# 2016 outlook

## Mixed expectations: What's ahead for the global economy and markets in 2016?

AUTHOR

**Stephanie Flanders**
*Managing Director,*
*Chief Market Strategist for the UK and Europe*


## IN BRIEF

- In December 2015 we saw an interest rate rise in the US, further monetary loosening in the eurozone and another lurch down in oil prices – all key developments which will frame the outlook for investors for many months to come.
- The big message is one of divergence: the world is divided, not just by the direction of monetary policy, but by region and by sector, with the brightest spots in the global economy largely in the developed markets and close to consumers.
- Despite the prospect of further rate increases in the US and probably the UK, policy in most of the world is still highly supportive. It makes sense for investors to be tilted in favour of risk assets over core fixed income, and developed market (DM) assets over emerging ones.
- But at this stage of the cycle the base case for even favoured DM equity markets is for returns to remain in single digits. This strengthens the case for investors to explore alternate asset classes. If global growth worries recede, there could also be scope to boost returns later in the year through increased exposure to undervalued assets, for example, in EM.
- The risks we worry most about are another significant bout of dollar strength, due to missteps by the Federal Reserve or the European Central Bank, and/or a further weakening in global growth due to continued adjustments in emerging markets and the disinflationary forces coming out of China.
- Political risks are also a lurking concern, particularly the UK referendum on European Union membership, the European migrant crisis and the general election in the US.

## OVERVIEW: KEY THEMES FOR 2016

It's possible that the key events that will shape the global economy and markets in 2016 have already happened, in the closing weeks of 2015. December saw three meetings – by the European Central Bank (ECB), Opec oil producers and finally the US Federal Reserve (Fed) – which between them have set the tone for global investors for the first part of 2016, and quite likely the rest of the year.

With the loosening in policy by the ECB followed by a first Fed rate rise only two weeks later, we had decisive confirmation that monetary policy on both sides of the Atlantic is on divergent paths. Many developed central banks have tried to raise policy rates since the global financial crisis. None has been able to make that rate rise stick. In 2016, we find out whether the world's most important central bank will be the first – and manage to follow that rate rise with a few more.

More important for investors than the exact timing of this first US monetary policy tightening is the pace of subsequent rate rises, which was a key focus on the day of the December move. The strength of US consumption and investment will be important in paving the way for continued gradual "normalisation". But for investors it will also be important to watch the dollar and the price of oil.

That is where the Opec meeting comes into the equation. World energy prices fell by around 12% in December, partly because the producers represented at that meeting had failed to agree any reduction in oil production. This further decline in the price of energy appears to be largely supply-driven and should ultimately be positive for global consumption and growth. But as we learned in 2015, it also complicates the picture for central bank policy by pulling down inflation and  for investors via the effect on headline US corporate earnings. It has also caused problems for high yielding corporate debt.

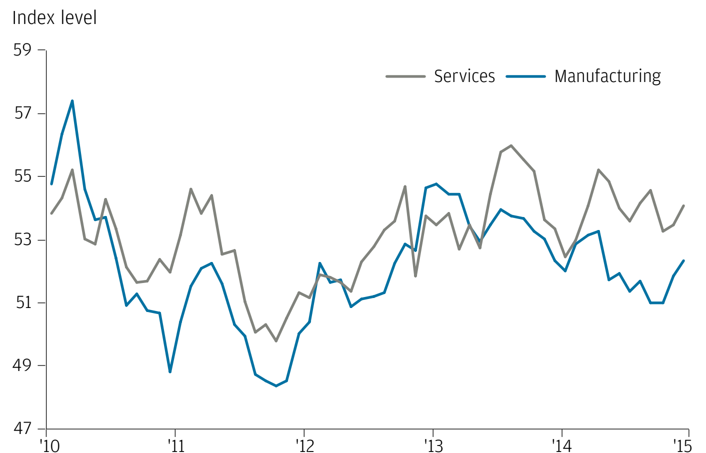
In this outlook, we lay out what we see as the key trends shaping the global economic landscape in 2016, before drawing out the key implications for investors. We end with a focus on the key risks hanging over markets – and the judgments we will be monitoring most closely as we move through the first part of the 2016.

