STUCK IN A RUT
OUTLOOK 2016:  
Stuck In A Rut

Mr. X is a long-time BCA client who visits our offices toward the end of each year to discuss the economic and financial market outlook. This report is an edited transcript of our recent conversation.

Mr. X: I always look forward to our end-year meetings, and am delighted to be back for another in-depth discussion of the economic and market outlook. I find it very helpful to talk through the various issues that are on my mind and to hear your perspectives. And the timing could hardly be better because I find myself even more conflicted than usual about how things will play out in the coming years. On the one hand, I remain concerned that extreme monetary policies are creating major economic and financial distortions that ultimately will have significant unintended negative consequences. Last year, you stated that the Debt Supercycle had ended, but I see little progress in reducing elevated debt levels around the world, and easy money just encourages more leverage. On the other hand, I recognize that economic growth remains dangerously fragile and needs all the help it can get. Thus, I veer between worrying about inflation and deflation. I suppose this should give me sympathy for the challenges faced by central bankers.

A year ago, you persuaded me against significantly reducing my equity exposure, but I am again wondering if I should dramatically cut the risk exposure in my portfolio. The economic outlook appears fraught with risks and, not surprisingly, I also find the geopolitical environment very troubling.

You can see that I am rather confused about a number of important issues and I hope that things will be clearer by the end of our discussion. But, before we get into the details of your views, let’s revisit your predictions from a year ago and see what went right and what went wrong.

BCA: You should not feel bad for being confused. This is a common feeling among investors, and policymakers also are divided about the outlook and the appropriate course of action. Forecasting relies on identifying periods in the past that bear some similarity to the present environment and then applying the lessons of those earlier episodes. The current situation is unusual in that we lack good historical precedents that provide a guide to how things may play out.

There have been no other periods in modern times when, all at the same time, debt levels have been so high almost everywhere; the pace of technological change has been so rapid; a geopolitical paradigm shift has been underway; and interest rates have been so low for so long. Thus, it is not surprising that you and investors in general are finding this such a challenging time. The dearth of unambiguously cheap financial assets makes it even more difficult.
Clearly, we have a lot to talk about. But, as you suggested, let’s start by looking back at the predictions we made a year ago. Our key conclusions were as follows:

- The drop in oil prices is a net positive for the global economy. In a world plagued by deficient aggregate demand, resources are shifting from high savers (oil producers) to lower savers (consumers). Low oil prices pose a threat to political stability in some producing countries and will negatively impact non-OPEC supply. This sets the scene for prices to rebound by more over the next couple of years than is priced in the forward markets.

- Borrowers and lenders remain under pressure to delever in most economies and regions. For the first time in decades, easy money has been unable to trigger a new credit cycle and effectively, this means the death of the Debt Supercycle.

- Despite the stimulus from lower oil costs, the pace of global economic growth will remain disappointingly slow in 2015. The demise of the Debt Supercycle has blunted the impact of monetary policy and there is opposition to using fiscal policy to boost growth. Economic activity will be constrained by the growth in real incomes which is likely to stay modest.

- The pace of U.S. economic growth will remain above trend for a couple of quarters before dropping back into the 2-2½% range in the second half of 2015. A firm dollar and smaller gains from home and equity prices will offset the benefits from lower oil prices.

- The euro area will remain stuck with low economic growth for the foreseeable future and a period of deflation is probable. Growth in the region is likely to average 1% or less over the next couple of years.

- Japan’s economic growth remains constrained by falling real wages and Abenomics is not expected to change this. The weak response of exports to a lower yen is a further bearish sign. A marked improvement in growth is not in the cards.

- The Chinese authorities are attempting the delicate task of squeezing out credit excesses while avoiding a major growth slowdown. While there is risk of a policy mistake, we do not expect a hard landing.

- Inflation will stay very low throughout the developed world over the coming year and central banks will maintain a highly accommodative policy stance. The Fed is on track to raise rates in mid-2015, but slowing growth in the second half will limit the pace of subsequent hikes. The ECB will step up QE, possibly to include purchases of corporate bonds.

- Government bonds are expensive in most countries but the forces keeping yields down – excess global savings and low inflation – will persist in 2015. We recommend neutral
duration, with a curve strategy geared toward a flattening. Corporate bonds are preferred to governments as we do not expect a rise in default rates. Continue to avoid EM bonds.

- Stick with a benchmark weighting in equities. Although monetary policy will remain supportive, the profit outlook will be more challenging – especially in the U.S. where a firm dollar will undermine overseas earnings. Relative valuations and monetary conditions warrant a diversification away from the U.S. and toward Europe. Japan also offers a tactical opportunity.

- It is too soon to move back into EM equities given deteriorating economic growth and earnings, poor valuations and weak commodity prices. Our favored markets are China, Taiwan, Mexico, Singapore, Malaysia, central Europe and domestic sectors in Korea.

- We recommend staying with a defensive sector strategy, focusing on consumer staples, health care, utilities and selected financials.

- Commodities are in a secular bear market so any bounce in prices will be short-lived. Monetary conditions appear favorable for gold, but bullion missed its chance to move into a full-scale bubble.

- There are compelling reasons to expect the dollar to move higher in 2015, but the strong bullish consensus is a concern. There is more downside for the yen than for the euro. Avoid commodity-related currencies.

- The geopolitical risks will be concentrated in emerging economies although elections in Europe will also generate some uncertainty for investors. Russia’s ability to cause problems will be constrained by economic pressures. Geopolitics will support safe haven assets such the U.S. dollar and Treasuries.

- A cautious investment strategy is appropriate, especially given that long-run asset returns will be very modest from current levels. We estimate a balanced portfolio for a U.S.-based investor will deliver average returns of only 4.4% a year over the next decade, before inflation and taxes.

The macro environment turned out broadly as we had anticipated. Global growth remained subdued with the IMF currently estimating a meager 3.1% for 2015, modestly below their year-ago expectation (Table 1). Not surprisingly, inflation remained low in this environment. In fact, it has averaged close to zero in the past year in the G7 countries, helped of course by the drop in oil prices. It is worth noting that just four years ago, the IMF was predicting that global growth would average 4.8% in 2015, while G7 inflation would be 1.5%.

Regionally, there were no major surprises. Growth in the U.S. averaged around $2\frac{1}{2}$%, much as it has for the past several years, the euro area did a little better
TABLE 1
IMF Economic Forecasts

<table>
<thead>
<tr>
<th></th>
<th>ANNUAL % GROWTH IN REAL GDP</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>OCTOBER 2015 FORECASTS</td>
<td>OCTOBER 2014 FORECASTS</td>
<td></td>
</tr>
<tr>
<td>ADVANCED ECONOMIES</td>
<td>1.8</td>
<td>2.0</td>
<td>2.2</td>
</tr>
<tr>
<td>U.S.</td>
<td>2.4</td>
<td>2.6</td>
<td>2.8</td>
</tr>
<tr>
<td>EURO AREA</td>
<td>1.5</td>
<td>1.9</td>
<td>1.9</td>
</tr>
<tr>
<td>JAPAN</td>
<td>-0.1</td>
<td>0.6</td>
<td>1.0</td>
</tr>
<tr>
<td>EMERGING ECONOMIES</td>
<td>4.6</td>
<td>4.0</td>
<td>4.5</td>
</tr>
<tr>
<td>CHINA</td>
<td>7.3</td>
<td>6.8</td>
<td>6.3</td>
</tr>
<tr>
<td>WORLD</td>
<td>3.4</td>
<td>3.1</td>
<td>3.6</td>
</tr>
<tr>
<td>G7 INFLATION RATE (%)</td>
<td>1.5</td>
<td>0.2</td>
<td>1.1</td>
</tr>
</tbody>
</table>

SOURCE: IMF WORLD ECONOMIC OUTLOOK.

than expected, but was hardly strong, and Japan again disappointed. Despite fears to the contrary, China continued to avoid a hard landing, even though the official GDP numbers overstate growth. Our concerns about the emerging world in general were validated, with activity continuing to deteriorate in a number of countries. The median growth of the 152 emerging economies tracked by the IMF slipped to an estimated 3.2% in 2015 which, except for 2009, was the lowest level since the late-1990s’ Asia crisis (Chart 1).

With regard to our market views, the recommendation to have a cautious investment stance was appropriate given that global stock and bond returns were negligible (Table 2). In line with our view, U.S. equities underperformed those in the euro area and Japan in local-currency terms. However, dollar strength reversed the euro area’s outperformance in common-currency terms. Our recommendation to remain significantly underweight emerging market equities and to avoid commodity-related assets and currencies worked out well.
Our sector strategy also was generally validated with consumer staples, health care and technology all outperforming. U.S. financials also did much better than their Euro area counterparts, as we expected. Our overweight in utilities played out in the first half of the year, but the gains subsequently were reversed. Thankfully, we told you to underweight the materials and energy sectors and we hope that you followed that advice.

