Manulife Asset Management™

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Assessing January's fallout: Market outlook & opportunities

For most market watchers, this past January has been memorable – probably for all the wrong reasons. But what is the likelihood that it will set the tone for the rest of 2016? What does it mean for investors with a longer-term view? In this note our investment professionals share their views and, along the way, draw the distinction between volatility and opportunities.

Global Equities – Paul Boyne, Senior Portfolio Manager

We started the year worried about deflation risk, excess debt and slowing global growth coupled with what we felt was high multiples, often disguised within simple P/E (price-to-earnings ratio) but visible on a debt-adjusted basis. Towards the end of 2015 the market was sanguine. But, as concerns over China's possible missteps in their attempt to regulate their slowing economy build, and faced with continued evidence of slow global growth and falling energy prices, the market now cares and is reacting accordingly. In this volatile and gloomy environment, we think quality is what will protect the most value and with the recent sell-off in the market, these quality names are more attractively valued.

The Fed raised rates for the first time in nine years in December in conjunction with evidence of the beginnings of wage growth in the US[1]. However, this comes at a time when we are seeing evidence that corporate growth is slowing. In retail, companies are ending the year with too much inventory[2]. Industrials and transports are clearly in a slowdown. Margins are peaking[3] and many companies have too much debt which, for the most part, is a result of the low borrowing costs. The question we think needs to be considered is as follows: at what point does the blind faith, knee-jerk reaction of buying risk assets become tested in the face of evidence that Quantitative Easing (QE) has failed in all regions to produce its desired growth and inflation targets, and the fact that increased debt is delivering lower and lower incremental growth? Perhaps we have started to reach that point with the material sell off we are seeing.

In fact, US forward inflation rate expectations have once again dipped below 2%[4], a point at which Fed Chairman Ben Bernanke felt compelled to reintroduce quantitative easing in both 2010 and 2011 as well as Operation Twist. Low, or even negative, rates and QE are distorting prices, causing misallocation of capital and undermining some industries and we are concerned about the effects on valuations as investor sentiment changes and central bank credibility is tested.

In Europe, European Central Bank President Mario Draghi has hinted strongly at his intention to pursue more QE and even negative interest rates to try to stimulate growth and inflation as he worries about deflationary trends[5]. The subtext is a weaker currency as he tries to siphon off growth from stronger regions. They may not be alone with Japan considering more QQE (Quantitative and Qualitative Easing), a decision that may be rendered inevitable dependent upon China's policy reaction to its own slowing economy.

[1] Bureau of Labor Statistics: The Employment Situation, December 4, 2015
[2] US Department of Commerce: Manufacturing and Trade Inventories, November 2015
[3] Factset: Q4 Earnings Season – By the Numbers, (p.5) January 15, 2016
[4] All market data from Bloomberg unless otherwise noted, as of January 21, 2016
[5] Reuters: Draghi raises prospect of March policy easing as outlook sours, January 21, 2016

Emerging Market (EM) economies are slowing and return on equity profiles are deteriorating following the misallocation of the excess capital that has built up in the regions. This slowing growth mixed with excess debt in many countries – often US dollar denominated – is resulting in weaker currencies and causing deflationary pressures on the West.

Despite the global gloom and our longstanding concern about slowing growth and deflationary risks, we find that our focus on quality has served us well and we are excited about the opportunities that the market sell-off is offering. We are upbeat about quality companies that are classic compounders of wealth and those that are going through value-add transitions.

Classic compounders of wealth characteristically have wide moats and are typically in the best position to weather a downturn in the market. They also tend to share similar characteristics – a strong balance sheet, stable cash flows and high returns on capital. These companies also tend to operate in industries where demand will remain strong regardless of the economic environment.

Meanwhile, companies that are going through value-add transitions offer the opportunity to invest where the market gives no credit to the positive and accretive changes that we believe a company is making.

Sectorally, we remain cautious about commodity industries (and by extension, emerging markets) as well as European financials; and continue to feel sanguine about "sustainable" quality franchises within areas such as healthcare and consumer staples.

At the end of the day, we continue to be wary of companies with excess leverage and continue to focus on companies with what we believe to be sustainable cash flow streams and thus those that are able to drive profit margins in a low- or no-growth environment.

Fixed Income - Global Multi-Sector Fixed Income Team

It is our view that higher volatility will continue into the first part of 2016 across all asset classes (fixed income, equities, commodities and foreign exchange) as markets digest the first rate hike by the Federal Reserve and low commodity prices continue to put pressure on certain sectors of the credit markets as well as the major exporting countries. We will be watching the markets for a number of different triggers that bring stability to markets before contemplating an increase in risk within the portfolio. These triggers could include, but are not limited to, increased visibility in the path of rate hikes by the Federal Reserve, confirmation of a bottoming in Europe and a better understanding of economic growth in China and how fast it is actually slowing.

We anticipate that the US economy will continue to grow at a moderate pace in the year ahead, outperforming most of its developed market peers. We believe that Treasury yields will rise over time. However, external factors, such as foreign economic growth, monetary policies and relative yield levels across developed markets, may keep long-term rates in the US lower for an extended period of time.

