Global Perspective

December 2015

In this edition of Global Perspective, we analyse the key drivers for economies and markets into 2016. Investment decisions are becoming more complex, as growth paths and monetary policy settings diverge. Parts of the corporate sector face pressures on cash flow, at a time when equity valuations are less supportive. The net result is portfolio construction becomes ever more important, with a focus on careful country, sector and stock selection.

Standard Life Investments

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A world of low numbers

2016 looks to be a challenging year for investors, as different countries and asset classes are at such different stages of the investment cycle. The sustainability of yield becomes a more important driver of investor choice.

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Although the global economy looks set to expand into 2016, this remains a world of low numbers, whether in terms of GDP, CPI, interest rates, bond or dividend yields. Choosing between asset classes is further complicated by pressures on corporate profits, divergent economic growth and hence policy decisions, plus a variety of potential political shocks. Accordingly, the House View has become more cautious. In recent years, a pro-equity stance has been the correct strategy; any sell-off on growth concerns about the US, Europe or China has been seen as a tactical buying opportunity, on the grounds that central banks would do enough to keep the world economy expanding. 2015 has been different – global equity returns (in US dollars) are only modestly positive over the year-to-date within a 15% range. We expect 2016 to be more of the same: modest total returns accompanied by sharp market cycles. Hence, one of our preferences is to invest in corporate bonds, higher up the capital structure, while another is to be short duration, as we see upside risks for bond yields.

Getting more complicated

In the coming year, as well as navigating the usual obstacles of correctly forecasting growth, inflation, interest rates and corporate profits, there are a variety of complex economic relationships to understand, and political and geopolitical obstacles to overcome.

How slowly or rapidly will certain key economic relationships evolve in 2016? For example, how effective will the Chinese government be in stabilising that economy and helping with its rebalancing? There have been about a dozen separate interest rate and reserve requirement cuts from the People's Bank of China since November 2014, yet much of manufacturing remains in recession. The success of Chinese policymaking matters enormously for a range of developed market and emerging market (EM) asset prices. A second example would be correlations; for example, how correlated will the US dollar be with US Federal Reserve interest rate increases (see Chart 1)? A more stable dollar would be a considerable support for global commodity prices and the willingness of global investors to buy into EM assets. On the other hand, another year of sharp US dollar appreciation against its major trading partners would hurt US corporate earnings, which have flattened out in the past year. A third example would be elasticity – what is the strength of the relationship between the tightening of the US labour market and the subsequent rise in wages or productivity? As US unemployment falls below 5%, does this lead to a step-change deterioration in unit labour costs? Signs that the Federal Reserve is behind the curve in terms of tightening monetary policy would have serious implications for the shape of the US yield curve.

The strong and the weak

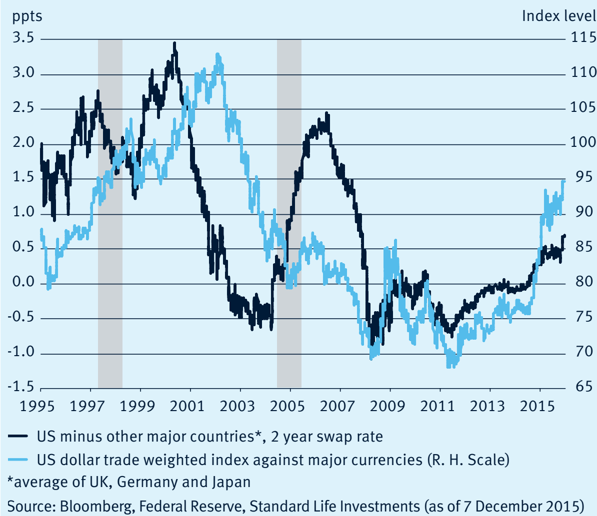
The good news for the global economy is there are signs of strength in many key areas and countries. One driving force is the lagged effects of cheaper commodity and energy prices, all supporting household incomes and business margins. A second factor is the state of the labour market, improving steadily in most of the larger economies and leading to better real income growth. Pent up demand and greater credit availability bolsters consumer durables, with global auto sales above pre-recession levels. One difference going into 2016 will be more supportive fiscal policy (see Chart 2). EU governments are moderately relaxing their debt targets, while fiscal spending in China is growing its fastest since summer 2012.

