2016 Global Economic and Financial Market Expectations

The Word of the Year in Financial Markets is “Gradual”

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As with every new year, we approach 2016 assessing whether it will be a green year for stocks (less volatile with a -1 standard deviation or better) or a red year for stocks (more volatile with a -2 or -3 standard deviation event). For 2016, we will likely see an increase in stock market volatility due to uncertainty surrounding Fed monetary policy tightening along with economic weakness in much of the rest of the world. However, the backdrop of low inflation, an expanding economy, stabilizing oil prices, slower U.S. dollar appreciation, and a Federal Reserve committed to "gradual adjustments in the stance of monetary policy" should result in another green year for most risk-based assets, particularly U.S. and European stocks.

Global Economy & Monetary Policy

- While global economic growth will struggle to accelerate during the first half of 2016, we believe the U.S. economy should continue to grow thanks to low inflation and accommodative Fed monetary policy. After strengthening significantly the past 2 years, the U.S. dollar should start to cool off while oil prices begin their bottoming process.

- Deflationary forces and restrictive fiscal policies in place across the U.S., Europe, Japan, and China will make it difficult for the global economy to avoid a slowdown. However, we are optimistic that as the year progresses, global monetary authorities outside the U.S. will step up their efforts to reflate their own economies to the benefit of worldwide growth. The pace and magnitude of Fed interest rate increases within the U.S. will be extremely slow and low.

- The Fed expects to raise the overnight Fed Funds rate 4x in 2016 bringing the rate to 1.375%. Market participants, including ourselves, think the Fed with raise rates only 2x in 2016 bringing the rate to 1%.

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- We believe the pace and magnitude of Fed interest rate increases will be extremely slow and low. We don't believe the U.S. or global economy can withstand a successive series of interest rate increases over the next year or two. Low inflation, a strong U.S. dollar, and economic weakness in Europe, Japan, and China (our largest trading partners) argue against the need for any significant interest rate increases. Low oil prices will help hold inflation down along with such global deflationary forces as excess savings, aging demographics, and restrictive fiscal policies.

- In the U.S. in 2016, GDP growth should remain in a 2% - 2.5% range. Employment is in a steady uptrend and wage growth will modestly strengthen as the labor market continues to improve. The savings from low oil prices should be very supportive for the consumer sector and spending. The housing sector will continue to improve. Dollar strength along with aging demographics, falling fertility rates, and deflationary forces from Europe, Japan, and China will continue to remain a headwind to economic growth. The U.S. will be one of the better- performing developed market economies.

- The Euro area economy will continue to spend much of 2016 fighting deflation. Private sector deleveraging is still at a very early stage compared with that of the U.S. ECB Chairman Mario Draghi has continued to emphasize that he will do whatever it takes to prevent a slide into long-term deflation. The ECB still has room to more aggressively ease monetary policy.

- Mired in deflation for the past 25 years, Japan's economy should continue to improve as we expect the Bank of Japan (BOJ) to increase its level of monetary policy accommodation in 2016 through increased asset purchases. The BOJ remains the world's easiest central bank and it should continue to make monetary policy even easier in 2016.

- The Peoples Bank of China (PBOC) has begun cutting interest rates and the government has started to increase stimulus through infrastructure-related investments. More monetary policy easing and fiscal stimulus packages should occur in the coming year to fight slowing economic growth. The country's transition towards consumption and services and away from exports and capital spending is in the early stages and will take many years to occur. Economic growth should remain in a 5-7% range in 2016.

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Financial Markets

- The key to future financial markets' performance will be the Fed's ability to communicate a very complex monetary policy shift from an unprecedented level of easing to the beginning of policy tightening. This situation is made more difficult by the fact that the ECB, BOJ, and PBOC are all still focused on easing monetary policy to promote economic growth. Chair Yellen stated that the initial rate increase in December of 2015 will be followed by "gradual" tightening as officials watch for evidence of higher inflation. The FOMC committee "currently expects that, with gradual adjustments in the stance of monetary policy, economic activity will continue to expand at a moderate pace and labor market indicators will continue to strengthen."

- Although the bull market in stocks is maturing, we believe it still has room to run in 2016. In order for stocks to outperform bonds and cash, earnings growth will need to improve. Earnings growth should be helped in the coming year by low interest rates, low inflation, and the fact that the economic headwinds from last year's 30% drop in the price of oil and 10% strengthening of the trade-weighted U.S. dollar should begin to subside. However, price appreciation may be slow and volatile, warranting a defensive position. Given the record highs made by U.S. stocks over the past six years combined with slowing growth outside the U.S., income may become a larger portion of total return than principal growth in the coming year as financial assets with relatively higher yields/dividends may outperform more aggressive growth-oriented assets.

- We favor U.S. and European stocks and are currently avoiding Emerging Markets stocks. Within the U.S., the outlook for profit margins is not encouraging because of tough pricing conditions and the potential for wage costs to rise. Market breadth has deteriorated over the past year with returns primarily generated by only a few large stocks. Nevertheless, monetary policy will remain accommodative for quite some time. There are no economic imbalances in place that indicate a recession is coming. There is not extreme investor bullishness that usually signals a vulnerable stock market. The U.S. is the most dynamic economy in the world with the deepest and most liquid stock market offering exposure to all styles and sectors. For 2016, we like the non-cyclical and defensive sectors of Healthcare, Consumer Staples, and Utilities. Overall stock market returns will most likely be in the mid-to-high single digits.

