BT Investment Solutions

Thinking about what's changed

18 January 2016

The start of 2016 has been volatile, with many investors questioning the outlook ahead and triggering reviews of strategic allocations. In this article, Tim Rocks, Head of Market Strategy and Research, considers activity in the market and whether this changes BT Investment Solutions' economic assumptions.

Our assumptions for 2016 have been for:

+ steady economic growth in the US
+ some improvements in Europe and Japan
+ stabilisation in China following aggressive stimulus.

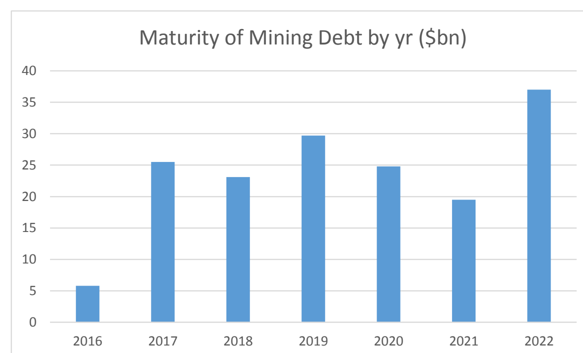
The question is, whether the market volatility indicates deeper economic changes that might mean our assumptions no longer ring true. In reviewing these assumptions, we have looked at some of the following activities in the market.

+ Falling oil prices
+ Currency depreciation in China
+ Downward slide in US manufacturing
+ Central bank responses in light of market volatility.

Why oil prices are falling

The first thing to note is that the collapse in oil prices does not reflect a deterioration in economic activity. The dominant cause of the collapse has been over-supply, particularly the steady erosion of Organisation of Petroleum Exporting Countries (OPEC). At the November OPEC meeting, Saudi Arabia declared it would raise production to defend market share rather than cut production to boost prices – a move which could be the knock-out blow to the OPEC cartel. Saudi Arabia is seemingly willing to accept a permanently lower price and will deal with this by doubling its refining capacity. It may also see a lower oil price as politically advantageous in its growing feud with Iran, remembering that Iran is about to start exporting oil again now western sanctions have been lifted.

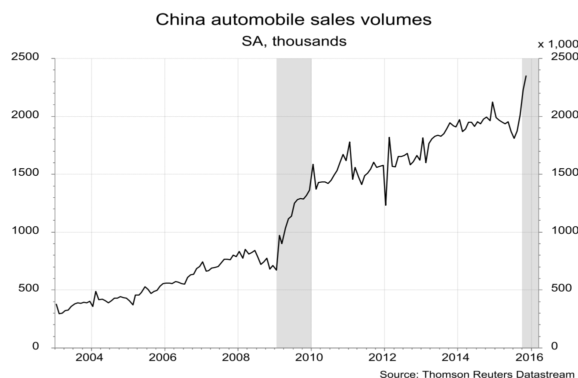
Falling oil prices is a net positive for global growth. It acts like a tax cut for motorists across the globe, and lower freight related transportation costs will eventually feed through to lower product prices across the board. These effects will take some time to come through however, and in the meantime oil producers will come under considerable financial strain. The greatest threat is that oil and energy producer defaults create financial contagion. However, we see this as a low probability this year given that interest rates are so low and that many loans do not fall due until 2017 and beyond. The chart opposite shows there are relatively few loans facing maturity this year compared to subsequent years across the energy and mining sectors.



Source: Datastream

Chinese currency depreciation

China's decision to depreciate its currency by another 1.5% so far this year has raised questions about the current state of the economy. The economic data suggests there has been no material change in the outlook in recent months, with industrial sectors remaining weak and consumption continuing to hold up reasonably well. In fact, recent data on car sales has been very strong in response to incentives introduced late last year. The chart opposite shows how car sales have increased by 23% over the past year.



Source: Datastream

US manufacturing is on the slide

One area of noticeable deterioration in recent months has been US manufacturing. A combination of weak demand, a rising US dollar, and high inventory levels has seen manufacturing indicators weaken. The extent of the weakness is a surprise and has given us cause to potentially downgrade our forecasts for US growth. However, US manufacturing is less than 10% of the US economy, and we expect manufacturing will stabilise once the inventory issue has been addressed.

Another issue we are monitoring closely for the US economy is the rise in corporate bond yields. Spreads have increased for energy producers but the effect has now expanded to higher grade credit in other sectors. Companies will have to pay more to issue or replace debt, and companies with lower credit ratings will be far less likely to be able to issue debt. This is not a material issue yet but it requires further monitoring.

Source: Datastream

How will central banks respond to the current market turmoil?

Market outcomes could be far worse if the US Federal Reserve (Fed) continues to raise rates regardless of the negative sentiment, compounded by any lack of further stimulus from the Bank of Japan or the European Central Bank (ECB).

We expect central banks will respond with further easing of monetary policy. Inflation rates are already well below target in all major developed markets, and the recent fall in oil prices points to further falls in headline rates. Central banks are also much more aware of systemic financial risks since the financial crisis. All the major central banks meet in the next two weeks: ECB on 21 January, Fed on 27 January and Bank of Japan on 29 January. These will be notable market events, and could provide the necessary circuit breakers for positive sentiment to return to global markets.

Conclusion

At this stage, we see no evidence of a material change to the global economic outlook, although US growth momentum is stalling to a degree. As a result, conditions need to be monitored more closely than normal. We will be watching Chinese and US manufacturing and inflation data for any evidence of changes in trend. Corporate bond defaults among energy producers will also be important to monitor, as well as upcoming central bank commentary in relation to policy reaction in the near term. To date, we have made no significant changes to our market forecasts and, given our favourable view of share markets, are looking to potentially increase positions if there is further weakness.

For more information on our outlook for 2016 and how it relates to your investments, please contact BT Investment Solutions.

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