower population growth and slower productivity growth, which will reduce GDP growth and keep real interest rates low.[8] And the ongoing deleveraging from high debt ratios will continue to exert downward pressure on current demand.

Likely, we have entered a period of secular stagnation heavily impacted by lingering debt overhangs, persistent demographic shifts in savings preferences, and increased efficiency of capital. No doubt a global savings glut has been a contributing factor, but one that will dissipate more quickly than these longer-run trends, which are powerful and long lasting, and will impact our economic outlook for many years to come. Current deeply negative interest rates will likely shift back toward zero, but within our investment horizon are unlikely to return anywhere close to the historical averages. As Michael Corleone discovered, it is not easy to escape genetic or demographic destiny.

Secular stagnation has a major impact on investment policy decisions. Research Affiliates' 10-year capital market return expectations are published on our Asset Allocation site and incorporate the influence of secular stagnation. The expected returns of both mainstream equities and bonds are heavily dependent on the equilibrium real rate of interest, which serves as a key building block for all long-term investment returns in an economy. With slow GDP growth propagating negative or near-zero real interest rates, our message is that expected returns across most asset classes should be lower than their long-term averages. We currently expect about 0.7% average annual real returns over the next decade for both core U.S. bonds and core U.S. equities. A return to higher GDP growth and associated higher real interest rates would certainly brighten this picture, but that requires faith that "temporary headwinds" will dissipate at some point. We simply don't have that faith. We see evidence of secular stagnation continuing in the long term, and the consequent dampening of growth, as our nation's and the developed world's inescapable destiny.

Endnotes

1. Rob Arnott, "Does Unreal GDP Drive Our Policy Choices?" Research Affiliates *Fundamentals*, April 2011.

2. We question the relevance of the entire concept of "escape velocity." Escape from what? To what? Are we ignoring the fact that both slower labor-force growth and an older labor force virtually guarantee slower long-term economic growth?

© 2022 Research Affiliates, LLC. All rights reserved. Duplication or dissemination prohibited without prior written permission. Generated on 11/22/22.

3. "Ben Bernanke's Blog" *Brookings*.

4. Lawrence H. Summers. "U.S. Economic Prospects: Secular Stagnation, Hysteresis, and the Zero Lower Bound." Keynote address at the NABE Policy Conference, February 24, 2014.

5. The equilibrium rate of interest is the real interest rate that, over the long run, will allow for full employment while meeting the Fed's goal of low and stable inflation. Suppose, for example, that the Fed would like the actual real rate of interest to be −3% and the inflation rate to be 2%. Because the lowest the nominal rate of interest can go is 0%, the lowest achievable real rate would be −2%. Given these constraints, interest rates would remain persistently higher than desirable, and unemployment would likely not fall as low as desired. We would face a choice between higher than desired inflation, or higher unemployment and likely slower economic growth.

6. Rob Arnott and Denis Chaves discuss the impact of demographic trends on GDP growth in "Mind the (Expectations) Gap: Demographic Trends and GDP," Research Affiliates *Fundamentals*, June 2013. We find it shocking that the simple arithmetic of demography, and its impact on economic growth, eludes so much of the economics profession. Economic growth equals the sum of labor force growth plus productivity growth. If the working-age population is set to grow about 1% per year slower in the coming 20 years than in the past 60 years, then 3% growth becomes 2% growth. What's so hard to understand about that? Older workers are closer to peak productivity, so they are more productive than younger workers, but their productivity growth is slower; if this has a ½% impact on productivity growth, then 2% growth becomes 1.5% growth. So, why does most of the economics profession cling to the same growth targets as the past?! Oh… they get *paid* to do so… that's right!

7. Ben Bernanke, "Why Are Interest Rates So Low, Part 3: The Global Savings Glut," Ben Bernanke's Blog, *Brookings*, April 1, 2015.

8. Research Affiliates forecasts U.S. real interest rates to remain negative or near zero for much of the next 10 years as Shane Shepherd discusses in "Not-So-Great Expectations: Why Real Interest Rates Won't Soar," Research Affiliates *Currents*, April 2015.

