AQUILA

Flash

What will drive the equity markets in 2016?

The outlook for growth, monetary policy, geo-politics and the EU are issues likely to continue to impact equities in 2016. While we expect the world economy to grow next year, growth is unlikely to be strong enough to prevent markets from worrying about a loss of economic momentum. The major central banks will still be supporting markets. But investors view their policies with increasing concern, making them less effective. In the US, a steeper rise in interest rates than generally expected could give rise to turbulence. We also suspect that the EU will run into more problems, providing another source of market volatility. Meanwhile, geo-political issues have lately become even more problematic. All in all, we don't see enough positive factors to justify an overweight stance in equities and reduce our commitment to the asset class back to neutral.

Economic growth, monetary policy, geo-politics and the EU are all likely to influence the equity markets next year.

In assessing the outlook for equities in 2016, one must first consider what the main influences on markets are likely to be. Undoubtedly, the strength of the world economy, in terms of the growth rate, will be a major influence. But trends in central bank monetary policies will also be important. It seems likely that the EU will experience more turbulence next year than in 2015. The recent terror attacks in Paris suggest that geo-political threats are on the increase, adding more uncertainty to the investment outlook. On the other hand, the forthcoming Presidential election in the US seems unlikely to be a major driver of the markets.

The world economy will continue to grow in 2016.

Although some commentators see another global recession just round the corner, we take a more optimistic view. We note that leading economic indicators, such as the Purchasing Managers' Indices, are posting numbers significantly above the 50 mark – which denotes expansion – on a worldwide basis. They thus give a stronger reading than they did through most of 2013 and 2014. Secondly, the monetary aggregates are rising in OECD countries, indicating an ongoing demand for credit. Moreover, fiscal policy has now turned less restrictive, having been a dampening factor on global growth in recent years. Although markets have focused of late on the negative effects of the sharp fall in commodity prices, some positive developments are now becoming apparent. Importantly, it looks as though the Chinese economy has stabilized, and we don't expect that economy will suffer either a credit crunch or a collapse in its property market. Although the growth dynamic in China is not as strong as before, that country remains the most powerful force for growth in the world economy. Overall we expect the world economy to grow by around 3% next year. But 3% growth is not strong enough to prevent markets from worrying intermittently about the health of the world economy. Those worries are likely to focus on the US or China.

Monetary policies of the major central banks will become increasingly divergent.

Next year, the Fed is likely to raise interest rates faster and by more than the market currently expects. This is because the "core" rate of consumer price inflation is already 1.9% and therefore close to the American central bank's long-term inflation target. Moreover, from this November, the fall in the price of oil will cease to have a marked lowering impact on year on year headline rates of inflation. The result of this is that headline rates of inflation are likely to rise rather strongly in coming months. If, as many economists expect, wage inflation also accelerates, then inflationary pressures will be even stronger. Set against this, we expect that the Bank of Japan will move to make its monetary policy yet more stimulative. This policy shift will

most likely occur in April when the Bank of Japan is scheduled to publish updated forecasts for the Japanese economy. Meanwhile, the ECB is likely to pump billions of euros, in double digit quantities on a monthly basis, into markets throughout next year. Relative to other central banks, the People's Bank of China has a lot of room for maneuver. We expect it will use this to further reduce key interest rates next year. On balance, the monetary policies of the world's major central banks should continue to be supportive for financial assets in 2016. We think that markets will cope with forthcoming rises in US interest rates, in part because these will be linked to the better performance of the US economy. But higher US interest rates are likely to attract capital away from the emerging markets, leading to increased market volatility.

One way or another, the EU will experience more problems next year than in 2015.

Although its recent absence from the headlines suggests the Eurozone is in much better shape than it was in the crisis years of 2011 and 2012, a look under the surface suggests that the true situation is not much different from that 3 or 4 years ago. The current refugee problem shows yet again the inability of EU institutions to handle complex problems at the European level. The chaotic scenes of desperate migrants now shown nightly on evening news programs provide support for those arguing for a UK exit from the European Union. The upcoming British referendum on this issue could well undermine market confidence. Meanwhile, recent terrorist attacks in Paris boost the support for Europe's nationalist parties. Europe's debt dynamic remains negative and there is almost no political will to undertake meaningful structural reform. We are concerned that the EU is likely to be a source of more negative headlines next year, something which will trouble investors.

Ongoing terrorist attacks could seriously unsettle markets.

Geo-politics are always an uncertainty factor for the markets. Events in the Middle East, the East and South China seas, in Eastern Europe, as well as terrorist attacks on Western societies all need to be carefully monitored. A systematic increase in the scale of terrorist attacks could seriously destabilize markets. Normally Presidential election years are good years for the US stock market, even though the overall market is unlikely to be influenced much by the eventual result – whether a victory for the Democrat candidate or for the rival Republican one. The election result is, however, of more importance for the performance of specific industrial sectors. Banks, oil and pharma stocks, for example, are likely to react positively to a Republican win. Alternative energy, infrastructure and education-related stocks are likely to react positively to a Democrat win.

A reduction in the equity allocation – back to neutral – looks appropriate.

From the perspective of economic growth, it seems unlikely that the markets will be boosted strongly by good news next year. Although monetary policy remains a positive factor, this influence is losing its power. Moreover, we think it likely that US interest rates will rise faster than investors currently expect and that the EU will attract more negative headlines than it has over the past 12 months. Considering that the current broadly positive environment – moderate growth, lower inflation with yet more monetary stimulus to come – is already embedded in valuations, a reduction in our equity allocation back to neutral looks appropriate. In taking this step, we are locking in the profits which resulted from our equity purchases last August.

Aquila & Co. AG, 25. November 2015

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