The 'two-speed' economy remains a key investment theme. The strength of household consumption and business services contrasts with weaker production and trade data. Indeed, the manufacturing sector is in, or close to, recession in several countries, such as the UK or Taiwan. The main causes are the deceleration in emerging market economies, led by the marked slowdown in China but encompassing the recessions in Brazil and Russia alongside the impact of low oil prices on most oil exporters, especially in the Middle East. At best, EM policy responses look to stabilise the situation; the burdens from past excessive credit growth or over-investment will take time to work through.

Cycles within cycles

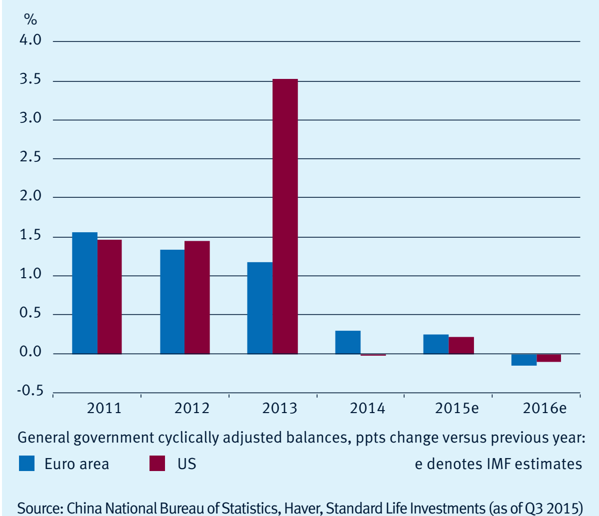
All in all, global real GDP should pick up modestly from about 3.0% towards 3.25% per annum(p.a.) while core inflation is stable at around 3% p.a. The US continues to grow 2-3% p.a., we expect a soft landing in China (around 6% p.a. GDP growth) and growth in Europe moving towards 1-2% p.a.

Chart 1
Mind the interest rate gap



Source: Bloomberg, Federal Reserve, Standard Life Investments (as of 7 December 2015)

Chart 2
Pulling back on austerity



Source: China National Bureau of Statistics, Haver, Standard Life Investments (as of Q3 2015)

Looking at the economic cycle in more detail, as long as consumer spending holds up and excess inventories at factories are run down then a rebound in industrial activity can be expected. This requires real wages to take over from cheap oil as a driver of household spending. Nevertheless, this improvement is not expected to lift economic growth in 2016 considerably above 2015 levels as other factors continue to restrain activity, such as excess capacity, excessive debt levels and the first interest rate tightening in the US for nine years.

A second cycle will encompass inflation. Global headline inflation was only 2.3% p.a. in October, the lowest since 2009. As long as commodity prices do not slide further, then the depressing effect of lower energy prices on headline inflation will start to ease from spring 2016 onwards. Annual inflation rates, currently close to zero in the major economies, should rise back towards the core rate (about 1-2% p.a. in developed markets). El Nino effects on food prices could exacerbate the trend. This should affect bond yields as the worst of the deflationary fears are removed. Core inflation should be boosted by one-off factors such as medical and housing costs, but otherwise the dis-inflationary effect from weak EM looks to restrain company pricing power into 2016.

Signs of divergence

History suggests that financial markets become more volatile when monetary policy or general financial conditions diverge noticeably between countries. We expect to see this in 2016. Policy tightening by the world's most important central bank will be offset to some extent by continued easing by the 2nd, 3rd and 4th most important central banks, as growth and inflation still remain below target in China, the Eurozone and Japan. Markets have currently priced in three interest rate increases in the US in 2016, although our analysis of labour market pressures suggests that the Federal Reserve will need to be a little more aggressive. History suggests caution ahead: the Federal Reserve is tightening policy at a much later stage than in the traditional post-war business cycle, while previous episodes of policy divergence between the US and Europe have not ended well, e.g. 1994.