Mr. X: Your predictions were indeed broadly on target, but you must have been taken aback by some developments. What were the major things that caught you by surprise?

BCA: Inevitably, there were several things that surprised us. Relative to our expectations, the dollar was stronger and oil prices were lower. This helps to explain why it took longer than we expected before the Fed raised rates. The extreme volatility of the Chinese stock market also was unexpected with the A share index rising 60% in the first half of the year, followed by a 40% plunge in the subsequent three months.
Fortunately, most surprises were generally in the right direction in the sense that moves were just more extreme than we had predicted.

**Mr. X:** O.K., I will give you a good grade for your end-2014 predictions, but I need you to do just as well for the coming year! If I had to summarize my overall impression of 2015, I would say that, more or less, it was a continuation of the previous year’s trends: subdued economic growth, low inflation and continued easy monetary policy. So, the question is whether this picture will change much in 2016. Or let me put this another way: when we meet again in a year’s time, what will we think was the overriding theme that characterized the previous 12 months? A year ago, you emphasized the End of the Debt Supercycle as the major theme and that seems to have been justified by events.

**BCA:** That is a very good and important question, and one that we are always thinking about. It also was on the agenda for the most recent meeting of our Research Advisory Board. From a big-picture perspective, we do not anticipate any groundbreaking changes in underlying trends in the coming year. So in that sense, we expect another similar year for the macro environment. But, there could be an important shift in perceptions about the nature of underlying problems and thus the longer-run economic and market outlook.

**Stuck In A Long-Term Rut**

There is widespread understanding that recoveries typically are weak after balance sheet recessions, and the current cycle’s sluggish pace of global growth clearly fits into that pattern. Generally, this is assumed to be a temporary phase, followed by an eventual return to more normal conditions. Thus, there is a tendency to view current economic problems as more cyclical than structural. This is highlighted, for example, by the Federal Open Market Committee’s median expectation that the real fed funds rate will average 1.5% in the long run (2018 and beyond). This compares to an average of minus 1% during the past eight years and only 0.2% during the previous economic expansion (from 2001 to 2007).

Viewing the current global economic malaise as largely cyclical is a big mistake because there are powerful structural forces at work. Investors may come to appreciate that over the coming year, and this could be one of the defining aspects of 2016. The following structural forces will impede the return to what historically has been regarded as “normal”:

**Debt headwinds.** Our End of Debt Supercycle theme was not a one-year story. It represents a major regime change that will be in place for a decade or longer. Current high debt burdens were built up over decades and their debilitating legacy will cast a shadow over economic trends for a long time. In the post-Debt Supercycle world, demand will be constrained by the growth in incomes, which is likely to be modest.

**A Peak in Globalization.** We raised the retreat from globalization as a risk factor in last year’s discussion, and it has now
become a more pressing issue. Whether we are looking at flows of goods, capital or labor, the gloss clearly is off the view that the world will continue to become more integrated. World trade volumes have ceased to increase faster than GDP and this has important implications for those economies – especially in the emerging world – that built growth models dependent on rapidly expanding trade. Technological innovations such as 3-D printing and advanced robotics, along with narrowing labor cost differentials, will undermine the growth of goods trade and this will lead to a parallel decline in direct investment flows. Meanwhile, the massive migrant flow from the Middle East and Africa to Europe is bound to trigger tighter controls on future cross-border flows of people. Populist views on a range of anti-globalization policies are gaining credence.

**Intensified Demographic Pressures**

The aging of populations throughout the developed world and in China has been going on for some time, but the trend is accelerating and its effects will become more pronounced. The working-age population is expected to decline by 0.3% a year over the next few decades, the slowest growth in modern history. The problem is most acute in many parts of Europe and in Japan. The combination of slower labor force growth and the growing importance of human versus physical capital (e.g. Instagram versus Kodak), implies less need for traditional capital goods, with gloomy implications for investment spending. Aging also has long-term bearish fiscal implications given increased burdens on entitlement programs and a falling ratio of taxpayers to dependents. But, for the foreseeable future, the impact will be offset by an ongoing low level of low real interest rates. Thus, no fiscal crisis is in the cards any time soon.

**Monetary Policy Exhaustion**

Central banks have been leaning hard against growth headwinds during the past eight years and economic activity would have been lower without such aggressive policy actions. However, monetary policy has largely achieved all it can in terms of boosting growth. Interest rates cannot be pushed much lower, and in a post-Debt Supercycle world, even zero or modestly negative interest rates cannot trigger a vibrant new credit cycle. This leaves policy relying on the other two less effective channels of monetary transmission: pushing asset prices up and exchange rates down. Central banks have been successful in boosting asset prices, but there is a limit to how far that can be done once valuations become extended. And creating full-fledged bubbles is hardly a solution as the costs of the investible bust will exceed any near-term benefits to growth. Meanwhile, the ability of any one country to push its exchange rate down will depend on the policy actions of other countries. Thus,

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1 For more discussion of this point, please see “From Savings Glut To Investment Dearth”, *BCA Global Investment Strategy Special Report*, November 20, 2015.
even though the Fed has maintained a highly stimulative stance, the dollar has risen because of the even more aggressive moves by the Bank of Japan and European Central Bank.

**Financial Asset Returns.** Central banks’ success in lowering interest rates and pushing up asset prices has an important consequence. From current valuations levels, future asset returns will be a pale shadow of historical levels. We have raised this point with you several times in the past, but it is worth repeating. A year ago, we said that you should expect a balanced portfolio to deliver total returns of around 4.5% a year in nominal terms over the next decade, far below historical annual returns of more than 10%. We have not changed that view. Such a dramatic slowdown in asset returns is bound to create a drag on growth.

We can look at all this in a slightly different way. In the 25 years or so leading up to the economic and financial crisis, global growth benefited at various times from an amazing combination of powerful forces:

- A dramatic fall in inflation that had widespread benefits for the economy and financial markets.
- A rapid expansion of private credit that allowed demand to outpace the growth in incomes.
- The post-1990 opening up of the global economy – especially in the emerging world – that led to a rapid expansion in trade and investment.
- The information technology boom that followed the development of the Internet and related innovations.
- A massive expansion in asset values, triggered by booms in the prices of financial assets and real estate.
- Broad geopolitical stability underpinned by U.S. dominance.

Despite all of the above developments, the underlying growth rate of the global economy has not really improved over the period, while that of the advanced economies has slowed significantly (Chart 2). And most of these positive tailwinds will not exist or may even become headwinds in the years ahead. It is not clear to us that investors and policymakers have taken on board this fundamental change in the outlook, implying that there is scope for a major
shift in expectations at some point. We cannot be sure that this will occur in 2016, but it certainly is a risk.

**Mr. X:** It sounds as if you are endorsing Larry Summers’ view of secular stagnation.

**BCA:** We don’t feel it necessary to attach that specific label to the outlook although we do share some of his views. The key point is that the constraints on growth we listed are fairly intractable and thus should not be regarded as just temporary problems. Maybe it won’t be “stagnation”, but it will be a pace of growth that many will regard as disappointingly slow and one that will leave economies vulnerable to any new negative shocks. And in the event of another shock, policy will have a limited ability to soften the blow.

Obviously, there are differences between regions when it comes to the growth outlook. The potential growth path for the euro area and Japan is much slower than in the U.S., largely reflecting demographic trends. And these economies also are much less dynamic from an entrepreneurial point of view. This means that they are much more vulnerable to shocks. Meanwhile, the period of rapid growth in the emerging economies is over with countries facing a range of challenges. The bottom line is that potential growth rates are slowing across the globe.
Interesting recent research by Olivier Blanchard, Eugenio Cerutti and Larry Summers, showed that recessions lead to permanent losses of output, challenging the conventional wisdom that lost output is regained during recoveries. Moreover, their research showed that recessions are often followed by a reduction in potential growth itself. Given the severity of the last downturn, that implies considerable lost output that will never be recaptured. There has been a striking downgrade over the years in the Congressional Budget Office’s estimate of U.S. potential GDP, yet actual GDP continued to fall far short of the downwardly revised estimates (Chart 3).

One can look at the problem of sluggish growth from either a demand or supply perspective, but they are related and it is thus a false distinction. From a demand perspective, we have the issues of excessive debt, the end of the commodity bull market, and China’s transition to slower growth. On the supply side, there is the impact of demographics and, possibly, a declining productivity payoff from technology. But there are strong feedback loops between all of these trends.

**Mr. X:** You have raised some interesting issues, and I would like explore two in more detail: the debt overhang and the impact of technological change. Let’s start with debt. I understand that the End of the Debt Supercycle does not mean that debt levels are suddenly going to come down, but I

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**The Debt Overhang: Where Are We Now?**

**BCA:** Progress has been minimal in the majority of countries with total debt-to-GDP ratios holding at record levels or rising even further. As we have noted in the past, it is extremely difficult to reduce debt burdens when nominal incomes are growing so slowly. The median growth of nominal GDP for 36 advanced economies in the Bank for...
International Settlements debt database was a meager 2.2% in the year to 2015 Q2 (Chart 4). While the growth of debt also has slowed a lot, it is still above that of nominal GDP. Thus, the ratio of debt-to-GDP for the 20 countries has remained close its secular high of 270%.

