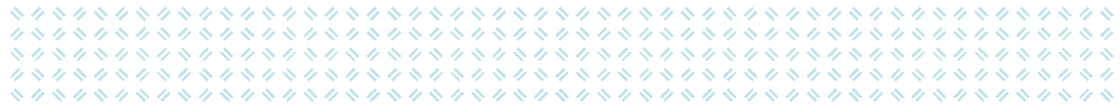


Familiar themes in a new year

21 January 2016

The start of 2016 has already seen volatility in sharemarkets, with concerns about China and emerging markets one of the key drivers. While these concerns are likely to linger across the year, BT Investment Solutions expects 2016 to be a reasonable year for asset markets.

In this article, Tim Rocks considers expectations for 2016 and key themes.

The prospect for a reasonable year

Our central case is for global growth to remain relatively subdued held back by concerns over China and emerging markets. However, there is some prospect for improving conditions in developed markets as the benefits of low oil prices work through, inflation remains low and policy settings remain supportive. This would help to ensure a positive year for equity markets.

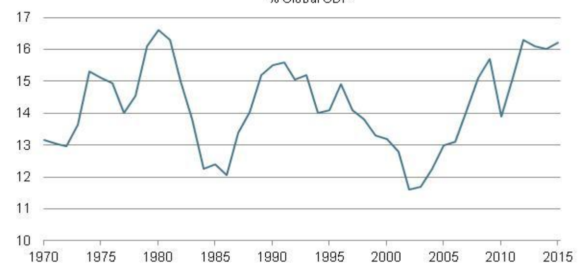
Key themes for 2016

We expect the year to be dominated by four key themes:

1. Ongoing low global inflation
2. Further falls in commodity prices
3. Support from Central banks
4. Improving fundamentals in US and Europe

These themes are outlined further as follows.

Chart 1:
Global Business Fixed Investment
% Global GDP



Source: Bridgewater

1. Global inflation will stay low

We expect the deflationary pressure of the past few years to continue given:

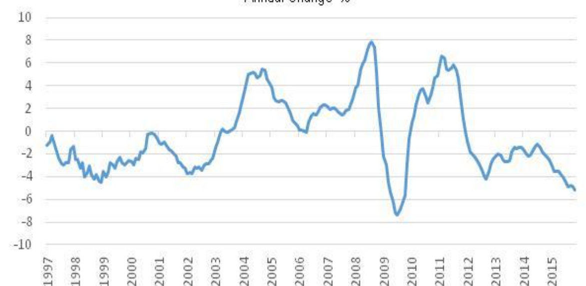
+ Structural pressures

  The key factor in this area is previous overinvestment leaving global capacity elevated at a time when global demand is weak (see Chart 1). As a result, firms have no pricing power.

+ Cyclical pressures

  A collapse in energy and commodity prices, along with intense Chinese discounting of consumer goods into Western markets has compounded the pressure (see Chart 2).

Chart 2:
China Factory Prices
Annual Change %



Source: Datastream

Many are expecting a bounce in inflation due to tightening labour markets and the potential for wage inflation. While this is a risk that needs to be monitored, it is likely that these other deflationary pressures will dominate again in 2016.

2. Commodity prices will fall further

The end of the commodity price collapse, when it does occur, will be a major event for markets. Many assets are highly correlated with commodities including emerging market equities, resource stocks and the Australian dollar. However, we do not see this as imminent.

The trigger for the recent weakness in commodity prices has been weakness in China, where the transition from investment to consumption is finally underway. There is likely to be some uplift in Chinese commodity demand in 2016 given the substantial amount of stimulus introduced in recent months, particularly changes in rules around local government finances as shown in Charts 3 and 4.

