Ken Taubes of Pioneer Investments and Mike Wilson of Morgan Stanley Wealth Management share their views on the global economy—and tips on how to invest in the current environment.

Equities have rebounded—and then some—since the 2009 stock-market bottom, but the global economy still struggles. Europe remains in recession, and growth in emerging economies has stalled. The U.S. economy, meanwhile, expanded more slowly than expected in the first quarter of 2013. Such an anemic recovery has prompted central banks worldwide to take aggressive measures. The effect on markets, say Pioneer Investments’ Ken Taubes and Morgan Stanley Wealth Management’s Mike Wilson, is uneven. The two chief investment officers recently participated in a panel discussion moderated by Gabe Altbach, Pioneer’s head of product marketing. The topic: investing in today’s environment. The following is an edited version of their conversation.

Gabe Altbach: Mike, what is your read on the U.S. economy today? What more can central banks do to encourage growth?

Mike Wilson: Economic data has softened globally. But we expected that to happen. The economists at Morgan Stanley were calling for a soft patch in the second quarter. However, [in the U.S.], we don’t think it will be anything more than a soft patch. A recession is not in the call.

Europe continues to struggle with structural issues and has been in a recession for quite a while. I think that made it easier for the [Federal Reserve] to say it will continue with its latest round of quantitative easing rather than end it prematurely or before yearend. Both the Fed and the [European Central Bank] have held meetings separately, and both banks suggested they will lean toward more [of the easy monetary] policy. The ECB has alluded to doing more if needed, in terms of direct lending and supporting the structures already in place in Europe. All of that will continue to help the markets.

Altbach: Ken, how would you grade the performance of central banks around the world?

Ken Taubes: I would say the Fed started out with an A in 2008 and 2009. Since then, it has earned a B-minus, largely because I think they're beginning to overdo it. While [gross domestic product growth] was revised to 1.8% in the first quarter [down from 2.4%], growth is still positive. Yet the Fed is monetizing debt like crazy. I probably would give the ECB a D. I think it has been very late with monetary easing, even though the region is in recession and experiencing disinflation. The Japanese finally started doing something, but they, too, have been battling disinflation without much policy action.

Overall, you can’t ignore what's going on. Every major central bank in the world is more or less all in. And with global GDP expanding only modestly and the real economy not absorbing a lot of capital, a lot of loans aren't growing greatly. So where's this liquidity going to go? I would argue it's going to keep going to financial assets. People are going to buy bonds and stocks, [and this] will help propel the markets up, even in the face of modest growth.

As a way of explaining some of the recent economic data, I would say we’re seeing a slight pullback in inventory. Most of the weakness has been in industrial production. At the end of last year, people were afraid to produce. Companies held back in the face of the fiscal cliff. But underlying consumer...
demand wasn't all that bad, and inventories got low. So, in the first quarter, companies rushed to rebuild and probably overdid it.

There are some bright spots, however. Sectors that are sensitive to interest rates, such as autos and housing, are starting to pick up. Despite slow economic growth globally, exports are rising. In fact, our trade deficit is narrowing, which means GDP is going to be positively impacted by that sector. Why is that happening in the face of weak growth overseas? I suspect it's because we're taking market share. I think we're going to be in better shape in the next couple of months.

Wilson: I also think there is a real divergence between the private economy and the public economy. The Fed has done a poor job of putting pressure on the government to do something at the fiscal level. Now we're actually having a recession in government spending. If you look at the private economy, it's growing much faster than the headline number in GDP. I think nominal GDP [growth] in the private sector is somewhere over 5% now. I think that's an important difference [to consider] when you're investing.

Taubes: I agree, and that raises a point about the Fed. The private sector is already growing. The Fed can't get GDP up in the public sector through monetary policy. That's why I think the Fed is moving in the wrong direction. There's nothing it can do monetarily to change the public fiscal situation.

Altbach: Mike, what is your take on Japan’s all-in effort to stimulate the economy? Will it work? And what does it mean for investors in terms of allocating to Japanese securities?

Wilson: Japan has a long history of failing to make structural change. But ever since [Prime Minister Shinzo] Abe was elected [in December], there has been significant movement. Real plans are being put into place. Real discussions are happening. For example, we’re seeing wages go up for the first time at a lot of companies. That's going to be helpful for the consumer economy. Of course, the verdict is still out. There is a big election this summer, and if that goes well, we could see more structural changes that will bolster the economy as well as the market.

Taubes: I don't think Japan will solve all of its problems with monetary policy. It has a gigantic debt problem, worse than any other country in the world. I suppose one way to ease [the debt load] is to inflate out of it [through monetary policy], but there are other big structural issues. Tax rates generally are high. And the demographics are terrible. Women still do not make up a large percentage of the workforce, so getting them to work could help solve some of the problem but not all of it.

What Japan really needs is population growth. I don't see any movement in that direction whatsoever. Immigration is not really possible in Japan. That’s one thing that sets the U.S. apart: We have dynamic immigration and open borders, for the most part. That will help fund our entitlement programs, and from my perspective it is something that Japan desperately needs.

Altbach: Mike, given today’s low interest rates, have you been adjusting the asset allocation in portfolios?

Wilson: Our middle model used to have about 45% in cash and fixed income. But we felt that was inappropriate in a world with 0% interest rates. Now we’re running with 65% in equities and 35% in fixed income, given the relative value of equities. Within the 65% bucket, we include [the] alternatives [class]. I also believe that we could have a bit of a sloppy market for the near term, and hopefully, we can put some cash to work. But it will be toward equities, not fixed income.

