Schroders
Economic and Strategy Viewpoint

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We wish all our readers peace and prosperity for 2016

2015 review: China and oil and the Fed, oh my! (page 2)

- 2015 was a poor year for risk assets. Only government bonds and cash delivered a positive return. Global equities were dragged down by a lacklustre US market along with a terrible performance in the emerging world. Credit performed even worse than both government bonds and equities while commodity markets managed to surprise most, posting another awful year of negative returns.
- China hard landing fears, the commodities slump and Federal Reserve (Fed) tightening all weighed on sentiment and risk appetites. Grexit risk also returned along with political risk in Iberia following the two elections. Not to be left out, Brazil's corruption scandal has guaranteed political paralysis and its sovereign rating being downgraded to 'junk status'.
- To the upside, the European Central Bank (ECB) introduced quantitative easing and took rates into negative territory helping to boost European markets. The Bank of Japan (BoJ) maintained its stimulus, with Japanese equities outperforming most thanks to the yen depreciation of 2014. In emerging markets (EM), Russia equities performed well despite falling oil prices.

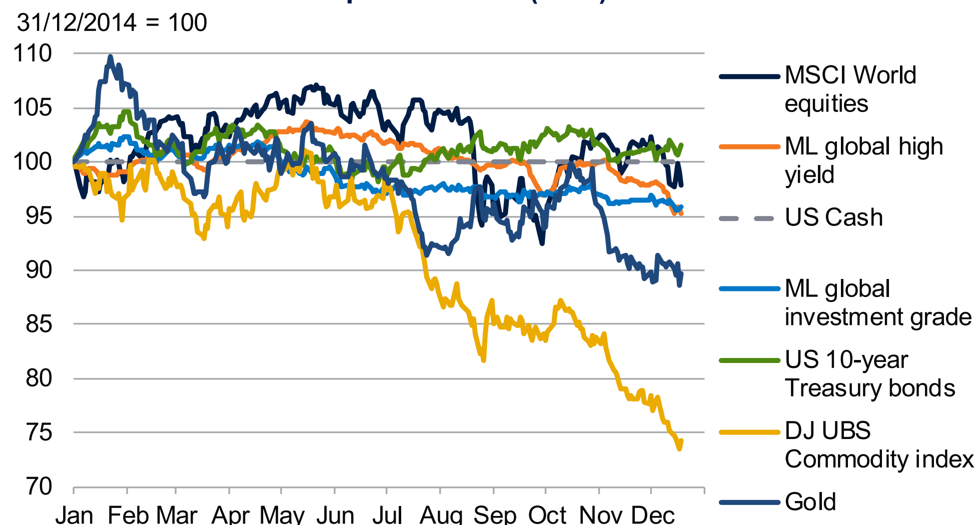
Themes for 2016 (page 10)

- Desynchronised global growth, a stronger dollar and the likelihood of China joining the currency wars are in prospect for 2016. Politics will also loom with the Presidential election and Brexit votes (to name but two).
- More immediately, the widening of credit spreads has raised fears of a sharper US downturn. This is a risk, but the fall in oil prices which is largely responsible for the credit move will also boost consumption. Lower oil prices are a mixed blessing, as 2015 has demonstrated, but history shows that they do not cause recessions in the major economies.

Views at a glance (page 16)

- A short summary of our main macro views.

Chart: 2015 Cross-asset performance (USD)



Source: Thomson Datastream, Schroders Economics Group. 21 December 2015.

2015 review: China and oil and the Fed, oh my!

Time to review the big market moving events of 2015

At this time of year, we like to take a step back and review the performance of markets, and the lessons we can learn for the coming year. 2015 will probably be remembered for the lacklustre performance of markets, and the uncertainty caused by central banks' actions (and inactions).

Investors had ended 2014 with solid returns from both risk assets and government bonds, and for those with exposure to European equities, it was a strong finish to the year. Oil prices had fallen significantly in the final two months of the year, causing economists to scramble to upgrade global growth forecasts, and cut global inflation forecasts.

Spring bounce supported by ECB QE

ECB finally introduces QE

2015 started with a continuation of those themes. Oil prices continued to tumble as it became evident that global supply would only increase in the near-term as non-OPEC members increased output, with Saudi Arabia not willing to cut back production. Falling oil prices helped push European inflation into negative territory and put the European Central Bank (ECB) under pressure to eventually announce its own QE programme of €60 billion per month of purchases. The historic move was seen as a further catalyst for European equities, as the ECB's QE programme was much larger than markets had expected – in-keeping with the way President Draghi usually delivered his announcements.