### 1. A divergent global recovery led by DM consumers

We have become used to the theme of "divergence", but the divergence that we saw in 2015 was multi-layered and is unlikely to go away any time soon. The world is divided by region and by sector, with developed economies doing better than emerging ones – and within each country, service sector businesses generally doing better than manufacturing (as seen in **Exhibits 1 and 2**).

#### The manufacturing sector is weak globally but services have more momentum

**EXHIBIT 1: GLOBAL MANUFACTURING VERSUS GLOBAL SERVICES PURCHASING MANAGERS' INDICES**




Source: Markit, J.P. Morgan Asset Management; data as of 18 December 2015.

It's no secret why this pattern of growth exists. For several years it was the emerging market world that was contributing the lion's share of global growth, supported by cheap global liquidity, the rise of China and – often – credit-fuelled domestic recoveries. This helped to sustain the global recovery at a time when developed market households, businesses and governments were focused on retrenchment and rebuilding balance sheets after the Great Recession.

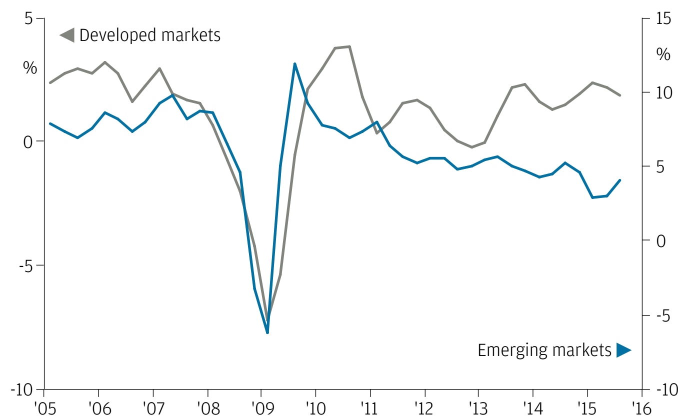
More recently, however, the balance has shifted and it has been the turn of the emerging market economies to adjust and retrench. Global trade is weak, China's demand for key capital goods and commodities has slumped and producer prices are falling in 14 of the 20 largest economies in the world. Now it is developed economy consumers that are carrying the global recovery forward. They can walk, but they are unlikely to run.

This mixed picture explains why global growth has been relatively weak in 2015 and is likely to remain so in 2016. But we do not expect a serious slowdown or recession, because we see decent supports for private consumption in developed markets going into 2016, including higher real wages, increased household borrowing and somewhat easier fiscal policy than in the recent past. This is especially true in the US and UK, where consumer spending looks set to rise by more than 2.5% in 2016, for the third consecutive year.

**Domestic demand is supporting growth in the developed world but holding back recovery in emerging markets**

**EXHIBIT 2: DOMESTIC DEMAND GROWTH RATE BY REGION**

Change year on year




Source: J.P. Morgan Economic Research, J.P. Morgan Asset Management; data as of 18 December 2015.

The eurozone grew by around 1.5% in 2015 and could do slightly better in 2016, though much will depend on whether private investment finally starts to pick up. The most encouraging feature of the past 18 months has been the relative strength in the periphery of the eurozone – notably Italy and Spain – and the pickup in domestic demand due to higher consumer confidence and the fall in the price of oil. Domestic demand rose 1.7% in the 12 months from October 2014, whereas net exports fell by more than 0.8%.

Japan has once again struggled to put years of intermittent growth behind it in 2015. The Bank of Japan (BoJ) has made progress in increasing inflation, but will not come close to reaching its target of 2% in 2016. Both employment and lending growth look healthy relative to the years since the global financial crisis, and micro-economic data such as rapid jobs growth at small companies suggests that structural reforms in some sectors are having an effect. But though there are improvements in corporate governance in key parts of the market, “Abenomics” clearly has a long way to go. Even if inflation does pick up in a lasting way, investors also do not yet have a convincing answer to the question of what happens to the country’s mountain of sovereign debt.