Altbach: Ken, do you agree? Are there opportunities in fixed income today?

Taubes: Value is hard to come by in fixed income. For the next few years, I think it will be impossible to get any capital appreciation from Treasuries. The two-year note is at 34 basis points. Even if the yield goes to zero, mathematically, you can't make any money. On the other end of the spectrum, in high-yield [bonds], you're capped on the upside by calls and redemptions.

However, I think we’re in an environment where credit [corporate bonds should] continue to do well. In fact, the conditions are [ideal] for credit. Companies are growing. They're generating cash flow and earnings and are able to deleverage if they choose to, or at least maintain their creditworthiness. [I think] inflation is low and we have easy money. In that environment, I believe spreads will continue to tighten.

Wilson: Our view is that within fixed income, we want to be short duration, long credit. But we don't like passive credit. So, we don’t believe there is a lot of value in [exchange traded funds] that track credit indexes. If you're good at
picking specific bonds, there are still opportunities. My rule of thumb is that you always want your yield greater than your duration. Today, it's pretty hard to get a 3% yield with a three-year duration. You can do it, but you have to be very good at picking those credits.

**Altbach:** Ken, are commodities near the end of their long run? What role do alternatives play in portfolio construction now?

**Taubes:** I don’t think there is a clear answer for what will happen to commodities, but I have a few speculations. One is that when prices become so profitable for miners and manufacturers, there is a supply response. We've had an incredible supply response for a lot of commodities that are now in overproduction even though global growth isn’t particularly strong. And if you take a long view of commodities investing, generally, it has been a zero-sum game. Unless you trade it very well, the asset class hasn’t made money for people.

Precious metals may be the one exception. With central banks remaining very steady in terms of [monetary] easing, people may once again become interested in gold, especially if the economy begins to come back. But long term, I think commodities are difficult to invest in and to make money from.

As for alternatives, that's an area we've been looking at as a firm. By and large, I think people are hoping alternatives will provide reasonable returns with lower volatility [than stocks]. Unfortunately, that may not be the case, given how low yields are. The only way to get any income or any sort of return is through leverage.

**Altbach:** Mike, same questions for you: What is your commodity outlook and what role should alternatives have in a portfolio today?

**Wilson:** The only thing I would add about commodities is that it’s a self-correcting market, both on the upside and the downside. Take energy. I don't think you can produce a barrel [of oil] today for less than $70. We’re likely not going back to the 1990s, when we had oil prices of $15 to $20 per barrel. I also believe that as prices go down, demand will pick up. The super cycle is over. The demand from China [which helped fuel the commodities bull] was a once-in-a-lifetime event. But I still think commodities can be an inflation hedge, because if the central banks do get out of control and the economy overheats, you probably will see commodity prices increase.

I agree with Ken about precious metals. For our commodity exposure, we're [recommending] about 4% in precious metals and 2% in non-precious metals. Gold tends to do very well in periods of financial repression, and despite the recent selloff, we’re still in a world of financial repression. We had a 40% correction in gold from 1974 to 1976, and then gold increased by 800%. I'm not saying gold is going up 800%, but I think it's too early to give up on the gold bet, given what central bankers are doing.

As far as alternatives go, I think they have a place in [almost] everybody’s portfolio. But they can’t be correlated with the equities in your portfolio, and you don’t want to pay high fees for them. With the fee structure on some of these alternative [strategy mutual funds], you're in the hole 4% to 5% before you even get going. In a low-return environment, that's a non-starter.

**Altbach:** Mike, where do you see opportunities in emerging markets?

**Wilson:** Historically, the emerging markets have traded as one bloc, especially within regions. For example, Latin America, Brazil and Mexico historically have traded together. Yet in the last three or four years, Mexico has outperformed Brazil by about 70%. There are real structural changes going on in Mexico that are not happening in Brazil. These countries are getting bigger, and some of them are not emerging anymore; they’re turning into developing countries. And therein lies the opportunity.

The other thing that's developed is the idea that emerging-market indexes are skewed toward three industries: materials, energy and financials. What has underperformed over the last year and a half? Materials, energy and financials. [In other words], the emerging markets are dealing with the same global trends that companies in the U.S. are dealing with. So there needs to be a reconstruction of these indexes to include consumer-oriented companies, which will benefit from the domestic growth in these countries.

**Taubes:** We have been increasing our exposure to emerging-market debt over the last 12 to 18 months. Unlike in the West, where you see deteriorating fiscal situations and rising debt-to-GDP ratios, in many emerging market countries, you're seeing credit improvements and upgrades. And as these countries become better credits, you're potentially going to see less volatility.
The other attraction has been that many of these countries haven't been engaging in the same monetary policies as Western central banks. In some cases, you are still able to get positive real yields [or yields that exceed the rate of inflation]. That is attractive to us. Obviously, there has been a pretty big rally on the bond side of emerging markets. The opportunity is not quite what it was a year ago, but I think there's still potential as the [credit] upgrades and restructurings come through in some countries.

On the equity side, I think Mike has it exactly right. The emerging market indexes are very heavily weighted to certain sectors that haven't been particularly attractive from a global growth perspective. But if we do get some global growth again in the next 12 months, I think they [potentially] can outperform. Emerging-market stocks look cheap compared with [equities in] a lot of developed markets.
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