Voya Global Perspectives™

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2014 Forecast:
Broadening Global Economic Expansion

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By
Douglas Coté, CFA
Chief Market Strategist

Karyn Cavanaugh, CFA
Market Strategist

INVESTMENT MANAGEMENT

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Executive Summary

Global economic expansion is marching forward at a modest, almost fitful pace, but it is indeed marching forward. Only four years removed from the deepest economic downturn since the Great Depression, the global economy has surged to an all-time record; total global output has nearly doubled over the past decade, from $37 trillion to $73 trillion projected for year-end 2013[1], with nearly one-third of that coming since 2007. And this rising tide truly has lifted all boats; while the post-crisis expansion was led by the emerging and frontier markets, it has recently expanded to include a greater number of developed economies as well. So while risks and uncertainties remain, savvy global investors have found numerous opportunities in recent years and that will persist in 2014.

As we discuss in our forecast for 2014, we expect the bull market to be sustained by:

- A broadening of the global economic expansion fueled by...
- ... improvements in worldwide manufacturing production and the power of global consumerism, as well as...
- ... global tectonic shifts — powerful catalysts for growth — in energy, technology, global trade and frontier markets.

Forecast for Year-End 2014	
S&P 500 Price	2020
S&P 500 Earnings per Share	$121
S&P 500 Price/Earnings Ratio	16.7x
U.S. Ten-Year Treasury Yield	3.25%
U.S. GDP Growth	3.0%
Euro Zone GDP Growth	0.5%
Global GDP Growth	3.75%
U.S. Unemployment Rate	6.25%
Crude Oil (NYM)	$80/barrel
Gold (NYM)	$999/troy oz

[1] *World Economic Output Database*, International Monetary Fund, October 2013.

Introduction

Conventional wisdom now holds that the tapering of the Federal Reserve's U.S. Treasury and mortgage-backed bond purchases may adversely impact equities in 2014. You may recall a similar event-driven paranoia from this time last year, when the looming "fiscal cliff" apparently was poised to pummel equity markets. Instead, a number of them — including the S&P 500 Index, Dow Jones Industrial Average and Russell 2000 Index — surged to all-time record highs, proving wrong those commentators who overlooked the resilience of a private economy increasingly propelled by broadening global economic expansion.

This global economic expansion has been a major source of corporate revenue; 50% of the sales booked by S&P 500 companies is derived from non-U.S. sources, while a similar claim can be made by any number of large companies around the world. Meanwhile, catalysts for growth that we refer to as "tectonic shifts" will continue to boost the economy. As we've discussed in the past, these tectonic shifts — broad trends that continue to produce positive surprises in both the U.S. and global economy — can be found in energy, technology, global trade and frontier markets. Tectonic shifts are slow moving, as the name implies; when fully evident, however, they can have an explosive, outsized impact on the world economy. These impacts manifest themselves in the fundamental metrics that are critical to market pricing, but do so in ways that make forecasting difficult and that tend to cause or contribute to many upside surprises. For 2014, we believe the impact will be felt most profoundly in global manufacturing and the global consumer.

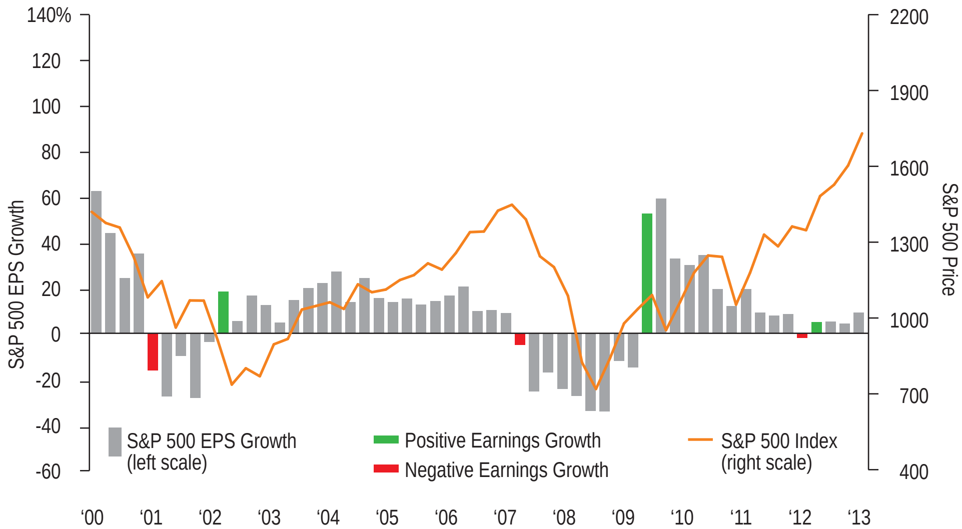
In the past year a parochial view has emerged that the U.S. is the best of the developed economies, and many have assumed that 2014 will mark another year in which the U.S. will be among the top performers globally. This opinion certainly has merit, as we'll discuss. However, a closer look reveals the U.S. share of world GDP has actually declined since 2007. So what's driving global economic growth if not the U.S.? Certainly not Europe or Japan, two economies that have shrunk as a percentage of world GDP since 2007. In fact, the credit for the broadening global economic expansion goes to emerging and frontier markets — one of our tectonic shifts.