A key source of uncertainty in the outlook is China, which saw a significant slowdown in the core industrial side of its economy through 2015 and continues to have a significant disinflationary effect on the global economy. In effect, the industrial side of the economy has already had a “hard landing”, but services have been more resilient and account for a much larger share of GDP than a decade ago.

China’s ongoing challenge is to manage this cyclical slowdown without undermining the structural move to a more consumer-oriented economy, which would be good for global imbalances as well as being good for China. More than most emerging market economies, it also needs to find a way to unwind the financial excesses built up from the post-crisis credit boom – ideally, before it has fully opened its capital account to the rest of the world.

That is why we have not seen the kind of emphatic fiscal and monetary response to economic weakness from the Chinese authorities that we saw in the global financial crisis. But the authorities have acted to support the economy with successive reductions in interest rates and reserve requirements for banks, along with an expansion in certain parts of the budget.

In the latter part of 2015 there were signs that these steps were helping to stabilise China’s economy. If so, that could reduce the pressure for the authorities to use further exchange rate depreciation to revive net exports and tackle deflation. But China and its currency are a key theme for investors to watch in 2016, as we discuss further below.

## 2. Implications for monetary policy and the cost of money

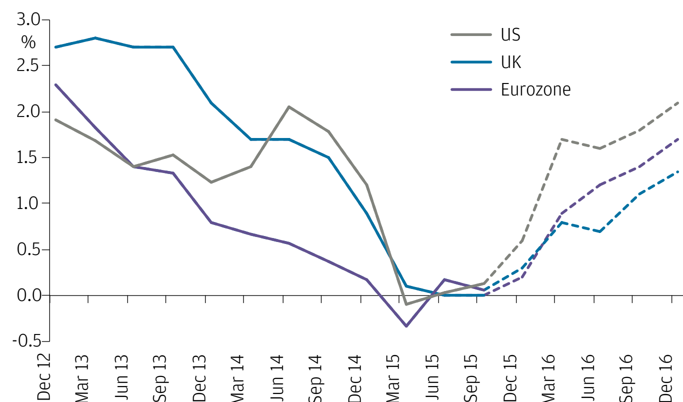
The coming divergence in global monetary policy has been hotly debated for well over a year, but we had to wait until the last month of 2015 to see official policy rates diverge in Europe and the US. Ironically, the US tightening in mid-December was greeted much more positively by financial markets than the ECB’s expansionary moves a few weeks earlier. There have been bumps on the road for the Fed, but considering the communication and policy challenges involved, the first part of this historic transition could have gone a lot worse.

In the case of the ECB, the extension of the minimum length of official bond purchases will expand the programme by roughly a third. The ECB also took its key policy rate further into negative territory, to -0.3%. The euro jumped against the dollar on the day the decision was announced, but is still ending the year around 3% weaker against the dollar than it was in mid-September, and around 12% weaker than at the end of 2014.

## Inflation is expected to pick up in most economies in 2016 but remain well below target in the eurozone

**EXHIBIT 3: INFLATION AND INFLATION FORECASTS**

Quarterly, change year on year

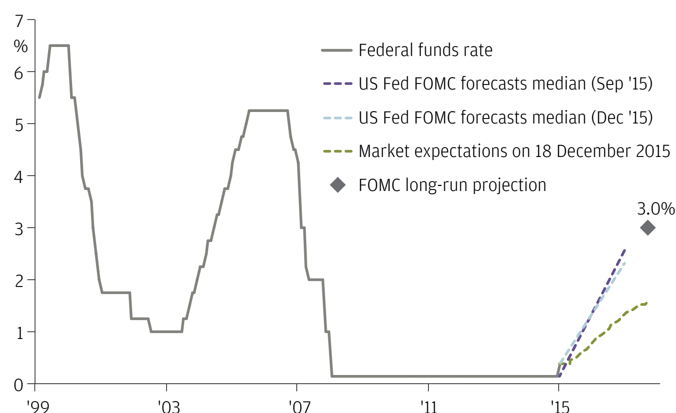



Source: Bloomberg, J.P. Morgan Asset Management; data as of 16 December 2015.

