EDISON

# Illumination: Equity strategy and market outlook

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# Global perspectives: Spigots shut-off - for now

- **First commodities, then emerging markets and now US high yield.** Although the Fed has only just raised rates (16 December), financial conditions have been getting tougher for some time as investors re-price credit and emerging market risks. While this was always going to be a very gradual tightening of US interest rates, recent market events already highlight the possibility of a pause in Fed rate increases – or even a reversal – during 2016.
- **2015 was a difficult year for investors.** Last year we highlighted the possibility of a strong start to 2015 with weakness in the second half. This was one of our better predictions - and we suspect many investors would have done better by taking a long summer holiday. Absent a major market rally into the end of the month, the majority of global asset classes will have delivered negative returns in US dollar terms during 2015.
- **We expect global equities to move sideways in 2016.** Aside from the question mark commodity markets place over the real pace of global growth, global equities remain fully priced in our view and we would not be surprised if major equity indices finished 2016 at levels similar to today - which would be a re-run of 2015. After December's increase, we believe US interest rates could end the year rather lower than Fed policymakers' current projections and the actual monetary policy divergence between the US Fed and ECB may become less acute compared to 2015. This would ease upward pressure on the dollar towards the middle of 2016. In bonds, we expect the yield curve to flatten, provided there is no surprise rebound in commodity prices, as 10-year yields remain near current levels.

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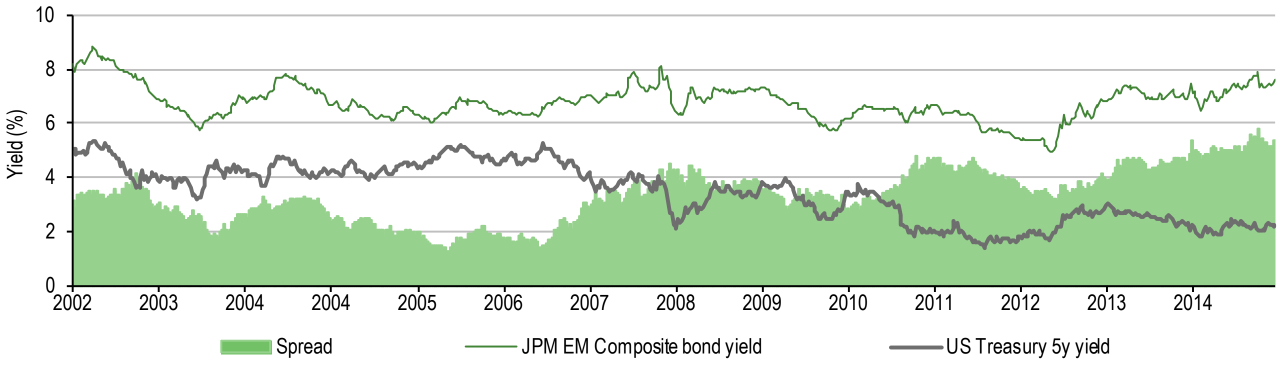
## Spigots shut off – for now

With the first increase in US interest rates in nearly a decade now behind us, data points keep turning up which indicate that a significant turn in the credit cycle could already be underway. First, the rise in the US dollar has stressed emerging market corporate borrowers. During 2015, EM corporate credit spreads against similar maturity US Treasury bonds have widened considerably, Exhibit 1.

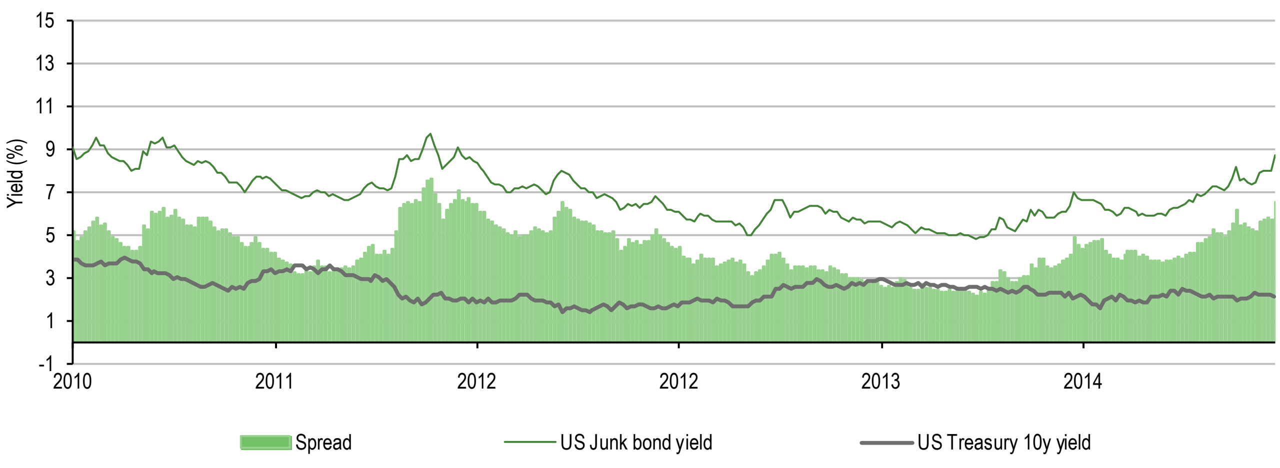
**Exhibit 1: Emerging market corporate bond yields**