Chart 3:

Local Government Bond Issuance

RMB per month

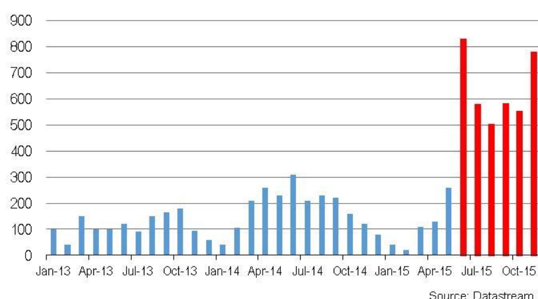
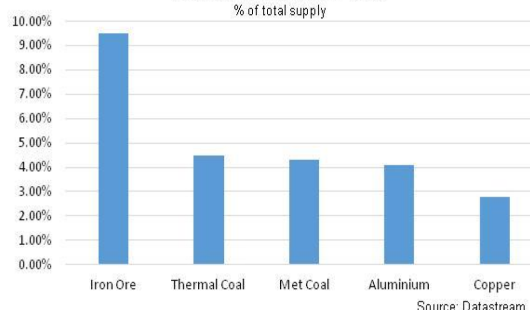


Chart 4:



3. Central banks are still supportive

The US Federal Reserve (the Fed) has now increased interest rates once. Despite this, we expect that monetary and fiscal policies around the world will remain broadly supportive of economic growth and markets. In fact, more stimulative measures could be introduced if:

+ commodity prices continue to fall,
+ core inflation stays low, and
+ financial distress becomes more evident amongst commodity producers and emerging market economies.

Inflation rates remain well below official targets in all major markets (see Chart 5). The Fed is raising rates in anticipation of rising inflation from wages and stabilisation in the oil prices. If wages and inflation rates do not rise, policy expectations will need to be adjusted (see Chart 6).

Further deflationary pressure may also see a policy response in Europe and Japan. In those regions, the inflation rates are lower, so there will be little tolerance for further falls in inflation.

Chart 5:

US and European Core CPI

Annual Change %

Chart 6:

US Wages

Annual Change %

4. Fundamentals in the old world are improving

The US and Europe continue to make steady progress towards addressing the imbalances that contributed to the financial crisis. In the US, household and business balance sheets have improved. Household debt has fallen from 130% to 100% of income (see Chart 7), and the savings rate remains higher than in the 2000s (Source: Bloomberg).

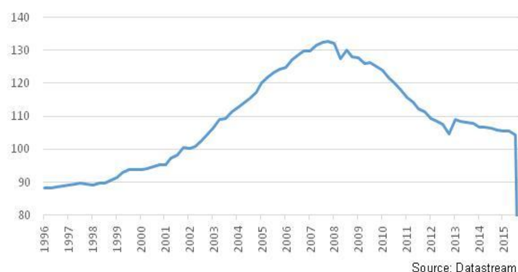
In Europe, the most significant recent development has been an improvement in the financial sector. Europe has taken longer to recover from the crisis, partly because the banking sector was hamstrung by the sovereign debt crisis and increases in banking regulation. But banks are now lending again, as shown in Chart 8, and Europe economy should now catch up to the US.

These structural improvements set the platform for a stronger recovery in economic growth in the US and Europe once consumers stop saving as much and investment rates start rising. We expect this to become increasingly evident in the second half of the year. Rising confidence could be positive for consumption and business investment and allow the benefits of lower oil prices to come through.

Chart 7:

US Household Debt

% disposable income

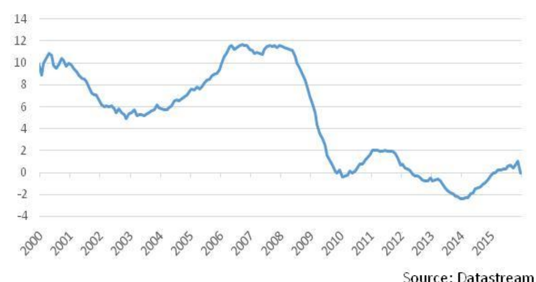


Source: Datastream

Chart 8:

Euro Bank lending

Annual Change %



Source: Datastream

A reasonable year for portfolios

This scenario is a reasonably positive one for asset markets over the rest of the year.

Equities

+ We expect this to be the best returning asset class, supported by low bond yields.
+ Unhedged international equities will outperform as earnings growth accelerates and the Australian dollar falls.
+ Australian equity returns will be boosted by high-yielding sectors.

Property

+ Property will make strong returns but may slightly underperform broader sharemarkets as income growth will be stronger in the broader market.

Fixed interest

+ This asset class is likely to underperform equities.
+ We expect that the Fed will raise rates only slowly and this slow pace eases concerns in the bond market as bond yields will increase only slightly.
+ The RBA could cut rates one more time in 2016 as business investment fails to recover in the non-mining sector.

For more information about the key themes in 2016 and your investments, please contact BT Financial Group.

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