The ECB's move reinforced the fall in the euro in previous weeks, which eventually pushed the Swiss National Bank to give up maintaining its peg – shocking markets with a huge appreciation on the 16th of January.

The spring also saw weakness from China which prompted monetary easing and additional fiscal stimulus – prompting optimism to return to some commodity markets which ultimately proved to be premature.

Meanwhile, the general election in the UK was far less contentious, but the Conservative Party managed to surprise everybody by winning an outright majority. Most pollsters were left red-faced having predicted a hung parliament.

Greece and China wreck the summer

Grexit risks de-rail European equities

As spring turned to summer, volatility started to hit markets as commodity prices fell further on the back of the resilience shown by US shale gas producers. Concerns spread to the impact on energy producing firms and their performance in not only equity markets, but also US high yield debt. In Europe, Greece's new government led by Syriza decided to play chicken with the rest of the Eurozone. Greece was demanding a reversal of some structural reforms and more relaxed fiscal policy in exchange for even more bail-out funds. The rest of Europe balked at Greece's proposal and effectively showed Greece the door. Syriza quickly backed down and accepted the onerous near-original terms of its latest bail-out, but not before shredding the nerves of investors, and pushing negotiations to the brink.

Panicky markets amplified China's popping bubble into a sonic boom

The summer concluded with China's equity bubble finally popping. At this time it seemed the world suddenly became aware that China was slowing, with investors looking at the Chinese market and (incorrectly) seeing in the slump a portent of economic collapse, and their panic transmitting the sell-off to global equity markets.

This panic was made worse by the authorities' decision to devalue the CNY in August, which prompted fears that China was on the brink of a much larger devaluation and for many confirmed the view that the country was headed for a hard landing. Ultimately, these fears proved unfounded, and we saw something like stability return to markets.

Central banks' indecision in autumn

Fed spooked by China and financial markets delays its first rate hike from September to December

Autumn saw China fears spread to wider emerging markets as once again commodities took another leg down in performance. Rattled by concerns over the risk of a China hard landing, the Federal Reserve (Fed) decided not to raise interest rates in September despite reasonably strong US macro data. External factors and volatility in markets were cited, but markets reacted badly as equities in particular saw another sell-off. The disappointment caused the US dollar to weaken, especially against the euro, which prompted the ECB to react. Draghi strongly hinted at a substantial increase in its QE programme by the end of the year.

In October, Canada elected Justin Trudeau as its new Liberal Prime Minister, ending nine years of Conservative party rule. The Liberals campaigned on a message of real change, promising to use fiscal policy to galvanise the economy.

Fed thaws out in time for winter

As winter approached, China hard landing fears were abating. The government announced further fiscal stimulus measures along with monetary policy easing from the People's Bank of China (PBoC). On the currency front, there was speculation that the devaluation was linked to China's bid for inclusion in the IMF's Special Drawing Right (SDR) basket, which seemed to be confirmed when it was announced that the basket would incorporate the yuan from September 2016. Though a political victory for the Chinese government, this delivered little apparent practical benefit to the currency, which continued to weaken amid renewed capital outflows.

ECB disappoints investors with small increase in stimulus

Investors turned their attention back to central banks. First the ECB. Despite the strong hints from Draghi of further stimulus, the eventual announcement greatly disappointed. The ECB extended its purchases into 2017, but did not increase the monthly amount of purchases. Draghi's reputation as a central banker who over-delivers was now shattered. On the other side of the Atlantic, Janet Yellen at long last raised interest rates for the first time in nine years, and unlike Draghi, managed market expectations perfectly. Indeed, risk asset rallied on the more positive message from Yellen, albeit temporarily.

As for the Bank of Japan (BoJ) and Bank of England (BoE), it was a quiet year for both. The BoJ maintained their QE programme despite markets calling for additional stimulus. Governor Kuroda remains confident over the recovery in Japan and the prospects of inflation recovering. As for the BoE, Governor Carney did his usual dance with markets, raising expectations of a hike before backing down. Only one committee member is calling for a hike, with no signs of others joining him.