## The market is expecting an even more gradual path of US rate rises than the Fed

**EXHIBIT 4: FEDERAL FUNDS RATE EXPECTATIONS**

FOMC and market expectations for the Fed funds rate




Sources: Bloomberg, US Federal Reserve, New York Federal Reserve, J.P. Morgan Asset Management; data as of 16 December 2015.

It would be better for global financial stability if the ECB did not feel under pressure to push the euro down further in 2016. But that depends on what happens to eurozone inflation. As **Exhibit 3** shows, forecasters have less confidence that inflation will move back to target in the eurozone than in the US and UK. In fact, this is a key reason why monetary policy on both sides of the Atlantic is set to diverge.

As ECB president Mario Draghi has admitted[1], this weaker inflation is partly due to home-grown disinflationary pressures – including the fact that unemployment remains well above the long-term average, and the average eurozone growth rate is still well below 2%. But inflation prospects in the eurozone and other developed economies have been further complicated by the renewed decline in world oil prices.

The price of Brent crude fell another 12% in the first three weeks of December. That matters for policy and for markets, because it lessens the bounce-back in headline inflation that we would have expected to see in the next few months as the previous fall in oil prices dropped out of the annual comparison.

Fed president Janet Yellen has suggested that the Federal Open Market Committee (FOMC) will need to see further concrete evidence of upward wage and price pressure before increasing interest rates again. Along with the recent oil price fall, that puts the Fed on a path for at most three to four rate increases in 2016, which is a much slower pace of tightening than in the past. But **Exhibit 4** shows that even this modest pace is not as gradual as the future path for rates that is currently priced in by the markets.

How and whether that expectation gap is resolved in 2016 is a key issue for investors. The tacit consensus is that the FOMC will revise down its rate forecasts, as it has many times before since 2009. But if it is the markets that have to adjust to the Fed this time, that could deliver a significant hit to the bond market as well as providing unhelpful upward pressure on the dollar.

With its economy expected to grow 2.25%-2.5% again in 2016, the UK is clearly on the US side of the monetary policy divide, and the Bank of England (BoE) much closer to rate increases than the ECB. But the BoE's Monetary Policy Committee is in no rush to tighten. Though there has been a moderate pickup in wage growth in 2015, the exchange rate is a key consideration, and core inflation is still well below target. Faster productivity growth offers the prospect for real wages to pick up, without squeezing corporate profit margins or adding to domestic inflation.

Another potential argument for holding off rate increases in the first half of next year is the referendum on the UK's membership of the EU, which the government would like to hold by the early summer, and which could cause some volatility in sterling and other UK markets.

As mentioned above, the Chinese central bank is likely to be still in easing mode in 2016. Many central banks in the struggling emerging market (EM) economies will want to ease policy to revive growth and offset the negative effects of deleveraging. But any further round of capital outflows would clearly limit their room to do that, and may even force them to raise rates to defend the currency.

It's difficult to summarise the prospects for EM economies because conditions vary enormously and some – especially commodity importers such as India – are at a much later stage

[1] Global and Domestic Inflation, speech to Economic Club of New York, 4 December 2015. http://www.ecb.europa.eu/press/key/date/2015/html/sp151204.en.html

of adjustment than others. That's why it is important for investors to differentiate between them. We do know that developments in China will be key to the outlook, because many EM countries are now more reliant on Chinese growth than demand from Europe or the US.

## 3. Prospects for investors

We expected returns for developed market investors to be lacklustre in 2015 and they certainly were. A standard balanced portfolio of 50/50 global stocks and longer-term government bonds would have delivered a small negative return in 2015 of around 1%. The same portfolio in 2014 would have delivered a total return of more than 9%.[2]

We should note that the index returns in key markets have been heavily distorted by the sell-off in energy and other commodities, which means that many real-life investors will have done better than suggested in **Exhibit 5**. The distortion is particularly apparent in the UK, because energy and commodity companies account for such a large chunk of the benchmark indices and active managers could outperform by simply avoiding those stocks. Though the FTSE All-Share has delivered negative total returns in the past few years, the average UK equity manager is looking at a 6.2% total return year to date. Indeed, the average annual return for UK funds over the past three years has been 11.7%, compared with a 6.8% return for the FTSE All-Share.

