MARKET OUTLOOK 2016

Looking out, there is little reason to expect the rich global supply of savings to decline much from current levels. The deleveraging cycle will eventually end, but unless there is a new releveraging cycle, household saving rates will remain elevated. Likewise, despite a sharp move towards fiscal deficits in a number of petroleum-exporting economies, the IMF expects cyclically–adjusted budget balances to continue to improve over the coming years. Thus, the public sector's contribution to the global savings glut will, if anything, continue to increase. Where things do seem to be changing is on the investment side. Four factors are decreasing investment demand. First, the debt supercycle in emerging markets is cresting. These countries have been responsible for all of the increase in the global investment-to-GDP ratio over the past 15 years. Second, the drop in commodities prices is prompting companies in the resource sector to slash capex budgets. Third, global potential GDP growth is slowing, partly on account of lower productivity growth, but mainly because the working-age population is expanding more slowly, which means slower future demand growth. Fourth, the move to a "capital-lite" economy is reducing demand for heavy machinery and other big-ticket investment items because value is being derived from making better use of the existing capital stock. Therefore the supply of global savings is likely to remain ample at a time when global investment demand is trending lower. This is a recipe for lower **interest rates**, a point that much of the investment community seems not to have grasped.

Looking out, the performance of US **stocks** will hinge on whether incoming economic data validates the FED's decision to hike rates. Stretched valuations and a challenging earnings outlook dampen the picture somewhat. US stocks now trade at a Shiller P/E of 24, ca. 20% above the post-1960 median. However, a low discount rate implies a higher present value of future cash flows, and hence a higher P/E for stocks. Equity valuations outside the USA generally have a lower valuation, and corporate profit margins have more scope to rise. As such, non-US stocks are likely to outperform their US peers over the long haul. European equities are quite cheap, trading at a Shiller P/E of just 14. This, combined with accelerating profit growth and improving business confidence, should give euro area stocks a lift. Emerging markets have clearly gotten cheaper over the past few years, but have yet to reach washed-out levels and become a compelling buy. The Chinese H-shares are quite cheap, trading at a forward P/E of 6, and at a price–to-book ratio of only 0.9. This is below the valuations that US stocks traded at in 1982, the start of the 18-year bull market. Earnings- per-share, as well as dividends, have increased more rapidly in China than in the USA over the past nine years.

The **dollar's** slide between 2000 and 2008 was likely influenced by a growing reluctance among foreign investors to continue shoveling ever more money into the USA. The global financial crisis and subsequent euro crisis reversed this trend, as it made US assets seem attractive relative to all other alternatives. The shale boom also helped reduce the US petroleum import bill, narrowing the trade deficit in the process. Nevertheless, the dollar will ultimately need to fall substantially in order to eliminate what would otherwise end up being a persistent current account deficit. Working against the valuation drag on the dollar are cyclical forces, which remain dollar supportive. This is most clearly the case in the emerging market world, where weak growth and capital outflows are likely to keep emerging market currencies under pressure. To a lesser extent it is also the case in the developed market space, where the FED remains the only major central bank contemplating raising rates further. The market expects US rates to exceed rates in the euro area and Japan for a very long time. This means that investors will only buy lower-yielding bunds and Japanese government bonds if they expect the euro and the yen to appreciate against the dollar for many years to come. However, for that to happen, the euro and yen must first undershoot their fair value. With the FED still guiding for four rate hikes this year - compared with the market's expectation of two hikes - the risk is that rate expectations drift higher before they drift lower. This means that the dollar could strengthen some more in the next few months, before coming back down later this year.

The steep decline in the **oil** price was a result of the growth in shale oil production, which made it impossible for OPEC to maintain its hold over prices. In addition Saudi Arabia could have cut production to make way for increased shale output, but this would have benefited Iran and Russia, something the Saudis did not want to do. The central role played by certain governments in the production and ownership of oil creates situations where the state is primarily interested in maintaining a stable level of revenue from oil sales. Crude prices are now being set in the free market, and in a free-market equilibrium, the price of oil will be driven down to the cost of production for marginal producer. The marginal producer is in the shale space, where break even prices are in the mid-USD 50 range. However, due to continued technological progress, the breakeven price has been steadily trending lower, and could reach the low-USD 40s by the end of the decade. The long dated oil prices, which are still close to the mid-USD 50s, could fall further from current levels.