If we look at the various regions, none has managed to achieve a noticeable decline in the ratio of total non-financial debt to GDP (Chart 5). In some cases (e.g. the U.K. and Spain), there was progress in reducing private debt ratios, but this was offset by a continued rise in the government debt-to-GDP ratio. The U.S. debt ratio appears to have stabilized, but at a very high level. The debt situation continued to worsen in all major emerging economies.

Mr. X: Well, once again, I have to ask the question that never seems to get a definitive answer: what is the end point of excessive debt levels? We all know that the aging of the baby boom generation is going to place growing pressure on government finances, so even if private debt levels stabilize, overall debt burdens seem destined to increase steadily in the major developed economies in the years ahead. Is the end point inflation, default or some other kind of financial chaos?

BCA: We understand your frustration, but it is hard to give a hard-and-fast answer to this question. In a perfect world, economies would grow fast enough that debt-GDP ratios would recede over time. But that seems most unlikely to occur. That leaves inflation or default as the other two options.

We would not be so foolish as to suggest that a return to high inflation is impossible. However, it is not in the cards any time soon, given the weak state of growth. The world currently is more deflationary than inflationary, and it goes beyond the commodity complex. The price of traded manufactured goods declined by 4% in the 12 months ended September 2015. Moreover, it is hard to see the current generation of central bankers presiding over a major sustained rise in inflation. Their attitudes were formed during the inflationary flames of the 1970s and they are determined not to repeat the mistakes of the policymakers that allowed that earlier inflation to take root. This explains why the Fed raised rates in December even though their preferred inflation indicator (the core PCE deflator) had risen by only 1.3% over the previous 12 months.

If economies go into another deflationary slump, then the next generation of central bankers may have an entirely different set of priorities. In other words, before we get another bout of inflation, we probably have to first suffer a painful downturn, in order to discredit the current policy orthodoxy.

This would seem to leave default or, to use a less scary euphemism, “debt restructuring” as the other solution. No major western government is likely to default on its obligations to private investors, short of a catastrophic scenario. However, one can envisage a country – and Japan comes to mind – converting its central bank holdings of government debt into low coupon perpetuums –
CHART 5
Debt Is Elevated Everywhere

FOR ALL PANELS*:
- TOTAL NON-FINANCIAL DEBT
- PRIVATE NON-FINANCIAL DEBT
- GOVERNMENT DEBT

* SOURCE: BANK FOR INTERNATIONAL SETTLEMENTS.

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effectively writing them off. And it would be sold as not really being a default because the central bank is part of the public sector and thus the government simply owes that debt to itself! In effect, it would amount to pure debt monetization.

We should stress that we don’t see any of these extreme outcomes – high inflation or default – occurring without first having a deflationary crisis. And, importantly, it is not likely to be debt levels themselves that cause such a crisis in the first place. The current environment of extremely low interest rates ensures that although debt levels are at or near all-time highs, the same is not true for debt-servicing costs in most countries (Chart 6). Extreme levels of debt can be sustained for a very long time if borrowing costs are low – just look at the example of Japan.

If interest rates rise because economic activity is strong, then presumably cyclical budgets will improve and governments would have some room to cut spending and/or raise taxes. The toxic situation would be in the unlikely event that rates rose to problem levels when growth and inflation were still weak. Presumably, governments would then ramp up financial repression to offset those pressures. This can be done by central banks suppressing market pressures on interest rates and by regulatory actions that force financial institutions to purchase more government debt.

**Mr. X:** So, once again, you are telling me not to worry about lingering high debt levels.
BCA: It is a serious long-term issue and we do worry about it. The odds of a near-term debt crisis are highest in selected emerging economies, but weak exchange rates should act as a partial shock absorber and keep the impact localized. You can be sure that we will be keeping a close watch for signs that debt burdens are becoming a market-moving problem.

Mr. X: OK, I will rely on you to warn me when problems are starting to erupt. I would now like to turn to the question of technological change and its impact on the economy and financial markets. I realize that technological advances generally are positive for real living standards and growth. Yet, there seems to be a lot of disruption because the speed of change is so fast. There is a lot of debate and differing opinions about this topic and I would be interested in your perspective.

The Impact of Rapid Technological Change

BCA: This is indeed another complex and important topic. From a big-picture perspective, we also take a positive view of technological advances. In the most part, they are good for productivity and that is the only sustainable source of rising living standards. Everything from the development of the wheel, the printing press, steam power, electricity and the Internet represented new General Purpose Technologies that dramatically altered the way that societies and economies were structured, and ushered in dramatic improvements in productivity.

While the information technology revolution is still continuing, many developments represent improved ways of doing existing tasks, rather than doing completely new things. For example, 3-D printing is an amazing new technology that will simplify some production processes and lower costs. But it does not represent the same kind of breakthrough technology that the Internet itself was. And the economic impact of Social Media on the economy is unclear.

The popularity of Social Media indicates that consumers get a lot of utility from it. This is not fully captured in GDP which is designed to measure the value of goods and services that are produced, and a lot of the activity on Social Media is “free”. This gets into the discussion of whether GDP is the best measure of economic progress and that is a complex topic that we do not have time to get into. Meanwhile, one could argue that employee time spent on Social Media during working hours contributes to some loss of productivity. Overall, we doubt that Social Media activity means that output is significantly understated.

A big issue related to this discussion is whether the job disruptions from new technologies will offset much of the benefits. The growth of the so-called sharing economy, highlighted by the spread of Uber and Airbnb, is expected to cut a swathe through many service jobs. This is not something that we are very worried about. Services like Uber and Airbnb have led to a marked increase in the supply of services, and by reducing
prices, they also boost demand. In effect, it encourages more effective use of the existing capital stock. While this may help depress new investment, it represents a positive supply-side shock. The benefits should more than compensate for the disruption to legacy companies and jobs.

The data show quite a marked slowdown in productivity growth in the major economies in recent years, despite ongoing technological advances. There is a debate about whether this is because new innovations are becoming less potent for the economy, or because the data increasingly understate productivity.

The measurement of productivity has become increasingly difficult as services such as IT and health care account for a growing share of GDP. It is relatively easy to measure the productivity of auto workers, but less so for doctors and App developers. Yet, if productivity growth was much higher than the official data suggest then one can ask why inflation is not a lot lower. If the productivity data is understated, then the inflation data must be overstated. That would put policymakers in a bind given that even the published inflation data are far below the 2% level desired by most central banks.

Pulling this all together, technology remains a positive force, but the marginal boost to growth probably is less than it was. One indication is the much slower pace of decline in the price indexes for information processing equipment and software (Chart 7). As these price indexes are adjusted to reflect quality improvements, a slower decline rate reflects a weaker pace of estimated quality gains. And such a trend is not surprising given

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3 If we assume that nominal GDP is measured reasonably accurately, then the other side of any upward revision to real GDP would have to be a downward revision to the price deflator.
a marked slowdown in the growth of the real net capital stock of IT equipment in recent years.

Mr. X: Call me a Luddite if you wish, but I am not convinced that the information technology revolution has made us wiser. I am besieged with an overload of emails every day, many of which are a waste of time. We have access to massive amounts of information, but I don’t see any evidence that we are better at understanding or forecasting events. If anything, there seem to be more divergences than ever in opinions about major trends. In other words, the increased information flow has led to increased confusion because everyone can now find some obscure data to support any weird view they may have.

BCA: There is some truth in what you say – there clearly has been an increase in short-termism among businessmen and investors, and the IT revolution may be partly to blame. But that does not mean that the benefits from IT are not real. Anyway, this is a big discussion topic that we can perhaps pursue another time.

Mr. X: Fair enough. Getting back to the macro environment, you are predicting continuing disappointing growth and low inflation. Yet, the Fed has just raised interest rates. I am not unhappy with that decision because I have long believed that the zero rate policy was doing more harm than good in terms of fueling financial distortions while providing little benefit to growth. Do you think the Fed has made a mistake?

The Policy Outlook

BCA: Just like within the Fed itself, BCA strategists are divided on that question. Some of us agree with you that zero rates long ago ceased to be necessary while others believe that there was no compelling need to move given the downside risks to growth and inflation. It is indeed quite extraordinary to see the Fed raise rates when oil and commodity prices are plunging and manufacturing activity is so weak. In any event, a 25 basis point move in short rates is not going to have a big or lasting impact on the economy or markets.