Source: Thomson Reuters Datastream

Second, yields in the US high yield market have moved sharply higher in recent months, Exhibit 2, and are now close to their highs since 2010. As sovereign yields have remained relatively stable, the high yield credit spread is closing in on its highest level this decade.

**Exhibit 2: US junk bonds – yields at 5-year highs**

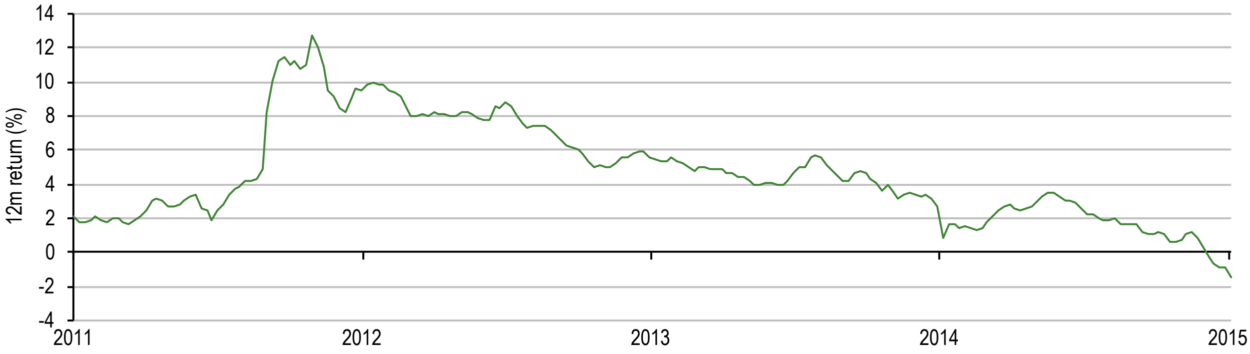



Source: Thomson Reuters Datastream

Third, in the space of a weekend two credit funds (Stone Lion and Third Avenue) have suspended redemptions, apparently due to a lack of liquidity in the US high yield bond market. While not nearly as shocking as the markdowns on supposedly safe money market funds in the lead-up to the 2008 crisis, these development are consistent with the flow of cash from reach-for-yield investors drying up as investors realise the days of US ZIRP are passing.

Fourth, prices of US senior leveraged loans have continued to decline over the autumn even as these would normally benefit from expectations of higher interest rates; this positive dynamic has been more than offset by concerns over credit quality, Exhibit 3.

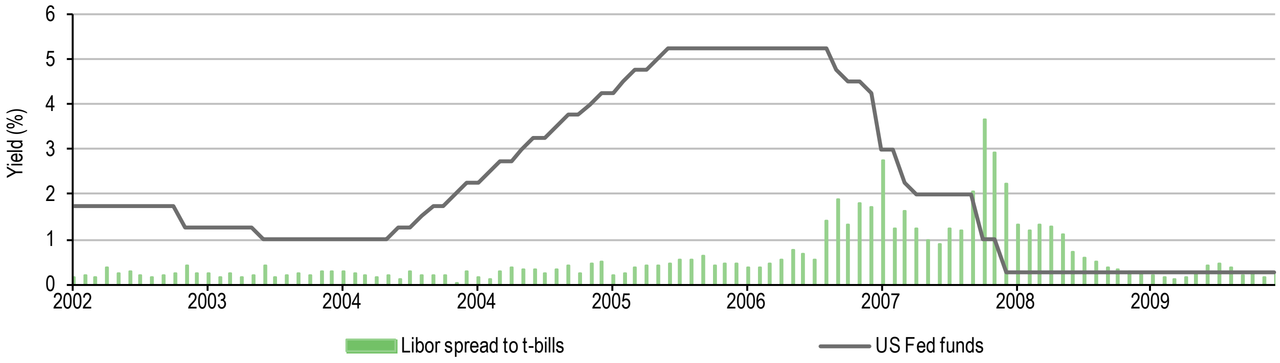
**Exhibit 3: Negative 12-month returns on senior bank debt**




Source: Thomson Reuters Datastream

In our view, it is not at all surprising that risk premia in US credit markets have increased from the very compressed levels which had already attracted policymakers' opprobrium in recent years. What we do think is remarkable is that investors are turning their back on issuers well before a single rate increase from the Fed. In 2007, the first signs of cracks in the financial system occurred two years after the Fed had finished tightening policy, Exhibit 4.

