MULTI-ASSET
OUTLOOK 2016

POSITIONING FOR A GLOBAL GROWTH BOUNCE

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- In 2016, we think the strengthening consumer will pull up struggling industries, setting off a global growth bounce.
- We see several long-term forces starting to influence markets in 2016, including demographics, politics, and structural change.
- Fiscal policy has been missing in action for years, forcing monetary policy to work overtime. However, we see a small, but much-needed, fiscal push finally arriving in Europe, China, and Japan next year.
- While we expect commodities prices to stabilize in 2016, supply cutbacks will put downward employment pressure on commodity-producing economies.

As we ring out 2015 and prepare for 2016, a massive divergence in the markets must be resolved. Around the globe, basic industry appears to be in recession while the consumer appears healthy and is gathering steam in major economies like the US and China. Markets seem to have priced in that this divergence will continue. We do not think it can – either the consumer will pull industry up, or industry will pull the consumer down.

We think the consumer will have the edge and, as a result, we are entering 2016 positioned for a global growth bounce. Fiscal policy has been missing in action for years, forcing monetary policy to work overtime. But we see at least a small fiscal push coming in Europe, China, and Japan, and think such contra-cyclical policy is just what the doctor ordered.

Overall, we see 2016 as another year in which monetary policies – and now fiscal policies, too – encourage investors to stay in developed markets, particularly Europe and Japan.

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Global QE has created a new world order

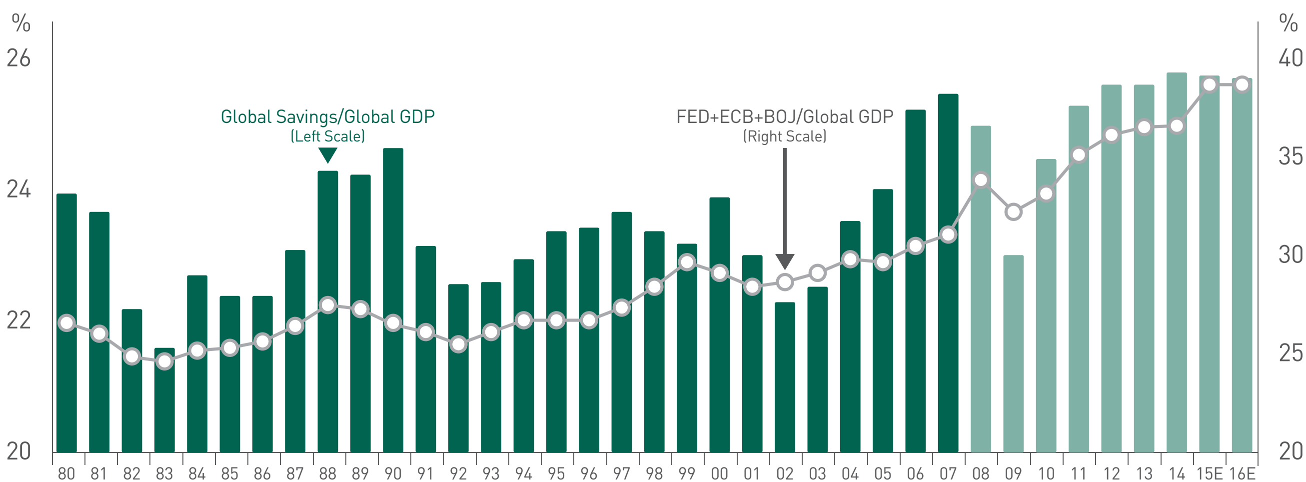
As we had expected, markets began 2015 exhibiting a trend of low nominal returns with rising volatility. This was a consequence of, and occurred in tandem with, the end of extraordinary monetary accommodation. But then the European Central Bank (ECB) extended the accommodation era by launching its own quantitative easing (QE) program, only to be joined by most other central banks (with the notable exceptions of the Federal Reserve and Bank of England) cutting policy rates.

Instead of markets soaring into this accelerating deluge of monetary accommodation, China inadvertently took away the punch bowl by imposing much stronger measures to slow its debt growth. This led to a surprisingly abrupt halt – not only in China's growth, but also on the industrial side of the global economy, threatening its minimum speed limit.