The more important issue is what happens next. If the Fed were to follow the path of rate hikes implied by the FOMC’s ‘dots’, then that would be a mistake. And the markets agree with us on that because they are discounting a fed funds rate of only 1.75% by the end of 2018, as opposed the 3.5% implied by the FOMC’s projections (Chart 8). We side with the markets and expect the Fed’s ‘dots’ to be revised down steadily over the coming year and beyond.

If U.S. rates were to rise in line with current FOMC expectations, i.e. faster than the market currently is discounting, then presumably the dollar would rise sharply. That would hurt profits and exports, put further downward pressure on inflation, and potentially create considerable turmoil in global markets, all eventually forcing the Fed to backtrack. The economic environment that we discussed earlier is consistent with an equilibrium
CHART 8
The Markets Don’t Believe The Fed

FED FUNDS RATE TRAJECTORY:
- FOMC MEDIAN PROJECTIONS: DEC. 2015
- MARKET EXPECTATIONS*: DEC. 16, 2015

* AS DISCOUNTED IN OVERNIGHT INDEX SWAP CURVE

CHART 9
The Long-Run Path of Real U.S. Interest Rates

U.S. REAL* FED FUNDS RATE

* DEFLATED BY CORE PERSONAL CONSUMPTION EXPENDITURE DEFLATOR.
NOTE: THE HORIZONTAL DASHED LINES REPRESENT PEAK-TO-PEAK AVERAGES OVER NBER-DESIGNATED BUSINESS CYCLES; THE 1980s RECESSIONS ARE TREATED AS ONE CYCLE. THE SHADED AREAS REPRESENT NBER-DESIGNATED RECESSIONS.
real rate below the 1.5% that the Fed’s forecasts imply. The real interest rate has been on a downward path for some time, and a major reversal in trend is unlikely in the foreseeable future (Chart 9).

The bottom line is that even though the Fed has emphasized that it will tighten at a very gradual pace, it will move even more slowly than FOMC members currently expect. Thus, you should assume that U.S. interest rates will remain at historically low levels for a long time.

Mr. X: It is hard to disagree with that view, and I know it does not make sense for me to worry at the same time about both downside economic risks and excessively easy monetary policy. I will just have to get used to financial distortions as an inevitable and ongoing by-product of the economic world you have described. If the Fed is going to find it difficult to raise rates a lot further, then I suppose we can forget about any rate hikes in the euro area or Japan for the foreseeable future.

BCA: Absolutely. While the U.S. economy has hardly boomed, it has performed much better than either the euro area or Japan. You asked about secular stagnation earlier – Japan has been stuck in weak growth for years and this clearly is a threat for the euro area.

In Japan, a key objective of Abenomics was to pull the country out of deflation but the success has been relatively limited. The core inflation rate has moved into positive territory, but remains far below the 2% target (Chart 10). And this is despite a 25% drop in the trade-weighted yen over the past three years. Inflation expectations did rise sharply with the introduction of Abenomics, but recently have faded, albeit remaining in positive territory. The Bank of Japan has held off from expanding its quantitative easing (QE) program, but more action cannot be ruled out given the weakness in the economy.

Turning to the ECB, President Mario Draghi has emphasized that he will do
whatever is necessary in order to prevent a slide into a Japan-style deflation. Unlike the Fed, the ECB has a single mandate of inflation and that remains far below the desired level of close to 2% (Chart 11). And, as with Japan, this is despite a drop in the exchange rate over the past two years.

It is interesting to compare the growth of balance sheets for the Fed, ECB and BoJ since the crisis. You can see from Chart 12 that the ECB has significantly lagged the other two banks in responding to low growth and low inflation. So while recent easing moves by the ECB were very modest, we would not be surprised to see more aggressive action from Draghi.

**Mr. X:** Since you have argued that monetary policy is largely exhausted, why does it matter what the ECB and BoJ do?

**BCA:** It does not matter what we think – it matters what the markets think, and they continue to attach a lot of importance to shifts in monetary policy. More easing by the ECB and/or BoJ may have little economic impact, but it probably would move markets.

In both the euro area and Japan, the credit channel clearly is impaired with credit growth remaining lackluster, despite very low interest rates. The Debt
Supercycle ended in Japan 25 years ago, yet there is still little appetite for a lot more credit in the private sector. And in the euro area, we are in the very early stages of a retreat from debt. As we discussed earlier, this increases the reliance on manipulating asset prices and exchange rates, but there are good reasons to doubt the efficacy of these channels especially in Japan and Europe where the equity culture is nowhere near as strong as in the U.S. And of course, not every country can successfully push its exchange rate down.

**Mr. X:** I am in full agreement with you on this. But it raises the worrying question of what policy can do in the event of another economic downturn. We have not conquered the business cycle and this expansion has already been quite long by historical standards. What happens if we get another recession in the next year or so when interest rates are still close to current levels?

**BCA:** That is a question that must keep central bankers awake at night. The unfortunate answer is that there will be very little that monetary policy will be able to do to soften the blow. Of course, they will act: we would get more use of negative interest rates and a lot more QE, but it is hard to image that either would help economies that much. The problems that currently ail economies are not related to the level of interest rates.

The obvious answer to your question is that, in the event of a new downturn, the right response would be massive fiscal stimulus. Several prominent economists such as Larry Summers and Paul Krugman have been arguing for increased fiscal stimulus for some time, and we have a lot of sympathy for their view. There are major infrastructure needs in many countries and governments can borrow at rates they would never have dreamed of several years ago.

In the U.S. in 2014, real government infrastructure spending in net terms (i.e. after depreciation) hit the lowest level since 1950 (Chart 13). There has been a modest revival in the past year, but the level is still at an extreme low. And it is hard to claim that the U.S. does not need to spend money upgrading basic infrastructures such as roads, bridges, airports and sewers. There is a similar need in many other countries.
The problem is that increased government spending – even on needed infrastructure - is politically difficult in the U.S., and constrained by budget rules in the euro area. Japan’s infrastructure is generally good and a shrinking population does not really need more government spending.

Attitudes toward fiscal stimulus would change in the event of another recession when it became apparent that monetary policy was powerless to help. And perhaps central banks would help at that point by purchasing whatever quantities of debt that government were forced to issue. In other words, we will end up with an effective policy response, but it will come late, after a lot of damage has been done.

**Mr. X:** That is not exactly a cheerful message. Before we finish talking about policy, we should discuss the situation in emerging economies. With many of these countries facing capital outflows and falling exchange rates, it obviously is difficult for them to ease, despite weak growth. Some, such as Brazil and South Africa, have even been forced to raise interest rates. And then we have China – they have scope to ease but are wary of triggering renewed credit excesses. With the emerging countries now accounting for around half of world GDP, maybe global monetary conditions are not as easy as everyone thinks.

**BCA:** Many emerging countries are indeed between a rock and a hard place when it comes to monetary policy. Given the deterioration in economic activity there certainly is a case for a marked easing. However, as you pointed out, the reversal in investors’ attitudes toward EM investments has led to a reversal in capital flows and thus major exchange rate weakness – especially in countries with current account deficits (Chart 14). This is a huge problem for those countries that have a lot of foreign currency debt. As you noted, a number of countries have been forced to raise interest rates to help stem currency weakness, but they have
tried to soften the domestic impact with backdoor injections of liquidity.\(^4\)

At the end of the day, the trend in exchange rates will be as good a measure as any about the monetary stance in emerging economies. On that basis, the message is clear – conditions remain on the accommodative side.

The situation in China is rather different because it runs a current account surplus and does not have an overhang of foreign currency debt. China has lots of room to pursue monetary and fiscal stimulus and, as you said, the main challenge for policymakers is to find the right balance between supporting growth and controlling credit excesses. This is a tricky task, leaving lots of scope for mistakes, but we do expect policy to be biased toward further ease in the coming year.

Overall, taking account of both the developed and emerging countries, global monetary conditions are accommodative, albeit not excessively so judging by the sub-par trends in growth and inflation. And this should continue to be the case in 2016, providing continued support to asset prices.

Mr. X: I look forward to getting into your specific market views shortly. But before we do that, let’s explore the economic outlook in a little more detail.

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Pulling all this together, it is difficult to see why the pace of growth should accelerate, and easier to see why it might slow. But this will still leave the U.S. as one of the better-performing developed economies. The contrast between the GDP trend in the U.S. and that in the euro area and Japan has been dramatic (Chart 16). At least U.S. activity has far surpassed its pre-crisis peak which is more than can be said for these other regions.

Mr. X: I guess we know it is a slow-growth world when 2% is regarded as a good performance. The euro area cannot seem to get a lucky break. The crisis in the periphery has receded, but a new set of problems has been created by the surge in migrants and the ghastly terrorist attack in France. Are there any grounds for optimism toward the euro area?

BCA: It hard to be optimistic with politics becoming an increasing risk factor.
The migrant issue and terrorist attack have exposed the deeply fractured state of the region’s politics and the difficulty of dealing with common problems. The vision of deepening integration is becoming increasingly fanciful, raising questions about the sustainability of the single currency itself.

