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Will 2016 be “The Good”, “The Bad” or „The Ugly“?

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The beginning of Q4 is the time for an outlook on the coming year. At first we want to establish the determining factors for the economic activity and the markets. On this basis, we will introduce three scenarios.

Bumpy transformation process in China

The dominant factor is the bumpy transformation process in China, which is happening on several levels, transforming the economy from production- and investment to consumption- and service-driven growth.

Fed: increase of the Fed funds rate

At the same time the recovery from the Great Recession in the USA has made a lot of progress, as a result of which the central bank has been sending out signals of an imminent rate hike.

The effects of these two factors are exacerbated by the deterioration of the fundamental environment on two levels.

A decrease in market liquidity

The liquidity on the market has decreased. This means that negative shocks are transferred more easily from one market segment to the other. This implies higher market price volatility and lower financial stability.

Increase in debt

The debt of companies in the emerging markets has increased drastically in the past ten years. At the same time, profitability has fallen significantly. These different streams have set off numerous effects, exacerbating the regional and sectoral divergence:

Downward spiral in the emerging markets

In the emerging markets a downward spiral has started to turn. The weak import demand in China causes exports and export prices to decline and leads to weak industrial production. Because at the same time the production of commodities has increased significantly, commodity prices are caught in a falling trend. Overall economic growth in the emerging markets and the commodity-exporting countries is disappointingly weak, which results in significant capital outflows. This, in turn, causes currencies to depreciate in the emerging markets, which restricts liquidity and makes interest rate rise. The deterioration of the financial environment in the emerging markets generates a dampening of the economic activities. The downward spiral bottoms out once the stimulus measures in China are strong enough to prevent a hard landing.

The strong US dollar

The comparably solid employment growth in the USA can be used less and less as a justification for a zero interest rate policy. The expectations of rising rates in the USA has caused the effective US dollar to appreciate relative to many currencies; more so vis-à-vis emerging markets currencies than against many main reserve currencies. Given that domestic demand in the USA has recorded strong growth figures, the current account deficit in the USA will probably expand. This would be positive for the global economy and it would dampen the appreciation pressure on the US dollar.

Roll-over effects

The roll-over effects from the emerging markets to the developed economies take place on numerous levels: industrial production is weak also in the industrialised economies. The currencies are appreciating relative to the emerging markets and commodity-exporting countries. As a result both import and, following suit, producer prices fall. This means the deflation pressure increases. At the same time the financial environment (falling share prices, widening spreads for default and liquidity risk, rising volatility) deteriorates. This leads to an increase in uncertainty among the market participants and the central bank members. The latter fact reduces the optimism with regard to the own projections (employment growth, achievement of the inflation target) and delays or prevents rate hikes by the Fed. This relationship, too, counteracts a further appreciation of the US dollar.

On the basis of this environment we can derive three scenarios for 2016 that we can describe along the lines of Sergio Leone's Western "The Good, The Bad, and The Ugly":

Scenario #1: recovery (Good)

Global economic growth accelerates. The developed economies continue to grow above potential, while economic growth in the emerging markets picks up moderate speed. The financial environment improves. In this scenario the US Fed raises the Fed funds rate. This is negative for bonds without default risk and hard currency bonds from the emerging markets, but positive for risky asset classes (bonds with default risk in the developed countries after an initial correction, global equities, local currency bonds of emerging markets). The US dollar depreciates on the back of the declining regional divergence.

Scenario #2: weakening (Bad)

The downward spiral in the emerging market continues to spin. The global deflation pressure (pressure for falling papers on a broad basis) increases, and so does the instability on the financial markets. Company earnings shrink on a global scale. This depresses investments and employment. In this scenario investors tend to prefer credit-safe and liquid government bonds. This environment is ultimately neutral for the US dollar vis-à-vis main reserve currencies and positive for emerging markets.

Scenario #3: stabilisation (Ugly)

Economic growth in the developed economies weakens to potential, while the economic growth in the emerging economies remains low. Inflation rates remain low, but rise gradually due to the base effect. The calming of the financial markets enables the US central bank to raise the Fed funds rate cautiously. This scenario is slightly negative for bonds with no default risk and hard currency bonds from the emerging markets; it is moderately positive for some risky asset classes (bonds with default risk in the developed countries after an initial correction, global equities, local currency bonds of emerging markets). The appreciation of the US dollar is over, but it is too soon for a bout of depreciation.

Western vs. reality

From a positive vantage point, the markets have the bad scenario partially priced in already (especially the emerging markets). The probability of the bad scenario, however, is definitely higher than the materialisation of a tail risk; the most likely scenario is the ugly one. While the recovery scenario is desirable, it is less likely than the two other scenarios. The scenario that ultimately materialised might therefore be a different one than the one referred to in the Western.

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