We would expect 2016 to be somewhere in between the return trends of 2014 and 2015, with more upside potential for equities than in 2015 but also greater downside potential for bonds. In an environment of solid but unexciting growth in the US and other developed economies, and only gradual increases in US interest rates, it makes sense for investors to tilt their portfolios in favour of risk assets over core fixed income in 2016 – and developed market assets over emerging ones.

### Equity markets did much worse in 2015 than in 2014

**EXHIBIT 5: EQUITY MARKET PERFORMANCE**
Total return (percentage)

| | 2015 USD | 2015 local | 2014 USD | 2014 local |
|---|---|---|---|---|
| US | 1.2 | 1.2 | 13.7 | 13.7 |
| Europe | -2.1 | 9.3 | -5.9 | 7.2 |
| Japan | 8.4 | 10.9 | -6.1 | 7.12 |
| UK | -5.5 | -1.2 | -4.8 | 1.2 |
| EM Asia | -9.7 | -5.5 | 8.1 | 5.5 |
| EM LatAm | -28.5 | -6.2 | -12 | -0.63 |
| EM EMEA | -19.2 | -2.8 | -14.7 | 3.3 |

Source: S&P, Stoxx, Nikkei, MSCI, FTSE, J.P. Morgan Asset Management. US is S&P 500, Europe is Stoxx 600, Japan is Nikkei 225, EM Asia is MSCI EM Asia, EM LatAm is MSCI EM Latin America, UK is FTSE All-Share. Data as of 18 December 2015.

[2] Based on the MSCI AC World and the Barclays Global Government (7-10 year) indices

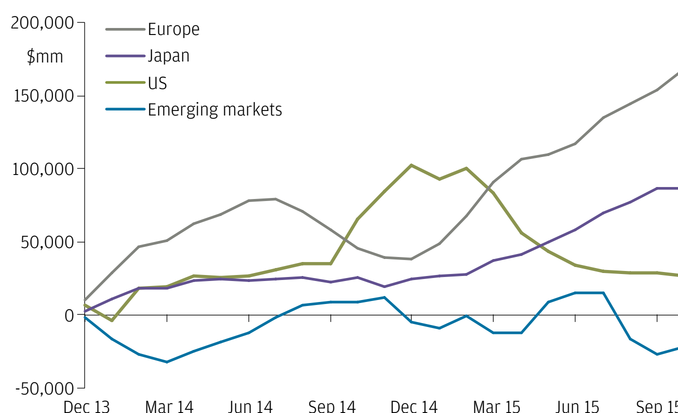
With the eurozone less advanced in the economic cycle, we see scope for Europe to continue to outperform the US. Japan was the best-performing developed market in 2015. That looks less likely in 2016, especially if the BoJ decides that the economy is doing well enough to manage without further easing.

The fall in oil prices suggests that the UK may show a similar pattern to 2014 and 2015, with the index underperforming but large parts of the market doing quite well, especially sectors that are close to the domestic consumer. As we discussed in a recent publication[3] it is unusual for the consensus trade – avoiding commodity stocks – to deliver such a high degree of outperformance. Sooner or later the tide for commodities will turn and it will be more difficult for managers to beat the index. This will be another key point to watch in the second half of 2016.

Money flowed out of US and EM funds and into Europe and Japan in 2015 (**Exhibit 6**). We may see this trend continue in the first part of the year, if the hoped-for recovery in US corporate earnings does not materialise and investors continue to be worried about the world's economic momentum and the adjustments under way in emerging markets.

### Money has flowed out of the US and emerging markets in 2015, and into Japan and Europe

**EXHIBIT 6: CUMULATIVE EQUITY FLOWS SINCE JANUARY 2014**




Source: MorningStar, J.P. Morgan Asset Management; data as of 18 December 2015.

