MARKETS AND TRENDS 2016

A RELAY RACE:
IT'S THE HANDOFF THAT COUNTS

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1 Baseline scenario: Relay race (70 %)

Dear readers,

Like every year, a motif runs like a thread through our economic and financial market outlook. This time we are being sporty, because in 2016 the Games of the XXXI Olympiad will take place. New records will be set in the contests – but there will be disappointments and defeats, too.

For the financial market scenarios in 2016 we have chosen three traditional track and field events from the various Olympic disciplines: the **relay race** as well as the **steeplechase** and **sprint** (for alternative scenarios see page 10). They differ in terms of the course and speed as well as in the risk of reaching the finishing line without falling or being disqualified.

Our baseline scenario for the annual outlook is the "relay race": optimum performance is only possible if there is a perfect interplay between speed and dexterity. Therefore, for the teams of the industrialised and emerging economies "it's the handoff that counts". However, no economy has such a perfect level of training. Thus, although momentum in the global economy will pick up in 2016, it will remain at a moderate pace in most countries. We assign a 70 % probability to this scenario.

Economic growth: consumption-driven

The **global economy** should expand at a rate of 3.3 %, slightly more strongly than in the previous year (2.9 %). No pronounced cyclical pattern can be discerned, which is a result of subdued industrial activity that will not live up to its role as a pacesetter. This will apply equally to countries where industry has a large share of the economy, such as Germany, or to those with a small share like the United States. Industrialised countries, whose consumers will continue to drive their economies forward, will be the primary source of economic growth in 2016.

The US will set the pace and economic growth there will rise to 3 %, after 2.5 % this year – in other words, considerably above the trend of 2 %. This acceleration will also be helped by fiscal policy, which will hardly act as a brake any longer. Consumption will have a good run with growth of 3 % as the labour market has reached the threshold of full employment. Weaknesses in the US team will be the low level of industrial activity as well as sluggish demand for US exports.



Given its capabilities, the **euro area** should have a good run in 2016. With growth in gross domestic product of 1.6 %, it will even manage to slightly exceed its potential. Spain and Ireland will continue running at an above-average pace, but Italy and France, the hitherto weak heavyweights, will finally join the race and their growth rates should manage to almost keep up with the rest.

Frantic German consumption

Germany should be on par with the euro area with growth of 1.7 %. The most important factor driving the German economy will remain consumption, which will rise by around 2 %. Thus, collectively bargained wages in the overall economy will see a further 2 % increase and employment will expand by approximately 0.5 % in 2016. However, no impetus can be expected to come from the savings rate; it should remain practically unchanged. In 2015, the fall in oil prices provided a very strong boost to consumers. This effect is likely to be somewhat weaker in 2016. The inflation rate will average 1.2 % over the year. In addition, the large influx of people to Germany will have a positive effect on consumer spending.

Investment in machinery and equipment is unsatisfactory. Capacity utilisation is just about average and the difficult economic situation in many emerging market countries as well as weak global capital formation mean that, for the time being, no surge in demand for German industrial products can be expected. Pressure on earnings will remain. While unit labour costs in manufacturing industry will rise, producer prices will fall. They should stabilise over the course of 2016, however. Construction activity will act as a growth driver. Demand for apartments in cities and their environs will be high. However, companies will hold back on investing in commercial properties and the capital expenditure drive announced by the public sector has, in the figures at least, not materialised yet. Momentum should be somewhat stronger in 2016.

The German export industry – a classic stimulator of economic activity – will only fulfil its task to an insufficient degree. Companies will benefit from the weak external value of the euro, though developments on world markets will be ambivalent. China is adapting its growth model towards favouring consumption, which will tend to have a negative effect on German industry; important emerging countries will only just gradually emerge from their crisis. Positive impulses will come from the US and, in particular, from a recovering euro area. Overall, the strongly competitive German industrial sector will be able to increase its exports. Nonetheless, a similarly dynamic growth in imports will result in no real growth in the trade surplus.

Emerging markets to stabilise

For all oil-importing countries, the **structurally low oil price** will be a significant competitive advantage. As a direct effect, on the one hand real incomes of consumers will rise and, on the other, input costs for companies will fall, which will have a positive impact on profits and capital expenditure. Apart from the EU and Germany, the largest beneficiaries will also include China and India. Commodity-exporting emerging countries should not see any further decline in 2016. **Brazil** and **Russia** will manage to avoid a further deterioration of their situations and will only see a slight contraction. The sharp devaluation of their currencies will have a supportive effect.