**Exhibit 4: Normally the crack in credit markets is after the Fed tightens...**




Source: Thomson Reuters Datastream

We are now wondering if declines in both equity and credit markets at the beginning of December may have unnerved Fed policymakers – something which has recently proved rather easy to do – and is arguably responsible for the market risk on/risk off volatility seen during Q4. Over the weekend before the FOMC, the WSJ reported that Fed officials were worried that US rates would go up in December, only to come back down soon after. This is exactly what has happened with many other central banks which have tried to raise rates since the 2007-09 period.

The concern appears to arise from the acknowledgement that long-run growth rates, and in turn equilibrium interest rates, are unlikely to be nearly as high as before. This is due to weaker productivity trends, adverse demographics and levels of debt/GDP, all factors which we have discussed at length previously. In consequence, rates cannot be cut as aggressively if demand weakens in future.

It was not immediately clear if the WSJ article, sourcing Fed officials just days before the FOMC meeting, was merely intended to calm markets with some 'leaked' forward guidance that rates are not on a one-way upward path. The summary of the article was rather ominous for US growth if reflective of Fed officials' private views, as it ended with the comment that "the age of unconventional monetary policy begun by the 2007-2009 financial crisis might not be ending." In this respect it was notable that during Fed Chair Yellen's press conference the priority was to make significant progress normalising interest rates before allowing the Fed's balance sheet to decline by slowing or halting the re-investment of principal and interest from securities holdings. Yellen also highlighted the desirability of getting rates to a level where they could be cut to stimulate the US economy if needed. We are unsure why the equity market responded so positively to the press conference on 16 December; a Fed which is raising rates in part to enable them to be cut later can hardly be described as investor-friendly.

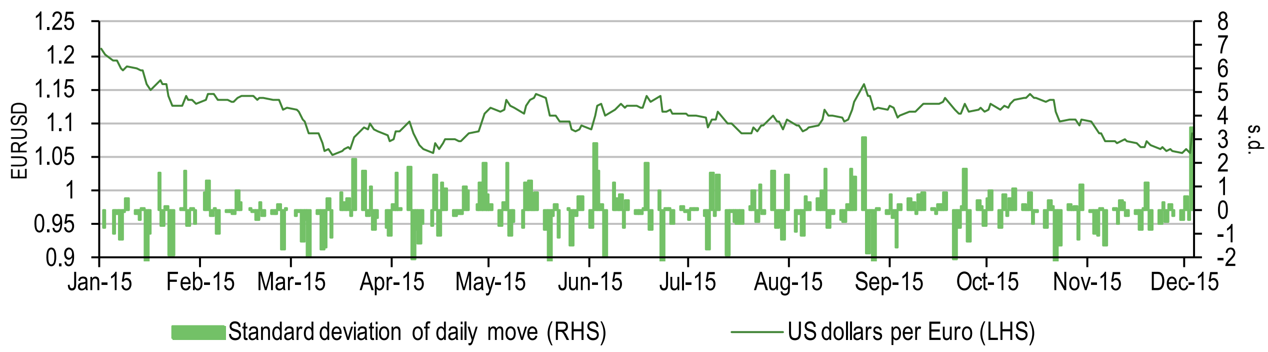
## ECB: Sins of omission

The sharp declines in European markets after the ECB's December monetary policy announcement highlights the credibility risk of talking the talk without following through. If you talk extensively about "**size**, composition and duration" – and then go on to highlight **duration** as the primary monetary policy change, then markets expecting fireworks will be certain to be disappointed. For the crowds of investors conditioned to push up equity prices and go short the currency on QE announcement days, size matters. Before the announcement, with the ECB emphasising that its asset purchase programme is "considered to be a particularly powerful and flexible instrument," we believed an announcement of an increased pace of QE was almost a given.

The policy divergence between the US Fed, on course to raise US rates with seemingly little concern in respect of global developments and the ECB, which remains much more focused on the risks emanating from a challenging external environment, has become increasingly stark during H215, notably in emerging markets. This is even as, paradoxically, the near-term momentum in the Eurozone has in fact been more encouraging than in the US.

But the December ECB policy decisions and commentary considerably narrow the policy gap between the two central banks. Unsurprisingly, the absence of an increase in the size of the ECB's QE programme led to a very strong day for the euro against the dollar, against a weight of expectations that the euro would continue to weaken into the end of the year, Exhibit 5.