Historical agreement on climate change agreed

On the 12th of December, climate change talks in Paris resulted in the "Paris Agreement" which sees 195 nations attempting to cut greenhouse gas emissions to a point that will prevent global average temperatures rising by 2°C above pre-industrial levels. Countries will be required to individually determine their contributions to limiting warming to several degrees through emission targets, with the contributions being reported and reviewed every five years. Crucially however, the contributions are not legally binding. The other major initiative came in the form of developed nations pledging to give more than $100 billion per year in public and private financing by 2020 to developing nations in order to encourage the uptake of clean energy and facilitate adaptation to climate change.

And just as you thought the year was done…

One final twist in the China currency tale

In the same month, in yet another twist in the Chinese story, a continuing depreciation of the CNY blew oxygen on the embers remaining from August's anxiety, and finally prompted comment from the central bank seeking to clarify the exchange rate policy position on the 11th of December. The PBoC highlighted a newly published trade weighted index as a more appropriate reference for the market than the bilateral USDCNY rate, reinforcing our expectations for a gradual depreciation.

Latin politics provided some final upsets in the Old World and the New

Elsewhere in EM, Brazil's year reached its inevitable denouement. The country has suffered a deteriorating fiscal position as the its recession has deepened as well as political paralysis engendered by the ongoing 'Car Wash' scandal. Expectations for a downgrade built throughout the year and on the 16th of December the country was stripped of its investment grade status by Fitch. Having already been slashed to junk by S&P, this saw Brazil slip into the lower tier of EM debt and prompted a spike in the USD denominated bond yield. To round off a disastrous year, Finance Minister Levy resigned, to be replaced with the more left leaning Barbosa.

Just as the year was drawing to a close, the Spanish election on 20th of December surprised observers as the results showed no obvious politically acceptable majority coalition combination. The new and moderately centrist 'Citizens' party was supposed to win enough seats to finish third and become the king makers with either the incumbent centre-right People's Party or the centre-left Socialist Workers' party. However, Citizens was beaten into fourth place by the radical anti-austerity and anti-EU Podemos. The old guard are unlikely to want to work with Podemos, but as Citizens has not won enough seats, we could end up with either a minority government led by the centre-right, or a centre-right and left grand coalition. The latter would be incredibly difficult given the conflicting views on everything from fiscal to structural reforms, not to mention the personal clashes between the two leaders. Fresh elections in 2016 are certainly another possibility, but are unlikely before the start of the second quarter. Christmas paella anyone?

Cross-asset performance comparison

Government bonds are clear outperformers as everything else loses money

Looking across the major asset classes, the only two to yield a positive absolute return were bonds and cash (chart on front page). US 10-year Treasury bonds generated a total return of 1.5% – less than the 2.15% yield to maturity that was on offer at the start of the year, highlighting the downside risk to capital in bond investing.

The MSCI World equity index was achieving reasonable single digit returns through the first half of the year, but performance collapsed in the summer after fears of a China hard landing escalated. Global equities are set to end the year in negative territory (-2.1%).

The worst performing broad asset class, for the third consecutive year, was commodities. The Dow Jones/UBS commodity index returned -33.8%, largely driven by falls in energy prices, but in particular oil, which as measured by Brent Crude has fall by 33.5% since the start of the year, and 66% since the start of 2013. Over supply and a lack of reaction from producers to falling prices pushed oil prices even lower. Meanwhile, gold ended the year down 10.3% and is the second worst performer. Rising interest rates have started to put gold under pressure, especially as there is little need for inflation hedging at present.

Both global investment grade bonds and high yield bonds ended the year in the middle of the pack, returning -4.7% and -4.1% respectively. Oddly, both underperformed both government bonds and equities, suggesting a lack of liquidity in those markets may have encouraged investors to reduce holdings. US high yield bonds had a very difficult year in 2015 as shale oil/gas producers feature heavily in the asset class. Concerns over the solvency of shale producers as oil prices fell lower prompted investors to price in a higher default rate. Note, the high yield index we use is a global index, and so is impacted less than a US index.

