Outlook 2016: A Delicate Balance

With the U.S. and China at different stages of the business cycle, central banks must tread carefully to avoid a repeat of last summer's volatility.

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KEY TAKEAWAYS

- As growth slows and wage inflation rises, the markets are giving the green light for the Federal Reserve to raise interest rates in December.
- Meanwhile, China is trying to stimulate its economy by gradually devaluing its currency, which will require a careful balancing act, because it is tied to the U.S. dollar.
- With valuations in the equity market at reasonable levels, the outlook for 2016 may come down to earnings growth, and if the China/U.S. balancing act is successful, there could be some recovery in oil prices, allowing earnings growth to recover from its current energy-induced slump.
- However, with the earnings cycle in the slowing phase and profit margins near historic highs, it may be a challenge to build an overly bullish case for equities.

The Fed vs. the PBoC

Looking toward 2016, some scenarios could bode well for the equity markets and global economy, while others may warrant a note of caution. Ultimately, the outlook for 2016 may hinge on the answers to several vital questions. For instance, how will the markets digest that the world's largest economy (the U.S.) is facing slowing growth and rising wage inflation, thus requiring its central bank (the Fed) to raise rates for the first time in nine years? And how will the markets react to the U.S. raising rates at a time when many other countries around the world are lowering them?

Perhaps the most pressing question is how the markets will respond knowing that the world's second-largest economy (China)—whose currency is pegged to the U.S. dollar—is slowing dramatically against both an unrealistically high, government-mandated growth target and a still-overvalued currency that wants to go down as capital flees, thus requiring further devaluation because it is the low-hanging fruit of stimulus tools? In other words, how will the Fed and the People's Bank of China (PBoC) reconcile that their respective economies are at points in the business cycle that require different forms of monetary policy, while faced with the reality that the currencies of both countries are linked?

The answer? Very carefully.

We saw this delicate balance play out over the summer, with the PBoC devaluing the renminbi (RMB) and causing such a tightening in global financial conditions that the Fed was forced to hold off its anticipated liftoff.

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The U.S. dollar

The principal transmission mechanism for this tightening was—and is—the U.S. dollar (USD), to which the RMB is tethered. With a lot of Chinese and emerging-market (EM) corporate debt issued in USD, a strong dollar is like a vice that keeps tightening, whereas a weaker dollar allows EM corporates to breathe a little easier. Also, a stronger dollar cuts in more ways than one, because as the dollar gains, commodity prices usually fall more, squeezing many commodity-producing EM issuers of dollar debt from both sides (less revenue and higher debt service).

The good news for the Fed is that, despite persistent strength in the dollar (with the broad trade-weighted index near cycle highs) and persistent weakness in credit spreads (due to weaker global growth and falling commodity prices), overall financial conditions have remained stable as we approach the December 15–16 Federal Open Market Committee (FOMC) meeting.