Economically, the world is getting bigger. But risks remain, and in this report we will cover the basis for our optimistic 2014 market outlook as well as the potential roadblocks along the way.

U.S. Fundamental Outlook: Corporate America Will Continue to Establish New Records

Our Global Perspectives investment philosophy is "fundamentals drive markets". It guides our interpretive decisions and investment strategy. It is our beacon, especially during times of market disruptions, geopolitical flare-ups, regulatory risk or those rare extreme events known as "black swans". The following is how it directs our market outlook.

Figure 1. Fundamentals Drive Markets



Source: Standard & Poor's, First Call, FactSet, Voya Investment Management

2014 Earnings and Price Forecast

The key fundamental is corporate earnings, and the most widely followed index in the world is the S&P 500. S&P 500 companies derive over half their sales from overseas; as such, when these companies are consistently delivering year-over-year earnings growth, it is a positive sign for both the U.S. and the global economy.

- We forecast S&P 500 earnings will grow to $121 in 2014 and the index will increase to 2020. This reflects a 10% boost in earnings from our 2013 forecast of $110 and a slight expansion of the price-to-earnings multiple to 16.7 from its current level of 16.2.
- The acceleration in year-over-year earnings growth from 8% in 2013 to 10% in 2014 will be driven by a broadening expansion of the global economy.
- Our favored equity sectors are those that are most affected by the tectonic shifts.
  - Consumer discretionary, driven by earnings and the rise of the global consumer
  - Technology, driven by earnings, "big data" and cloud computing
  - Industrials, driven by the broadening global expansion in frontier markets

- Similarly, we favor those asset classes that will benefit from the broadening global economic expansion and tectonic shifts.
  - Mid-cap equities, which are most levered to our key sectors and boast the appealing combination of large-company resources and small-company growth potential
  - Global REITs, driven by an undersupply of commercial real estate projects globally and international diversification characteristics
  - Emerging market equities, which offer diversification via lower correlations to domestic equities and are ripe for a turnaround after three years of underperformance
  - Senior loans, which deliver senior status in the corporate capital structure and floating rates of interests as rates normalize
- Sales growth will pick up in 2014 to close to 5%, from sub-2% in 2013, supporting the sustainability of earnings growth.
- Expected earnings growth for small- and mid-cap stocks will outpace that of large caps.

Equity Markets Continue to Climb in November

Despite generally slow growth in developed economies, a euro zone on the edge of a return to recession and mixed news out of China, 2013 has been a spectacular year for equities. November was indeed another strong month for the S&P 500, which posted a 3% return to bring its year-to-date gain to 29%; meanwhile, the strongest asset class — small-cap equities — is up more than 39% for the year. Though most equity asset classes have delivered gains, emerging markets skidded in November and are negative for the year while global REITs continue to struggle. On the fixed income side, a majority of bond classes were down as interest rates ticked higher; high yield bonds were a notable exception in November and have returned almost 7% in the first 11 months of 2013.

Index	Nov-13	YTD
Equity		
S&P 500	3.0	29.1
S&P Midcap	1.3	29.5
S&P Smallcap	4.5	39.3
Global REITs	-3.6	2.6
EAFE	0.8	21.5
Emerging Mkts	-0.9	-1.2
Average	0.9	20.1
Fixed Income		
Corporate	-0.2	-1.4
U.S. Treasury 20+	-2.7	-12.1
Global Aggregate	-0.8	-2.0
High Yield	0.5	6.9
Average	-0.8	-2.2
Overall Average*	0.2	11.2

*The Overall Average model allocation includes 10 asset classes, equally weighted: S&P500, S&P400 Midcap, S&P600 Smallcap, MSCI U.S. REIT Index/FTSE EPRA REIT Index, MSCI EAFE Index, MSCI BRIC Index, Barclays U.S. Corporate Bonds, Barclays U.S. Treasury Bonds, Barclays Global Aggregate Bonds, Barclays U.S. High Yield Bonds. Source: FactSet, FTSE NAREIT, Voya Investment Management.

Federal Reserve and Washington Politics

As the greenback remains the global reserve currency of choice, actions by the U.S. Federal Reserve have an outsized impact on not only the U.S. economy but also the global economy. There are a number of Fed events scheduled for 2014 that bear monitoring.

- Leadership of the central bank will be transitioned to Janet Yellen, whose dovish confirmation hearing in November propelled markets forward. We expect a dovish policy stance to persist in 2014.
- Quantitative easing gives way to “forward guidance”; that is, as the tapering of bond purchases begins, communication from the Fed about its federal funds rate intentions will become the primary rate-suppression tool.
- In contrast with her dovish bias on monetary policy, future Fed Chair Yellen is expected to be hawkish and strict on bank supervision, one of the central bank’s primary roles.

Meanwhile, a few miles away on Capitol Hill, Washington politics has been both a hindrance and a benefit to markets in recent years.

