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Turbulent capital markets: what to expect in 2016?

Gerhard Winzer

The price declines on the equity markets at the beginning of the year suggest a decline in investor confidence. Is this justified? Please find a few hypotheses for 2016 in the following:

Global economic growth remains low. The Great Recession of 2007 and 2008 has **reduced output potential** and growth potential. In addition, the efficiency of the monetary policies has fallen. The adjustment process in the emerging markets and the high level of debt have a dampening effect on growth. The disadvantageous demographic development, the dampened level of investments, and the low productivity growth put a lid on the outlook of higher growth rates. At least the USA and the Eurozone have shown resilience so far. However, the leading indicators suggest a decline towards potential growth.

In the emerging markets the adjustment process after the boom is keeping economic growth below the fallen potential. The financial environment remains restrictive, and **creditworthiness is falling** across countries. The bumpy transformation process in China continues. This means lower economic growth, supported by private consumption and the service sector. An expanded budget deficit in China prevents a hard landing. This is positive for the global economy.

Inflation remains low and below the respective central bank targets, even if inflation rises a bit on the back of a base effect. The risk of sliding into deflation remains elevated. An only bumpy landing in China could reduce the fear of deflation.

The **central bank policies remain expansive**. Their most important goal is to lift the low rate of inflation. The US central bank increases the Fed funds rate (i.e. the key-lending rate of the Fed) in a cautious fashion. The central banks in the Eurozone and in Japan took additional expansive steps.

The **yields** of **government bonds** with good ratings **remain low** and below the already fallen “natural” interest rate. The tepid investment activity and the weak growth rate in the emerging markets imply a savings surplus. This asset class represents a hedge vis-à-vis deflation risks.

Bonds that have default risk associated with them **and emerging markets currencies remain vulnerable** for the time being. The default rates in the USA are on the rise, and the emerging markets remain under pressure. However, the spread, adjusted for the expected default rate is positive and rising, whereas the emerging markets currencies have ceased to be expensive. The **attractiveness of this asset class increases over the year. Risky bonds in the Eurozone are more attractive than their peers in the USA.** The policy of the European Central Bank is supportive, and the economic recovery of the Eurozone is only in its early stages.

Only **low rates of (positive) return are expected for equities**. At the same time, the downside risks have increased. Company earnings are caught in a recession, with IT, healthcare, and consumer goods representing exceptions. Regionally speaking, equities in the Eurozone and Japan are the most attractive ones.

Commodities remain locked into a bear market, given that the overcapacities on the market are reduced only gradually. Gold does not offer a natural hedge for the risen uncertainty.

The **US dollar tends to appreciate** on a trade-weighted basis, especially relative to the currencies of the emerging markets. It also appreciates a bit more against the euro, at least as long as the US central bank keeps signalling a rate hike cycle. The Japanese yen is significantly undervalued in the long run.

The **geopolitical tensions and politics are gaining in importance** for the global economy and the markets. For example, an escalation in the Middle East could cause a drastic increase in the oil price. The flow of refugees supports the rise of anti-establishment parties. Also, two important votes will be held: the US presidential elections, with Hillary Clinton as current favourite; and the referendum in the UK on whether to leave the EU (with a neck-and-neck race in the offing).

The **instability on the financial markets is elevated**, caused by the fallen liquidity on the markets, by the extremely expansive central bank policies, and by the downside risks for the global economy. One example is the negative spill-over of the losses on the Chinese equity markets to the global equity markets. On the upside: overshooting, if recognised, harbours good investment opportunities.

The **extrapolation of surprising developments is challenging** because we are talking about “unknown unknowns” here. To take you through one example: the inflation pressure could increase in spite of economic growth remaining low. This would exert pressure on the central banks to raise key-lending rates. In this environment bonds would incur losses. The US dollar could depreciate because the US Fed may put an early end to the rate hike cycle. The UK could vote in favour of a BREXIT, and Donald Trump could become US President. The biggest surprise would be the acceleration of economic growth.

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