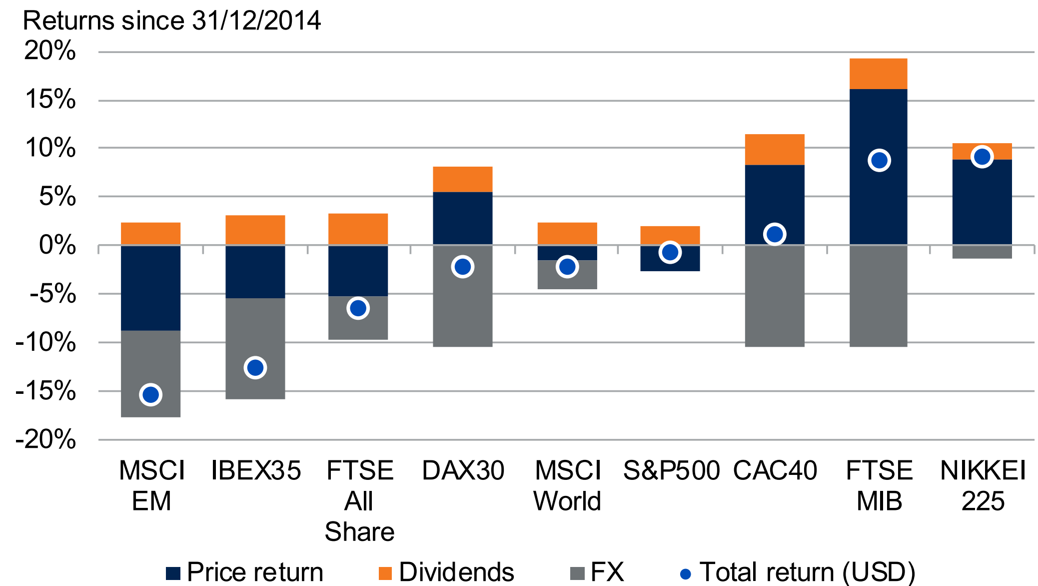
Comparing equity market performances

Despite the negative performance from the broad global MSCI World index, there were a few indices which provided strong returns (chart 1). The Italian FTSE MIB index was the best performing major market in local currency terms, returning 19.3%. However, when translated into US dollars, the return was down to 8.9%, and behind the Japanese Nikkei 225 which returned 9.2%. Those investors that picked

the Japanese index and did not hedge the currency exposure performed best.

Japanese equities provide best returns as EM equities perform terribly

Chart 1: Equity markets performance



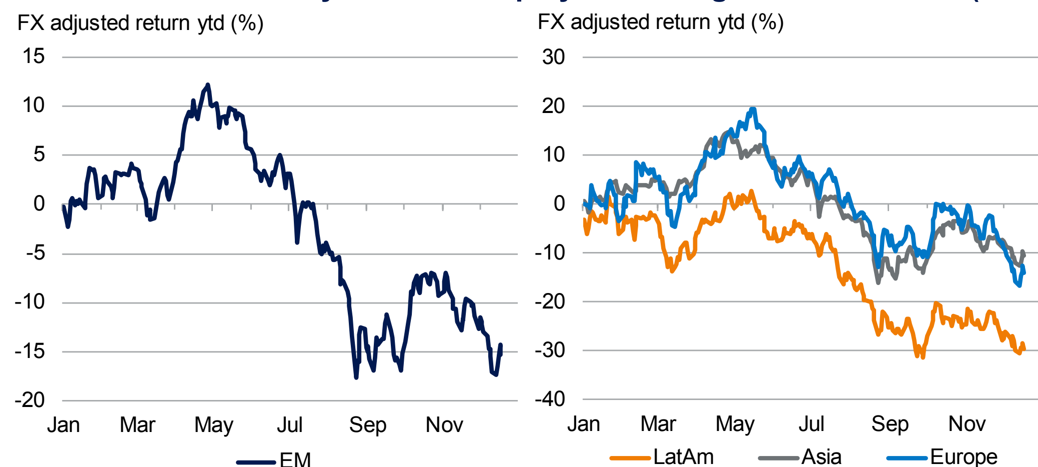
Source: Thomson Datastream, Eurostat, Schroders. 21 December 2015.

The Spanish IBEX35 was the worst major developed market index, returning -2.3% in euros, but -12.6% in USD. The banks within the index caused most of the underperformance as investors applied a discount against the risk that they might be forced to raise additional capital by regulators. More recently, the general election results caused yet another sell-off (not included in the above) as investors took fright from the uncertain political outlook for 2016.

The worst performing major equity index was the MSCI Emerging Markets index with a loss of 15.3% in USD. EM investors have been nervously living in the shadow of the Fed, and have had to contend with an array of China concerns, commodity collapses and political uncertainty. These problems have weighed more heavily on some markets than others, as Latin America's experience would attest (chart 2). That region's reliance on commodities has seen dollar returns suffer on two fronts, as corporate earnings slumped and the currencies depreciated sharply. Within the region, performance was worst in oil-reliant Colombia, where the market is down 25% year-to-date. However, while commodity importers in Asia and Europe outperformed Latin America, absolute returns were still negative for the year, pointing to broader problems than those afflicting the commodity axis.

