

Investment strategy insights

2016: Not a rerun of past crises | **13 January 2016**

CIO WM Research

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- The year has gotten off to a rocky start, with global equity markets down 4–6% in the first few days of trading.
- Bearish voices have become louder and more numerous, amplified by the negative tone in the financial media.
- We address concerns that 2016 may play out according to a script from one of a number of prior crises and present our moderately constructive outlook for global growth and investment returns.

2016 has gotten off to an abysmal start for risk assets, resulting in no shortage of negative research reports, market commentaries, and blog posts being featured prominently in the financial media. It's not our practice to offer rebuttals to the views of others. However, we felt it necessary to address some of the more acute concerns raised in several of recent reports garnering media attention. To be sure, more than a few of these press accounts have teased alarmist headlines out of relatively balanced market views in order to fit the current preferred bearish narrative. Others, however, faithfully reflect the sentiments and views of those who hold negative opinions on any or all of the following: the real global economy; monetary policy decision-making; and financial asset return prospects.

Given the flurry of e-mails we have gotten in recent days, we thought it might be helpful to place some of this negative commentary into the proper context and offer our own assessment of the more dire risk scenarios highlighted recently in the financial press. Although these bearish views vary, they have tended to fall sequentially into one of three very broad categories: 1) a repeat of 2008; 2) a repeat of 1997–98; and 3) a repeat of 1994.

Here is our take on the comparisons between 2016 and three other notable periods of economic and market turmoil:

- **The 2008 global financial crisis** – Most troubling to investors have been the more recent comparisons some have drawn between current market conditions and the prelude to the 2008 financial crisis. Citing a tightening of financial market conditions, a deceleration in global manufacturing activity, and a spike in equity market volatility, some foresee a deflationary spiral that would render current debt burdens unsustainable, thus setting off another credit crisis. While it's tempting for some to draw parallels to such a recent experience still seared into the collective consciousness of investors, we find such comparisons largely unconvincing. Financial sector leverage is significantly lower and central bank policy is far more accommodative than in 2007, and we see no evidence that credit-related losses will approach anything like what we saw during the crisis.
- **The 1997–98 Asian currency crisis** – China's decision to devalue the yuan, coupled with a surging dollar, has raised concerns in some quarters over rekindling a 1997–98-style currency crisis within the emerging markets. Back then, a threatened rate rise by the Bank of Japan and a shortage of currency reserves touched off panic-selling in the Thai baht that eventually rippled through the region. While we have some sympathy for this view based upon the challenges within the emerging markets and plunge in commodity prices, reserve balances are higher today and the level of externally funded (e.g., dollar-denominated) debt is significantly lower.
- **The 1994 tightening cycle** – Back in 1994, the FOMC began the process of "policy normalization" following an extended period of historically low Fed funds rates. Both emerging market equities and high grade bonds sold off sharply as market interest rates soared. While some have envisioned a replay of the 1994 "rate rout" as the Fed prepped to tighten policy for the first time in nearly a decade, we view this as a remote risk amid benign inflation, modest growth prospects, and a more deliberate policy approach. More popular prior to the Fed's December rate hike and the lack of resulting chaos in rate markets, this risk view has now largely been discredited. This should serve as a reminder to those who try too hard to base their outlooks on what has happened in prior periods. History may rhyme, but it never repeats itself.

But if neither a replay of 2008, nor a repeat of 1998, nor a reprise of 1994 is likely, then what can we expect in 2016?

- **No recession.** Despite the most recent growth scare, we foresee the continuation of a modest, uneven and (at least by historical standards) frustratingly sub-standard economic expansion – but no recession. Growth in the US is holding up fairly well, supported by a strong consumer with rising real incomes and spending power. The Eurozone continues its cyclical rebound even as

China's growth continues to decelerate and the emerging markets remain under stress.

- **No Fed policy mistake.** Even as the Fed seeks to continue a gradual process of normalization, most other global central banks are attempting to support their economies with ample liquidity and low interest rates. The Fed will have to weigh recent global market stress and soft data when deciding whether to tighten policy further this year. Given the caution they've shown in making this transition, we believe the risk of them moving too far or too fast remains quite low.
- **No credit crunch.** While credit spreads have risen in the US, we do not believe this merits direct comparisons to 2007–08. Much of the adjustment in the high yield segment of the corporate bond market is due to the collapse in energy prices, while the broader rise in investment grade spreads is due to higher new issuance as companies seek to borrow at low rates. Overall corporate leverage remains low, however – a significant difference from the financial crisis.
- **No earnings collapse.** US earnings were flat last year, largely due to headwinds from falling oil prices and a stronger US dollar. For 2016, we expect moderate earnings growth to resume as these headwinds dissipate and energy companies comprise a much smaller share of US profits. Most sectors of the S&P 500 grew earnings at respectable rates last year, and we expect similar growth in 2016. Outside the US in places like the Eurozone, we expect earnings to grow at a slightly faster pace.

As investment strategists, our job is to guide investors through the noise of economic data and financial market changes to help them reach their financial goals. For this reason, we are never sanguine about risks to our clients' portfolios or to our outlook. And we are never dismissive of the opinions of our colleagues in the industry even when they run contrary to our own. However, we believe the direct comparisons between 2008 and the current environment go more than a few steps too far given the current fundamentals. The fact that we are only eight years removed from that crisis (it probably feels like less to many) may lead some to overestimate the probability that it will happen again.

2016 is shaping up to be another challenging year, but we do not think there is cause for investors to panic. The global macroeconomic environment is uneven, with many emerging market economies slowing or contracting while large developed economies inch ahead with help from policymakers. As such, we expect only moderate returns on risk assets like equities, with higher volatility than investors have become accustomed to in recent years. While it's quite normal for equity markets to correct 5–10% during bull markets, larger downturns typically only occur leading up to or during recessions. Because we consider the immediate risk of either a US or global recession to be low, a significant further slide in global equity prices is unlikely in our view.

Appendix

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