AllianzGI 2016 Global Outlook: Volatility Ahead!

30 November 2015

Understand: Executive Summary

2016 looks set to offer a similar set of opportunities and risks to those that emerged in 2015. Economic growth will remain low and fragile, but we do not expect weakness in many emerging economies to drag all economies down into a global recession. Nevertheless, we expect monetary policy to remain extremely benign, with modest rate hikes in the USA in 2016 offset at a global level by potentially lower interest rates and more QE from Japan and Europe. Politics and geopolitics will add some additional volatility into the economic policy mix during 2016.

We thus expect more asset market volatility in 2016 which may favour more active management investment styles, and render the recent trend of indexing and ETFs less able to deliver returns to clients. Clear investment philosophies and disciplined investment processes, which focus on the longer term, have the potential to allow AllianzGI to deliver attractive alpha returns to client portfolios during a time when beta returns may be low.

Economic Growth

As 2015 has progressed, the world has seen estimates for global GDP growth revised lower and lower, now to levels well below that before the Global Financial Crisis. Our expectations for 2016 remain at the moderate end of expectations, consistent with our guiding narrative of Financial Repression.

All of the main regional economies face similar, yet different, economic challenges which will need more political and fiscal initiatives than we have seen thus far, while the strong monetary impulses from Quantitative Easing (QE) wane at the Zero Interest bound.

The USA has flattered to deceive all year, affected by remarkable weather conditions and the stronger dollar. Despite falling unemployment levels and low oil, consumption and investment have both been duller than expected and we envisage a similar outcome for 2016. Wall Street expectations will, no doubt, herald the attainment of economic escape velocity in 2016, whilst we expect a more sanguine result, with the economy expanding circa 2-2.5%.

Allianz Global Investors

Understand. Act.

Europe: The Surprise Package of 2015

Europe has been the surprise package of 2015, with very low expectations of economic growth at the beginning of the year. However, the onset of ECB QE and the sustained weakness in the Euro have helped growth to rise through the year, to circa 1-1.5%. Additionally, it is clear that ECB policies and regulatory oversight of the Eurozone Banks is now finally delivering credit into the economy, boosting investment and employment. The latter is then boosting retail sales and consumption, which have also benefitted from the much lower oil price.

Austerity within Europe is being quietly ended, so we remain optimistic that Europe can sustain its current growth rates into 2016, supported by the strong commitment from the ECB to keep the Euro at current levels through its QE program. Locally, we have seen strong restructuring progress in Portugal and Spain, showing that sensible austerity, when melded with good ECB policies for the banks, can address some of the EU crisis issues. Italy has now started on the same path and even France is showing signs of adopting more employment and labor market flexibility. Germany has remained resilient and we would expect it to remain so in 2016, although it remains most sensitive to the slowdown in Emerging Markets and in investment generally.

The UK has had a strong year in 2015 and we believe that 2016 may see some consolidation of this progress. Sterling remains strong, hampering further export success and as real wages are showing signs of losing momentum, albeit at decent rate of circa 3%, further consumption improvements may be limited. We would expect the UK to benefit from further market reforms by the new Conservative Government, keen to attract international investment.

Eastern Europe, whilst currently affected by the Syrian migrant crisis, has stabilized after the tensions which emerged over the Ukraine and remains supported by many EU infrastructure initiatives. Russia, however, is suffering from a serious recession as the collapse in commodity prices takes a heavy toll on the economy and any economic improvement will remain tied to higher gas and oil prices. Turkey has been badly affected by both the strains in the region geopolitically and by its own political elections that have stalled clear economic policy choices, which should now become easier after the clear-cut election results.