Commodities crush Latin American equities

Charts 2 and 3: A bad year for EM equity masks regional differences (USD)



Source: Thomson Datastream, Schroders Economics Group. 21 December 2015.

Despite its obvious commodity exposure, Russia's domestic MICEX equity market has actually been one of the best performers in 2015, delivering around 23% year-to-date in dollar terms. Much of this stems from the favourable entry point, with 2015 following the particularly sharp end-2014 adjustment in oil. It certainly does not reflect a strong economic performance in Russia this year, where a deep recession has taken hold.

One drag on performance was China, though for the first half of the year it was one of the strongest performing markets. The rally which began at the end of 2014 on the back of the Hong Kong Shanghai connect found new legs in March as expectations of stimulus built and the government first implicitly and then explicitly endorsed the boom in equities. Convinced of government support for the market, investors piled in, with the index 60% higher by June than at the start of the year. However, there had been signs of trouble on the way up, with the regulator clamping down on margin financing and other practices only to back off as it sparked a selloff. It was one such intervention which finally popped the bubble, causing a sharp correction which proved deaf to blandishments from the regulator and government. At this time it seemed the world suddenly became aware that China was slowing, with investors looking at the Chinese market and (incorrectly) seeing in the slump a portent of economic collapse, and their panic transmitting the sell-off to global equity markets.

Government policy created and eventually popped a bubble in China

Chart 4: China's equity market rally and slump

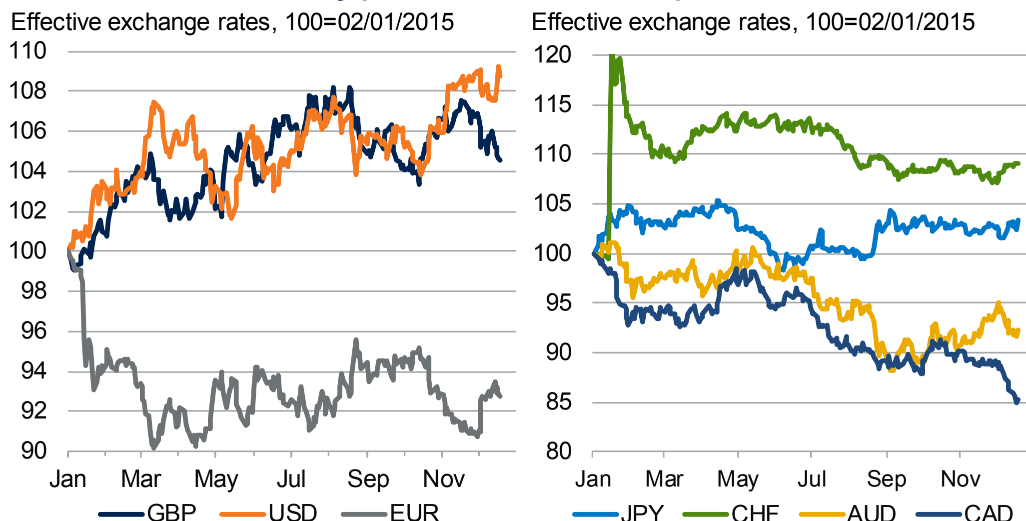
Source: Thomson Datastream, Schroders Economics Group. 21 December 2015.

Comparing currency market performances

The divergence in global monetary policy helped the US dollar have another strong year against its main trading partners (+8.8%). The main beneficiary was the euro (7.3%), following the introduction of QE and a negative deposit rate by the ECB. Meanwhile, trade weighted sterling was sandwiched between the two, but rose on a trade weight basis (+4.5%) thanks to hawkish sentiment from the Bank of England.

EUR wins the 2015 currency war

Charts 5 and 6: Currency performance in developed markets



Source: Bank of England, Schroders Economics Group. 21 December 2015.

Elsewhere, a less aggressive Bank of Japan and a lack of safe haven assets helped the trade weighted yen to appreciate 3.3% over the year, partially revering the depreciation seen in 2014. On the commodities front, both the Australian and Canadian dollars depreciated to reflect the weakness in their main export markets (-7.8% and 14.8%), with the Canadian dollar falling to its lowest level against the USD since 2003.

Lastly in developed market currencies, the biggest shock of the year was the 22% appreciation in the trade weighted Swiss franc (CHF) over just two days in January after the Swiss National Bank announced it would stop its currency interventions to weaken the CHF. Since the initial shock, the CHF has fallen back by more than half and should end the year up 9.1%.