Worries about profits

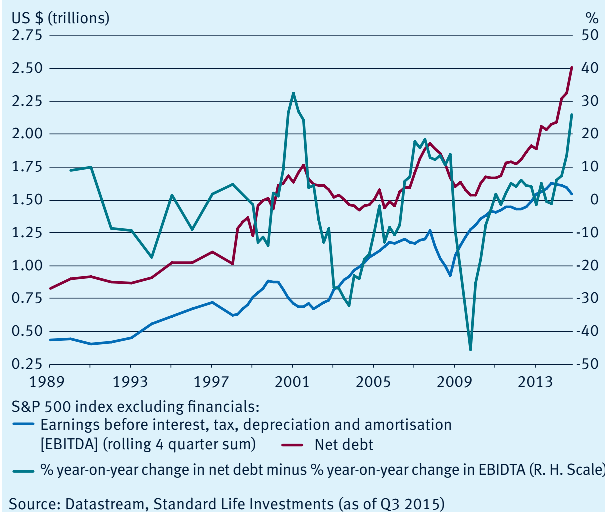
Global profit growth is constrained by limited top-line sales. On a national accounts basis, US profits have peaked; 2015 saw modestly negative S&P 500 revenue growth (modestly positive excluding energy). This partly reflects the state of the cycle – unit labour costs are picking up – partly the effect of the stronger US dollar and partly the impact of weaker overseas demand and stronger overseas competition. A warning sign historically is that the US economy entered recession on average 5-7 quarters after the peak in profit margins.

A further concern is the moderate deterioration in US company balance sheets over the past two years, reflecting the dual effects of sluggish earnings and rising net debt (see Chart 3). Corporate treasurers have borrowed at low yields ahead of US rate increases, using the proceeds for share buy backs and M&A activity rather than capital spending. The corporate financing gap has widened sharply to its highest level since early 2008, causing corporate bond spreads to widen. It should be noted though that most credit metrics are still reasonable, rather than stretched, after excluding energy, metals and mining issuers, which have been particularly affected by the EM slowdown.

What is in the price? Consensus forecasts for 2016 US earnings per share have only declined to 8% p.a. The positive scenario for 2016 is that top-line sales growth beats expectations, for example on the back of upside surprises to nominal GDP reports from the US, China and Europe. In effect, the global consumer begins to spend their income gains and the manufacturing sector recovers from its current weakness. For US firms, a stable US dollar would also help. Conversely, triggers for a more negative outcome would include a sharper appreciation of the US dollar, a larger rise in borrowing costs, worsening unit labour costs or more pressures on pricing power. The recent earnings season showed share prices reacting adversely to earnings disappointments.

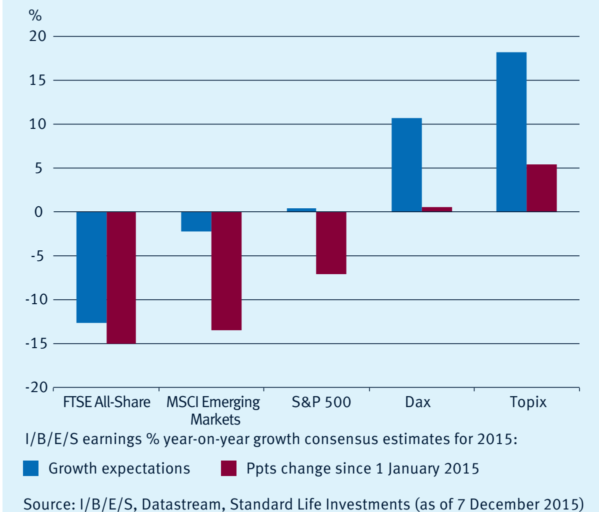
While the US corporate sector is becoming more vulnerable to external shocks, as its room for manoeuvre becomes more limited, it is important to emphasise that other countries are

Chart 3
Corporate debt explosion



Source: Datastream, Standard Life Investments (as of Q3 2015)

Chart 4
Divergent expectations



Source: I/B/E/S, Datastream, Standard Life Investments (as of 7 December 2015)

in better shape (see Chart 4). The outlook is still for positive profit growth in Europe and Japan. Companies are in a more favourable stage of the business cycle and able to expand margins, with corporate self-help and currency depreciation also helping.