Inflation: hardly any price pressure

For industrialised nations, the connection between the oil price and the rate of inflation remains unbroken, while a tight labour market – such as in the USA or Germany – hardly has an inflationary effect any more. The inflation rate will remain moderate, both in the United States as well as in the euro area. Although there will be a jump from a basis effect at the turn of the year, apart from that there is not much discernable price pressure. In the US, we expect the inflation rate to average 1.5 % over the year and 0.9 % in the euro area.

Monetary policy: divergent paths

In many developed economies there will be no reduction in the degree of monetary expansion despite the fact that many have reached their growth potential. The **European Central Bank (ECB)** would definitely like to run another lap in the 2016 relay race. It will intensify its expansionary monetary policy even further. There will be a clear lack of faith in a self-sustaining recovery. The **US Federal Reserve**, on the other hand, will be ready to hand off the baton and raise interest rates, with the **Bank of England** effectively following suit in their slipstream. In any case, monetary policy will remain loose in both countries. That is why the maxim for bond markets is: in view of the low starting level and the cautious approach by central banks, real interest rates will stay low across the globe.

Exchange rates under the spell of monetary policy

On the foreign exchange markets, the direction of monetary policy will fundamentally support the US dollar. However, the divergent stance of monetary policy has been an issue on the markets for some time with the result that it is priced in to a substantial degree. After all, the euro/dollar rate fell temporarily to a 12-year low. Anyway, it has always been the case that the US dollar appreciated in the run-up to previous cycles of interest rate rises and then lost part of its gains again. Today, the US dollar is already significantly overvalued in terms of purchasing power parities or real exchange rate indices. The ECB and the Fed will lean against any more extreme moves, at least verbally or even by using monetary policy instruments, not least to support their respective export industries. We expect that the **euro/dollar** will move more or less sideways in 2016 and should stand at around 1.05 by the end of the year.

Due to the expansionary policy by the ECB, the euro/Swiss franc rate will see a slight recovery, at best. The Swiss National Bank should be able to prevent any renewed appreciation. The **British pound** should rise somewhat against the euro in 2016 as a result of the Bank of England's interest rate hike.

Equities: doomed to success

In 2016, equities will move within a tense environment of high valuation and a lack of alternative investment opportunities. This will not be a continuous process, however. In fact, it can be expected that volatility will increase even further in view of the maturity of the equity cycle.

Low commodity prices, the likelihood of continued euro weakness as well as a stabilisation in emerging markets will play into the hands of German equities. Although the growth rates of corporate profits will not be significantly higher than their US counterparts across the leading indices, in contrast to the US it is likely that there will be a further noticeable rise in the valuation of euro-denominated stocks in light of an expansion in the ECB's purchase programme.

It is possible that the **DAX** will temporarily reach levels well above the 12,000 mark, although after that it will probably quickly run out of steam. Just as in 2015, therefore, a great deal of tactical skill will be called for in terms of equity investments. Price/earnings ratio ranges, from which a fair value for the DAX of between 9,000 and 12,000 points can be derived, provide particularly good guidance. Any significantly higher levels should be used to reduce equity allocation in an anti-cyclical manner and any possible dips should be used to increase it (DAX range: 9,000 to 12,500).

Interest rates: 10-year Bunds at 1 %

If the Fed and the ECB make opposite interest rate decisions, this should determine yields for a long time to come: The Fed's interest rate hikes will herald a rougher climate on the US bond market. We expect a rise in 10-year US Treasury yields by the end of 2016 to around 3 %. In contrast, the ECB appears resolute in wanting to give a massive boost to the economy and inflation. They have signalled an upcoming expansion in their purchase programmes and a reduction in the deposit facility rate.

The consequences will be persistent, negative interest rates on the **euro money market**, on **short-term German government bonds** and **Pfandbriefe**. Yields on shorter-term maturities will probably not manage to stay out of negative territory in 2016 in view of underlying hopes of interest rate cuts. On the other hand, **longer maturities** will likely lead a life of their own. The influence of the ECB will be limited, despite its asset purchase programmes, as the strong rise in yield showed in the spring of 2015. Moreover, the attractiveness of euro-denominated bonds is suffering from the considerably higher interest rates on US fixed-income securities. For international investors, concerns about protracted euro weakness could lead to purchasing restraint.

The fundamental interest of the European Central Bank in a steeper yield curve in the medium term also militates in favour of higher bond yields. Since the middle of 2015, the spread between 10- and 2-year Bunds has been below one percentage point, which is historically extremely low in light of the massive money policy measures undertaken. If the curve remained relatively flat, questions would arise regarding the possibilities the ECB has to influence the situation using monetary policy instruments. The lack of investment alternatives for institutional investors would intensify further.

