AQUILA FLASH

Aquila & Co. AG | 19. April 2016

Six hurdles for the market

A number of issues explain the difficult start for stock markets this year.
Stock markets in Europe and Japan have had a particularly poor start to the year. There are many explanations for this – among them, fears of a world recession linked to fears about China, the weak trends in the commodity markets, the at times bizarre nomination contests for the 2016 US Presidential election, the upcoming Brexit referendum in the UK and the difficulty investors find in assessing the outlook for US monetary policy.

Anxieties about growth are persistent because the economic growth trends are so weak.
Fears that a weak world economy could sink into recession have intermittently plagued the stock markets for years. But we don't believe that the world economy is heading into recession, not least because of our assessment of China. Then there is the clear positive growth trend which has been established in the US, albeit at a somewhat disappointing rate of around 2% this year. The various economic problems of Europe, Japan, Brazil, Russia and elsewhere will, however, mean that the overall growth outturn for the world economy is unlikely to be much above 3% in 2016. This is not strong enough to prevent the markets falling prey from time to time to recession fears.

But Chinese data trends have the potential to support global stock markets in the second half of the year.
Worries about China seem to have an impact on all financial markets. Investors are particularly concerned about a possibly imminent credit crisis, the heavy outflows on the external capital account and the weakness of the yuan. As we stated in a recent publication, we share these worries only partially. Rather, we expect that negative news and assessments about China will tend to fall out of the headlines the longer the year progresses. Given the Chinese government's scope to stimulate the economy via fiscal and monetary policy as well as through regulatory change we believe China could well become a support factor for general investor confidence in the second half of the year.

The worst negative effects of the weak commodity prices are now behind us.
Falling oil prices hit markets badly in the first two months of the year but we think that the negative impact on the broader economy of the sharp cutbacks in investment in energy will diminish over the course of 2016. At the same time, we expect that consumers will become more inclined to spend the savings windfall that lower energy costs have delivered to them. Regarding the outlook for the oil price, one can note that the surplus production of oil, currently estimated at around 1.5 million barrels a day (mbd.) on a global basis, and the re-entry of Iran as a supplier to the oil markets will both tend to push prices lower. On the other hand, the fact that the oil price is already rather low and the tendency, under normal conditions, for global oil consumption to rise by around 1mbd. annually both suggest there will not be another serious downdraft in prices. With the oil price having fallen to just $26 a barrel on February 11, itself a new low relative to the lows recorded in mid-2015, we believe that the worst of the price

turbulence is now behind us and expect that the influence of the oil price on stock markets will be neutral to mildly positive over the balance of 2016.

The US primary election process is unsavory but we think that some good could come out the present situation.
This year's nomination process for the 2016 Presidential election has been an indictment of the two established parties. The evidence so far points to an eventual fight between Hillary Clinton and Donald Trump, in which Mrs. Clinton looks like having the advantage. But there is a possibility that leading members of the Republican Party will manage to prevent Mr. Trump from achieving the 1237 votes he needs to be declared the party's official candidate. In such a situation Mr. Trump might be jettisoned in favor of another candidate with a better chance of winning – such as Michael Bloomberg who has so far not declared himself to be in the race. A good candidate who appeals to the middle ground could, we believe, defeat Mrs. Clinton and turn the 2016 Presidential election process into a positive factor for the markets in the second half of the year. In part, this might come about through a recovery of pharma stocks which have been hit by Mrs. Clinton's remarks on prescription drug prices.

Brexit would be a political catastrophe.
The closer we come to June 23rd – the day when the British people vote on Brexit – the more likely markets will become more anxious. We think it is a waste of time to analyze the economic impact of Brexit. Much more important would be the political effects. Here, we are clear that Brexit would have negative geo-political consequences and would indeed be a political catastrophe for the rest of the EU. In the event of a vote for Brexit, speculation that the EU might fall apart could rattle the markets even more seriously that at the time of the second Greek crisis in the late summer of 2011. However, although Mr. Cameron seems to have been weakened by the revelations of the Panama Papers, we still believe that in the end the British people will vote against Brexit. This outcome has become somewhat more likely now that the Labour Party leader, Jeremy Corbyn, has come out in favor of Britain remaining in the EU. A vote against Brexit would remove an uncertainty factor for the markets in the second half of this year.

There is still the risk that inflation trends will push the Fed to raise interest rates faster than the market currently expects.
Right now, headline US inflation is 0.9% but the core rate (that derived by excluding volatile food and energy prices) is already 2.2% and hence above the Fed's long-term inflation target. Also, the price deflator for US consumer spending excluding food and energy (which is the Fed's preferred gauge of inflation) is already at 1.7%. Regarding wage trends, one can note that wages have only risen at an annual average 2% rate over the last 5 years, which compares with an annual average 3% rate over the last 30 years. It is therefore not surprising that the Fed, in its latest Beige Book publication, highlighted the risk of pent-up wage demands. In our view, there is a significant risk that forthcoming inflation developments will push the Fed to raise interest rates faster than the market currently expects. Such a development, were it to occur without a simultaneous pick-up in US economic activity, would be very negative for stock markets.

Our view for markets over the balance of the year is one of restrained optimism.
On the basis of the points outlined above we are somewhat optimistic about stock markets over the balance of the year. We don't expect an improvement in economic trends and can't exclude from our assessment the possibility that inflation will push the Fed into further interest rate hikes. Set against this, our central scenario also includes the chance that developments in China, in the oil markets, in the continuing US election process and regarding the Brexit referendum could all turn out to be supportive factors for the markets in the second half of the year. Thus we are sticking with our neutral allocation to equities and would view periods of market weakness as an opportunity to add to equity positions.