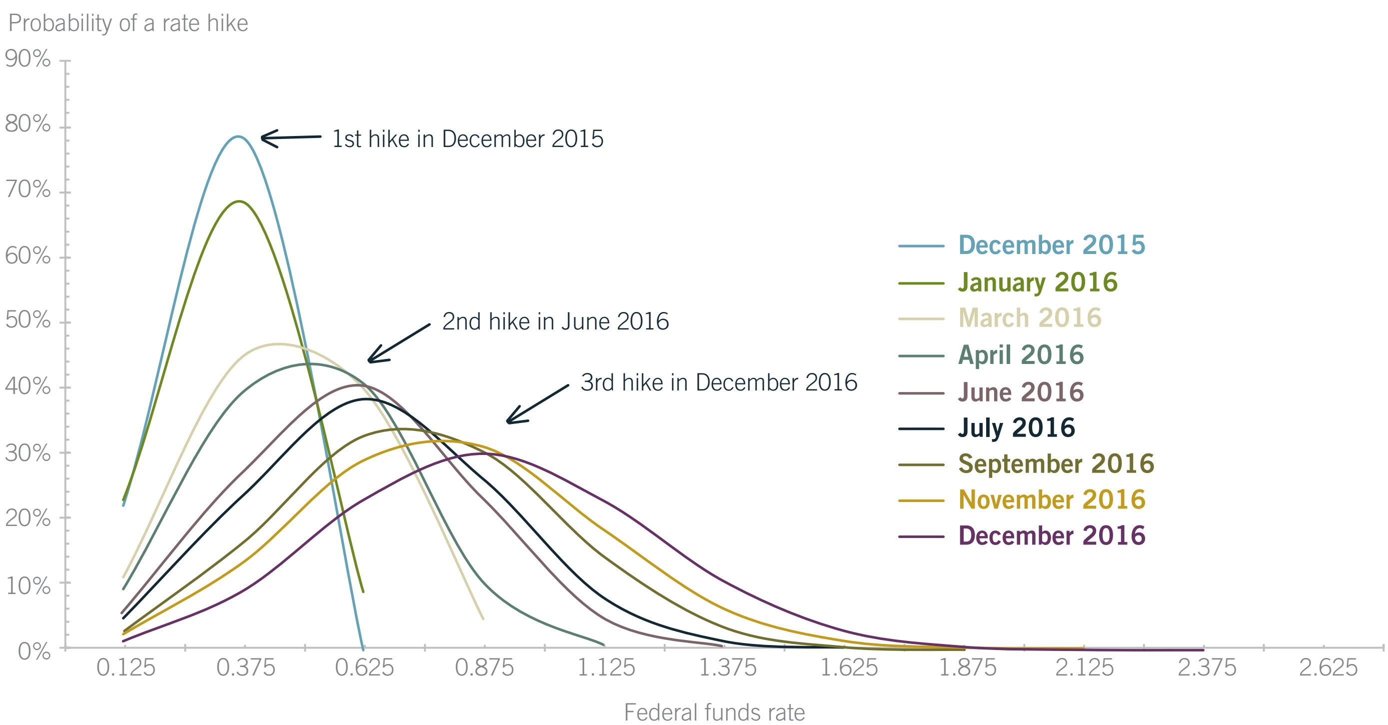
A green light for the Fed

So, with the market-induced probability of a December liftoff holding on to its post-October nonfarm payroll gains and actually building on it in recent weeks, the likelihood of a fed rate hike now stands at roughly 80%,[1] which indicates that the markets are giving the Fed a big "thumbs up" to raise rates (Exhibit 1).

This means we will likely see the first U.S. rate hike since September 2006, while the Chinese leadership is struggling to grow faster, reform its old economy, and manage what could be a gradual long-term currency devaluation (with capital controls, if needed). On top of this, the European Central Bank (ECB) just announced another interest-rate reduction, and also stated that it would extend its quantitative easing program through at least March 2017.

1 Based on the fed funds futures curve, as of Dec. 7, 2015.

Exhibit 1 Based on the fed funds futures rate, the market expects the first Fed hike this December, the second one next June, and the third one next December.



The federal funds rate is the interest rate at which depository institutions actively trade balances held at the Federal Reserve (called federal funds) with each other, usually overnight. Source: Bloomberg Finance L.P., Fidelity Investments, as of Dec. 2, 2015. Weekly data.

All of this suggests that, despite the risk of an occasional sell-off over the near term, the dollar is not likely to break its long-term uptrend anytime soon. And if the bull market for the dollar continues, it's unlikely that commodities will be able to break out of their now four-year-old bear market. Furthermore, if commodities (especially oil prices) remain under pressure, then the wait for crude oil prices to return to the $50 to $70 range may be a bit longer.