The situation would at least somewhat ease off in relation to the moderate rise in the yield of **10-year Bunds** that we as-

sume will pick up to around 1 % by the end of the year. The interest rate on 10-year government bonds will probably move within a range of between 0.4 % to 1.2 % for Germany and between 2.2 % and 3.2 % for the US.

Covered bonds will continue to be dominated by the ECB's purchase programmes and their spreads to government papers will remain low. In the case of corporate bonds, there will be a temporary tightening of spreads.

Open-ended real estate funds slightly better

Rising prices for properties are not yet reflected in the performance of German open-ended real estate funds. By the end of 2016, their annual performance should increase to nearly 3 %. In a low interest rate environment, this remains an acceptable return for investors.

Gold: hardly any return opportunities

The gold price will move in a range of between 1,000 and 1,200 US dollar per troy ounce. Rising real US interest rates and a robust US dollar will have a dampening effect. Financial investors and speculators with a more macroeconomic focus should act as catalysts for this development. However, private investors are presumably more likely to make purchases – whether of bars, coins or jewellery – based on long-term capital preservation considerations if global prices fall. Central banks, too, have set their sights on the yellow metal as an emergency reserve. This especially applies to China, which is striving to achieve reserve currency status for the yuan. Therefore, from Beijing's perspective it will be important to catch up with the US and the Europeans. After all, mining output will probably not grow any further but instead, like the proceeds of recycling, recede in 2016.

Asset allocation: tactical approach

Taken together, the prospects for financial markets in 2016 from a risk/reward perspective will remain muted. Opportunities resulting from the flood of liquidity due to monetary policy operations will stand in contrast to the fundamental risks associated with modest economic growth. In terms of their valuation, equities and real estate will be borderline. That is why, more than ever, the crucial factor will be rapidly anticipating the next change of topic in the markets.

The aftershocks of the European sovereign debt crisis, political uncertainties in the euro area (compounded by the refugee crisis), the risk of 'Brexit', the VW emissions scandal and its consequences as well as the interpretation of the fall in crude oil prices as the harbinger of an economic downturn all have the potential to trigger sudden about-turns on the financial markets. However, they do not have the power to bring about a shift into the alternative scenarios, since these risks do not materialise in our baseline scenario. Tactical allocation continues to take precedence over a buy-and-hold strategy.



Financial market forecasts in the baseline scenario

	Changes since year end	Current level*	Q1/2016	Q2/2016	Q3/2016	Q4/2016
	vs. euro, %	vs. euro				
US dollar	14,0	1,07	1,05	1,10	1,15	1,05
Japanese yen	10,2	132	131	135	136	131
British pound	11,7	0,70	0,70	0,68	0,70	0,66
Swiss franc	10,6	1,09	1,10	1,10	1,10	1,10
	in basis points	%				
MRO rate	0	0,05	0,05	0,05	0,05	0,05
ECB deposit facility rate	0	-0,20	-0,30	-0,30	-0,30	-0,30
Overnight rate Eonia	-5	-0,13	-0,20	-0,20	-0,20	-0,20
3M Euribor	-17	-0,09	-0,15	-0,15	-0,15	-0,15
2-yr Bunds	-27	-0,38	-0,35	-0,30	-0,25	-0,20
5-yr Bunds	-15	-0,14	-0,05	0,00	0,00	0,15
10-yr Bunds	-3	0,51	0,70	0,90	0,80	1,00
10-yr swap rate	6	0,87	1,00	1,20	1,10	1,30
10-yr Pfandbrief	3	0,84	1,00	1,20	1,10	1,25
Federal funds rate	0	0,13	0,63	0,88	1,13	1,38
3M USD Libor	11	0,37	0,90	1,10	1,40	1,60
10-yr US Treasuries	9	2,27	2,80	2,90	2,90	3,00
	in local currency, %	index				
DAX	10,4	10.960	11.900	11.700	11.200	12.000
Euro Stoxx 50	9,4	3.432	3.700	3.650	3.500	3.800
Dow Jones	-1,4	17.737	18.300	18.000	17.800	18.500
S&P 500	0,2	2.084	2.150	2.120	2.080	2.150
Nikkei 225	10,8	19.649	20.800	20.500	19.800	21.000
	%	%				
Brent crude $/bbl	-23,8	44	45	48	47	48
Gold $/oz	-11	1.071	1.050	1.100	1.150	1.100