China: Economic Rebalancing

China, the world's second largest economy, has been slowing down for some time as its inevitable economic rebalancing from fixed asset investment and the Manufacturing sector towards Services and Consumption takes place very slowly. In addition, declining productivity growth, too much debt, and the appreciation of the RMB is weighing on the economic growth trend. Official statistics still report real growth hovering around 7%, although many probate indicators suggest it is much lower. The latest Five Year Plan will target a doubling of GDP from 2010 to 2020, i.e. circa 6.5% from here on. The slowdown in China and its rebalancing will continue to have serious ramifications for both the commodity producing countries and the Asian economies who have ridden the Chinese dragon for the last 20 years.

India should see stronger economic growth in 2016 as momentum emerges from the reforms and plans initiated by the Modi Government. Whilst reforms have been slower and less dramatic than many have hoped for, there is no doubt Modi is moving India forward and is attracting more Inward investment. Additionally, there is room for interest rates to be reduced which will support both investment and consumption in 2016.

Japanese growth remains disappointingly low despite very aggressive policies from the Bank of Japan and as yet only modest reform plans from the Abe Government. More is expected in 2016 but the ageing headwind is not allowing Japan to be an engine of economic growth just yet, despite the weaker Yen.

Australasian prospects look much more difficult into 2016 as the rebalancing of China seems to have permanently affected many commodity prices, the weaker Yen and Euro have tightened international trade competition and the strength in the US Dollar has lifted financing costs for local borrowers.

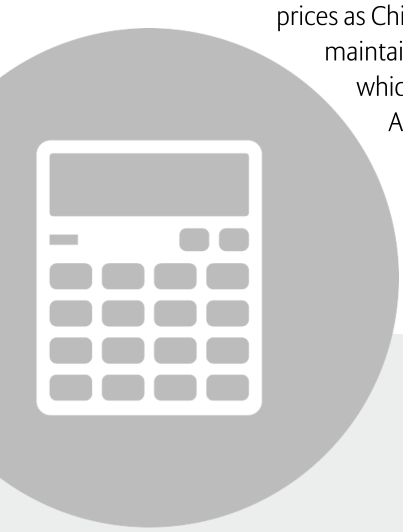
The Middle East and Africa have been badly affected by the collapse in commodity prices and the consequent fall in investment intentions from both big oil and mining concerns which leaves little economic improvements to be expected in 2016. Many of the OPEC producers, including Saudi Arabia, are now running huge budget deficits which are only affordable through reductions in their Sovereign Wealth funds and an increase in public sector debt, leaving little prospect for growth to improve in 2016. However, with sanctions being slowly removed in 2016, we can expect to see Iran offer strong interesting growth potential as oil investment starts and other industries return to the country.

Latin American economies have taken a serious turn for the worse as commodities have slumped and the prospects there for 2016 look poor as politics worsens and government finances slump, exacerbated by serious political scandals in Brazil. Despite the Olympic Games in 2016, the prognosis for Brazil will not improve in 2016 as the currency remains very weak and consumer leverage very high. Venezuela and Argentina are also experiencing very high levels of domestic inflation which may prelude further debt default.

Thus whilst global economic growth remains dull and fragile, there are emerging signs for optimism in the medium term. Global trade now accounts for nearly half of World GDP, demonstrating how successful globalization has been. New trade deals like the TPP between the US and Asia should, by removing tariffs and barriers, boost trade, and this could be followed in 2016 by a similar deal between the US and Europe. China's "one belt, one road" policy will also help drive investment into many developing economies.

Inflation: What Inflation?

Inflation remained subdued during 2015. In general, we expect more of the same in 2016. There are many reasons why many segments of the global economy are experiencing low inflation rates. Firstly, oil and other commodities have fallen to low levels and they are expected to remain low in 2016. Secondly, we are seeing a wave of lower global trade prices as China and others seek to gain or maintain market share in traded goods, which is good for consumers. Additionally, we continue to expect pay rises to remain subdued as there is quite a lot of slack in many economies, especially in Asia and Europe. However, we continue to expect to see local service inflation globally to be resilient and to be an offset for some of the disinflationary forces mentioned above. Also importantly, we are seeing many output gaps beginning to close which is traditionally a harbinger of inflation. Within our Financial Repression narrative, it is important this current low level of inflation ends in 2016, because we need some inflation to erode the real value of the world's high debt levels.