- Congressional “sequestration” — automatic government spending cuts — have helped cut the budget deficit to below 4% of GDP; this is a significant positive, as when governments spend less they ultimately tax less.
- Implementation of the Affordable Care Act — aka Obamacare — has gotten off to a rocky start, which may promote continued uncertainty about its impact on health care, which makes up one-sixth of the U.S. economy
- The Dodd-Frank act — signed into law in 2010, though many of its rules and regulations are still being written and/or implemented — represents the most onerous increase in regulation for financial firms since the Great Depression and stands as an obstacle to a positive lending environment.

While both the Federal Reserve and Washington can make mistakes, they each have also shown a willingness to revisit policy errors rather quickly. For example, after Fed rhetoric throughout the summer sent interest rates soaring on expectations of a September start to tapering, the FOMC surprised markets by opting to delay the wind-down of its asset-purchase program following its mid-September meeting. Or when Congress passed the Troubled Asset Relief Program (TARP) to combat the Credit Crisis in 2008 after its initial rejection of the plan spawned severe market dislocations. In other words, while DC brinksmanship and uncertainty is likely to persist in 2014, we expect the backdrop ultimately to be positive. As always, we counsel against trying to “Washington-proof” a sound investment strategy and instead advocate a focus on the fundamentals.

Global Assessment: Manufacturing and Consumers Will Drive Economic Improvements

Before we go in depth on our tectonic shifts (see page 12), let's take a look at two areas of the global economy that we expect to feel their impact most profoundly — global manufacturing and the global consumer — and how they will contribute to improving growth in three key regions of the developed world: Europe, China and Japan.

Global manufacturing is the economic sector that benefits most from the convergence of the four major tectonic shifts.

Global Manufacturing

Global manufacturing is the economic sector that benefits most from the convergence of the four major tectonic shifts. A few observations about manufacturing and the likely impact on the U.S. economy of strength elsewhere in the world:

- According to the U.S. Bureau of Economic Analysis, every $1.00 spent in manufacturing adds another $1.48 to the economy, the highest multiplier effect of any economic sector.
- The U.S. remains one of the largest manufacturers in the world, with the highest productivity and among the lowest energy costs, a key component of manufacturing.
  - A survey of American manufacturing companies by the Boston Consulting Group in September 2013 found that 54% were planning or actively considering shifting production facilities from China to the U.S.
- Global purchasing manager surveys have been encouraging but tentative. PMI remains one of the most important fundamental metrics to monitor as an indicator of a country's health. Emerging countries increasingly have broken into the top ten of global manufacturers. China is nearly even with the U.S. as the world's largest manufacturer, while Brazil stands in sixth place. India entered the top ten in 2010, while Russia stands at the precipice in 11th place.

Global Consumer

The U.S. has experienced 17 consecutive quarters of positive economic growth, propelling the net worth of U.S. households to an all-time high of $77.3 trillion as of third quarter 2013 (see Figure 2), greater than the entire world's GDP. The growth of household wealth has been particularly profound in 2013, with equity markets surging to record highs and nationwide housing prices increasing at an average of 12% year over year; we think these trends will continue in 2014. Household wealth is a pillar of consumer spending, and its growth can spawn a virtuous cycle in tandem with economic activity.

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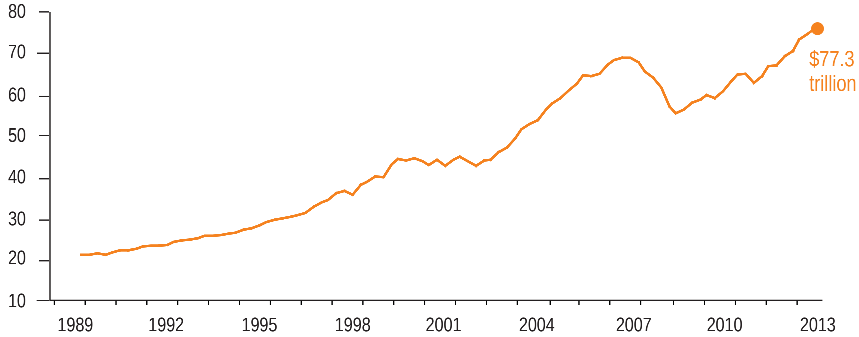
Not only are consumers the demand-side driver in the U.S. — where they account for 70% of economic activity — they serve as a barometer of any country's economic health and the standard of living for its citizens. Global consumer confidence increased this year in what is part of a slow but unequivocal upward movement in sentiment. While U.S. consumer sentiment has at times been lukewarm, actions — no doubt fueled by robust housing and stock market gains — speak louder than words.