In emerging markets, one of the main stories this year was China's devaluation in August. Though only a small adjustment (around 3%), and according to the authorities only reflecting a more "market oriented" determination of the currency, this change served to prompt fears that China was on the brink of a much larger devaluation and for many confirmed the view that the country was headed for a hard landing. Ultimately, these fears proved unfounded, and we saw something like stability return to markets, though in China's case this was at least in part because of heavy restrictions on further selling. SDR inclusion did little to bolster the yuan, and renewed weakness has in fact been visible since the announcement. The recent announcement that the PBoC sees a trade weighted basket as a more appropriate reference point than the dollar suggests this will continue.

A flurry of announcements on the RMB helped unsettle markets

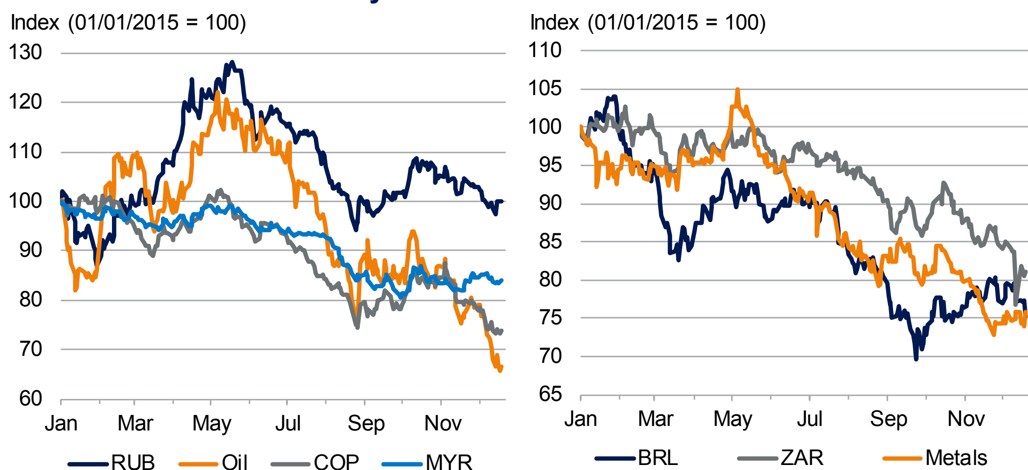
Chart 7: China's currency regime has been under increasing scrutiny

Source: Thomson Datastream, Schroders Economics Group. 21 December 2015.

Beyond China, collapsing commodity prices have dealt a blow to commodity producers in Latin America and elsewhere, as reflected in asset prices. Currencies are perhaps the cleanest way to see the impact, and as charts 8 and 9 show, a number of emerging market economies see their fortunes closely entwined with commodities. The weakness in oil has taken a particularly heavy toll on the Russian ruble (though returns have held up thanks to high carry), but has also acted as a drag on oil exporting economies in Asia and Latin America. Meanwhile, the ongoing softness in metals prices has created significant headwinds for exporters like Brazil and South Africa.

Commodity currencies crunched by price collapse

Charts 8 and 9: Commodity turmoil has hit EM FX



Source: Thomson Datastream, Bloomberg, Schroders Economics Group. 21 December 2015. Currencies shown in total returns.