**Exhibit 5: ECB disappointment caused largest move in EUR/USD during 2015**




Source: Thomson Reuters Datastream

The ECB will not have wanted to jolt markets in this way and may have been surprised how markets largely ignored the third component of the policy package – which is to re-invest any principal amounts received from securities purchased under QE programme, thus ensuring the ECB's balance sheet will monotonically increase at the rate of the additional monthly purchases rather than rolling off by default.

There may be a difference in perspective between policymakers and investors here; academic arguments may suggest the stock of bonds held by central banks is relevant in terms of the economic effect of QE programmes. However, such theories tend to be discounted by traders who know the marginal demand for a security which will have the greater impact on price than the stock held.

That said, the reinvestment of principal will lead to a greater gross amount of ECB purchases over time and perhaps the day's market reaction would have been softer had this been quantified by Draghi immediately, rather than a day later at an event in New York, as an additional €680bn of ECB QE by 2019.

The excuse given by Vítor Constâncio, vice-president of the ECB, that markets had got ahead of themselves does not really fit with Draghi's press conference comments that staff forecasts for inflation and growth included the easing in money markets which followed the pre-announcement of ECB policy changes at October's meeting. In our view, embedding market expectations into growth and inflation projections, yet later suggesting that they were unrealistic, is unintuitive to say the least.

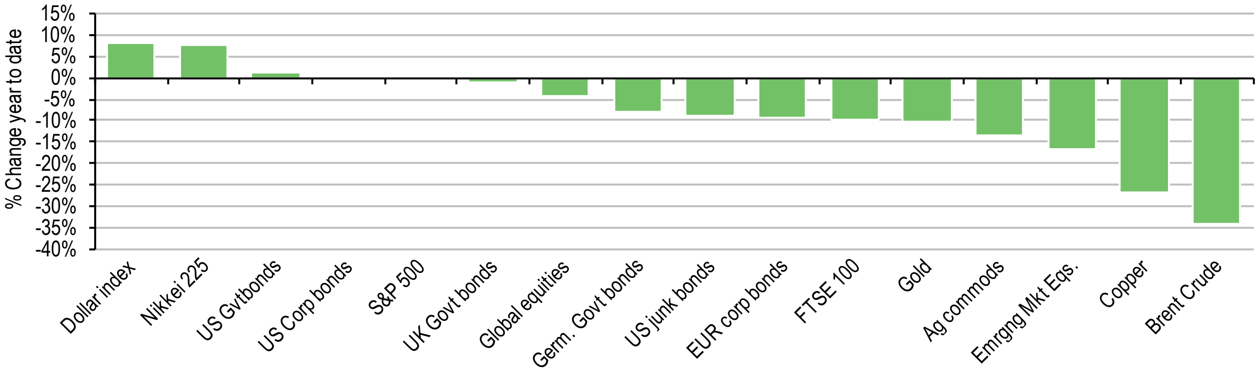
Ultimately, while the ECB claims not to target the exchange rate, the rapid depreciation of the euro since October may have given it pause to consider whether it was at risk of causing disorderly FX volatility if, as was the case, the US Fed raised US rates later in December.

## 2015: Caution was warranted – but 2016 no easier

2015 has proved to be a rather difficult year for global markets as most asset classes have delivered negative returns in US dollar terms, while commodity markets and commodity-related equity sectors are showing signs of distress. In a volatile year for equities in general, safe government bonds have not delivered the offsetting diversification benefits as yields started the year at levels already implying limited confidence in the economic outlook.

In 2015 we suggested the dollar would be strong due to the policy divergence between the ECB and Fed and a cautious approach to equities remained appropriate on the basis of valuation and growth concerns. For 2016, we find ourselves holding very similar views. For global equities valuations remain high in the context of slow corporate revenue growth. Earnings momentum also remains clearly negative on a global basis and is likely to act as a drag on equities.

**Exhibit 6: Global asset class returns in USD**




Source: Thomson Reuters Datastream. 2015 year to 15 December 2015

## Conclusion

Though US monetary policy will be tightening only very slowly during 2016, US credit markets are already beginning to feel the pain as liquidity evaporates in the high yield market. It remains an open question whether this tightening of credit conditions will propagate into other markets but is clearly not helpful for global equity performance during 2016.

Aside from the question mark commodity markets place over the real pace of global growth, global equities remain fully priced, in our view and we would not be surprised if major equity indices finished 2016 at levels similar to today - which would be a re-run of 2015.

After December's increase, we believe US interest rates could end the year rather lower than Fed policymakers' current projections and the actual monetary policy divergence between the US Fed and ECB may become less acute compared to 2015. This would ease upward pressure on the dollar towards the middle of 2016. In bonds, we expect the yield curve to flatten, provided there is no surprise rebound in commodity prices, as 10-year yields remain near current levels.

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