- Monthly retail sales exceeded $428 billion in October 2013, a record high. U.S. automobile sales have recovered from their post-crisis troughs to overtake pre-2006 levels, posting record sales of $223 million in October.
- Despite a deceleration of the housing recovery in the face of rising mortgage rates, the U.S. housing market has delivered consecutive monthly increases in housing starts, home sales and, most important, housing prices, reducing the number of underwater home values. Building permits, a piece of forward-looking data, rose to the highest level in nearly 5½ years in October, solidly in line with a recovering market.
- A further rise in interest rates may dampen the housing recovery but will not derail it. Mortgage rates are likely to remain at historically low levels, supplies in many areas are constrained, price levels are 20% below peak, and household wealth is at a historical peak. And although household formation is constrained, there are now 4 million former homeowners who are now renters, suggesting a significant pipeline of pent-up housing demand.
- The unemployment rate has ticked steadily downward, starting the year at 7.9% and currently standing at 7.0% after November's robust jobs report. And while the labor participation rate is near historical lows, the most recent Job Openings and Labor Turnover (JOLT) report from the Bureau of Labor Statistics shows the highest number of job openings in five years.
- Globally, the consumer is a burgeoning force in its contribution to global economic expansion:
  - Consumer spending in China contributed 45.9% of the nation's economic output, potentially rivaling U.S. participation in the future as it continues to grow.
  - A 2013 McKinsey study estimates that annual consumption in emerging markets will surge to $30 trillion by 2025.
  - The African Development Bank projects that consumer spending in sub-Saharan Africa will explode to $2.2 trillion in 2030 from $680 billion in 2008.

Figure 2. Stronger Equity and Housing Markets Have Driven U.S. Household Wealth to All-Time Highs



Source: Bureau of Economic Analysis, Federal Reserve, FactSet

Note: Data as of 09/30/13.

Europe is a tale of two markets — Germany prospers while most of the rest of the region remains either near or in recession.

Europe: Despite Improvements, Risks Remain

Europe is the only developed country or political zone at immediate risk of a "double-dip" recession. It is also a tale of two markets — Germany prospers while the rest of Europe remains either near or in recession. Without Germany, the future of the currency bloc would be bleak.

One of the profound differences between Europe and the U.S. and Japan is the lack of aggressive monetary stimulus; in fact, the European Central Bank has been shrinking its balance sheet while the Federal Reserve and Bank of Japan expanded theirs. This has served to strengthen the euro, making exports from the region more expensive as other countries continue to find ways to devalue their currencies. We expect Europe will be compelled to institute or reinstate monetary stimulus and competitive devaluation of the euro in 2014.

Certainly, there are more fundamental and sustainable ways to grow the individual euro zone economies, but given little political will to institute pro-growth policies such as tax cuts, deregulation and labor market reforms, the possibility of another European crisis looms.

- *Global Manufacturing*: Overall manufacturing production in the euro zone is still tentative, only recently showing faint glimmers of growth.
- *Global Consumer*: Euro zone unemployment is high, at 12.2%; while it remains at dangerous levels in the periphery — Spain is at 26%, while Portugal is at 15% — even France is suffering from high levels of joblessness, at 11%. Accordingly, the region delivered economic growth of only 0.1% in third quarter 2013, down sharply from the second quarter.
- A European banking union with a single bank-resolution mechanism — responsible for deciding which banks to shut down and which to save — is imperative for the stability of the region's financial system.

A positive offset to weakness in Europe has been the consistent strength in Germany and a recent resurgence in the U.K. Germany, in particular, exemplifies the competitiveness that countries need to thrive in the global economy.

- Third quarter 2013 German GDP growth highlighted domestic demand as its main driver amid weak exports, supporting a shift already underway in the country from a much-criticized export driven economy to one with a domestic orientation.
- Germany continues to be among the world's leaders in exports, propelling its current account surplus to €20 billion. Notably, with only about 1.2% of the world population, Germany is the world's fourth largest producer and largest exporter of cars and commercial vehicles.
- The U.K., meanwhile, has taken a different path to renewed growth, combining fiscal austerity with pro-growth economic policy. While this plan drew much criticism from both Europe and the U.S. as it evolved, it has begun to bear fruit. The U.K. reported annualized third quarter GDP growth of 3.2%, the fastest pace in three years, and both housing and industrial production have reached post-recession highs. It is becoming clearer that reining in government spending is the partial answer to out-of-control debt, while lowering taxes on the private economy bolsters risk taking and growth.

China Has Shown Signs of Stabilization and Recently Announced Sweeping Reforms

China is the world's second-largest economy and a huge driver of economic growth around the globe. On the negative side, its rate of GDP growth has slowed dramatically in recent years; it now stands at 7.8%, down from double-digit levels in 2010. However, China has shown signs of stabilization and recently announced sweeping reforms aimed at economic growth and a concerted tilt toward greater market orientation. In addition, China recently relaxed its one-child policy, recognizing that an aging population is an impediment to growth. A few more highlights from China are below.

- *Global Manufacturing*: China's manufacturing sector has reported a PMI in expansionary territory all year, and industrial production has returned to double-digit year-over-year growth.
- *Global Consumer*: China is determined to move from an investment-led economy to a consumer-driven one. Accordingly, retail sales have delivered year-over-year increases of more than 12% each month of 2013.
- In the long run, only time will tell if China's economic reforms will be enough to help fix its outdated and inefficient model of state-owned enterprises.

Japan: “Abenomics” Providing a Much-Needed Jump Start

For 15 years, Japan experienced gradually falling prices, a debilitating deflationary cycle that made debts more onerous, created disincentives for spending or investment, and generally held the nation in continual pattern of stagnant growth. Japan’s aging population has exacerbated its economic woes. However, the implementation of “Abenomics”, an aggressive stimulus program instituted last year by new Prime Minister Shinzo Abe, seems to be working; at the very least, it has given the world’s third-largest economy a much-needed jump start.