In this new world order, with too much liquidity chasing too little corporate earnings, markets rotated instead of correcting. Commodities, all emerging assets, and cyclicals suffered while assets in the way of new sources of global liquidity continued to work steadily higher. Thus ends the second consecutive year in which policymakers who were worried about growth inadvertently damaged it. (In 2014, Europe's Asset Quality Review squashed bank lending leading up to this year-end event, stalling out continental Europe's economy.)

As investors, we need to take inadvertent consequences into account as never before. While it seems more difficult every year to look ahead with any accuracy, some truisms have held and should continue to hold. First, don't fight the trend of global central banks. Markets are still heading up in 2016. Second, with output gaps everywhere and capital piling up in financial assets instead of finding its way to productive use in the real economy, markets continue to look for new sources of demand. Several, including demographics, politics, and structural change, offer longer term encouragement. Some of these forces will slowly seep into the year ahead.

Normal sources of liquidity have simultaneously surged post-crisis



As of 15 October 2015. Sources: Haver, Federal Reserve, Bank of Japan, World Bank, Trading Economics. Gross savings are calculated as gross national income less total consumption, plus net transfers. Estimates are based on World Bank GDP and demand forecasts. Source for 2015 and 2016 Gross National Savings / Global GDP: PineBridge Investments. Any opinions, projections, forecasts and forward-looking statements presented herein are valid only as of the date of this document and are subject to change.

Forces that will affect markets in 2016 (and beyond)

Demographics. As aging baby boomers begin to leave the workforce, they also segue out of the accumulation phase and enter a long period of dis-savings. In Japan, particularly, we increasingly see investments targeted for an aging society and the only sensible minimum wage architecture around, with 3% annual increases targeted for each of the next eight years. This should be long and steady enough to change the deflationary mindset and usher in more confident consumers.

Meanwhile, after a period of long delay, Millennials are entering the workforce in huge numbers. While spending more soberly than their parents, thankfully, they actually do appear to want cars and other consumables as their confidence grows in their employment prowess.

China's new economy. To our eye, China is tacking back toward its old formula: borrow, invest, grow. To arrest its sudden growth stoppage, China appears ready to go halfway toward a middle ground between fast but unproductive debt growth financing old, overbuilt industries and some form of new investment. While the consumer has risen from a third to half of the economy, much of China's industry is stagnant. A return to overinvesting in steel and cement is not the answer, and it's not where we see China heading. As the world's largest carbon-dioxide emitter, nowhere is there a greater or more imminent need to begin shifting the energy-efficient infrastructure away from coal toward cleaner energy sources.

Climate change. Indeed, the world is beginning to address global warming in a manner that will soon begin to gradually phase-out a massive installed base of energy infrastructure. Developments connected to the Paris climate summit and legislation mark the beginning of an energy-efficient replacement cycle, an investment wave that will last decades and strand much of today's sunk capital.

Technology. The implementation is finally at hand of robotics and the Internet of Things, with machines communicating with machines. Older industries, along with their obsolete capacity, will increasingly be taken out of the system instead of being restructured.

Forced fiscal spending in Europe. The immigration crisis in Europe can be viewed as a form of forced fiscal spending, which Europe needs in its post-crisis deflationary environment to begin repairing the damage done by its prior austerity wars. Markets always vote for contra-cyclical policy, and they should. France appears on the cusp of allowing its deficit/GDP to head back toward 5%, a break from the Maastricht Treaty and a move that is likely to be followed instead of challenged elsewhere in Europe.

The stabilization of commodities prices. After several years advocating the end of the commodity "supercycle," we are no longer bearish on this asset class. While declining commodities prices have weighed on many emerging economies, price stabilization in 2016 is likely to be a double-edged sword, driven by supply cutbacks that will put downward employment pressure on commodity-producing economies. Only India and Mexico appear poised to shake off the emerging doldrums.

Where we find opportunity

Within equities, our favorites remain Japan, Europe, Mexico, and India. In US equity, with the global growth bounce coming, we prefer value styles or small cap stocks. Within fixed income, our preference is moving lower in quality after a year where credit spreads blew out. We once again like US high yield and European US-dollar-denominated CoCo (contingent convertible) bonds. Instead of intermediate-term debt, we prefer liquid alternatives that benefit from rising short rebates, as well as bank loans. In private markets, we still find value in timber and private credit.

All told, we are heading into a period with more and bigger winners and losers. On the brink of such change, markets are as obsessed as ever with the near term. But looking forward at how fundamentals will evolve over the intermediate term has never been more important, in our view.

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