Outlook as of January 2016

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World Economy

- We expect US consumers to drive global growth in 2016, aided by still-low interest rates, lower energy costs, and cheaper import prices from the stronger dollar.
- The late surge in holiday sales was an encouraging signal that US consumers are finally comfortable spending the savings from the steep decline in energy prices. US GDP growth in 2016 will be driven primarily by this bargain-conscious consumer. Federal government spending should also be additive to GDP for the first time in five years and help offset incrementally tighter monetary policy.
- A slight uptick in German consumption is a tentative sign of economic improvement in the Eurozone. However the region remains reliant on exports and a weak euro to boost GDP growth and inflation from their current anemic levels.
- Japan is finally seeing a rise in exports from the weaker yen. If additional quantitative easing measures are not implemented, fiscal constraints will limit the support that can be provided from government spending and a further delay in the planned sales tax increase will be necessary to forestall yet another recession.
- China continues the difficult task of working down excess inventories caused by the explosive growth in industrial spending over the last decade. While the government has both monetary and fiscal policy flexibility at its disposal, strong consumer spending is required to offset the lost growth from lower capital investment.

Monetary Policy & Currencies

- The US monetary tightening cycle has finally begun, although the Federal Reserve reiterates the gradual path of expected rate increases. Continued low rates will still provide substantial monetary accommodation to the overall economy.
- Investors were disappointed that last month, the ECB failed to raise its monthly bond purchase program beyond the current €60 billion target. The resultant strength in the euro may derail the nascent economic recovery and lead to pressure for further stimulus early in the New Year.
- The Bank of Japan remains hesitant to expand its balance sheet. Instead, it will extend the maturity of bonds and broaden the pool of securities eligible for its QE program. Any ensuing strengthening in the yen could be detrimental, both to economic growth and the bank's inflation targets.
- Delays in expanding these key central bank balance sheets caused some dollar weakness against the euro and yen last month. Nevertheless, divergences in both relative interest rates and the direction of central bank policy should favor the dollar over most developed market currencies in 2016.

Bond Markets

- Interest rates across the US yield curve rose mid-month in response to the long-awaited announcement of a quarter-point rise in the Fed Funds rate. The entire yield curve should continue to shift upward in equal proportion as the Fed tightens into a strengthening economy.
- Sub-investment grade bonds have experienced notable price weakness as a number of distressed debt funds suspended investor redemptions in December. Default concerns continue to be confined within the energy and metals/mining sectors, with little indication of contagion spreading to other areas of the bond market.
- Better economic growth and higher state tax collections offer a generally healthy backdrop for municipal bonds. Pockets of weakness do exist among some well-known credits, so selectivity and diversification remain important factors when navigating this asset class.
- Developed international bonds remain unattractive, given the extremely low levels of absolute yields and the potential for unexpected rate spikes, as we saw in December. By contrast, emerging market debt is much more appealing as many (although not all) emerging central banks still have flexibility to lower short term rates. Dollar based exposure is strongly recommended as EM currencies would most likely weaken along with falling rates.

Equity Markets

- Despite basically flat US equity returns in 2015, the secular bull market characterized by advancing valuation multiples continued as earnings declined last year due primarily to a sharp drop in energy and materials sectors. Earnings this year are expected to rise in both absolute and relative terms, from better economic growth and easier comparisons to the prior periods, respectively. Hence, we foresee stocks advancing over the course of 2016.
- European equity markets remain reliant on continued monetary easing to spur economic growth and provide further currency devaluation to boost export activity. With fundamentals beginning to improve and monetary policy expected to be incrementally more accommodative, equity markets should improve in local currency terms.
- The strong 9.3% advance in the Nikkei in 2015, coupled with the BoJ's reticence to implement further monetary easing, suggest greater caution around the Japanese equity market for 2016.
- Emerging markets equity returns over the last two years have been hurt by the abrupt end of the commodity supercycle. Overall valuations are now at very attractive levels. If commodity prices do not fall too far from current levels, we should see better returns in 2016, principally from economies that benefit from lower energy prices and greater export competitiveness.

Alternatives & Commodities

- Expected defaults and bankruptcies in the US energy sector should take excess production capacity out of the market and allow prices to stabilize. However, continued high output from OPEC producers, plus the impending resumption of Iranian oil exports, should prevent prices from rising materially in the near to mid term.
- A Fed tightening cycle is generally an unfavorable environment for precious metals, as it raises the opportunity cost of holding the commodity. The gradual nature of the rate rises should help prevent significant price declines this cycle.
- Industrial metals continue to be closely tied to Chinese growth. As stabilization in China appears to be more reliant on consumer as opposed to industrial spending, prices may still be vulnerable and the recovery may take years to develop.
- With the advent of higher US interest rates, hedge funds positioned for macroeconomic uncertainty and market volatility are attracting greater interest from investors seeking downside protection and lower correlations to less stable public markets.
- High asset valuations make it challenging for private equity firms to buy assets at reasonable prices; hence, we focus on disciplined managers and secondary funds to add value. We also look to opportunities in private debt and infrastructure, where valuations are more reasonable.

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Ben is the firm's Chief Investment Officer and a member of the Investment Committee. He has more than 25 years of experience in investment management. Prior to joining HPM Partners, he was Chief Investment Officer and Head of Global Investment Solutions for Deutsche Bank Private Wealth Management in the U.S.

Ben has been featured in the *Wall Street Journal* and *Reuters*, and is a frequent commentator on Bloomberg TV and radio, Fox TV and CNBC, appearing regularly on network programs such as *Power Lunch, The Closing Bell, Squawk Box, and Worldwide Exchange.*

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