At the very least, “Abenomics” has given Japan a much-needed jump start.

- *Global Manufacturing*: Japan’s loose monetary policy has led to a 25% decline in the yen, boosting exports and corporate profits and giving new life to the Japanese manufacturing sector, which expanded at the fastest pace in seven years in its latest reading.
- *Global Consumer*: Japan’s economy grew 1.9% in the third quarter, lower than the 3.8% rise in the previous quarter but enough to drive the country to its highest level ever in terms of aggregate economic output and private consumption. However, an aging workforce, new consumption taxes and a high savings rate mitigates the ability of Abenomics to alter Japan’s deflationary trend.
- Inflation had been nonexistent since October 2008, but the latest report indicates that core consumer prices (excluding food) rose 0.9% from the year before.

The Two Sides of Global Risks

Headline systemic global risks have waned for the most part, with many of them actually becoming economic positives. For each of these, however, there is a second-order risk that requires vigilance.

- *Systemic risk (+)*: Unconventional global central bank monetary stimulus has supported financial and housing markets.
  - *Second-order risk (–)*: Rising rates have the potential to derail the housing recovery and burst speculative asset bubbles fueled by quantitative easing.
- *Systemic risk (+)*: The global banking system has been strengthened by increased regulatory and capital requirements.
  - *Second-order risk (–)*: The shadow banking world of hedge funds, securities dealers and other more lightly regulated financial companies has grown to an estimated $72 trillion as of 2012 according to the Financial Stability Board.
- *Systemic risk (+)*: Inflation remains below target levels due to low growth and high unemployment in the developed markets, giving central banks flexibility to stimulate.
  - *Second-order risk (–)*: Inflation spirals out of control on a policy mistake based on the Fed’s “forward guidance”. Deflation, though, may be the far greater risk for the developed economies, especially the U.S., Europe and Japan.
- *Systemic risk (+)*: North America energy independence reduces reliance on Middle East producers and promotes economic growth and stability in the U.S.
  - *Second-order risk (–)*: Emerging economies dependent on the high price of energy and commodities will be hurt by lower prices, contributing to global instability.

In a dynamic global economy, some of these risks are a normal part of the macro environment that investors should recognize when constructing an optimal portfolio based on expected return and risk. An intense focus on any one of these or other risks is likely a reason why so much cash remains on the sidelines despite the market's recent success. It is also why so much opportunity remains in the equity markets even though they have more than doubled in the past five years. Nevertheless, risks remain, and a healthy appreciation of risk is vital in portfolio decision making.

Energy has become a competitive weapon for the U.S. and North America.

Global Tectonic Shifts: Catalysts For Growth

Traditional short-term market forecasts typically ignore trends that are slow moving, hard to measure and/or veiled in their influence on the global economy. Disregarding these sub-surface themes is a critical gap in forecasting methodology because, like continents colliding, their explosive intensity may have the power to change the face of the earth. We call these trends "tectonic shifts" and regard them as a meaningful part of the broadening global economy.

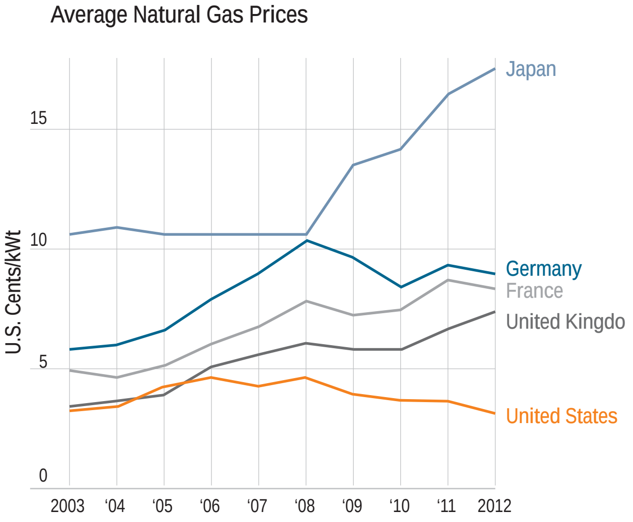
Energy

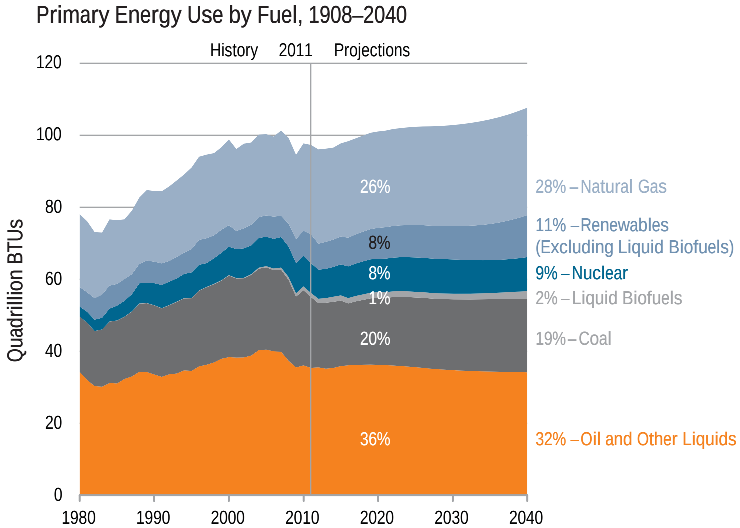
Energy has become a competitive weapon for the U.S. and North America to promote economic prosperity, military security and the standard of living of its citizens. Abundant and affordable energy is a magnet for foreign direct investment and acts as a de facto supply-side tax cut for business and consumers. Energy has a multiplicative impact on jobs across industries, in particular those directly in support of production.