Worries about politics

A final concern for investors in 2016 will be politics. On top of normal elections, such as the US presidency, there are concerns about the outcome of the UK referendum on EU membership, the rise in populism across Europe, exacerbated by the surge in migrants, as well as the complicated mix of events seen across the Middle East. On the plus side, structural reforms in countries such as Argentina and India would be warmly received by investors looking for growth opportunities. All in all, politics may be a source of volatility for financial markets.

Implications for financial markets

Overall, we remain cautious regarding the market outlook for 2016. The list of potential drivers of market turbulence is rather large. While there are areas of value in financial markets and asset classes, we encourage investors to remain highly selective in their asset allocation decisions over the next 12-18 months. The sustainability of yield, whether delivered in equity or corporate bond markets, will become ever more important.

Different financial markets are in different phases of the investment cycle. The US is at a later stage, as shown by the state of the profits cycle, the widening of corporate bond spreads and the state of company balance sheets, possibly amplified by the effects of US policy tightening. Europe and Japan are more mid-cycle, with less corporate vulnerability and still supportive policy. EM assets are suffering a mid-cycle pause as long as growth revives.

How should investors position their portfolios against this backdrop? During 2015, we steadily lowered risk in multi-asset portfolios to the lowest levels since early 2012. This reflects concerns about valuations, the slowdown in corporate earnings growth, the slowdown in global nominal GDP growth and an upturn in financial market stress. Put another way, the only equity market which is Heavy in the House View is Europe (all others are Neutral). This reflects more favourable prospects for European earnings as top-line sales recover while costs are contained. The Global Investment Group has preferred to move up the capital structure, in terms of holding more investment grade corporate bonds. Default risk is rising but investment grade valuations are attractive as long as no recession appears. The same argument applies to global real estate, although certain capital cities are becoming less attractive. Generally, we expect developed markets to outperform emerging markets for another year, although the risk of a 1997-98 style financial crisis remains low.

We remain cautious about global government bonds, so duration in our portfolios is short. We are concerned about the upside pressures on yields reflecting Federal Reserve tightening, the increase in headline inflation in 2016, and any pull back from safe haven flows. Light positions in US Treasuries, UK gilts and Japanese government bonds are only offset by a Heavy position in European debt. This is supported by weak inflation across the Eurozone, and ECB policy; negative deposit rates have driven over 40% of Eurozone government bonds into negative yields.

In terms of portfolio construction, as valuations have become somewhat stretched for many financial assets, such as equity, fixed income and real estate, so cash becomes more important to mitigate wealth shocks, while more dynamic asset allocation techniques should show their worth. The House View has emphasised sustainable yield as a key theme for some time, but with pressures on corporate cash flow and dividend payouts, so 'sustainability' becomes even more important. Key triggers to raise or lower risk exposure in portfolios in 2016 will include the direction and extent of the US dollar's move, the success of China's policy stimulus, and the impact of Federal Reserve tightening on indebted EM countries.

House View

The following asset allocation is based upon a global investor with access to all the major asset classes. For regional versions of the House View, please contact your Standard Life Investments representative.