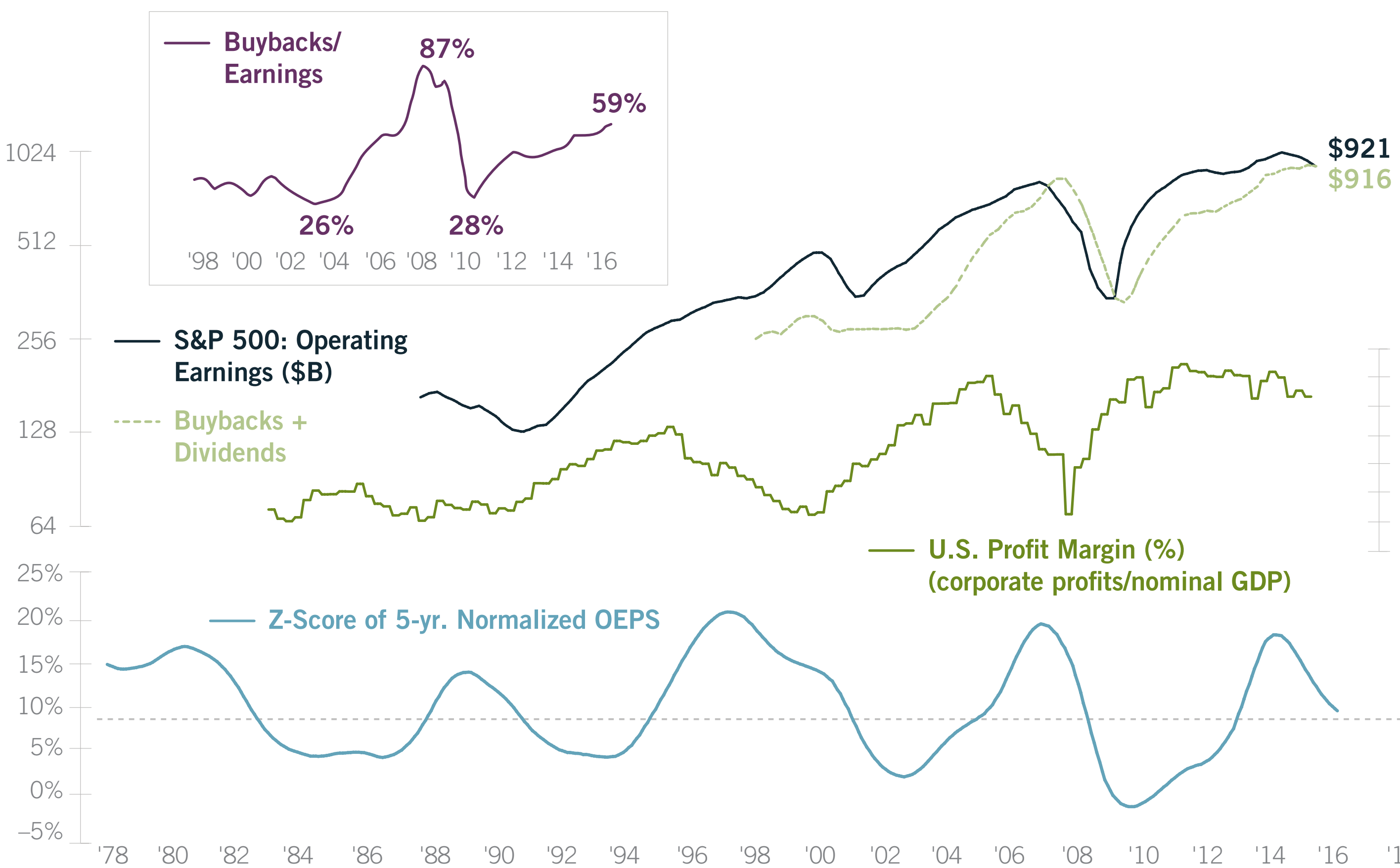
Earnings and valuation

With the U.S. earnings cycle having peaked in early 2015, profit margins near record levels, and more than half of corporate earnings coming from share buybacks (Exhibit 2), it remains to be seen what we can expect from earnings growth in 2016, especially if those sectors that are tied to the global economy (industrials, energy, and materials) remain depressed. Mid single digits might be a reasonable expectation, which is where earnings growth was in 2013 and 2014, and where it would have been in 2015 if energy were stripped out.

Fortunately, valuations seem reasonable, with the forward price-to-earnings ratio at 16 times earnings for the Standard & Poor's 500 Index.[2] While valuations may in large part be reasonable because interest rates are low, my sense is that

2 *Source: FactSet, based on the closing price of the S&P 500 on Nov. 27, 2015.*

Exhibit 2 The earnings cycle is slowing at a time when profit margins are near record highs and more than half of earnings growth is coming from share buybacks.



Z-score: a statistical measurement of a score's relationship to the mean in a group of scores. It is a way to de-trend a series (e.g., take a series, subtract the three-year moving average, and divided the result by that same moving average to get the Z-score. "Normalized" OEPS (operating earnings per share) takes the five-year average of earnings instead of the past four quarters. Source: Bloomberg Finance L.P., Fidelity Investments, as of Dec. 2, 2015. Monthly data.

they should remain reasonable even if yields do rise, provided that such an increase is accompanied by an acceleration in earnings growth.

Intuitively that makes sense, since yields would presumably only rise meaningfully if nominal GDP growth (and, therefore, earnings growth) were to accelerate, thus allowing the Fed to normalize short rates back to the 2% to 3% level. On the other hand, if the U.S. fell into a stagflationary cycle consisting of simultaneously slowing growth and rising wage inflation, earnings growth could be pressured if profit margins get squeezed both by price deflation and wage inflation. This is what is playing out in China right now.

On the whole, however, the outlook for 2016 really seems to be more of an earnings question. But with over half of earnings coming from buybacks, which are in part facilitated by free cash flow but also by cheap debt, it remains to be seen how long that cheap debt window will remain open. In recent months, U.S. Treasury yields have risen while credit spreads have widened. But that hasn't stopped corporations from issuing record levels of debt this year,[3] as yields remain low in absolute terms and investors' appetite for Treasuries remains brisk. However, it's something to watch closely in 2016, given where we are in the earnings cycle and where profit margins are.

Balancing act

So where does that leave us? Again, with a delicate balancing act between the Fed and the PBoC. Assuming the Fed will tighten only slowly and gradually, and assuming that China can remain somewhat intact through its "impossible trinity" (a theory that states it's impossible to have a stable foreign exchange rate, free capital movement, and an independent monetary policy all at the same time), then 2016 could be a relatively painless manifestation of a late cycle for the U.S., and a soft landing for China and EMs. So perhaps the best-case scenario is just a lack of bad news for a market that has learned to always be looking over its shoulder.

3 Corporate bond issuance in the U.S. reached $1.2 trillion through the first nine months of 2015, the highest level through that period of a year on record. Source: Dealogic, Securities Industry and Financial Markets Association (SIFMA), as of Sep 30, 2015.

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