We continue to embrace credit risk but we are being more defensive in our sector exposures, recognising that sector, quality and issuer selection are more important factors today than they were earlier in the credit cycle. Given the macro environment and increased market volatility, we remain cautious regarding our exposure to emerging markets.

The asset class serves to diversify the portfolio away from developed market economic and interest rate environments. However, we are being selective at this time, recognising that there will be wider performance deviations across countries, qualities and currencies moving forward.

In regards to currencies, we believe growth differentials, diverging central bank policies and structural positives will continue to be supportive for the US dollar.

Commodities - Craig Bethune, Senior Portfolio Manager & Diana Racanelli, Senior Portfolio Manager

As we sit watching oil prices decline to the high US$20s (down 22% year to date)[6] we note that both fundamental and technical levels are at play. The market remains concerned about oil supply being too high and more recently about demand being softer due to moderating global growth. Stress in the high-yield bond market is further compounding the pressure on producers perceived as having less than pristine balance sheets.

We remain in an oversupplied market today and the introduction of further Iranian supply[7] is not what the market needed. That said, current levels of oversupply are falling and are expected to become more balanced by the end of 2016. However, oil prices today are far lower than the US$40 - US$50 price built into most 2016 production models and are near cash operating costs for many producers.

OECD inventories are approximately 240 million barrels above normal[8] (roughly 9%) but spare global oil production capacity is much lower today, with roughly 2 million spare barrels per day (bbl/d)[9] available to meet supply disruptions if needed, which normally would support higher prices.

Non-OPEC production is declining, but slower than initial expectations due to improving productivity and capital efficiency. Production has relatively flat-lined following an initial decline of about 500,000 bbl/d in the US onshore[10]. Part of the challenge is that phases of many long-term projects, such as the Canadian oil sands or Gulf of Mexico wells, continue to come online following years of investment. Expectations are that non-OPEC production will contract by a further 400,000 - 600,000 bbl/d in 2016[11] due to lower investment as industry capex is set to decline for a second year in a row as a result of low crude prices. Bank line redeterminations may be harsher in the spring given continued weakness in oil prices.

From the market perspective, oil, having broached US$32, technically looks to the mid-US$20s for its next level of support. Short positions remain high on expectations that OPEC will not defend prices and inventory storage in the US will fill during the first half of 2016, which remains a possibility, but the relaxation of export rules should help mitigate an extreme outcome. From our perspective, the first half of the year will have the most challenges, with conditions becoming more favourable for oil as the year progresses.

Global demand growth remains positive. Despite a tougher outlook near term for global economic growth, oil demand looks set to grow above 1 million bb/d in 2016 (today the market expects 1.2 million bbl/d of growth[12]). Warm weather has presented a headwind for demand growth relative to a colder winter the prior year. So far, gasoline demand growth remains positive as SUV (sport utility vehicle) and car sales remain strong globally.

While things seem overwhelmingly difficult at the moment, we know that the current low prices are creating the conditions for an attractive energy market in the future. Without OPEC helping though, the supply side correction process can be slower than the market likes. We will watch for opportunities in quality franchises with strong balance sheets at attractive prices through the first half of the year.

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[6] All market data from Bloomberg as of January 22, 2016, unless otherwise noted
[7] Financial Times: Iran storms back into glutted oil market with prices at 13-year low, January 18, 2016
[8] Reuters: Should we worry as oil hit 3 billion barrels? November 20, 2015
[9] U.S. Energy Information Administration: What Drives Crude Oil Prices?
[10] U.S. Energy Information Administration: Short Term Energy Outlook, January 12, 2016
[11] Evercore ISI: Crude Oil: Game Changers, January 20, 2016
[12] UBS: Global Oil: Monthly Agency Data Snapshot, UBS Investment Research, January 21, 2016

Turning to precious metals, the price of gold has been volatile during the first three weeks of 2016. After surging almost US$50 (or 5%) during the first week, prices dropped US$30 per ounce (oz.) in the second. Prices have since recovered, hovering around US$1,100/oz.

The recent movements are a confluence of several factors:

On the upside:

- Large inflows to gold ETFs have increased global gold demand by about 7% year-to-date. This demand has been driven by safe-haven buying resulting from the significant drop in global equity markets and increased volatility.
- There are also signs of some seasonal strength in the price of gold as Asian demand is generally stronger this time of year heading into the Chinese New Year (8 February).

Meanwhile, factors keeping gold prices in check have included:

- The overhang of the Fed interest rate hike sequence; and
- The US dollar is still rising against most currencies, making gold more expensive in some local currencies.

In the near term, we expect volatility in gold markets to continue. Demand could weaken after the Chinese New Year only to pick-up as the Indian wedding season kicks in from late March through early May. Any further weakness in global equity markets could support the price of gold as would a slowdown in the pace of interest rate hikes in the US. We continue to believe that the price of gold will remain range-bound, but prefer its exposure over other metals like copper which, although also volatile, is down over 7% year-to-date.

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