What’s in store for global equities in 2016?

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Next year promises to be a better year for equities than 2015, when markets were rattled by much weaker-than-expected growth in emerging markets. But there is a positive side to this weakness that will come through in price developments. In 2016, consumption in the developed world – particularly the US – will likely show significant strength, partly because of wage and employment growth, but also because the prices for many goods and services are falling.
The outlook for economic growth in 2016, particularly in the developed world, is therefore much healthier than at the start of 2015, which creates a positive backdrop for equity markets, especially in the US. Yet careful analysis remains crucial as innovation stocks augment their leadership in the face of the many disruptive forces that are changing the shape of global equity markets.

One of the key stories of 2015 was the global threat of deflation that originated in the emerging markets and was most visible in languishing commodity prices. Deflation is very much a double-edged sword; it can have a significantly detrimental economic impact, but it can also kick-start regenerative economic forces. Initially, it leads to a decline in trade, as amply evident in weak export data across the world and in global trade flows as recorded, for example, by the OECD. Traded goods flows will remain soft for the foreseeable future as China and the rest of the emerging world are not likely to stage a robust economic recovery any time soon.

But deflation has positive side effects. Deflationary tendencies have not only manifested in commodity and oil prices but in many other goods as well, which in itself provides a boost to real incomes. In the US, and to a lesser degree in the UK, labour market strength, resulting in job and wage growth, further raises real incomes.

In 2015, US consumers hoarded the windfall from lower energy (and other) prices and the overall savings rate rose despite higher real incomes, posing a conundrum for investors. This effect is likely to be transitory; this year, the improvement in employment will be reflected in consumption patterns as the US consumer returns to spending. Auto sales and housing formation are providing early indications that this is indeed already happening. The disruptive influence of online spending makes consumption data harder to read than previously, to some degree obscuring the underlying strength of consumer spending. While, for example, the likes of Walmart may post disappointing sales, online retailers like Amazon.com may see sales improve. At an aggregated level, however, consumers should progressively feel more confident to spend their various windfalls and wage gains.

This means that US consumers are entering 2016 stronger than in they have been in a decade. US consumption will easily be able to weather the expected modest interest rate increases and the domestic economy may well turn out to post a surprisingly strong performance. To some extent, the US domestic economy will act as the safety valve for the global economy, which continues to suffer from a depressed state of affairs elsewhere, especially in emerging markets.

The strength of the domestic economy leaves the US equity market better placed to cope with tighter monetary policy than other markets. This means that in US-dollar terms, we can continue to expect the US market to outperform.

Innovation watch
One of the key themes for investors in 2016 will be one of innovation. Disruptive innovators are set to change the shape of markets in a number of industries. We are witnessing this in technology through social media and the internet; in pharmaceuticals through the breakthroughs in new therapeutic areas like oncology; and even in gaming through slews of games coming online. Innovation will transform global equity markets, creating a new environment in which US leadership will continue to thrive. The technology-heavy Nasdaq Composite Index will be at the heart of this story as it remains best placed to benefit from the disruptive forces emanating from within information technology and biotechnology, sectors where earnings momentum is strong. Overall, the stock market will bifurcate between the sources of innovation and the remainder of the economy. Before long, we can expect that investors will once again speak of 'old' and 'new' economy stocks, much as they did in the late 1990s. Active managers will have an advantage over market-cap-based investors, whose exposure to 'old economy' stocks is backward looking and will sooner or later be out of synch with the newly emerging economic order. The leadership of innovation stocks and sectors is still narrow, but it is persistent, and will be a key source of returns for selective longer-term investors.

The prospects for Europe are gradually improving. Even if still modest, the recovery in domestic demand in Europe looks more secure than in the past and, contrary to common perceptions, it will curiously benefit from the wave of migration from Europe's south-eastern corridor. The European Central Bank's insistence on furthering its loose monetary policy means there is little policy risk to this domestic recovery, other than the perennial risk from the periphery in the form of sudden tensions in Greece or Portugal. Although never publicly admitted as such, currency weakness will remain a policy objective for the ECB. In this context, the euro is unlikely to stage much of a rebound and turn into an obstacle to economic recovery.
The outlook for global emerging markets, however, looks precarious. Growth is slowing and structural problems are emerging just as the interest-rate cycle in the US begins to turn against them. Investors can expect further weakening of currencies across emerging markets and little prospect for a revival in commodity prices to come to their support. Deflation risks are rising in China in particular and there will be a growing case for a further adjustment in the renminbi, especially if the US dollar strengthens.

But in emerging markets, it is important to distinguish between stock market performance and the economy, as their paths may be diverging. Anticipating significant further economic weakness in China and emerging markets overall, emerging and Asian stock markets had a troublesome year in 2015. For many, a depreciating local currency amplified the effect in US-dollar terms.

This considerable adjustment in emerging-markets stock prices, and the three-year underperformance it triggered, may now be coming to an end. In absolute terms, many investors appear to have given up – in other words, quit emerging markets – which is the point at which careful investors might start looking for opportunities. Any investment strategy based on this premise of tentative opportunities will need to navigate a challenging economic environment: today's weakness in emerging capital markets will reveal itself in the economy tomorrow.

Economic data coming out of China is likely to weaken, while countries like Brazil and Russia will show a particular weakness, meaning that the news flow at company or economic level may not improve much, if indeed at all. Undoubtedly, 2016 will be another challenging year from that perspective, but stock prices have likely discounted much of the bad news.

We continue to favour those emerging markets that are committed to a reform agenda as these nations will continue to attract investors' confidence for tackling their structural problems. Countries where this is not the case will not see any investor interest.