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Global Market Strategy – January 2016 & the year ahead

Damned if they do, damned if they don't

The US Federal Reserve finally raised interest rates in December, a decision which it both forced upon itself and was forced upon it.

The problem now is that emerging markets ('EM') will continue to struggle during 2016, faced with the sustained dollar strength because of the trajectory of US rates. This may help to explain why the market rallied strongly following the Fed announcement (the waiting was finally over), and then equally retreated when everyone realised both that rate rises would be slow and gradual because world markets aren't strong enough to take too much US anti-inflation medicine, and because momentary relief from US rate uncertainty paled against the cards now stacked against EM.

Ironically, the dollar's direction of travel against the euro could be reversed in 2016, despite more quantitative easing by the ECB. Both the dollar and sterling have soared against the euro in 2015 but the dollar at least, may have peaked because it is highly unlikely the US will raise rates again until the Autumn at the earliest. If the dollar does keep its current strength, there is less need for sustained ECB monetary easing, because the dollar/euro exchange rate is itself making the Eurozone more competitive.

If the dollar's upward trajectory is now limited, the pound on the other hand could keep rising against the euro since there is still an anticipation that Britain will raise rates sometime in 2016. 'Tis better to travel etc. Investors should expect sterling to rise to near 1.50 to the euro during the year. Against the dollar, a range of $1.40-$1.70 can be expected to continue.

2015 was a tough year to make money in any sector. In 2008, bonds rallied 30%. In 2015, there was no outperformance from any single sector. The main commodity index fell 30%. Energy fell 23%. Oil fell 32%. Gold fell 17%. The S&P500 fell 0.75% after posting an 11% increase in 2014. (Warren Buffet's Berkshire Hathaway had its worst year since 2009, falling 11%, mainly due to its exposure to American rail freight which was badly affected by lower commodity demand.) Both the FTSE100 and the IBEX fell 6.3%, but France, Germany, Italy, China and Japan rose 9.5%, 9.5%, 13%, 10.4% and 9.1% respectively. Most of the world's major banks revised their forecast more than once during 2015, yet still managed to get their analysis wrong. Canadian investment bank, RBC Capital, was among the most bullish of forecasters. It projected a 2015 year-end target of 2,325 points for the S&P500, driven by a "combination of earnings growth and multiple expansion." Instead, the index remained below 2,150 for the duration of the year and suffered some volatility, including when the Fed raised rates. The main market move, however, happened in August when the Chinese stock market crash spilled over into global markets and caused a correction in several U.S. benchmarks, including the S&P 500.

Preferred markets for 2016 are Europe and Japan, and the preferred sector is Financials.

Markets were taken aback in December when Japan said they would sustain but not increase their QE. The decision was the main reason for the mid-month sell-off of risk assets, and algorithmic trading exaggerated the retreat. Japan, however, has to continue attempting to stimulate a predominately export-driven economy with an ageing population, and so a weak currency will remain a priority. Consequently, foreign earnings should help to grow Japanese corporate top-line valuations.

Europe is supported not only by Draghi's "we will do whatever we must" promise to stimulate a return of gradual inflation, but also by the fact that many of the Eurozone countries have significantly reduced government deficit positions and, as shown by the recent Spanish elections, governments are warned against further hardline austerity. Being encouraged to take their foot off the throat of the populace, incentivises those in authority to offer the carrot rather than the stick, which in turn should lead to greater freedom in consumer spending. From a technical perspective, European corporate earnings are 22% below their 10 year historical mean, so there is considerable upside potential for expansion.

Globally, good retail numbers from the consumer for November is an indication people are spending the savings they have made from lower energy costs. There have also been signs of gently rising wages as labour markets widely become more competitive, largely rid of the excesses which preceded and brought about much of the financial crisis. It would be an exaggeration to claim inflation is back, indeed the main worry is a continued slow-growth environment, verging on deflation.

Such concerns put a brake on over-exuberance for equities, but an absence of quick-fire interest rate rises should bode well for gently accelerating equity investment while cash searches for yield.

Bonds generally offer an uncompelling avenue for investment in terms of value, although government bonds will remain well-supported as insurance against another deflation crisis. If there is a sell-off in the corporate bond market, it will bode badly for all other assets with the exception of government bonds.

Favoured investment plays:

Nil risk:	USD & GBP cash (in preference to Euro cash)
Cautious risk:	AAA Corporate / Government bonds (short duration)
Balanced risk:	Managed / Multi-asset funds
Market risk:	UK**, European equity**
Adventurous risk:	**Japan,** Asia**,** US equity
Speculative risk:	Timber, Water, **China,** India,

Disclosure:

Nicholas Chappell has the following personal investment exposure: Technology (US) 15%, US smaller cos 1%, (Other) US equity 7%, UK smaller cos 10%, (Other) UK equity 15%, Iberia 1%, European Telecoms 1%, (Other) European equity 8%, India 2%, Japan 10%, China 4%, (Other) Asia 11%, Energy 2%, Pharmaceuticals 10%, Cash 3%.