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- The ECB is in the process of a very aggressive bond buying campaign to help fight deflation. ECB monetary policy accommodation is about 2 years behind the Fed in the U.S. European stocks still look cheap by standard valuation measures and relative to U.S. stocks. Although we remain cautious on European stocks, if the ECB continues to deliver, European stocks could perform nicely in 2016.

- In emerging markets (EM) stocks, caution is warranted as many of these countries are tied to the performance of commodities which will continue to be in a bear market. On the economic and earnings fronts, things continue to look weak. Weak currencies are hindering monetary policy, global trade is declining, deflation is widespread, and forced deleveraging continues. Monetary policy in China is still too restrictive and will need to be aggressively eased in the coming year for growth to accelerate. Fortunately, the PBOC has plenty of room for further easing.

- Commodities will likely struggle again in 2016 as prices search for a bottom. The global slowdown in manufacturing has sustained the oversupply of many industrial commodities such as copper, iron ore, and aluminum. The strong U.S. dollar has also reduced demand. After the strong rally in the U.S. dollar the past two years, further advances should be minimal. As soon the dollar and industrial production begin to stabilize, commodities prices will bottom. This could happen over the next year but it is too early to invest in this asset class.

- The oil market is much more complicated. OPEC has refused to reduce its aggressive level of production in the face of falling prices. Non-OPEC countries are planning supply cuts for this year. Eventually, balance will be restored in the market as lower prices will induce higher demand just as non-OPEC production is declining. Prices should move higher in the latter half of 2016.

- While gold is a good hedge against geopolitical events or a major spike in risk aversion, the strong U.S. dollar and deflationary global forces will prevent it from having much of a recovery in 2016.

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- We do not believe that upcoming U.S. political elections will have any type of negative effect on the financial markets. The impact of a Democrat or Republican in the White House working with a Republican-controlled Congress should be a neutral event.

- Any acceleration of U.S. economic growth combined with the Fed beginning to "gradually" raise interest rates is clearly negative for bond prices. However, we believe the rise in yields will be a slow, gradual process given the unprecedented low levels of inflation in the developed world combined with current economic weakness in Europe, Japan, and China. Divergent global monetary policies (U.S. Fed tightening with Europe/Japan/China easing) will help keep a lid on U.S. bond yield increases/price declines. Yield spreads on investment grade and non-investment grade corporate debt should tighten (prices increase), especially from the current, extremely wide levels, as the global economy slowly grows and the pace of Fed rate increases is gradual.

- Given our modest projected level of growth for the U.S. economy and continued low inflation, fair value of the 10 year maturity U.S. Treasury Note yield should be in a range of 2.00 – 2.75%. With the 10 year U.S. Treasury currently trading at 2.22%, we expect U.S. bond yields across the curve to finish the year near the higher end of this range. A significant rise in bond yields should be prevented as the Fed takes a gradual approach to re-normalizing interest rates.

- Municipal bonds enjoyed a very good year on a risk-adjusted return basis versus almost every other asset class in 2015 due to decreased supply and a continued increase in demand by investors searching for a solution to a continual and seemingly unending growth in taxes. We feel this favorable environment for municipal bonds will continue in 2016. With this as our backdrop and very little change in anticipated interest rates, we feel 2016 will be another positive year for municipal bonds. Credit fundamentals for many cities and states strengthened in 2015 given increased tax receipts and defaults were extremely low. We do not see any triggers to dramatically reduce credit fundamentals of general obligation bonds from strong municipalities or essential service revenue bonds.

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Summary

The divergence of global financial markets and sectors that began in 2015 should continue in 2016. Global central banks are going their separate ways as the Fed began raising interest rates at the very end of 2015 while the ECB, BOJ, and the PBOC are all in the midst of further monetary policy easing. Uncertainty, volatility, and skittish markets may become the norm in the upcoming year as investors wait to see how the Fed manages U.S. monetary policy. The pace and magnitude of Fed interest rate increases will be extremely slow and low because we don't believe the U.S. or global economy can withstand a successive series of interest rate increases over the next year or two. Stocks should outperform bonds and cash. Earnings yields on stocks are much higher (more attractive) than bond yields, and stock market sentiment is very negative, which is usually a very good contrarian indicator for the future direction of prices. However, stock price appreciation may be slow and volatile, warranting a defensive position. Given the record highs made by U.S. stocks over the past six years combined with slowing growth outside the U.S., income may become a larger portion of total return than principal growth in the coming year as financial assets with relatively higher yields/dividends may outperform more aggressive growth-oriented assets.

In such an uncertain and complicated economic and financial environment, maintaining a balanced portfolio and taking a flexible approach to tactical asset allocation will be critical to portfolio success in the coming year as global financial markets wait to see how "gradual" Fed monetary policy tightening can be.

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January 4, 2016

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Notes:

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