The euro area’s economic problems are more structural than cyclical and stem from its internal imbalances. For example, Germany, France, and Italy have made disappointingly little progress in reducing labor cost differentials with each other (Chart 17). And government debt burdens remain very elevated in the periphery. It will be hard to keep Greece within the single currency without more debt relief and it may not be easy to get agreement on that. Finally, private sector deleveraging is still at a very early stage compared with that of the U.S.

As far as the near-term picture is concerned, the growth picture has improved recently, especially in Spain and Ireland. The big three: Germany, France and Italy are expanding, but at a moderate pace - all had average annualized growth rates of 1.3% in the first three quarters of 2015. The trend in leading indicators and purchasing managers’ indexes paint
a reasonably encouraging near-term picture (Chart 18), but the IMF’s forecast of 1.9% euro area growth in 2016 is on the optimistic side.

Mr. X: I am more bearish on Europe than you appear to be. I view the single currency as a giant mistake and seriously doubt that it can hold together in its current form. No doubt, politicians will make every effort to shore it up, but ultimately it will end in failure because we will never get the fiscal integration that is necessary to ensure its survival.

BCA: We also are not convinced that the single currency can survive over the long run. At the moment, there is a lot of support for the euro among politicians and the populace, even in countries that have suffered economically. However, over the long run, there will have to be a significant revival in real living standards in countries such as Italy and Portugal for the single currency to survive and it is not clear whether this will happen. And we agree that fiscal union is required and that will be very hard to achieve. In any event, this will not be an issue for several years because, as you say, politicians will act vigorously to shore things up.

Mr. X: Let’s turn to Japan. A year ago, you were not particularly optimistic about that economy and that turned out to be warranted. Have you changed your view?

BCA: Once again, there are not a lot of positive things to say. We noted earlier that Abenomics has not been able to deliver on its plans, with growth and inflation falling short of expectations. The government has announced new increases in spending but we doubt the moves will be large enough to have a big impact. Meanwhile, the trend in the leading economic index does not inspire great confidence in the near-term outlook (Chart 19).

Last year, we noted that it would be important to track the trend in real wages as a sign that deflationary pressures were easing. There is some good news on this front with real wages no longer falling, and a planned rise in the minimum wage should also help. On the other
hand, the trend in machinery orders is soft and exports are declining. In sum, the economy remains trapped in low growth and we see few signs that this will change.

Mr. X: Are there any developed economies you are positive about?

BCA: Not really. The U.K. economy has been doing well, but the strength in sterling over the past couple of years is bound to take a toll on exports and planned cutbacks in government spending also will impact growth. Yet the U.K. should remain one of the better-performing economies.

Turning to Canada, our home base, the picture is not great. The weakness in oil and commodity prices has hurt the western part of the country and resulting exchange rate weakness has not benefited exports as much as hoped. This may be because so much manufacturing capacity has been lost in recent years and it cannot easily be reversed. The new government plans to increase infrastructure spending, but that will take time to feed through into growth. Meanwhile, house prices are very frothy in Toronto and Vancouver, a source of major concern to the central bank. Historically, Canada’s growth tended to broadly match that of the U.S., but a gap has opened up that likely will persist in 2016. Australia’s economy has held up quite well, but it suffers from the same resource price pressures as Canada, and exports to China have fallen sharply. Finally, there is not much to inspire optimism in Switzerland,
given the negative impact of its extremely strong real exchange rate and a recent sharp drop in consumer confidence.

**Mr. X:** So much for any chance that you might counter my own bearishness. While we are on this gloomy track, we should now talk about China. You have long argued against the hard landing scenario that many have been predicting and that has been the correct call. But I don’t trust the official GDP data and everything I read suggests that the economy is much weaker than the published growth of around 7%. Are you still confident that a hard landing can be avoided?

**BCA:** The official GDP data are indeed dodgy and we suspect that growth is closer to 6% than 7%, and may even be in the 5½% to 6% zone. If it was much weaker than that, the authorities would be much more aggressive with stimulus. Thus far, their moves to ease monetary and fiscal policy have been rather timid, suggesting that the government is not overly concerned about the pace of growth.

The manufacturing sector is in recession with sharp declines across a broad range of indicators (Chart 20). There is deflation in the industrial sector and that has put downward pressure on profits and capital spending. Things will not ease until excess capacity diminishes and that will take time. The construction sector also is in decline, as previous excesses are worked off.

The service-oriented sectors are faring much better, although growth also has
slowed there. The transition toward consumption and services and away from exports and capital spending is to be welcomed and will play out over many years. But it was never going to be easy, and deflation in the industrial sector will have knock-on effects on employment and thus growth in services spending. Thus, overall growth seems destined to remain in the region of 5% to 6% in the coming year.

As we and others have noted, China has a lot of policy room to maneuver should additional stimulus be needed. Monetary conditions are still very tight, reflecting high real borrowing costs for companies, and a high real exchange rate. And gross general government debt is still only 43% of GDP, leaving plenty of room for a fiscal push (Chart 21). Thus, unless there is a major policy mistake, there is still no need to fear a hard landing in China.

Mr. X: I hope you continue to be correct about that as I don’t think the world economy could withstand a big negative shock from China. Your caution toward other emerging economies has certainly been justified with Brazil and Russia in recession and most others suffering a major slowdown. So much for the idea that the BRICs would continue to triumph!

BCA: The emerging world has indeed been buffeted by a perfect storm of events. The downturn in resource prices hit the energy and commodity exporters hard while the contraction in manufacturing trade hurts countries such as Taiwan and Korea. It is hard to find any emerging economy where exports are doing well. Annual growth in industrial production for the overall emerging world was only 3% in the first nine months of 2015, a level normally seen only in recessions.

As we discussed earlier, in many countries – most notably those with current account deficits – weak exchange rates constrain policymakers from easing aggressively. Meanwhile we do not expect
any major sustained rebound in resource prices in the coming year. Thus, it will remain a difficult environment for the majority of emerging economies.

After such gloomy comments, we should try to end our discussion of the economy on a more positive note. One silver lining from the slow-growth environment is that we are not getting a buildup of the typical imbalances that precede recessions. Most importantly, inflation is low, and likely to stay that way for some time. Indeed, the trend in the prices of resources and traded manufactured goods is deflationary, not inflationary (Chart 22). This will ensure that monetary policy maintains an easy bias. In the past, most recessions were triggered by tight money.

**Mr. X:** O.K. I will take some small comfort from that, although I would be more concerned about a recession being triggered by a geopolitical event or some other shock. But we should move on to your market views. The picture you have painted sounds quite bond friendly, although it is hard to imagine yields going any lower in Europe or Japan.

### Bond Market Prospects

**BCA:** The macro environment does indeed continue to be very bond friendly and in our Global Fixed Income Strategy service we are recommending that investors stay long duration. The combination of excess global savings, stimulative monetary policy, low inflation and ongoing demand for low-risk assets is keeping yields at unusually low levels and this is not likely to change any time soon. Indeed, the ECB’s decision to extend its QE program will mean an even greater decline in the number of euro area bonds available for private investors (Chart 23). The BoJ’s purchases of government bonds also exceed net issuance, keeping yields at very low levels.

In Germany, yields are negative out to six years as the ECB soaks up the dwindling supply of Bunds. About €3 trillion
of European government bonds currently are trading at negative yields, representing 40% of the total. Core euro area bonds are among the most expensive within the developed world as measured by the distance of real yields from their historical average (Chart 24).

It seems extraordinary that Italy can borrow for 10 years at 70 basis points less than the U.S. while it costs Portugal a mere 20 basis points more than it costs the U.S. Treasury. Yet, while European peripheral bond yields and spreads do not compensate for the medium-term fundamental risks, this has been the case for some time. Unless a country is perceived to be at imminent threat of exiting the single currency, ECB backing makes peripheral bonds attractive for yield-starved European bond investors. Thus, peripheral spreads, with the exception of Greece, could grind even lower in the coming months. The skies will darken for peripherals once the ECB begins tapering its asset purchase program, but this may not be for years.

The U.S. Treasury market offers high yields compared to those on offer in Europe and Japan. However, from a global perspective, the U.S. yield advantage is not as attractive as it appears after hedging for currency risk. Even so, Treasury yields are not likely to rise much over the next 12 months, and we cannot rule out a decline if the economy disappoints.

Overall, government bonds are not going to be a high-return investment from current yield levels. In the long run, we
assume that yields will edge higher so, at some point, it will be appropriate to shift to a low duration stance. In the near term, however, sovereign bonds in the major developed countries will be a good hedge against downside economic risks and will provide some stability to your portfolio. Thus, you should keep benchmark bond weightings.

Mr. X: A year ago, you were recommending an overweight position in corporate bonds, but you shifted to an underweight stance early in the summer. What would it take for you to turn more positive given that spreads have widened a lot and there is still a desperate search for yield? And in a similar vein, what about emerging market bonds where spreads also have blown out?

