

What to Look For in 2016 – Bryan Dooley, CFA

Last week global equity markets slumped on renewed concerns over China's economic slowdown and further devaluation of its yuan currency. Coming into the New Year, we pause to reflect on the key drivers of last year's markets and what to look for in the year ahead.

For most investors, 2015 was an unrewarding year. Total returns on stocks, bonds and commodities ranged from negligible gains to steep losses depending on the asset class and investment style. Overall, last year was a manic-depressive ride as markets swung from hopes for further monetary stimulus in regions such as Europe and Japan to worries about U.S. monetary policy getting tighter as investors braced for the first interest rate increase in nine years. The MSCI World Stock index ranged from a high of 1810 in May to a low of 1550 in late September - a variation of almost 15 percent - before finishing the year at a slight loss.

China's decelerating economic growth and strategic rebalancing was a key theme driving markets in 2015 as it has been already this year. Lesser demand for raw materials from the world's second largest economy pummeled commodity prices, knocked down China's stock market as well as other emerging market bourses and roiled high yield bonds. Lower commodity input costs are normally growth-positive for developed countries, but markets have been very fickle lately. Investors seem to be indiscriminately throwing babies out with the bath water at times.

Developed markets have fared better than developing markets recently, but even within the better performing regions progress has become increasingly concentrated. For example, the so-called FANG stocks: Facebook, Amazon, Netflix and Google-Alphabet, accounted for a very large portion of the S&P 500 index's modest 1.37% total return in 2015. Without those heavily-weighted components of the bellwether index, the S&P 500 would have finished deep into the red. Meanwhile, the MSCI World Stock index fell 2.74% for the 2015 year as non-U.S. markets slumped in the second half of the year and the greenback rose against all other major currencies.

Adding to the turmoil, many of the dominant themes in the first half of year, such as soaring biotechnology stocks and advancing European share prices ended up being second half losers. In Q3, China's sudden currency devaluation contributed to the long-awaited official stock market correction – the first ten percent market decline in four years – followed by a decent bounce in Q4 which took the major markets closer to even for the year.

Lower for longer is the new mantra for oil prices, and that is also likely to be the case for both economic growth and investment returns in the year ahead. After the record-setting launch of the new Star Wars movie last month, Disney executives would probably agree that sequels are the way to go. But in the case of financial markets, we can probably just stay with the 'new normal' thesis popularized back in 2008.

During the financial crisis six years ago, a leading investment firm popularized "the new normal" theory which predicted the world was in for an extended period of sub-par growth. The premise for this conclusion was that excessive debt taken on during the prior two decades had effectively stolen growth from the future as those borrowings ultimately need to be repaid. Since nothing much has changed fiscally amongst the major government powers, a formidable headwind remains. A recent study by consulting firm, McKinsey Global Institute showed total worldwide debt has actually risen by \$57 trillion since the Great Bailout of the financial system, rising to 286 percent of global economic output from 269 percent since 2007. So much for the "Great Deleveraging" that was to follow the Great Recession.

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Slow growth may be the new normal but that is not necessarily a bad thing. Overheating economies have problems of their own, not the least of which is the typical central bank overreaction. Overall, I am generally comforted, by the steady, accommodative hand of most of the world's largest central banks.

For the year ahead expect equities to see the same heightened levels of volatility as last year. Besides the ongoing geopolitical stresses, the U.S. election in November is likely to create some additional fiscal uncertainties, especially given the rather bizarre cast of characters currently leading in the polls. On the plus side, earnings have had a year to catch up with high stock valuations and the energy sector should not be as much of a drag in 2016 assuming oil prices stabilize around these lower levels.

In terms of the central bank policy, rising interest rates by themselves likely won't tank the American economy or stock market as some fear. But if the Fed continues to press on with rate increases, performance is likely to remain uneven among sectors. Some sectors such as U.S. bank stocks could actually benefit from higher interest rates as the net interest margins earned on loans expand.

In fixed income, markets also saw increased volatility and a bit of a replay of the prior few years' forecasting blunders. Each year preeminent economists and the Fed itself forecast higher rates, only to be surprised later by another round of sluggish growth and flat to lower long term rates by the end of the year. Flat rates last year generally helped the performance of our Fixed Income strategies and in particular our holdings of preferred stock – which, despite its name, is really fixed income.

Get ready for yet another year of choppy interest rate movements with short term interest rates continuing to bump up towards one percent, while longer term rates remain low as the yield curve flattens. In this environment, we like the 'barbell' strategy using solvent, higher yielding corporate bonds and some commercial mortgage-backed securities (CMBS) for earlier maturities. Higher grade bonds and select preferred stock issues farther out the rate curve provide both extra yield and duration exposure.

Best Wishes for a Happy, Healthy and Prosperous Year Ahead!

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Stock Market Performance

	1/08/16	W-o-W	M-o-M	Y-o-Y
DJIA	16,346	-6.2%	-7.0%	-8.7%
S&P 500	1,922	-6.0%	-6.9%	-6.8%
MSCI World	1,561	-6.1%	-6.5%	-7.8%
S&P/TSX	12,445	-4.3%	-3.7%	-13.9%
BSX	1,303	0.0%	-2.2%	-4.2%
FTSE100	5,912	-5.3%	-3.6%	-10.0%
DAX	9,849	-8.3%	-7.7%	0.1%
CAC	4,334	-6.5%	-7.4%	1.7%
Nikkei	17,698	-7.0%	-9.2%	3.1%
Hang Seng	20,454	-6.7%	-6.6%	-14.2%
Shanghai	3,186	-10.0%	-8.2%	-3.3%

Key Rates and Prices

Currencies	1/08/16	Month ago	Year ago
EUR	\$1.09	\$1.09	\$1.18
GBP	\$1.45	\$1.50	\$1.51
JPY	¥117.26	¥122.93	¥119.66
CAD	\$0.71	\$0.74	\$0.85
CHF	\$1.01	\$1.01	\$0.98
AUD	\$0.70	\$0.72	\$0.81

Fixed Income

3M LIBOR	0.62	0.49	0.25
3M Treasury Bill	0.20	0.27	0.02
2Yr Treasury Note	0.93	0.93	0.61
10Yr Treasury Note	2.12	2.22	2.02
Fed Funds Rate	0.50	0.25	0.25

Commodities

Gold/oz.	1,104.05	1,074.96	1,208.73
Silver/oz.	13.94	14.17	16.36
Copper/lb.	2.03	2.08	2.77
Oil	33.16	37.51	48.79

Global Economic Calendar (January 11th—January 15th)

Mon: Adjusted Real Retail Sales (SWISS), Housing Starts, BOC Business Outlook Survey (CAD)

Tue: Industrial Production (GB), JOLTS (US), Merchandise Trade Balance (CH)

Wed: EIA Petroleum Status Report, Beige Book, Treasury Budget (US) Industrial Production (EMU)

Thurs: BOE Announcement & Minutes (GB), Jobless Claims, Import & Export Prices (US), ECB Minutes (EMU)

Fri: Merchandise Trade (EMU), PPI-FD, Retail Sales, Empire State Mfg Survey, Industrial Production, Consumer Sentiment, Business Inventories (US)

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