Event horizon

2016 Global Market Outlook – Q4 Summary

> *"The outlook for economic growth remains lacklustre globally and global central bank divergence remains the key market driver. However, we are keeping a keen eye on three major events on the horizon which may cause short-term volatility and a flight to safety. Although we remain cautious and do not see any strong buy signals, we remain watchful of opportunities that any volatility may present."*
>
> Andrew Pease, Global Head of Investment Strategy

Key market theme

Our investment strategy outlook is broadly unchanged. The outlook for economic growth is lacklustre globally and inflation pressures are muted. However, recession risks for the U.S. economy are still low. **Global central bank divergence remains a key driver of market returns.** The U.S. Federal Reserve (Fed) might be contemplating a rate hike but the European Central Bank (ECB), Bank of Japan (BoJ) and Bank of England (BOE) are all considering further easing measures.

Global central bank divergence remains a key driver of market returns. We are also keeping a keen eye on three events in particular which could cause short-term volatility and a flight to safety.

Three events on the horizon to keep an eye on

It's been an uneventful northern hemisphere summer; the Brexit vote was a smaller blow than feared and markets have not overly penalised riskier asset classes. However, as the weather cools, markets could start to heat up and there are three events in particular which could cause short-term volatility, and if underestimated by the market could cause a flight to safety:

The U.S. presidential election

While we believe the market fundamentals are more likely to steer the course of the U.S. markets, the U.S. presidential election does have the potential to deliver a market shock.

The Italian referendum

The Italian referendum on constitutional reform will be held December 4. Prime Minister Matteo Renzi faces a populist, anti-austerity backlash and the popular Five Star Movement is pushing for a vote on the euro. A 'No' vote in the referendum could force Renzi to resign, causing a spike in fears about Italian stability and the fate of the euro.

Mid-December Fed rate rise

Investors are likely to become more nervous as the mid-December Federal Open Market Committee (FOMC) meeting approaches. We think the Fed is on track to deliver a 25 basis point rate rise. Markets usually respond more calmly to the second and subsequent Fed hikes. However, the 12-month gap from the first rate rise makes this similar to a new tightening phase. January and February were volatile months as last December's rate hike was absorbed. There could be a similar reaction this time.

Asset class views

Our strategists have a broadly neutral view between equities and bonds with a slightly higher attraction to cash relative to last quarter.

We are concerned that risk assets, like equities and corporate credit, are vulnerable to bad news. Our investment process is keeping us cautious, but it is also keeping us watchful for any opportunities that volatility might present.

Equities: Our regional equity positioning is close to neutral

Our process has a neutral overall allocation to global equities. We prefer European and Japanese equity exposure to the U.S., mostly on valuation grounds. While emerging markets (EM) are moderately cheap our cycle score is negative due to the risks from high private-sector debt levels, but improving growth indicators means that this score has potential for an upgrade.

Fixed income: Bond yields are likely to rise, but only modestly

The Treasury rally following the Brexit vote on June 23 could mark the low point for government bond yields in this business cycle. Anecdotally, it seemed like many investors finally gave up on their bets that long-term interest rates would inevitably rise. This type of capitulation can be one of the hallmarks of a significant turning point for interest rates.

The upward pressure on bond yields from inflation pressures in the U.S. will be muted by deflation pressures in the rest of the world. Bond yields should rise, but only modestly. We're wary of government bonds on a 12-month outlook, although these could benefit from event driven risk aversion.

Currencies: Upper range for USD and beware sterling

The U.S. dollar (USD) looks to set test its previous highs as central bank policy divergence intensifies. The Fed feedback loop, where dollar strength limits the extent of Fed tightening, puts a limit on how far the greenback can rise.

The British pound looks at most risk, with a large current account deficit, more Brexit fall-out and additional BoE easing likely. It could fall further below 1.30 relative to the USD.

Conclusion: Watch that your risk assets are not vulnerable to bad news

The next few months could be challenging as markets navigate the U.S. election, Italian referendum and likely December Fed rate rise. The backdrop of expensive U.S. equity valuation and lacklustre economic growth trends keeps us concerned that risk assets, like equities and corporate credit, are vulnerable to bad news.

Our investment process is keeping us cautious, but it is also keeping us watchful for any opportunities that volatility might present.

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