© 2022 Research Affiliates, LLC. All rights reserved. Duplication or dissemination prohibited without prior written permission. Generated on 11/22/22.

The material contained in this document is for informational purposes only. It is not intended as an offer or a solicitation for the purchase and/or sale of any security, derivative, commodity, or financial instrument, nor is it advice or a recommendation to enter into any transaction. Research results relate only to a hypothetical model of past performance (i.e., a simulation) and not to actual results or historical data of any asset management product. Hypothetical investor accounts depicted are not representative of actual client accounts. No allowance has been made for trading costs or management fees, which would reduce investment performance. Actual investment results will differ. Simulated data may have under-or-over compensated for the impact, if any, of certain market factors. Simulated returns may not reflect the impact that material economic and market factors might have had on the advisor's decision-making if the advisor were actually managing clients' money. Simulated data is subject to the fact that it is designed with the benefit of hindsight. Simulated returns carry the risk that actual performance is not as depicted due to inaccurate predictive modeling. Simulated returns cannot predict how an investment strategy will perform in the future. Simulated returns should not be considered indicative of the skill of the advisor. Investors may experience loss of all or some of their investment. Index returns represent backtested performance based on rules used in the creation of the index, are not a guarantee of future performance, and are not indicative of any specific investment. Indexes are not managed investment products and cannot be invested in directly. This material is based on information that is considered to be reliable, but Research Affiliates, LLC ("RA") and its related entities (collectively "Research Affiliates") make this information available on an "as is" basis without a duty to update, make warranties, express or implied, regarding the accuracy of the information contained herein. Research Affiliates is not responsible for any errors or omissions or for results obtained from the use of this information.

Nothing contained in this material is intended to constitute legal, tax, securities, financial or investment advice, nor an opinion regarding the appropriateness of any investment. The information contained in this material should not be acted upon without obtaining advice from a licensed professional. RA is an investment adviser registered under the Investment Advisors Act of 1940 with the U.S. Securities and Exchange Commission (SEC). Our registration as an investment adviser does not imply a certain level of skill or training. RA is not a broker-dealer and does not effect transactions in securities.

Investors should be aware of the risks associated with data sources and quantitative processes used to create the content contained herein or the investment management process. Errors may exist in data acquired from third party vendors, the construction or coding of indices or model portfolios, and the construction of the spreadsheets, results or information provided. Research Affiliates takes reasonable steps to eliminate or mitigate errors and to identify data and process errors, so as to minimize the potential impact of such errors; however, Research Affiliates cannot guarantee that such errors will not occur. Use of this material is conditioned upon, and evidence of, the user's full release of Research Affiliates from any liability or responsibility for any damages that may result from any errors herein.

The trademarks Fundamental Index™, RAFI™, Research Affiliates Equity™, RAE™, and the Research Affiliates™ trademark and corporate name and all related logos are the exclusive intellectual property of RA and in some cases are registered trademarks in the U.S. and other countries. Various features of the Fundamental Index methodology, including an accounting data-based non-capitalization data processing system and method for creating and weighting an index of securities, are protected by various patents of RA. (See applicable US Patents, Patent Publications and protected trademarks located at https://www.researchaffiliates.com/legal/disclosures#patent-trademarks-and-copyrights, which are fully incorporated herein.) Any use of these trademarks, logos, or patented methodologies without the prior written permission of RA is expressly prohibited. RA reserves the right to take any and all necessary action to preserve all of its rights, title, and interest in and to these marks and patents.

The views and opinions expressed are those of the author and not necessarily those of RA. The opinions are subject to change without notice.

©2022 Research Affiliates, LLC. All rights reserved. Duplication or dissemination prohibited without prior written permission.

AMERICAS

Research Affilates, LLC
620 Newport Center Drive, Suite 900
Newport Beach, California 92660
USA

+1.949.325.8700
info@researchaffiliates.com

EUROPE

Research Affiliates Global Advisors (Europe) Ltd
16 Berkeley Street
London W1J 8DZ
United Kingdom

+44 (0) 203 929 9880
uk@researchaffiliates.com

© 2022 Research Affiliates, LLC. All rights reserved. Duplication or dissemination prohibited without prior written permission. Generated on 11/22/22.