Flash

Outlook for 2016

Worries over economic growth and potential defaults are likely to continue to affect markets from time to time in 2016. The upcoming referendum on the UK's continued membership of the EU could well be another source of tension, not least because it will shine a spotlight on a variety of EU shortcomings. But central bank monetary policies will remain supportive for financial markets and one should not underestimate the power of this support so far as risk assets are concerned. While equity market volatility may well rise in 2016, we still consider that equities are an attractive asset class. At the start of the year we believe we are well-placed with a neutral weighting in equities.

The world economy will continue to grow around 3% in 2016.

2016 growth forecasts for the world economy range from Citibank's 2.5% to Goldman Sachs' 3.5%. For our part, we don't see factors which would cause the world economy's growth rate to rise above its current 3%pa. Overall, the US economy is performing fairly well even though the Purchasing Managers' index for manufacturing has posted a drop from 50.1 to 48.6, thus standing at its lowest point since the end of the last recession in mid-2009. But we don't believe that the US is heading for a recession because 85% of her economy covers sectors other than manufacturing and overall these sectors are growing. Meanwhile the Eurozone economy will continue to benefit in 2016 from a weak euro, very low interest rates and cheap oil. But even these supports are unlikely to push the overall Eurozone growth rate above 1.5% in 2016. Relative to other European economies, Germany will continue to perform well and France will continue to disappoint. Among emerging market economies we don't expect much good news out of Brazil. Better trends there will need to wait for a change of political leadership. Regarding China, we think that her government can apply fiscal, monetary and regulatory policies which will keep the economy more or less on a growth path. We don't share the frequently heard opinion that China's economy is about to be laid low by a property collapse or a credit crisis. Combined, these country forecasts suggest that the world economy will grow, but not fast enough to prevent stock markets from worrying intermittently about its general health.

Central banks will continue to support the financial markets.

Hardly had the Fed announced its arguably-overdue rise in US interest rates than opinion began to be voiced that this move was a horrible mistake. We don't share that opinion and, indeed, think that the Fed will probably raise rates faster and higher in 2016 than the market currently expects. This is because the rate of core consumer price inflation is already 2% and thus corresponds to the Fed's long-term inflation target. Despite the likelihood of further rate rises, the Fed will still maintain a broadly expansionary policy stance in 2016. The Bank of Japan is set to buy around USD 55bn. worth of securities on a monthly basis up until at least March 2017, thus providing markets with massive injections of liquidity. Even absent additional, yet to be announced measures, the Bank of Japan will remain by far the most aggressively expansionary of the world's major central banks. The ECB will also remain a generous source of liquidity for the markets until at least March 2017 and there is speculation that the ECB (whose current monthly bond purchase target is EUR 60bn.) and the Bank of Japan may both raise their monthly purchase targets. Relative to other central banks the People's Bank of China has a lot of freedom to adjust policy and we expect that it will use this freedom to further reduce interest rates in 2016. Thus the world's central banks will continue to supply markets with large flows of liquidity in the coming year, remaining in a sense "at their service".

An increased number of negative headlines are to be expected from the EU in 2016.

Alongside the refugee crisis, the recently-concluded EU summit had a particular focus on the UK's demands if it is to remain a member of the EU. So far, the UK issue has not attracted much attention outside that country. This is surprising as the forthcoming UK referendum on continued EU membership, which must be held by the end of 2017, may in fact happen as early as this summer. We think this topic has the potential to unsettle markets in coming months, especially as it will bring into focus the many inefficiencies of the EU project. These inefficiencies are revealed by the EU's inability to deal with refugee and migration issues, the steady rise of public sector debt and the unwillingness to introduce meaningful structural reform. One way or another, we expect the EU will attract more negative headlines in the coming year and that these headlines will trouble markets.

Terror has taken on a new dimension.

The Paris attacks have heightened the perceived threat posed by terror. It is now widely understood that attacks on Western societies can happen at any time and that relatively small terrorist resources can cause damage and death on a massive scale. Were attacks such as those in Paris to be extended in any systematic way, the markets would be seriously affected. Leaving aside the terrorist threat, geo-political tensions are a continuing uncertainty so far as the markets are concerned. Obvious trouble spots include the Middle East, the East and South China seas and Eastern Europe.

The oil price still has further downside but should recover over the course of the year.

The oil price is hostage to an excess supply of oil currently standing at over a million barrels a day (mbd) worldwide. Supply is unlikely to decline as there is a furious battle among producers for market share and Iran is set to re-enter markets. But global demand should rise by around 1mbd this year if the world economy grows by 3% as we predict. With this perspective, we expect at least a consolidation of the oil price this year at around the $40 a barrel mark. In the nearer term, however, massive stockpiles suggest a further fall in oil prices is quite likely.

We begin 2016 with a neutral equity quota.

The continuing failure of the world economy to pick up steam is likely to provoke intermittent bouts of investor anxiety as to its fundamental health. Meanwhile, further weakness in the oil price in coming months could fuel default concerns. Then, the UK's EU referendum has the potential to unsettle investors from another direction. On the other hand, central banks remain in expansionary mode and thus represent a support for the financial markets which should not be underestimated. Although we expect an increase in market volatility, equities remain for us an attractive asset class, not least because, outside the US dollar area, viable investment alternatives are hard to find. We think we are well placed at the start of 2016 with our neutral equity quota.

Aquila & Co. AG, 21. December 2015

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