A brighter outlook for 2016

In brief

• 2015 has been a year of waiting, worrying and sideways markets. As we enter 2016, some of the waiting is over and some of the worries should diminish, providing a clearer, brighter outlook for 2016.

• However, in a still slow-growing U.S. and global economic environment, valuations are not looking particularly cheap across many asset classes.

• Because of this, returns will likely be modest with the best long-term gains accruing to those who recognize mispricing at both the macro and micro levels and have the patience to wait for it to resolve.

Sticking to the dots

Much of the waiting revolved around the Federal Reserve (Fed) and when it would finally boost short-term interest rates. For most of the year, it said it wished to see further labor market improvement and confidence that inflation would move back to 2% before making a move. However, over the summer, the Fed was clearly spooked by weakness in emerging markets (EM), volatility in both the Chinese currency and stock market and spillover volatility in U.S. markets; This caused the Fed to postpone hiking rates until the final meeting of the year, seven years to the day since it first reduced short-term rates to a near zero level.

While the wait for a first move is over, uncertainty about future Fed moves remains. In particular, while participants in the Fed’s December meeting expect a gradual 1% rise in the federal funds rate in both 2016 and 2017, futures markets are only pricing in tightening at half that pace.

It should be emphasized that a 1% per year pace is extremely modest by historical standards. In fact, the average pace of tightening in the five rate hike cycles since 1980 has been 2.5% per year. Moreover, macroeconomic conditions should warrant a relatively quick return to “normal” interest rates.
In particular, FOMC participants now expect real economic growth to accelerate to 2.4% in 2016. This seems like a reasonable projection, particularly given three recent positives.

First, the end of 2015 saw a further fall in oil prices, which should translate into even cheaper gasoline for consumers. Second, for the last few years, the federal government has only passed capital spending incentives at the end of each year retroactively for the current calendar year—clearly a useless policy if intended to promote investment spending. However, the tax agreement reached in December 2015 makes most of these tax breaks permanent and extends others for five years. Also in December, Congress passed a five-year transportation bill allowing for long-term spending on infrastructure projects that had been impeded for many years by stop-gap measures. These agreements, combined with the November agreement to increase federal spending over the next two years by $80 billion and to raise the debt ceiling until March 2017, amount to a considerable stimulus to the economy in both increased dollars and diminished uncertainty. Third, the Fed rate hike itself should boost consumer interest income far more than interest expense, while any increase in mortgage rates is unlikely to impede the housing market recovery.

Given all of this and despite a drag on growth from slower-growing inventories, diminished energy investment and the trade effects of a higher dollar, U.S. economic growth rate of close to 2.4% seems reasonable for the year ahead. It should be noted, that over the past three years, U.S. economic growth has averaged 2.4% while the unemployment rate has fallen by an average of 1% per year. This sharp decline in unemployment in response to modest GDP growth has been the result of a slowdown in productivity growth and a structural decline in the labor force participation rate. Without a surge in productivity or participation, the unemployment rate will likely fall to close to 4% by the end of 2016, far below the 4.7% rate that the Fed is projecting for the fourth quarter of next year.

While inevitable global shocks and worries may tempt the Fed to pause in its tightening cycle, this further tightening of the labor market, likely accompanied by some modest acceleration in wage growth and core inflation, should keep the Fed’s feet to the fire. This may well force the Fed to stick to its “dot plot” despite the market’s skepticism and its own history of vacillation.

**China, commodities and the dollar**

The worrying in 2015 has centered around three related issues: the slowdown in China, weakness in commodity prices and the surge in the dollar. All of these will remain valid concerns in 2016, although perhaps to a lesser extent than this year.

Slower growth in China has been inevitable for years for two reasons. First, as China’s share of global trade has grown, its ability to achieve further huge gains in exports has been increasingly limited by slow growth in the global economy itself. Second, China has quite deliberately been trying to transition its economy from a manufacturing-intensive economy to a more service-based model. While this makes sense given its stage in development and the needs of its people, productivity growth in the service sector is always slower than in the manufacturing sector.

However, the pace of the slowdown in Chinese growth has been the subject of intense debate. Few believe the official GDP data, which show the economy as still expanding at a 6.9% year-over-year rate in the third quarter. Weakness in homebuilding and exports, two key growth sectors, make that unlikely. Moreover, many observers have become increasingly concerned about the growth in corporate and local government debt in China.

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1Assuming a 5.0% unemployment rate for December 2015 and a 2015Q4 real GDP growth rate of 2.2%.
These fears came to a head over the spring and summer, when the stock market, which had been soaring over the prior year, began to slide. In addition, in August, the People’s Bank of China (PBOC) took steps to devalue the renminbi against the dollar to offset some of the appreciation it had experienced over the previous year as it moved up with the dollar against other global currencies. Both of these events rattled global markets. However, it should be noted that with some heavy-handed intervention, the Chinese government has succeeded in stabilizing the stock market and that, after a small devaluation, the PBOC halted further renminbi declines. Going forward, it is worth noting that China has massive foreign reserves and is a big beneficiary of lower global commodity prices. Because of this and because of the control that the Chinese government exercises over both the economy and the flow of information, the most likely scenario for 2016 is of a China that slows smoothly.