Profitability encourages further innovation in the energy industry, not only in production but in conservation and increased efficiencies. It raises government revenue and potentially lowers tax rates to businesses and residents in those states that benefit most. With production outstripping demand, the next big opportunity for North American producers is to export excess energy overseas; in fact, U.S. refined product exports have recently surpassed imports, a trend that will be achieved in all energy areas. The U.S. is a particularly attractive source of energy given its stability relative to the regimes across OPEC.

- Natural gas supplies 25% of energy needed to run the world's homes and businesses currently, and is expected to be the fastest-growing fossil fuel over the next 20 years, according to the Energy Information Administration. The U.S.'s abundant supply and substantial cost advantage compared to Europe and Japan will continue to benefit U.S. exports and manufacturing.

Figure 3: U.S. Has a Significant Advantage Thanks to Rock-Bottom Natural Gas Prices





Source: U.S. Energy Information Administration

Note: Average natural gas price for households over the period 2003–12 in U.S. cents/kWt (GCV) based on average exchange rates for each year.

- Oil derived from shale and deep-water drilling in the Gulf of Mexico and Alaska is once again the focus for new investment. The Energy Information Administration reported the U.S. achieved new all-time record increases in proved oil reserves each year from 2008 to 2011.
- The U.S. is home to a thriving renewable energy industry, with globally competitive firms in all technology subsectors, including wind, solar, geothermal, hydropower, biomass and biofuels. It produces more geothermal energy than any other country and is the second largest in terms of wind energy.
- The U.S. holds the world's largest estimated recoverable reserves of coal and is a net exporter of coal. Coal is used to generate 40% of the electricity in the U.S.
- The U.S. operates the most nuclear reactors, has the largest installed nuclear power capacity and generates the most nuclear power in the world. Nearly 20% of U.S. electricity is produced at 104 nuclear reactors in 31 states.
- The U.S. is an international leader in the development and deployment of smart-grid technologies and services. The U.S. is the world's fourth-largest exporter of electric grid equipment, with a 9.3% world market share and 2011 exports exceeding $22.5 billion.[2]

[2] All data in this section courtesy of SelectUSA, part of the International Trade Administration of the U.S. Department of Commerce.

Technology is actually an enabling force that creates better jobs.

Natural gas is providing the greatest marginal impact to U.S. energy independence, but coal, oil, nuclear and renewables are also important energy sources. The electric power industry — the backbone of American industry and commerce — depends on all of these sources along with smart-grid technologies for reliable power through redundancy, backup and recovery.

The pace of this shift to energy independence has been revolutionary and defies forecasting. Our analysis of these events and their possible impact on markets suggests four strategic views:

- The U.S. trade deficit will become a trade surplus by the end of 2015. This will double GDP growth from an anemic 2% to 4% — well above its long-term trend.
- The energy industry is a jobs machine, and the U.S. educational system should train for both the blue- and white-collar job opportunities that it will produce.
- OPEC's stronghold on energy prices is weakening as supply broadens.
- Global markets should plan as though energy independence for North America has arrived.

Technology

Technology is pervasive across industries and is embedded in the lives of U.S. consumers and businesses. As we discuss, there exists an opportunity to export this knowledge and capability to the rest of the world — in particular, to the emerging and frontier markets.

Technology is often viewed as disruptive and jobs-destroying, but it is actually an enabling force that creates better jobs. What should be clear is that not all of these jobs are professional occupations; technological advancements also spawn many well-paying blue-collar positions, and the U.S. educational system should respond to meet this need. These jobs can be found in such industries as environment technology, medical technology, and software and IT services, and they will undoubtedly continue to reshape the global landscape and drive economic growth.

- The dawn of the "smart factory" is here. Smart manufacturing integrates machines and technology to shorten innovation cycles, increase productivity and maximize reliability and quality.
- "Big data" harnesses or monetizes the billions of economic data points and streams available through high-speed computing. This explosive ability to analyze large volumes of information is growing by 50% each year and will continue to be the next frontier in innovation, productivity and business solutions.
- It is estimated there will be more cellphone accounts than people by 2014.[3] Mobile technology continues to expand and penetrate new markets, tapping into a world of previously unexplored economic opportunities.

[3] *The World in 2013: ICT Facts and Figures,* ITU (an agency of the United Nations), February 2013.

