Weekly Market Flash

2015 Markets in Review: Not Great, Could Have Been Worse

December 31, 2015

A popular parlor game for investors over the past couple weeks has been to guess whether the S&P 500 would finish the year out in positive or negative territory. Technically, of course, a calendar year is no different than any other string of 365 consecutive days. But we all know that the return representing the specific elapsed time from January 1 – December 31 holds a special place in the human psyche. Were the blue chip benchmark to ring out the year in the red it would be the fifth such calendar year loss so far this century. As it turns out, though, the index looks set to eke out a modest positive result for 2015, with most if not all the gains coming from dividends.

In other years of sub-normal returns for this key US benchmark, diversified investors have found varying degrees of comfort from the brisker performance of other asset classes. 2015, though, has been a stingy year across a wide swath of asset classes. The composite result is what one could perhaps best term as mediocre: not great, certainly, but not as bad as it could have been. We look here at some of the key forces that shaped the mediocre year gone by, and what they might mean for the next twelve months.

US Equities: The Year Earnings Mattered

At the beginning of 2014 – nearly two years ago – we asked the question "how much more?" in regard to whether US stock prices could continue to gallop ahead of earnings as much as they had for the two previous years. We were a year ahead of ourselves. Earnings was arguably the dominant headwind to share price gains in 2015. The current FY15 consensus, as the Q4 earnings season approaches, is essentially flat – minus 0.34 percent according to FactSet. Flat earnings growth begets flat price growth. It is true that much of the negative earnings performance came from beleaguered sectors such as energy and mining. But flat sales and weakened margins were hallmarks of performance across most sectors, particularly those more exposed to foreign currencies and global customers.

These headwinds are unlikely to abate significantly in 2016. For this reason, the scenario we have discussed in several recent commentaries continues to be our go-to model for next year; namely, a "quality rally" where companies with healthy balance sheets, robust margins and strong top line growth stand to benefit relative to the overall market. Currently the FactSet EPS growth consensus for fiscal year 2016 stands at 7.8 percent. Take that consensus with the usual grain of salt – these estimates almost always compress as the release dates approach. But the subset of quality companies in the index could fare rather better. Stock pickers of the world, unite.

Non-US Developed Markets: Dollar Dominant

Dollar-denominated investors had a hard time making money in non-US developed markets this year. The exception was Japan, where a 9.5 percent dollar-denominated return for the MSCI Japan index far outpaced comparable MSCI indexes for the rest of the G7. Most of Europe did fine in local currency terms. The MSCI EMU index returned nearly 12 percent on a local currency basis, but currency translation wiped out all but 90 basis points of that gain when re-expressed in dollars. The Pacific ex-Japan markets of Australia, Singapore and Hong Kong fared still worse, with double-digit dollar losses for the former two.

While currency markets are notoriously volatile and subject to rapid reversals, it would be challenging to make a compelling fundamental case against the dollar for 2016, and therefore little reason to foresee a meaningful mean reversion. Continuing policy divergence between the Fed and the ECB should be expected to bolster the dollar. A weaker dollar would be plausible if European exports were to surge in response to global demand (unlikely, given persistent demand weakness) or from the Fed needing to recant its December move and return to the zero lower bound (in which case we probably have a whole host of problems more pressing than the relative performance of US and non-US equities). We do not expect to see either of these outcomes, and thus remain underweight in our unhedged non-US DM exposures.

Non-US Emerging Markets: Waiting for Growth

Weak currencies were just one of a handful of problems facing emerging markets in 2015. Even in local currency terms, most countries on the MSCI Emerging Markets Index wound up the year deep in the red. And the two notable exceptions – Hungary and Russia, both of which scored large gains in both local and dollar terms – are hardly poster children for dynamic hotbeds of socio-economic growth. Growth, in fact, is the missing piece of the puzzle across many of the diverse economies which make up this asset class. The pain was felt most acutely in Latin America (down more than 31 percent for the year in dollar terms) but also hit former growth engine darlings such as Malaysia, Taiwan, Thailand and Indonesia. Over the entire asset class loomed the troubles of China, and the spectacular summer meltdown in its domestic equity market.

Here again, we believe the headwinds from 2015 are likely to provide further resistance to EM performance as the new year gets under way. The IMF has once again lowered its global growth estimate for the next year. Weak demand in major consumer markets, a large debt overhang and the potential for further negative surprises from China are all potential contributors to another year of weak performance. But there may be pockets of opportunity among the general gloom. Watch Argentina, long a capital markets pariah but now positioned for a return to normalcy under the new administration of Mauricio Macri. And with political and economic woes continuing to plague Brazil, there is a good case to make for Mexico as the jewel in the LatAm crown.

Commodities: Goodbye, China Supercycle

Every unhappy family is unhappy in its own special way, said Tolstoy at the beginning of *Anna Karenina*. So it went with the major subgroups of commodities this year. Gushing supplies and weak demand smacked oil prices, freakish weather patterns plagued natural gas sales, tepid demand from China undermined industrial metals while the expectations game around Fed interest rate policy was a net negative for precious metals. To each commodities class its own dismal story.

Among these stories, though, we see the end of the China supercycle as the key driving trend. Even assuming that Beijing's policy mandarins engineer a smooth transition from unsustainable levels of investment to a healthy rise in domestic consumption – far from a given – that outcome is not likely to restore demand for commodities to the go-go levels of the 2000s. But while we do not foresee a surge in commodities prices for the coming year, we do believe there will be some stabilization around current price levels in major markets like oil and copper. We continue to see $40 as a reasonable intermediate support level for crude, though we have reduced our upper band of the expected intermediate trading range from $60 to $55.

Fixed Income: Negative Rate Wonderland

To be perfectly honest, we never thought much about negative interest rates before 2015, apart from the occasional theoretical thought experiment. Now it looks as if they are here to stay, at least for the foreseeable future. The implications remain bothersome. Why would anyone pay the German government for the "privilege" of lending it money for a five year term? The widespread presence of negative rates upends many of the basic assumptions built into the financial and economic models that attempt to explain how the world should work. The direct implication is that the world is not working, and nobody really understands why.

We have analyzed a wide range of fixed income asset classes, perused many reports and arguments for or against taking on exposure to EM or non-US DM debt, high yield, and various "unconstrained" strategies aiming to profit from monetary policy divergence. Our conclusion is that it is nearly impossible to model potential rational outcomes for the intermediate future based on data from the past five, ten, twenty or even fifty years. If the mechanism is broken, models derived from a time when the mechanism worked are not likely to be helpful. Fixed income is the space in our portfolios where we manage risk, not where we seek to generate alpha-based outperformance. For 2016 that means sticking with the highest quality, most predictable and therefore least interesting exposures available from mainstream US government, corporate and municipal asset classes.

The Trend Is Your Friend

There is a thread of commonality weaving through our thoughts on all these asset classes, which is that 2016 is likely to be a year of trend continuation more than it is likely to exhibit sharp mean reversion. These trends – strong dollar, weak global demand, monetary policy divergence and China's slowdown key among them – look set to continue for the near to intermediate term. Trend continuation, however, does not necessarily imply higher predictability for asset class performance. Baseline volatility is higher now than it has been for several years. While it is still lower than it was in the final throes of the 1990s bull market, we expect to see a continued uptrend in baseline volatility as the year progresses.

Eventually that uptrend is likely to herald an end to the current bull run. That may be a topic of more importance for 2017 than for 2016, but there are never guarantees as to timing. The coming year calls for agility, discipline and a calm mind. We will be there for whatever the year has in store. Happy New Year to one and all!

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