Commodity prices have also had a huge impact on global markets in 2015 and promise to do so again in 2016. The collapse in oil prices since late 2014 has been ascribed to three factors: a slowdown in global demand, a surge in U.S. production and a decision by OPEC to try to maintain market share rather than cut production in the face of falling prices. Since then, two of these three issues have begun to respond to lower prices. According to the EIA, global oil demand is expected to rise from 92.5 million barrels a day (mbd) in 2014 to 93.8 in 2015 and 95.2 in 2016—healthy increases of 1.5% per year. In addition, lower prices are decimating U.S. investment in its relatively expensive shale oil industry with U.S. output expected to fall to 14.7 mbd in 2016, following a rise from 14.1 to 14.9 between 2014 and 2015, and with further declines likely. However, OPEC has not only not cut supplies, but it has increased them from 30.1 mbd in 2014 to 31.0 in 2015 and an expected 31.3 in 2016. Because of this, it is now expected that global oil inventories will continue to rise in 2016, although more slowly, postponing any significant rebound in prices. This is a negative for oil-producing nations and probably, on balance, a negative for S&P 500 earnings, as the energy sector used to account for roughly 12% of operating earnings, but in 2015 will likely contribute a loss. However, it should be emphasized that low energy prices are a net positive for consumers throughout the developed world and many of the emerging markets and, as such, should probably bolster rather than undermine global growth. In a similar way, low industrial metals prices will likely continue to hurt some Latin American economies such as Brazil and Chile without being a net drag on global growth.

Commodity prices will also respond to movement in the dollar in the year ahead. However, estimating the direction and magnitude of that movement is the most difficult call for 2016.

Fundamentally, the dollar is overvalued. On a trade-weighted basis, the dollar has risen by roughly 23% in the last 18 months. This surge has occurred despite the fact that the U.S. is running a large and growing trade deficit and Europe, Japan and China are all running trade surpluses. In the long run, a U.S. trade deficit should increase the demand for foreign currency as dollars have to be sold and foreign currency bought to facilitate huge U.S. imports. This economic force has been overwhelmed in the last year by currency traders betting that rising U.S. interest rates would make the U.S. a more attractive home for short-term capital.

Over the next few years, due to the lagged effects of the recent dollar rise, the U.S. trade deficit will increase while U.S. economic growth will slow down as the economy reaches full employment; this should, in time, push the dollar down.

Although some of these losses are one-time asset writedowns that should be less important in 2016.
In addition, it is worth noting that the last three times the Federal Reserve began to raise interest rates, the dollar rose in the six months leading up to the rate hike and then fell in the six months thereafter. Essentially currency traders bought the rumor and sold the fact. However, these fundamental forces and historical patterns have to be balanced against two important short-term realities. First, while the Federal Reserve is tightening, the European Central Bank, Bank of Japan and the PBOC are all easing policy, leading to growing central bank divergences, which should be dollar positive. Second, if we are right on the Federal Reserve misreading the labor market, they will be forced to tighten more quickly than the market expects, which would also be dollar positive. So, in the long run, we expect a lower dollar but how the dollar behaves in 2016 remains an extremely close call.

What is clear is that a lower dollar would be a big positive for the global investment environment. A falling dollar could stem outflows from troubled emerging market economies, allowing their central banks to set policy to help struggling domestic demand rather than fighting to prevent further depreciation. In addition, a lower dollar would provide a boost to global commodity prices and thus the earnings of energy companies. Finally, a lower dollar would increase the dollar value of the international component of corporate earnings next year, an important positive for U.S. equities.

**Investment implications**

So what does all of this mean for investors?

The first clear takeaway is that the year ahead should be a more difficult one for fixed income. Yields remain very low across a wide range of domestic high-quality Treasury, corporate and municipal bonds and even a modest backup in yields in response to Fed tightening could lead to negative returns in 2016. U.S. high-yield bonds may offer more opportunities. However, outside of the energy and materials space, in an environment of now relatively high credit spreads and good U.S. economic growth prospects. It’s also worth noting that European high yield has much less energy exposure and vulnerability to any central bank tightening than in the U.S.

Second, 2016 should be a better year for U.S. equities. Even if oil prices and the dollar stabilize at current levels next year, the drag from a high dollar and low oil that clobbered earnings in 2015 should not cause further losses in 2016, and any fall in the dollar or rise in oil prices could easily spark a low-double-digit increase in earnings. This, combined with more investor optimism, should act as a tailwind for stocks and sectors that traditionally do well in a rising rate environment. These sectors, such as financials and technology, should outperform bond substitutes.

Third, after three years in which U.S. stocks have outperformed international stocks, 2016 could see a turn in the tide. EM stocks are now quite cheap from a valuation perspective while European earnings should continue to recover in line with an improving European economy.

Finally, 2016 should be a year when good advice and active management are particularly valuable. The global economy is growing gradually, fixed income is generally expensive and global equities look fairly valued. However, there are pockets of attractive valuations in all markets, which should be accessible to intelligent portfolio managers. Perhaps most important, investors should recognize that even if the Fed sticks to its current plans, short-term interest rates by the end of next year should still be under 1.50%, well below the rate of inflation. This points to the need to invest in long-term assets which after a year of waiting and worrying, look a little more promising in the year ahead.
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