Global Trade

> *"Trade was the most momentous innovation of the human species, and globalization is bound to ensure furious economic progress in the coming century despite the usual setbacks from recession, wars, government fiscal ineptitude and natural disasters."*[4]

Global trade is evolving due to the three other tectonic shifts and energy in particular as the U.S. transitions from energy importer to exporter. This trend has the potential to accelerate global growth simply due to the size of the U.S. economy, and the U.S. thus has a vested interest in expanding free trade throughout the world. But energy is not the only benefactor in an expanding global trade arena. The manufacturing, consumer, technology, transportation and agriculture sectors will be active participants as well. Take, for example, the expansion of the Panama Canal, which for several years we have touted as a proxy for the broadening world commerce trend. According to the *Financial Times* the new Panama Canal — to be completed in early 2015 — will accommodate mega cargo ships with loads equivalent to 18 trains, 5,800 trucks or 570 planes!

Free and open trade will lift all boats in the global economy, and those countries that embrace it will be the biggest winners. The North American Free Trade Agreement (NAFTA) was enacted 20 years ago amid fears that it would lead to employment displacement and lowered wages, fears that have failed to materialize. While income disparities between the U.S. and Mexico have yet to disappear, Mexico has made huge strides and is on the brink of economic transformation.

Free and open trade will lift all boats in the global economy.

- A staggering 80% of goods produced for export in Mexico are destined for U.S. markets. An improving U.S. economy will directly support Mexico's economy as well.
- Since its implementation, NAFTA has empowered Mexico's industrial base by facilitating modernization and invigorated growth of manufacturing output, which has since tripled. Mexico's cheap, young labor and low-cost energy inputs, combined with its proximity, make it the least expensive country in the world to produce goods to be sold in the U.S.
- Recent energy industry reforms in Mexico will open up the its notoriously closed oil sector and may provide the biggest economic boon to Mexico in more than a century.

The latest numbers from the World Trade Organization show a slowdown in overall global trade volume growth to 2.0% in 2012, but this superficial decline in global trade is indicative of a transition rather than regression. It's no secret that the euro zone has just emerged from an 18-month recession and even now is barely inching forward. Removing intra-European activity, trade grew by 3.2% rather than 2%. In fact, there are some regions, such as Africa, where trade increased by double digits.

[4] Matt Ridley, "Humans: Why They Triumphed," *Wall Street Journal,* May 22, 2010.

But trade volume is not the global expansion story here; rather, it is shifting trade flows.

- Developing economies accounted for 47% of exports in 2011 compared to 34% in 1980.
- South-South trade — transactions between two developing economies — increased from 8% of all trade in 1980 to 24% of trade in 2011, while South-North trade — transactions between a developing and developed country — increased from 33% in 1990 to 38% in 2011. Only North-North trade declined as a percentage of all transactions.
- Technology diffusion in transportation, innovation, infrastructure, labor availability, trade policies and fuel prices continue to shape trends in global trade.

Frontier Markets

A prudent investor understands the benefits of broad diversification in a global expansion.

The International Monetary Fund (IMF) forecasts emerging and frontier markets to expand at a 4.7% rate in 2014, more than twice the pace of the developed markets' meager 2.1% growth. It's hard to truly appreciate the magnitude of developing market growth over the period of a year, so let's look at the last decade: These economies grew fourfold in size, to $28 trillion from $7 trillion, and increased their contribution to world growth to 38% from 20%. This broadening of the global economic expansion was a pivotal contributor to the increase in global growth, to $71 trillion per annum from $38 trillion, over the same period. This also creates a peripheral cause for optimism as a catalyst for continued growth in corporate profits.

While U.S. markets undoubtedly have had a banner 2013, a prudent investor intent on building wealth over the long term understands the benefits of broad diversification in a global expansion. Such an investor pivots toward those less-appreciated opportunities that are the key to future global growth.

The emerging markets have been under pressure for the past few years, but especially in 2013 as funds that had poured into these markets in search of higher yields reversed course after Fed tapering was first mentioned in May. But the less-correlated frontier markets have delivered a year of robust market returns, relatively unscathed by the turmoil punishing their emerging market brethren. The MSCI Frontier Market Index has returned 23.6% in 2013 through the end of November. Frontier markets are generally thinly traded, and their volatile and illiquid natures are not suitable for all investors. Regardless, the growth in these markets will continue to fuel earnings of U.S. companies as throngs of emerging middle class consumers demand goods and services.

Last year we introduced PIVOT — Peru, Indonesia, Vietnam, Oman and Turkey — as a basket of frontier markets making their way to the front of the global economy, and this year we are expanding to PIVOTS with the addition of sub-Saharan Africa.