BCA: Our changed view on U.S. corporate credit was triggered by a clear worsening in the sector’s financial conditions. Rising leverage and weakening profits has led to a marked deterioration in our Corporate Health Monitor, which in turn, has a good correlation with default rates (Chart 25). And although spreads have widened, they are not yet high enough to make us want to start buying again given that default rates are certain to rise. And, importantly, the deterioration in credit fundamentals extends beyond the energy sector.

The sell-off in high-yield bonds may soon move into a final capitulation stage, creating a good buying opportunity. But, to turn fundamentally positive on the sector, we will want to see signs
that corporate finances are stabilizing. The triggers for that likely will include an end to the dollar’s ascent, an improvement in corporate pricing power and stabilization in commodity prices. So please stay tuned to our research during the year as we update you on these trends.

Turning to emerging market credit, we strongly advise you to stay away. Spreads have widened for a very good reason and still do not fully reflect the risks. As we discussed earlier, a lot of emerging countries are caught in a vicious trap. Economic weakness calls for easier monetary policy, but the ability to cut rates is constrained by currency weakness that raises the cost of servicing elevated levels of foreign currency debt. Meanwhile, corporate leverage ratios have climbed sharply, warning of increased default risks (Chart 26). The end result of these
trends may well be a severe crisis among EM banks that causes yield spreads to spike higher.

Mr. X: Your clear message is that if I want to be in bonds, I should stay in developed country sovereigns, despite their paltry yields. I can live with that because that might still be better than what I will do in the stock market.

**Equity Market Prospects**

Mr. X: I understand that the extremely low level of interest rates provides considerable support to the stock market. But the earnings outlook in a low growth and low inflation world is poor, markets are not cheap and there are some worrying technical signs. So, once again, I ask the question: should I dramatically reduce my equity market exposure?

BCA: The worsening earnings picture has certainly made us more cautious on the equity market and we do not recommend more than neutral weightings for equities within your overall portfolio. And we would not argue strongly against moving to an underweight position. Our base case view is for the developed markets to grind higher over the next 12 months, delivering total returns of less than 5%. That is not a huge return premium over bonds, especially given the downside risks.

The two tail risks to our base case view are at opposite extremes: a major sell-off or a melt-up in prices. Let’s deal with each of these possibilities.

There is no guaranteed way to predict bear markets. Sometimes they come as a complete surprise which is why sentiment often is very bullish at major market tops. Nonetheless, if we look at the 14 U.S. bear markets since the 1950s, we find that all but three were associated with a marked tightening in monetary policy as signaled by a flat or inverted yield spread between 3- and 5-year Treasuries. The market downturns of 1976-78, 1987 and 2011 had little to do with the monetary cycle. Nine of the 14 bear markets also coincided with or preceded a recession, and in most of the other cases, earnings declined even if the economy did not (Chart 27).

We will not have to worry about monetary policy becoming tight for a long time. And there are no serious economic imbalances that warn of an early recession. On the other hand, profits are under pressure, so that is something to worry about. While much of the recent earnings weakness has been in the energy sector, the outlook for overall profit margins is not encouraging with tough pricing conditions and wage costs likely to move up. Margins were always going to struggle to stay at such elevated levels and while a collapse is not on the cards without a recession, a compression is

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5 For the purposes of this exercise, we define bear markets as decline of at least 15%, lasting at least three months. And as all but one of the episodes since 1970 was accompanied by a bear market in the MSCI ex-U.S. index, we can use the U.S. experience as a proxy for the world.
CHART 27
No Classic Warning Signs Of A U.S. Equity Bear Market

S&P 500

TREASURY YIELD CURVE: 5-YEAR LESS 3-YEAR

REAL SHORT RATES

REAL GDP

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NOTE: SHADED FOR BEAR MARKETS.
underway (Chart 28). And this is occurring when the U.S. market is expensive relative to trend earnings and book value.

Technical indicators can sometimes help identify growing market risks and the current message is mixed. On a positive note, there is not the extreme investor bullishness that would signal a vulnerable market. Traders are optimistic, but that is not shared by advisors or retail investors (Chart 29). On the other hand, breadth has deteriorated with the market depending increasingly on a few large stocks. The equally-weighted S&P 500 has held below its 200-day moving average as has the broader Value Line index.

Our conclusion from this rather convoluted picture is that while we cannot forecast a bear market with any confidence, the weight of evidence suggests that the risks are high enough to take seriously.

The tail risk at the other extreme is a market melt-up, as occurred in the late 1990s. The obvious trigger would be additional monetary stimulus that forces even more money out of cash and bonds. And ongoing merger and acquisition activity could add fuel to the fire. We attach low odds to this outcome because the circumstances that caused more aggressive monetary easing would presumably be bearish for corporate earnings.
In sum, there is a case for reducing your equity exposure, especially to the U.S. market. We continue to think that Europe and, to a lesser extent Japan, offer better return potential for the coming year.

**Mr. X:** That was your view a year ago and I suppose the reasoning is still the same.

**BCA:** Yes, the arguments have not really changed much over the past 12 months. There essentially are three reasons for expecting the U.S. market to underperform:

- The U.S. monetary cycle is more advanced than that of Europe and Japan. This affects both exchange rates and bond yields, with implications for relative equity performance.
- Profit margins are especially elevated in the U.S., casting a shadow over relative earnings prospects.
- The valuation of the U.S. market is less attractive than many other developed markets. As shown in **Chart 30**, the cyclically-adjusted price-earnings ratio (CAPE) for U.S. non-financial stocks is above its historical average, unlike many other markets.

Of course, the U.S. is not without some advantages. It remains the most dynamic economy and has the deepest and most liquid equity market, offering exposure to the full range of sectors and styles. Nonetheless, modest underweighting in the U.S. is still warranted.

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**RANKING IS BASED ON HOW FAR CURRENT CYCLICALLY-ADJUSTED PRICE-EARNINGS RATIO IS FROM THE HISTORICAL AVERAGE, EXPRESSED IN NUMBER OF STANDARD DEVIATIONS.**
Mr. X: Turning to emerging equities, your continued bearish stance kept me out of those markets and thus saved me from some losses. You adopted that stance some time ago when it was very controversial but it became a consensus view in the past year as poor market performance ground down even long-time EM optimists. Some strategists are predicting that 2016 will be better year for these markets but I see from your research that you have not altered your negative view.

BCA: We see no reason yet to adopt a more positive view. If anything, the cyclical economic and thus earnings picture continues to deteriorate against a backdrop of weak global trade, deflation in traded goods prices, forced deleveraging and weak currencies that are constraining policy (Chart 31). Moreover, as we noted a year ago, these equity markets are not as cheap as the overall EM price-earnings ratio suggests. The overall EM multiple is being held down by just two sectors: materials and financials. The PER based on equally-weighted sectors is not especially low by historical standards (Chart 32).

A more bullish near-term view will require better valuations and/or indications that the earnings picture is improving. That, in turn, will require stabilization in traded goods prices. From a longer-term...
perspective, there needs to be major reforms in governance and the regulatory environment that reverse the structural downturn in productivity and thus the return on equity.

To the extent that you are investing in EMs, you should focus on Taiwan, China, India, the Czech Republic, and Mexico. The key ones to avoid are Brazil, Turkey, Indonesia, Thailand and Malaysia.

Mr. X: Let’s end our discussion of equities with your view on sector strategy.

BCA: Not surprisingly, we continue to favor defensive over cyclical sectors. Trends in global trade, EM versus DM economic performance, and relative pricing power all favor this strategy (Chart 33). The global industrial sector effectively is in recession, undermining sectors such as industrials, materials, energy and transportation. Thus, you should focus on more defensive sectors such as consumer staples and healthcare.

Commodities and Currencies

Mr. X: You correctly predicted that resource prices would remain in a downtrend, but I have been surprised by just how weak the trend has been. When do you see the bottom being reached?

BCA: There is no sign of a bottom yet – especially in industrial commodities which are especially sensitive to the economic cycle. The downturn in global manufacturing activity has sustained the oversupply of many commodities including iron ore, copper and other base metals, and this has been exacerbated by dollar strength. The price index for industrial commodities remains in a powerful downtrend, below its falling 200-day moving average (Chart 34).

A trough in prices will be reached when industrial production and the dollar stabilize. That could happen over the next year, but we do not recommend taking a more positive investment stance in anticipation of an improvement that might be slow to materialize.
The situation in the oil market is different because the supply picture is complicated by OPEC’s unusually aggressive production strategy. We know that the oil market is being oversupplied to the tune of around 1.5 million barrels a day at a time when inventories already are at a record level (Chart 35). In the past, one would have expected Saudi Arabia to cut production to keep the market in balance, but those days seem to be over. The December
OPEC meeting highlighted the extent of OPEC’s breakdown with not even token measures to constrain the output of member countries. Oil prices weakened sharply after the December OPEC meeting as investors decided that excess supplies will continue to build.

