UNION BANCAIRE PRIVÉE

Press release

Outlook 2016: No Growth, No Gain?

2016 will be about the search for modest growth, while Fed fund rates will be hiked for the first time since 2007. While the US is further along into its recovery, Europe and Japan are only in the early stages of their growth momentum. China, in contrast, is set to grow at a slower pace than in previous years, as it continues with its economic and structural reforms. In all, world growth should remain moderate, and any positive surprises – such as economic growth beating expectations or wages rising more than forecast – look unlikely.

While corporate earnings should be positive, the year could be marked by periodic scares as the effect of rising US key rates spills over into vulnerable sectors such as emerging markets, which means that volatility will remain quite high.

The only way is up

2016 should see an end to the downward trend in long-term interest rates that has prevailed for the last 35 years, with the US being the first economy to raise rates. Despite uncertainties remaining, the probability of a Fed lift-off in December has increased, and market expectations have changed significantly. "The Fed should, however, remain cautious, as it strives to manage both external risks (such as China and unstable financial markets) as well as domestic ones (for instance, low unemployment and the potential for upwards pressure on wages)", says Patrice Gautry, Chief Economist.

In view of this, managing interest-rate exposure is imperative. The focus should be on asset classes that are less sensitive to interest rates, such as high-yield and convertible bonds. For investors in the credit market, the focus should be on the spread component, with the interest-rate component stripped out, as well as on a short duration. Equity markets should also be favoured in this environment: indeed, as long as the Fed remains cautious on managing its interest rates, the impact on equities should be modest – in fact, rate rises in the past have had a positive impact on equity markets –, and we expect price-earnings multiples to stabilise.

Europe looks positive

We believe that the outlook is brighter for developed countries than for their emerging counterparts. This is particularly true for the eurozone, as its stock valuations are decent, its central bank's policies are accommodative, and its underlying economy is starting to gain traction. Currently, Europe seems to be where the US was three years ago when they launched their quantitative easing programme; this means that European corporate earnings should throw up some good surprises in 2016. This in turn bodes well for consumer discretionary and sectors related to the domestic-cycle recovery.

Technology will drive growth

"With moderate growth, our favourite theme remains that of technology. The increasingly digital world will continue to transform our lives and, of course, our economies, and this is why we are favouring this sector", explains Jean-Sylvain Perrig, CIO. Its cost-effectiveness and its ability to scale quickly are additional positive factors, and, as technological innovation increasingly pervades our everyday lives, the sector is also becoming less susceptible to cyclical volatility. Valuations are still attractive, especially when compared to the potential for growth. This is also true for the health-care sector, which could pick up some of its lost momentum, as fundamentals appear unaffected.

More generally, we like growth stocks, which can also be found in the consumer discretionary sector, given that sustainable and above-average earnings growth will continue to be rewarded with significant premiums.

Country-picking in emerging markets

Even though we clearly continue to favour developed markets over emerging markets, careful country- and sector-picking could offer performance opportunities.

“2015 was an extremely harsh year for emerging markets, driven by concerns over China. These should, however, gradually abate thanks to the range of stimulus measures applied across several sectors, and as domestic consumption and investment already show signs of bottoming out”, underlines Patrice Gautry. A rise in rates and a strengthening dollar should continue to weigh on emerging markets’ performance, and a potential credit event or threats to a few large banks would not come as a surprise; however, a general collapse of emerging economies and a systemic crisis seem unlikely.

Past experience also shows that times of crisis can help kick-start economic reform. For example, after the Asian financial crisis, many east Asian economies benefitted from structural reforms, making them more effective and efficient. In countries such as India, a change in government allowed for impressive returns, comparable to those in more developed markets. India is still a country that we expect to perform well, along with Mexico; in contrast, we are less enthusiastic about Brazil.

Adapt portfolio to more moderate growth

As the world is working in moderate growth mode, investors will have to adapt their portfolio strategies and look out for sources of earnings.

“In 2016, we expect portfolio performance to yet again come from equity allocation, with developed equity markets continuing to outperform emerging markets. Adopting a highly selective stock-picking strategy will once again be key: while we remain bullish on equities, we believe that we are nearing the end of the rally”, concludes Jean-Sylvain Perrig.

On the downside, commodity markets will continue to be a source of deflationary risks. This may cause central banks to miss their inflation targets and affect commodity-driven economies and companies.

Overall, 2016 will be a challenging year, but investors who stay the course in selected sectors and asset classes should be able to generate attractive returns.

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