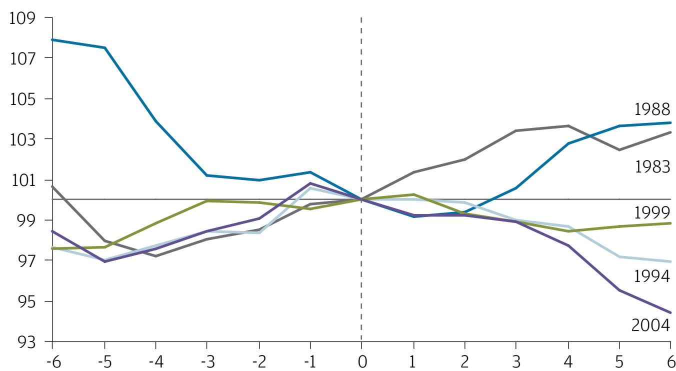
[3] "Market Insights: A fresh take on UK equities", Stephanie Flanders, David Stubbs and Alex Dryden, November 2015.

If global growth worries recede and US markets continue to take higher interest rates in their stride, there could be scope to boost returns later in the year through increased exposure to undervalued assets in emerging markets and energy. But the prospect of lower returns and higher volatility at this more mature stage of the cycle probably strengthens the case for increasing exposure to alternate asset classes such as hedge funds, as a source of both portfolio diversification and – potentially – downside protection.

### The dollar usually strengthens in the lead-up to US rate rises, but afterwards is a different story

**EXHIBIT 7: VALUE OF THE US DOLLAR: INDEXED TO 100 IN MONTH OF FIRST RATE HIKE**

Real trade-weighted exchange rate, broad definition. Month of first rate hike = 0




Source: US Federal Reserve, J.P. Morgan Asset Management. Month zero for each cycle was May 1983, March 1988, February 1994, June 1999 and June 2004. Data as of 18 December 2015.

## 4. Key risks and open questions

There is a wide degree of consensus in markets, and we know that at least some of these widely held views will turn out to be wrong. The downside risks we worry most about are another significant bout of dollar strength, due to missteps by the Fed or the ECB, and/or greater than expected weakening in global growth due to further adjustment problems in emerging markets and the disinflationary forces coming out of China. Political risks are also a lurking concern, particularly the UK referendum on EU membership, the European migrant crisis and the general election in the US.

These are the key calls for 2016 that we believe investors will need to keep under closest review:

- **A broadly stable dollar** The US currency usually strengthens in the lead up to higher rates, but once the tightening cycle is under way it has often turned (**Exhibit 7**). The consensus this time is that the dollar will continue to strengthen, at least in the first part of the year. This would be manageable, but another leap upwards could be damaging, not just for the balance of the US economy, but for broader global stability. The best outcome for investors would be a stable or falling dollar over the course of the year, because this would suggest that the momentum of global growth had shifted outside the US.

- **No recession in 2016** We are with the consensus in seeing no imminent threat of a US recession. This underpins our broadly positive outlook for 2016 and our belief that significant parts of the US and European high yield market will turn out to have been over-sold. But the persistent weakness in manufacturing worldwide and the recent quality and liquidity worries in US credit markets are both cause for concern at a time when bond markets are making a historic and potentially volatile transition to tighter monetary policy. Investors should keep their eyes out for signs that any or all of these issues are starting to contaminate the broader recovery.

## GLOBAL MARKET INSIGHTS STRATEGY TEAM

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*Managing Director*
*Chief Global Strategist*
*New York*

**Andrew D. Goldberg**
*Managing Director*
*Global Market Strategist*
*New York*

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*Executive Director*
*Global Market Strategist*
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*Global Market Strategist*
*Sao Paulo*

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*Global Market Strategist*
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*New York*

**Abigail B. Dwyer**
*Market Analyst*
*New York*

**Ainsley E. Woolridge**
*Market Analyst*
*New York*

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*Chief Market Strategist, UK & Europe*
*London*

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*London*

**Nandini L. Ramakrishnan**
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*Hong Kong*

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*Global Market Strategist*
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