Comparing EM debt market performances

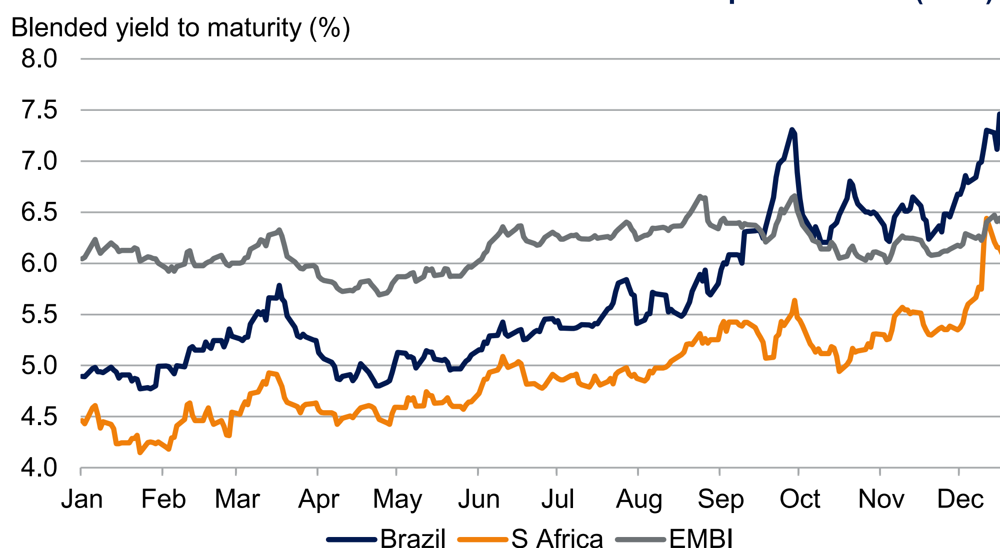
In emerging market dollar denominated debt, the year has been a painful one for Brazil, with yields climbing around 150 bps year to date. This has been driven by a mix of economics and politics, with a deteriorating fiscal position as the country's recession deepens on one hand, and political paralysis engendered by the ongoing 'Car Wash' scandal on the other. Expectations for a downgrade have built throughout the year and on the 16th of December, the country was stripped of its investment grade status by Fitch. Having already been slashed to 'junk' by S&P, this saw Brazil

slip into the lower tier of EM debt and prompted a spike in the USD denominated bond yield. The resignation of Finance Minister Levy only worsens the outlook.

Likely headed in the same direction as Brazil is South Africa, which is also battling a commodity related economic slowdown and worsening fiscal picture, and which is also capable of some spectacular own goals. Yields jumped dramatically in December on the initially unexplained sacking of the finance minister and replacement by an inexperienced and unfamiliar name. Though the reaction forced his replacement by a more respected name days later, the damage was done and yields only partially recovered. A 2016 downgrade is now widely expected.

Self inflicted political wounds undermine some markets

Chart 10: Political risks contribute to EM debt underperformance (USD)



Source: Thomson Datastream, Schroders Economics Group. 21 December 2015.

Lessons from 2015

Having reviewed events and the performance of markets over the year, we have found a few lessons worth considering for 2016:

- **Oil producers more resilient than previously feared.** Should not all shale producers be bust by now? Why has supply not collapsed yet? It turns out that while set-up costs are large for fossil fuel extractors, running costs are not. Oil prices can stay low for a very, very long time.
- **Greece can check out, but can never leave.** Despite all of the political upheaval, change in government, referendum, Greece was forced to take the deal it was initially offered. The government backed down once truly faced by Grexit. The UK should take note.
- **Rumours of Chinese market reforms are greatly exaggerated.** 2015 was an extraordinary year of Chinese government intervention in markets, the currency and the macro economy. Although they would claim they are making progress towards liberalising markets, their actions suggest otherwise.
- **Even Super Mario Draghi has his limits.** Despite making history by introducing QE from the ECB, investors will end 2015 cursing the ECB president for not meeting their heightened expectations of additional monetary easing. A closer inspection of data would have showed less of a need for more stimulus, but why should logic trump animal spirits?
- **US interest rates can rise without a markets apocalypse.** Janet Yellen showed that with consistent and clear forward guidance, the Fed could raise interest rates without causing mayhem. Indeed, her positive message triggered a significant end of year rally in risk assets.

Themes for 2016

2015 Themes: end of year report

A desynchronised world in 2015

2015's themes played out with varying degrees of success. We did not get a "disinflationary boom" as although inflation fell with the decline in energy costs this did not translate into stronger growth. Cutbacks in spending by oil producers and firms offset part of the boost to the consumer and the fall in oil prices itself was a signal that all was not well with demand in the world economy.

The "desynchronised cycle" theme continued with the Federal Reserve (Fed) finally raising rates on 16 December whilst the European Central Bank (ECB) and People's Bank of China (PBoC) eased further. The Bank of Japan (BoJ) refrained from increasing quantitative and qualitative easing (QQE), despite disappointing economic growth, but did keep policy loose. The net result of course was a strong rally in the US dollar (USD). We will carry this theme into 2016.

Our third theme, "Japan: winning the currency war", had mixed success. It did not really play out from the macro perspective as, although the trade deficit narrowed, this was mainly due to the decline in oil prices and growth has yet to receive much of a boost from exports. However, the strong performance of the equity market (the Nikkei has been the best performing market in USD terms year to date) suggests that companies chose to use the devaluation of the yen (JPY) to boost their profit margins. So investors saw victory even if economists did not.