As of: *18.11.2015
Sources: Bloomberg, Helaba Research

Country forecasts in the baseline scenario

	Gross domestic product Real change yoy in %				Consumer prices Change in yoy in %			
	2014	2015e	2016f	2017f	2014	2015e	2016f	2017f
Euro area	0,9	1,5	1,6	1,6	0,4	0,1	0,9	1,4
Germany*	1,6	1,5	1,7	1,5	0,9	0,3	1,2	1,5
France	0,2	1,2	1,3	1,5	0,6	0,1	0,9	1,5
Italy	-0,4	0,7	1,2	1,5	0,2	0,2	0,8	1,4
Spain	1,4	3,1	2,5	2,0	-0,2	-0,6	0,7	1,3
Netherlands	1,0	1,9	1,8	2,0	0,3	0,3	1,2	1,5
Austria	0,4	0,7	1,4	1,5	1,7	0,9	1,5	1,5
Greece	0,7	-0,5	0,5	2,5	-1,4	-1,0	1,0	1,0
Portugal	0,9	1,5	1,7	1,8	-0,2	0,5	1,1	1,3
Ireland	5,2	5,3	4,0	3,8	0,3	0,1	1,3	1,5
United Kingdom	2,9	2,4	2,2	1,8	1,5	0,1	1,3	2,2
Switzerland	1,9	0,8	1,2	1,6	-0,1	-1,1	-0,1	0,6
Sweden	2,3	2,8	2,7	2,6	-0,2	0,0	1,0	1,8
Norway	2,2	1,1	1,3	1,8	2,0	2,1	2,3	2,2
Poland	3,3	3,4	3,2	3,2	0,0	-0,9	1,5	1,8
Hungary	3,7	2,7	2,5	2,5	-0,2	0,0	1,8	2,5
Czech Republic	2,0	4,3	2,5	2,6	0,4	0,4	1,3	2,0
Turkey	2,9	3,0	2,8	3,5	8,9	7,5	7,3	6,7
Russia	0,6	-3,7	-0,5	1,5	7,8	15,5	8,5	6,0
United States	2,4	2,5	3,0	2,5	1,6	0,1	1,5	2,0
Japan	-0,1	0,5	1,0	0,5	2,7	0,8	0,8	2,0
Asia ex Japan	5,7	5,3	5,1	5,0	3,6	2,7	3,5	3,5
China	7,3	6,8	6,5	6,0	2,1	1,6	2,0	2,5
India	7,3	7,0	6,5	6,5	6,7	5,6	5,9	5,8
Latin America	1,4	0,3	1,5	2,5	10,7	13,0	11,5	9,0
Brazil	0,2	-3,0	-0,5	1,5	6,3	8,8	6,6	5,2
World	3,2	2,9	3,2	3,2	3,1	2,8	3,2	3,1

e=estimate, f=forecast; *working day adjusted
Sources: EIU, Macrobond, Datastream, Helaba Research

Detailed analyses on individual countries can be found in the full version of our Market and Trends 2016 on the internet (in German) at http://volkswirtschaft.helaba.de.





2 Negative scenario: Steeplechase (20 %)

In our negative alternative scenario “Steeplechase” growth comes to a standstill, regulations restrict business activity and investment does not materialise. Aside from economic rifts, political ones also open up. Military conflicts spread. In Europe, the sovereign debt crisis flares up again and casts doubt on the survival of the single currency. Depending on how many hurdles and obstacles appear, GDP growth in the US slows down significantly and economic output in the euro area as well as in Germany even contracts. The increasing underutilisation leads to deflation. Emerging markets are forced to seek recourse to the IMF; the risks of liquidity crises suddenly increase. A hard landing by the Chinese economy is the result of upheavals in the wake of a property and investment bubble.

Investors flee from risky assets into the safe havens of US Treasuries and Bunds. The Fed and ECB attempt to counteract the crisis with additional purchase programmes and interest rate cuts. Yields on 10-year US Treasuries fall as low as 1 % and the yield on 10-year Bunds drops below zero. The euro/dollar exchange rate comes under immense pressure and falls below 0.90. Corporate profits decline significantly and the DAX crashes to a region of around 6,000 points.

3 Positive scenario: Sprint (10 %)

In the positive alternative scenario “Sprint”, all economies race at high speed towards the finishing line with all members of their teams. Regulation and bureaucracy are reduced, Industry 4.0 gives rise to fast and efficient processes. A broad, self-sustaining boom is the result. Low production costs thanks to permanently low commodity prices lead to a surge in capital equipment investment in importing countries. The ECB terminates its purchase programme for government bonds but does not yet raise interest rates in 2016. The yield curves become considerably steeper. This leads to significant lower prices on the bond markets in the US and the euro area. In the Sprint scenario, equities gain and easily outperform fixed-income securities. Strong share price increases overcompensate for the negative effects of increasing interest rates. Shares experience double-digit growth across the globe. The DAX tests the 14,000 mark. In the competition between currencies, the euro benefits from a tailwind. The euro/dollar exchange rate recovers towards 1.30. ■

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