There is one "black swan" event present in the environment today which could affect the inflation outlook – namely if the serious geopolitical situation in the Middle East were to worsen and affect the supply of oil to world economies, reminiscent of the two oil shocks of the 1970s and 1980s. Clearly this event would be bad for economic growth but good for inflation!

Loose Monetary Policy: "It ain't over till it's over"

2015 has seen a global convergence of monetary policy from central banks, as more and more have reduced interest rates to the bone, or even to negative levels in Europe and more have moved into the mode of QE policies. And there is the prospect of even more to come possibly in Japan and Europe. 2016 will see the first major divergence of monetary policy as the World's Central Banker, the US Federal Reserve, is expected to start raising rates, nicely juxtaposed to almost every other central bank in the world, where zero interest rates are being deployed, rates – like in India and Brazil - are being reduced, or QE is increasing. All eyes will remain fixed on the US, as the US Dollar is still the main global currency and further strengthening will affect US Dollar borrowings and refinancings around the world. With Japan and Europe in full QE mode, China has become increasingly more active monetarily in supporting its economy. We do not, though, believe that the recent changes to policy over the summer of 2015 portend a deeper Renmimbi devaluation in 2016 as inclusion in the IMF's Special Drawing Rights basket is a key strategic objective of this Government.

We thus expect much more currency volatility in 2016 which will make finding attractive returns from international equity and bond markets harder to navigate. Regardless, we continue to believe that interest rates globally will remain low and central banks will remain slow to raise rates in the face of either rising economic growth, rising inflation or both.

Politics

Local political situations are always closely aligned to monetary policy and we expect 2016 to see further political events which will shape returns to investors.

Europe has had its usual rollercoaster ride, enduring another Greek crisis in 2015. We expect to see the focus here to move towards the British referendum on staying in the EU during 2016 and any negotiated treaty changes which shed light on how the journey to the United States of Europe (or is that the Euro-zone?) will progress from hereon. The EU still has many challenges as it moves forward with these goals and in the shorter term is still wrestling with the migrant crisis and the simmering events in Ukraine. Asian politics is centered around the growing assertiveness of China regionally, how to respond to the economic rebalancing of China, especially in Australia and other commodity countries and how to create more domestic demand as global growth slows.

LatAm politics remains very highly charged and difficult, with expectations high that the President of Brazil may be impeached for corruption, thereby throwing the economy into unpredictable stasis.

Again, as already mentioned, the geopolitical events unfolding in the Middle East will bear careful watching in 2016 as events are very uncertain and unforecastable at the moment, with echoes of the Cold War returning as Russia and the USA back different sides.

However, the key focus in 2016 will be the US Elections in November, where neither the Democrats nor the Republicans seem to be settling on a clear candidate. With the Clinton and Bush political dynasties both having their limitations, there seems to be, at the moment, a desire to try something different although this should not produce notably different economic policies. One thing is clear, that the polls may be unreliable as to the result!

Act: Volatility and Illiquidity

2015 saw the return of both more volatility to markets and a breakdown in correlations between many asset classes. We expect more of this in 2016, as economic and monetary policy and political events begin to highlight differences in the global economy.

Within the low interest rate environment, many market segments have seen the growing use of extreme leverage and algorithmic trading which is both exacerbating the volatility and causing markets to become more illiquid, with the inevitable consequence of QE that investors have been herded into similar assets and structures in the hunt for return and income.

We believe that being flexible and active will allow client portfolios to benefit from the volatility at an asset class level and that by doing in-depth research and focusing on quality and sustainability , we can help clients navigate markets where without taking risk, there is no return potential. As monetary policy diverges in 2016, we expect to see our clear investment philosophies and long term investment processes deliver the alpha which clients are searching for in a world where beta returns will be much lower and more volatile.

- Neil Dwane, Global Strategist