	December 2015 House View	
Risk	The Global Investment Group has tempered its near-term outlook, as a variety of drivers point to greater financial volatility in the coming year. While there are selective areas of value, investors should be highly selective in asset allocation decisions.	NEUTRAL
Government Bonds		
US Treasuries	Continued economic growth, especially tighter labour markets and rising wages, should enable the Federal Reserve to raise interest rates throughout the coming year.	MOVED TO VERY LIGHT
European Bonds	Bonds are supported by an environment of low inflation, modest economic growth, further QE and more negative official rates. Political pressures may affect peripheral bond markets on occasion.	HEAVY
UK Gilts	Domestic economic strength should give the Bank of England leeway to raise rates in the leeway of the US. Inflation pressures remain manageable while valuations are expensive.	LIGHT
Japanese Bonds	The Bank of Japan's sizeable bond-buying programme has driven valuations into expensive territory, as the authorities continue to try to reflate the economy.	MOVED TO NEUTRAL
Global Inflation-Linked Debt	While inflationary conditions are globally subdued, markets may react to a rise in headline inflation as the impact of previous commodity price weakness becomes less marked over time.	NEUTRAL
Global Emerging Market Debt	Dollar-denominated bonds are Heavy, as spreads show better value, while local currency bonds are Neutral as careful examination is required of individual currency and spread factors.	HEAVY/NEUTRAL
Corporate Bonds		
Investment Grade	Our preference is to be higher up the corporate capital structure. Widening US credit spreads create an attractive opportunity over low yielding Treasuries; improving cash flows benefit euro debt.	HEAVY
High-Yield Debt	Recent sell-offs have improved valuations modestly, but overcrowding remains a risk in the US market when monetary policy is tightened. European debt remains supported by yield-seeking investors.	NEUTRAL
Equities		
US Equities	Valuations are expensive on some metrics and margins likely to compress with higher wages and stiffer import competition but stock buybacks and dividend payouts are still supportive.	MOVED TO NEUTRAL
European Equities	Corporate competitiveness is improving and earnings should receive a lift from further euro depreciation, an improvement in domestic demand and lower energy costs.	HEAVY
Japanese Equities	The asset class is supported by earnings upgrades from a weaker yen, improving corporate governance, lower corporate taxes and the QQE programme. Abenomics' structural reform components must be implemented.	NEUTRAL
UK Equities	The domestic economic backdrop is supportive, but corporates have large exposure to overseas earnings, which are under pressure from a stronger sterling and commodity price pressures.	NEUTRAL
Developed Asian Equities	Trade flows are increasingly a headwind, with a strong Australian dollar affecting its terms of trade. China's economic slowdown is harming commodity producers.	MOVED TO NEUTRAL
Emerging Market Equities	There are pockets of deterioration within emerging markets with the commodity price slump badly affecting Brazil, political uncertainty in Eastern Europe and large behavioural shifts affecting the Chinese market.	NEUTRAL
Real Estate		
UK	The robust growth environment continues to bolster prices in the near term, and yields remain attractive compared to other assets, suggesting reasonable returns over a three-year holding period.	HEAVY
Europe	Core markets continue to offer attractive relative value in light of the low interest rate environment supported by QE. Meanwhile, recovery plays are showing consistent capital value growth.	NEUTRAL
North America	Canadian property faces headwinds from an interest-rate sensitive consumer and significant office construction. The US should benefit from continued economic growth but pricing is quite aggressive.	NEUTRAL
Asia Pacific	An attractive yield margin remains, but markets are divergent. Returns are driven by rental and capital value growth in Japan, but limited to capital growth in Australia, Hong Kong and China.	NEUTRAL
Other Assets		
Foreign Exchange	The US dollar has already sizeably appreciated despite upcoming rate rises; QE in Japan and Europe will keep currencies there under pressure. Sterling is supported by an eventual UK rate rise.	MOVED TO NEUTRAL $, €, NEUTRAL £, ¥
Global Commodities	Different drivers, such as US dollar appreciation, Chinese demand, Middle East tensions and climatic conditions, influence the outlook for different commodities.	NEUTRAL
Cash		
	The US is expected to raise interest rates again in 2016, with the UK and some emerging markets looking for an opportune time to follow. Policy should remain easy in Europe, Japan and China.	NEUTRAL

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