With the Saudis relinquishing their role as marginal supplier, U.S. shale production has taken over that position. As U.S. shale producers will always try to maximize output when profitable, the market will be biased toward oversupply until lower prices induce higher demand and reduce non-OPEC production by enough to restore balance to the market. Investors are ignoring the fact that these adjustments are underway.

U.S. production has already fallen by around 600,000 b/d from its April 2015 peak and a further 400,000 b/d cut is expected over the next several months. Moreover, 1 to 1.5 million b/d could be trimmed from non-OPEC offshore sources in 2016, as low prices have made it difficult to finance the capex required to make up for decline-curve losses.

Although Iran will boost production by 1 mb/d following the removal of sanctions, this will be absorbed over the next year by increased global demand. Pulling all this together, we believe that the global oil market should be in broad balance by the third quarter of 2016.

We cannot rule out further near-term weakness in oil prices, driven partly by speculative flows and exacerbated by mild winter weather in the U.S. and elsewhere. The bears are in the driving seat for the moment and one can never be sure how long overshoots will last and how far they will move. However, a gradual improvement in the supply-demand balance should allow prices to drift higher into a $45 to $60/bbl range in the second of 2016, and average $50/bbl, for the 2016 – 2018 period. It will be difficult for prices to rise much above this given the rapid response of U.S. shale producers to price moves. We would avoid shorting oil at this point.

**Mr. X:** You will not be surprised that I also want to talk about gold. You have consistently discouraged me from owning gold during the past few years, despite my inclination to the contrary. I grudgingly have to admit that you have been right and I have been wrong, but I still cannot abandon the view that bullion provides a hedge against a multitude of shocks.

**BCA:** We agree that gold can be a good hedge against events that cause a major spike in risk aversion. However, the combination of a strong dollar and deflationary global forces is providing a powerful headwind against bullion. The fact that gold has done so poorly at a time of negative real interest rates highlights the power of these headwinds.

We doubt that gold prices will stage much of a recovery in the coming year, so are still not recommending long positions. But, as we have noted before, there is an emotional element to owning gold, and modest holdings can be justified if it makes you more comfortable
with your portfolio. But it should not be more than 5% of your assets, thereby limiting the damage from continued poor price performance.

**Mr. X:** Last year you said that the dollar was likely to rise, although you did not expect a large gain. In the end, the trade-weighted index managed to rise by around 10% in 2015, similar to the previous year’s gain. There is still a lot of optimism toward the dollar, based largely on the divergence between U.S. monetary policy and that in Europe and Japan. Would you bet against this consensus?

**BCA:** Not strongly. Although the divergence in monetary policy should already be priced, the dollar is likely to gain further against emerging market and commodity-oriented currencies. Thus, even if there are limited gains against the yen and euro, the trade-weighted index should drift higher.

There is not a compelling case for further significant moves in the euro/dollar rate. The story about divergent monetary policies probably is overdone because the Fed is not likely to move rates much, if at all, in 2016 while the ECB has largely exhausted its room for maneuver. Meanwhile, in terms of economic surprises, the U.S. economy is more likely to disappoint rather than exceed expectations, while the opposite may be true for the euro area. Thus, we doubt that the rate will drop sustainably below parity over the next 12 months.

The yen also has little downside from current levels. In real terms, the yen is at a 45-year low, and the BoJ appears reluctant to ease any further (Chart 36). The disappointing performance of the Japanese economy rules out a major revival in the exchange rate, but the yen probably has found a floor at around current levels.

As we noted a year ago, one of the problems with the major exchange rates is that none appear very attractive based on their own domestic fundamentals. Take the U.S. dollar: the economy has had the deepest recession since the

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**CHART 36**

Real Trade-Weighted Exchange Rates

- **U.S. Real Effective Exchange Rate**
- **Euro Area Real Effective Exchange Rate**
- **Japan Real Effective Exchange Rate**

*Source: J.P. Morgan Chase & Co.*
1930s, followed by the weakest recovery of the post-WWII period; debt levels remain extremely high by historical standards; there is still a large deficit on the basic balance (the current account plus long-term capital flows); and the stance of monetary policy is extraordinarily accommodative. It is only when these trends are compared to those in the other major countries that the dollar starts to look better. In other words, the dollar’s appeal is relative, rather than absolute. That still matters of course, but makes for a less compelling bull case.

Mr. X: How much more downside is there in commodity and emerging currencies, in your view?

BCA: The Canadian dollar has moved very closely with oil prices so one must forecast those to get the currency right (Chart 37). Oil prices still have some near-term downside risk given the ongoing oversupply of crude, so the currency could fall by another 5% or so versus the U.S. dollar. But, as discussed earlier, there should be some stabilization in the second half of the year. The Aussie dollar is tied more to industrial commodity prices and these still have to find a bottom. So the outlook remains bearish for that currency.

As far as EM currencies are concerned, we have already discussed the toxic interaction between monetary policy, exchange rates and debt servicing costs that has left policymakers in a bind. Weak economies are screaming out for policy easing, but such action is constrained and the situation is not likely to improve any time soon. Exchange rates are inevitably following the path of least resistance, which is down. It is hard to put a percentage figure on the downside, but it could easily be another 10% in the most troubled economies.

Mr. X: Does the decision to include the renminbi in the SDR basket have a lot of significance?
BCA: It certainly has symbolic significance for China as it validates the government’s plans to fully internationalize the currency over time. However, the near-term impact will be limited. The capital account has yet to be fully liberalized and the domestic bond market is not very deep. This will constrain the use of the renminbi as a global reserve currency. That will change over time, and we don’t doubt that the renminbi will account for a growing share of global reserves in 10 years’ time – especially in the Asia region.

The Geopolitical Environment

Mr. X: A final important issue to address is the geopolitical environment. I enjoy reading your regular Geopolitical Strategy Service, not least because it makes a point of drawing market implications from the various events. You correctly advised that I should not let my investment decisions be influenced by headline-grabbing developments such as the never-ending Middle East turmoil and Russia’s aggressive new stance because they would have minimal impact on financial markets. However, I have been becoming increasingly disturbed by the geopolitical situation even before the recent terrorist attacks in France. So you can imagine how I feel now, and I can tell you that most of my acquaintances – especially those in Europe – share my concerns. Even if there is no immediate market impact, I would like to hear your views on how the Middle East situation, especially the ISIS threat, will play out.

BCA: It is impossible not to be disturbed by recent terrorist activity.

Unfortunately, more attacks are likely in developed countries, for three main reasons. First, the Islamic State militants are losing the conventional war on the ground in Iraq and Syria and many foreign fighters are likely to head home. Second, the collapse of the authoritarian regimes of Iraq, Libya, and Syria has created pockets of instability where terrorists can plot their next move. Third, technology has made it easier and cheaper for terrorist to carry out their attacks.

The effects of terrorism on the economy and markets will largely be psychological and transitory. In the long term, terrorism against soft targets becomes ineffective once social attitudes adjust to its higher probability, as happened in Europe during the violent 1970s and 1980s (Chart 38).
Of course, the Middle East situation is not without risks for markets. The demise of ISIS is at hand, but its defeat will not change the primary force that gave rise to it: a Saudi-Iranian proxy war in Iraq. As such, we could end up with renewed conflict, particularly if the Sunni populations in Syria and Iraq reject the rule of Assad and Iranian-backed Baghdad respectively. Furthermore, the future of the Kurds in Iraq and Syria remains unresolved and source of potential conflict between Turkey and its neighbors. In 2015, insecurity in the Middle East had no impact on oil prices, but it could in 2016 if the security situation in Iraq becomes more destabilized.

**Mr. X:** Let’s hope that does not come to pass. In any event, I still fear that the combination of terrorism and the migration crisis will have pernicious effects on European politics.

**BCA:** We certainly expect more political volatility in Europe and the issues you mentioned will support the populists. However, we do not expect the appeal of populist policies to necessarily result in higher support for populist parties. Furthermore, the best way to deal with the migration crisis and terrorism is with further integration of the region’s foreign, military, and domestic security policies. While the headlines may continue to focus on the continent, the real risk for Europe in 2016 is the U.K. referendum on EU membership. For the moment, we expect that the U.K. will vote to remain in the EU, but the polls are close and a lot can happen between now and then.

**Mr. X:** What other geopolitical issues are on your radar screen for the coming year?

**BCA:** The main market-relevant geopolitical risk over the next 12 months is the deterioration of economic and political fundamentals in emerging markets. The ‘Goldilocks era’ of the past decade hid institutional weakness and political risks from investors, who plowed into EM assets with little regard for political, sectarian, and ideological cleavages that remain relevant in these economies.

While each country may appear to have unique and idiosyncratic political fissures, the trigger for their eruption will ultimately be the same: economic malaise and decade-long policymaker complacency.