- Peru, Indonesia, Vietnam and Oman are each growing above 5% annually. Their younger, dynamic populations are propelling consumption as they increasingly hunger for goods and services. Despite economic turmoil over the last year, Turkey is growing at 4.4%; its growth prospects are looking up after the recent Iran nuclear accord, which will reignite trade ties with the country and boost exports. On the manufacturing front, industrial production remains in expansion mode; notably, Turkey's PMI just reached a 2½-year high, and Oman's free-trade agreement is expanding its current account surplus and variety of exports beyond oil and gas.
- The near-term fly in the ointment may be the reliance of some of these emerging markets on the ongoing accommodative monetary policies of the developed markets. Countries with high current account deficits, such as Indonesia and Turkey, are particularly vulnerable, which was evident this summer as Fed tapering fears prompted capital outflows and currency devaluations. The September taper delay has extended a lifeline to these markets, and their currency and bond markets have rebounded. However, the emerging markets countries best equipped to handle the inevitable U.S. Fed stimulus pullback will be those with healthy exports and current account balances.
- Economic growth in sub-Saharan Africa is expected to increase to 6% in 2014; by 2018, five of the world's fastest-growing economies will be in sub-Saharan Africa.
  - The median age in the region is only 18.6, lower than all other continents. In contrast, Asia has a median population age of just under 30.
  - Foreign direct investment inflows and sovereign bond issuance have already reached record levels. This is a critical component of development, funding infrastructure building and ensuring future economic growth.
  - The population of Africa is expected to be 1.4 billion by 2025, at which time the World Bank projects that most of Africa will be middle-income consumers with a propensity to spend.

Conclusion

The broadening of the global economic expansion may set in motion a virtuous cycle of growth far stronger than most investors realize. High economic growth leads to greater household wealth, which in turn leads to an increased tolerance for entrepreneurial risk taking, increased levels of spending and increased velocity of money. Corporate profits are the fundamental bottom line, and these profits are likely to be nurtured by a robust economy benefitting from improvements in global manufacturing activity and the power of global consumerism. Broader participation in economic growth also has a salutary impact on country and region risk, as it increases the wealth with which to deal with debt, unemployment, current account deficits and geopolitical risks.

With 2014 on track to be the sixth year of the current bull market and an enormous amount of still-sidelined cash waiting to get back in, questions remain about how to deploy these funds reliably and with discipline. Keep this in mind: If you invest like everyone else, you likely will experience the same subpar returns that everyone else does. If you invest differently, you may give yourself a better chance of enhancing total returns while managing downside risk.

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Many observers refer to the past ten years as a lost decade of investing. The blame cannot be laid solely at the feet of markets, however, as many delivered positive performance over the period. Investors are culpable as well, with many sabotaging their investing goals through an inability to construct effectively diversified portfolios and futile attempts to game diversification. We advocate the construction of portfolios that seek to capitalize on the lion's share of the world's investment potential and diversification benefits; this means looking beyond the U.S. borders, and it means maintaining a healthy and diverse exposure to fixed income instruments, even if interest rates are biased to rise. We also suggest an equal weighting of asset class exposures in order to avoid bets on price momentum.

Of course, building effectively diversified portfolios is merely the beginning; maintaining such portfolios is a long term endeavor that is fraught with challenges. In order to overcome these challenges — the folly of gaming diversification among them — a strong investment philosophy is essential.

Figure 4. Those Who Avoid Non-U.S. Markets Do So at Their Own Peril

2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Pac Ex-Japan -5.8%	EME 56.3%	Pac Ex-Japan 29.6%	EME 34.5%	Europe Ex-UK 36.4%	EME 39.8%	Japan -29.1%	EME 79.0%	EME 19.2%	S&P 500 2.1%	Pac Ex-Japan 21.7%	S&P 500 29.1%
EME -6.0%	Pac Ex-Japan 47.0%	EME 26.0%	Japan 25.6%	Pac Ex-Japan 33.2%	Pac Ex-Japan 31.7%	S&P 500 -37.0%	Pac Ex-Japan 73.0%	Pac Ex-Japan 17.1%	UK -2.5%	Europe Ex-UK 18.7%	Japan 26.3%
Japan -10.1%	Europe Ex-UK 43.6%	Europe Ex-UK 22.4%	Pac Ex-Japan 14.8%	EME 32.6%	Europe Ex-UK 17.5%	Europe Ex-UK -45.0%	UK 43.4%	Japan 15.6%	Pac Ex-Japan -12.7%	S&P 500 15.0%	Europe Ex-UK 26.2%
UK -15.2%	Japan 36.2%	UK 19.6%	Europe Ex-UK 11.3%	UK 30.7%	UK 8.4%	UK -48.3%	Europe Ex-UK 33.9%	S&P 500 15.1%	Japan -14.2%	EME 13.1%	UK 17.5%
Europe Ex-UK -19.9%	UK 32.1%	Japan 16.0%	UK 7.4%	S&P 500 15.8%	S&P 500 5.5%	EME -47.1%	S&P 500 26.5%	UK 8.8%	Europe Ex-UK -14.5%	UK 13.0%	Pac Ex-Japan 6.9%
S&P 500 -22.1%	S&P 500 28.7%	S&P 500 10.9%	S&P 500 4.9%	Japan 6.3%	Japan -4.1%	Pac Ex-Japan -50.0%	Japan 6.4%	Europe Ex-UK 2.4%	EME -18.2%	Japan 2.9%	EME -0.8%

Source: MSCI, Standard & Poor's, FactSet

Note: All data are based on equity indexes for each regional or country index and are total returns including dividends for each calendar year or partial year.