Global Commentary

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Avalon Advisors
GLOBAL INVESTMENT MANAGEMENT

2016 Global Outlook

2015 was a difficult year for equities. Global equity markets were down 1.88% in US dollars. A few markets like Japan (+9.92%) and the US NASDAQ (+7.1%) performed reasonably well. Emerging markets did poorly, down 14.87% with the notable exception of China. Both Shanghai and Shen Zen, despite massive volatility and a major correction, managed to generate positive returns of 6.43% and 56.91%.

Looking forward to 2016, we will still have to deal with the consequences of the Chinese economic slowdown which started affecting markets in the second half of 2014. The repercussions of this slowdown are still filtering down to the global economy and are currently affecting all the trading partners of China, both emerging and developed. It is impacting commodity markets and correlated industries like mining equipment, steel, rail and shipping. It is a significant burden for the finances of countries like Saudi Arabia, Russia, Canada, Australia and US states like California, Oklahoma, North Dakota and Texas. Because this slowdown is the result of deep structural imbalances, it seems difficult to make the case that the Chinese economy will turn on a dime and return to its prior growth rate any time soon. Consequently we are keeping a conservative posture when it comes to commodity producers and their suppliers and financial institutions exposed to these industries.

The US is facing several headwinds: a stronger dollar (up 9.25% in 2015), increasing interest rates, a severe downturn in the oil and gas industry, increasing minimum wages which affect industries like retailing or restaurants, and mounting healthcare costs. Also, existing deflationary tendencies, either imported or domestic, severely limit pricing power. In such an environment, GDP growth will probably remain below its 2.5% trend line. If not a recession, a lull is possible as corporate earnings growth could be challenging. Therefore the premium valuation of growth compared to value should perdure.

On the other hand, Europe and Japan are clear beneficiaries of lower commodity prices. With the exception of UK and Norway, their extracting industries are insignificant. Europe and Japan are still benefiting from large quantitative easing programs, lower interest rates, lower valuations, better earnings prospects and cheap currencies. The companies serving their domestic market or with significant business in developed markets are well positioned in this environment.

Most affected of all are the emerging markets, as they are often significant commodity exporters like Brazil or Russia. Also because of limited local capital markets, they often borrow in USD and peg their currency to the USD; a painful combination when the dollar goes up. So most, if not all emerging markets, have performed very poorly and we do not expect any material change in the present environment. One of the very few beneficiaries of present conditions is India. Unfortunately its stock market is quite expensive. We therefore remain underweighted in all emerging markets.

Finally, this outlook would not be quite complete without commenting on the political landscape. In the years following the last economic crisis, the level of discontent and frustration among voters faced with seemingly insurmountable problems has not abated. From Argentina to Greece, from India to Poland, antiestablishment candidates have come to power. Scotland and Catalonia have considered seceding. The United Kingdom is, again after 40 years, holding another referendum about exiting Europe (doubtful), so more surprises on the political front are quite possible. For instance, the impeachment of the president of Brazil is a possibility. Most problematic seems to be Venezuela, which is headed toward either martial law or a revolution.

In conclusion, we assume that the Fed will further increase rates during the year. Oil will remain in a trading range, barring some major geopolitical event. The US dollar will remain in a trading range against the Euro and the Yen. Inflation and long term interest rates will remain low in developed markets. We remain underweight in materials, energy and their suppliers and all emerging markets. We remain overweight in Japan and Europe.