In addition, we continue to worry that multipolarity is not priced in by the markets. Since we introduced the theme in 2013, the number of inter-state conflicts has risen and is approaching the highs of the late 1980s, when the world was awash with hegemonic instability (Chart 39). As a theory, multipolarity predicts higher frequency of military conflict as the number of independent geopolitical actors increases.

This year, we continue to worry about Chinese relations with their neighbors. The expansion of Chinese-controlled islands in South China Sea is a potential source of volatility, as are continued Chinese incursions into Japanese air space over East China Sea.

**Mr. X:** We can’t have a discussion of geopolitics without some comment on the
forthcoming U.S. elections. What is your prediction and how important do you think the result will be for the economy and markets?

BCA: The impact of American politics has been massively overstated by investors over the past three years. Despite a controversial President, an ineffective Congress, and a multitude of so-called crises, the economy has continued to grow and the market has reached new highs.

We expect the election to have a similarly muted impact. There are really only two potential outcomes: the continuation of the status-quo (Democrat as President, GOP-controlled Congress) or a GOP-sweep of all three institutions with a centrist Republican in the White House. While an anti-establishment candidate such as Donald Trump may win the GOP nomination, it is unlikely he would win against a centrist Democrat in a national election. What is lost in the media obsession about the ongoing Republican primary is that the median American voter is a centrist independent. Both of the likely outcomes are neutral – if not positive – for the market.

Mr. X: But who do you expect to win the actual election?

BCA: If we had to put up money a year before the election – which is not a smart investment – we would put it on Hillary Clinton. The longer the Republican primary goes on, the longer its candidates will delay moving towards the center, where that median voter sits. This will hurt the eventual GOP-nominee in the latter stages of the race.

Conclusions

Mr. X: I came to this meeting with many concerns about the economic and market outlook and you have not said much to ease my fears. Indeed, it seems that we agree on more aspects of the outlook than usual. You are predicting another year of mediocre performance for the global economy and markets and I see little reason to disagree with that forecast. And you have given tacit support to my inclination to lower my equity exposure.

BCA: We wish we had grounds for being more optimistic. It has been a challenging investing environment during the past year and very frustrating to think that the coming year may offer
The weights used in creating the balanced portfolio are not recommendations and are not based on any actual portfolios. They are just assumptions to create a 65% equity, 35% fixed-income portfolio. The historical returns in the table are in common currency terms and the future returns implicitly assume constant exchange rates.6 In the U.S., many large state pension funds continue to assume returns of more than 7% a year, an unattainable level, in our view. While long-run returns seem attractive for emerging market equities, a better buying opportunity is likely to emerge. As we told you last year, these numbers reflect average returns over the decade and within the period, there will be good years and bad years. The calculations are based on trend growth in nominal GDP, an assumption about profit margins and mean reversion of equity multiples.

The global economy is not in a stable equilibrium so the current unsatisfactory state cannot persist indefinitely. If growth is not strong enough to reduce the debt overhang or put an end to deflationary pressures then it implies ongoing vulnerability to negative shocks.

### TABLE 3

**Market Returns For The Coming Decade**

<table>
<thead>
<tr>
<th></th>
<th>COMPOUND % RETURNS P.A.</th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>U.S. EQUITIES</td>
<td>11.2</td>
<td>4.5</td>
<td>35</td>
<td></td>
<td></td>
</tr>
<tr>
<td>OTHER DEVELOPED EQUITIES</td>
<td>9.2</td>
<td>6.0</td>
<td>24</td>
<td></td>
<td></td>
</tr>
<tr>
<td>EM EQUITIES</td>
<td>12.0</td>
<td>8.5</td>
<td>6</td>
<td></td>
<td></td>
</tr>
<tr>
<td>10-YEAR TREASURIES</td>
<td>8.2</td>
<td>2.3</td>
<td>25</td>
<td></td>
<td></td>
</tr>
<tr>
<td>CORPORATE BONDS</td>
<td>8.2</td>
<td>4.0</td>
<td>10</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>TOTAL PORTFOLIO</strong></td>
<td><strong>9.7</strong></td>
<td><strong>4.5</strong></td>
<td><strong>100</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>INFLATION</td>
<td>2.7</td>
<td>2.0</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>TOTAL PORTFOLIO REAL RETURN</strong></td>
<td><strong>6.9</strong></td>
<td><strong>2.4</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

* Based on weights in final column.
These could relate to a policy mistake, a geopolitical event, or corporate financial distress. The next economic downturn could be very ugly but no doubt would bring around a major policy regime shift, including fiscal stimulus and possibly debt monetization.

There is another possibility to consider. Perhaps potential growth rates have slowed so much that even at current disappointing levels, growth could be fast enough to quickly close output gaps and thus trigger higher inflation and higher interest rates. This also would be a fairly grim scenario – having interest rates rise sharply at a time of high debt burdens and low real economic growth. Central banks would be in a tough spot, bringing us back to the risk of a policy accident.

In sum, it would be a struggle to give you a cheery story about the macro outlook. Our views on investment strategy will continue to evolve during the year in response to shifts in asset prices and the various market indicators and models that we follow. For the moment, caution is the operative word.

Mr. X: Many thanks for a thorough and frank discussion of the outlook. I wish it had been more cheerful but it is reassuring in a depressing kind of way to have you confirm my own biases. Let’s close, as usual, with a brief summary of your main economic and investment views.

BCA: We will be happy to do that. The key points are as follows:

- The current global economic malaise of slow growth and deflationary pressures reflects more than just a temporary hangover from the 2007-09 balance sheet recession. Powerful structural forces are at work, the effects of which will linger for a long time. These include an ongoing overhang of debt, the peak in globalization, adverse demographics in most major economies, monetary policy exhaustion, and low financial asset returns. Investor expectations have yet to adjust to the fact that sub-par growth and low inflation are likely to persist for many years.

- The Debt Supercycle is over, but weak nominal GDP growth has made it virtually impossible to reduce debt burdens. Nonetheless, a debt crisis in the advanced economies is not in prospect any time soon because low interest rates are keeping a lid on debt servicing costs. Perhaps high inflation and debt monetization will be the end-point, but that is many years away and would be preceded by a deflationary downturn.

- Despite ongoing exciting technological advances, the IT boom has lost its edge in terms of boosting economic growth. Even if productivity is understated, the corollary is that inflation is overstated, suggesting that central bankers will continue to face a policy dilemma.
The Fed will raise interest rates by less than implied by their current projections. And the European Central Bank and Bank of Japan may expand their QE programs. Yet, monetary policy has become ineffective in boosting growth. Fiscal policy needs to play a bigger role, but it will require another recession to force a shift in political attitudes toward more stimulus.

The U.S. economy will remain stuck in sub-2.5% growth in 2016, with risks to the downside. The eurozone’s performance has improved recently, but 2016 growth will fall short of the IMF’s 1.9% forecast. Japan’s growth will continue to disappoint as it will in most other developed economies.

China will continue to avoid a hard landing but growth will likely average below 6% in 2016 and beyond. Other emerging economies face a difficult environment of weak commodity prices, declining global trade. Those with excessive foreign currency debt face additional pressures with weak exchange rates preventing an easing in monetary policy.

Bonds offer poor long-term returns from current yields, but sovereign bonds in the major developed countries offer a hedge against downside macro risks and we recommend benchmark weightings.

The fundamental backdrop to corporate and EM bonds remain bearish and spreads have not yet reached a level that discounts all of the risks. A buying opportunity in high-yield securities could emerge in the coming year but, for the moment, stay underweight spread product.

We have turned more cautious on equities given a deterioration in the earnings outlook and in some technical indicators. No more than benchmark weighting is warranted and we would not argue against a modest underweight. The typical warning signs of a bear market are not in place but risks have risen.

The U.S. equity market is expected to underperform that of Europe and Japan. Continue to stay away from emerging equities and commodity-oriented bourses. We continue to favor a defensive sector stance, choosing consumer staples and health care over cyclical sectors such as materials, energy and industrials.

The bear market in commodities is not over. The sharp drop in oil prices will eventually restore balance to that market by undermining non-OPEC production and supporting demand, but this could take until the third quarter of 2016. The oil price is expected to average around $50 a barrel for the 2016-2018 period.
The strong dollar and deflationary environment create a headwind for gold, offsetting the benefits of negative real interest rates. But modest positions are a hedge against a spike in risk aversion.

The dollar is likely to gain further against emerging and commodity-oriented currencies. But the upside against the euro and the yen will be limited given the potential for disappointments about the U.S. economy.

As was the case a year ago, geopolitical risks are concentrated in the emerging world. Meanwhile, the new world order of multipolarity and an increased incidence of military conflicts is not yet priced into markets. We do not expect that U.S. elections to have any major adverse impact on financial markets.

Let us take this opportunity to wish you and all of our clients a very peaceful, healthy and prosperous New Year.

*The Editors*

December 17, 2015