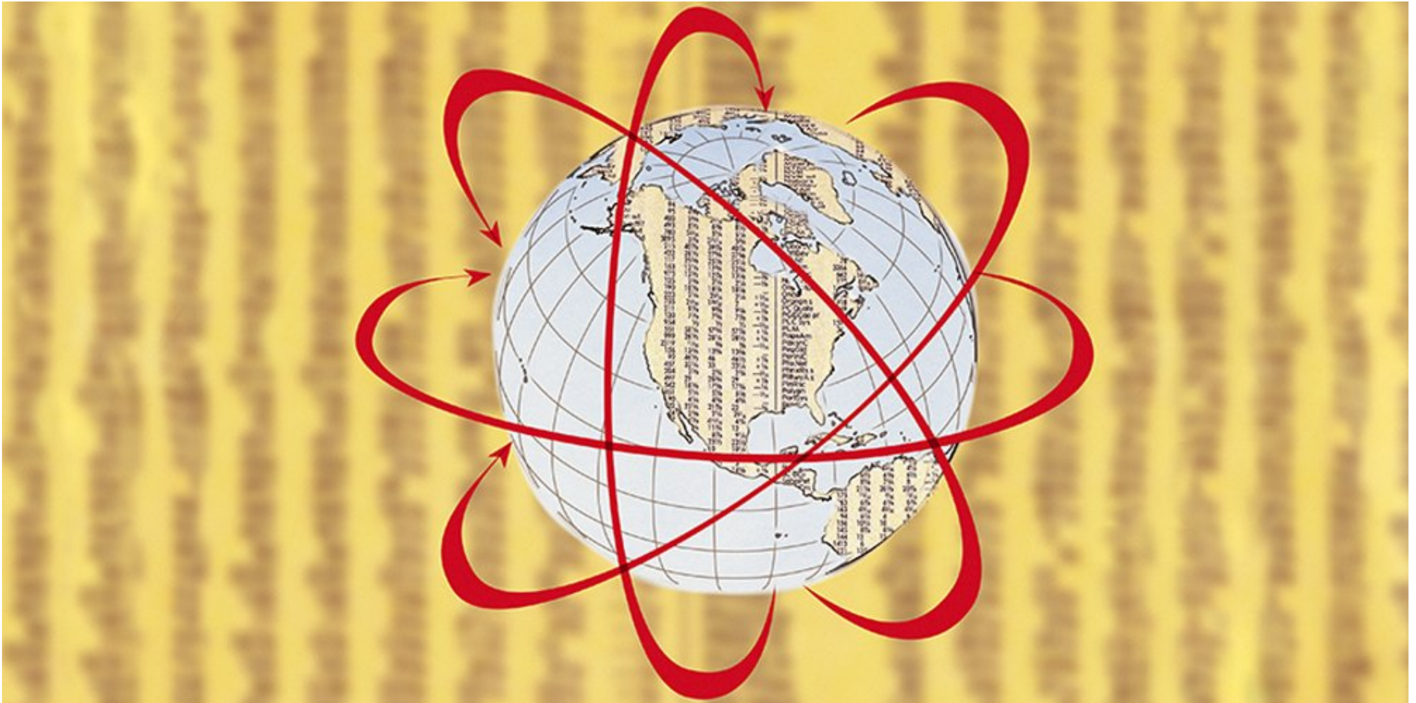

# Around the World: 1Q16 Global Market Insights

April 13, 2016

Financial markets remained turbulent throughout the first months of 2016. The S&P 500 Index declined by some 10% in the first six weeks of the year, only to gain 11% in the subsequent six weeks. Amid a plethora of concerns, it appears that financial markets decided that a hawkish Federal Reserve (Fed) and a Chinese currency peg were incompatible. The Fed's December forecast indicated that the funds rate would rise 100 bps in 2016. At the same time, China's central bank was no longer committed to keeping the renminbi broadly stable against the U.S. dollar.

This commitment has already resulted in a substantial appreciation of the renminbi since 2014, at a time when China's economic growth is slowing. The Fed read those market signals, decided that Chinese devaluation risked destabilizing financial conditions across much of the Emerging Markets economies, and so became less hawkish. A more modest pace of U.S. rate hikes may be a policy path consistent with decent global growth and financial market stability. The fact that the Fed is now paying more attention to these international feedback loops is an important evolution in how monetary policy decisions are made.

The strong, but no longer strengthening U.S. dollar resulted in a notable repricing of major commodities, especially oil, which is quoted in dollars. Since mid-January, oil prices rose by some 30%, from 30 USD/barrel to 40 USD/barrel. Other industrial commodities, such as iron ore and copper, also saw price increases of 10-30%. Firmer commodities prices together with a stable U.S. dollar provided a tailwind for many Emerging Markets commodities exporters. This is a key reason why many South American equities markets – Chile, Peru, Columbia and Brazil – are up significantly year-to-date. In the case of Brazil, market participants are focused on the domestic politics and the likelihood that the current administration will be replaced with a more business-friendly government before year

end. Nevertheless, commodities prices play a central role in explaining meaningful appreciation of the Brazilian real and the rising equity market, dominated by energy and mining companies.

We see several implications from a stable U.S. dollar and relatively low oil price for Emerging Markets and Japan this year. Japan's trade deficit has been improving since the second half of 2014, when oil prices began to decline. In the first quarter of 2016, Japan's trade deficit turned into a modest, but growing surplus, which underpins yen appreciation. It is hardly a coincidence that the yen strengthened by nearly 10% against the U.S. dollar (USD) when the balance of payments statistics for December (released in early February) revealed that Japan's trade balance swung from deficit to surplus. A sustainably stronger yen in the JPY 110-115 (per USD) range versus a range of 120-125 is a sizeable headwind to Japan's exporters; especially those focused on the U.S. market. At the same time, Japanese companies focused on Emerging Markets may see an improvement in both top line growth and profits, as Emerging Markets companies benefit from ample USD liquidity.

A source of growing uncertainty this spring is the U.K.'s debate on whether the country should leave the European Union. The referendum is set for June 23, 2016. As the impetus for the referendum was an internal Conservative party pledge made by David Cameron to keep the right wing from rebelling, the quality of national discourse on the issue is poor. The economic challenges to Brexit are significant. Polls indicate that 35% of the voters are undecided. The "Leave" camp is a disparate group of people of largely unrelated interests, and demography accentuates the Leave's edge. In the general election in 2015, voter turnout was 78% among the over-65s, who are overwhelmingly Eurosceptic, and 43% among those aged 18 to 24, who are overwhelmingly pro-European Union. To the extent that the outcome of the referendum will be dictated not by sound political and economic arguments, but by voter turnout, this remains a key source of uncertainty. If the "Remain" campaign prevails, the sterling and equities are likely to appreciate meaningfully from current levels immediately following the referendum.

In this environment, our global and non-US equity strategies have selectively reduced positions in Japan, with particular focus on USD-exposed exporters and banks facing headwinds from the Bank of Japan's negative interest rate policy. We have also moderated exposure to U.K. domestic consumption and property-focused companies due to a combination of valuation concerns and Brexit-related uncertainty. Our non-U.S. strategies have generally added to the Europe ex-U.K. region, where we continue to find a more favorable balance of corporate fundamentals and valuation risk, along with continued modest economic growth. Emerging Markets weightings have been steady-to-higher for our global and non-U.S. strategies in recent months, but remain underweighted versus the MSCI All Country benchmarks. Amid the more encouraging signs of near-term stabilization in Emerging Markets, we remain focused on identifying strong corporate fundamentals and continue to be selective in our approach across sectors and countries.

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