Economic Outlook

First Quarter 2016

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Markets Stop, Drop, Roll…And Rebound

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SEI recently released its first-quarter Economic Outlook. A summary of the conclusions is provided below:

- The dramatic slide in equity-market performance during the first part of the quarter actually was part of a much longer price correction that has proceeded in two phases, with the first beginning nearly a year ago. The selloff gathered strength at the start of 2016, but equity markets have rebounded sharply since mid-quarter.
- In fixed income, a similar risk-off/risk-on pattern occurred. Yields reached levels comparable to their 2011 peaks before a remarkable recovery, implying positive total-returns for investors who endured the quarter's rollercoaster ride.
- Most major countries remain in an expansion phase despite sustaining a growth scare over the past year.
- One of our bedrock macroeconomic assumptions has been that a global recession remains a low-probability event. We believe growth will grind higher, led by advanced and commodity-consuming emerging economies (China/India).
- Although China's debt is a concern, the bulk is state owned. Only a small fraction, about 5% of total debt, is held by foreign investors. The central government's debt ratio is rather low, and households are not highly leveraged either.
- On a sector basis, energy and materials have been the primary drags, but it's a mistake to assume that a contraction in these industries will lead to a downturn in advanced, service-based economies. While the U.S. shale oil boom is turning into a bust, total non-farm payrolls have been growing near the upper end of the historical range.
- Another bedrock assumption is that central-bank monetary policy will remain expansionary on a global basis, even in the U.S., where economic growth and inflation appear more entrenched than in most other countries.
- A more interesting question is whether central banks have reached the end of their policy effectiveness, as the Bank of Japan, and then the European Central Bank, implemented radical policy prescriptions only to see markets react negatively. The yen and the euro have gained against the dollar, running counter to expectations.
- We see better prospects for a durable earnings revival in the U.S. than elsewhere. The stalling of the dollar's appreciation in the past year suggests that U.S.–based corporations should see some relief. We see U.S. earnings growth in the 5%-to-9% range over the next year, and look for equity prices to appreciate in the same neighborhood.
- It's hard to make a case for emerging-market equities. Earnings have collapsed 30% since mid-2014. We need to see stronger global economic growth, improved trade flows and additional supply discipline from commodity producers.
- Markets will remain difficult to navigate, but we lean in a bullish direction, mainly because we are confident that the world economy will exhibit modest growth and that central banks around the world will do "whatever it takes."
- Safety and stability still look expensive, as do government fixed-income securities. We like U.S. risk assets because the fundamentals seem better than most, although political dysfunction is becoming an increasing worry.
- The sharp recovery in emerging-market debt and equity and high-yield securities underscores the fact that beaten-down areas can come roaring back with little advance warning. Under these circumstances, diversification seems a better strategy than concentrated positions as trends shift back and forth in almost random fashion.

A full-length paper is available if you wish to learn more about this timely topic.

Important Information

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