Finally our "back to the 1990s" theme – where the strength of the USD leads to pressure on emerging markets and forces the Fed to keep policy loose – did materialise. The Fed ducked a rate rise in September in response to worries about China, and emerging market concerns have been a persistent theme in 2015.

US dollar: buy the rumour sell the fact?

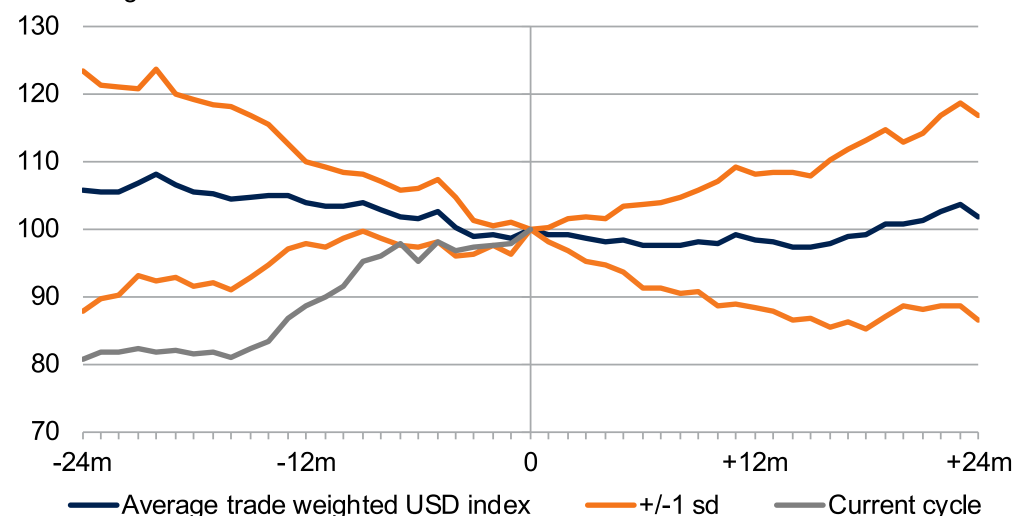
The dollar tends to weaken after the Fed raises rates

Some of these themes will roll on into 2016. The desynchronised cycle will persist with the Fed expected to tighten further whilst policy stays loose or gets looser in the Eurozone, Japan and China. The Bank of England (BoE) is expected to follow the Fed, but not until next August.

Will we see a further appreciation of the USD as a result? After the 9% gain this year there is a temptation to take profits. There is some evidence that the dollar peaks once the Fed begins to tighten policy, a "buy the rumour sell the fact" story.

Chart 11: The USD and Fed tightening cycles

Trade weighted USD indexed to 100 at date of first hike

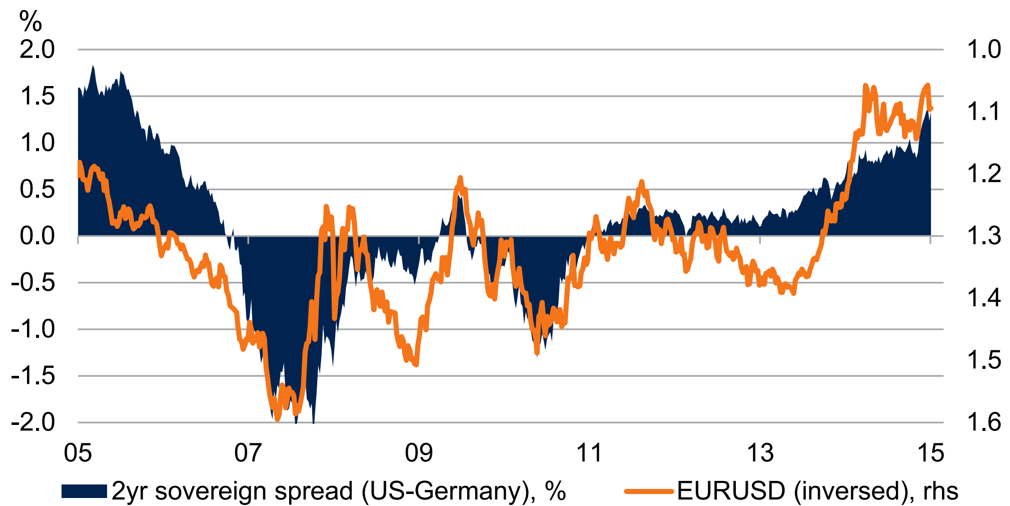


Source: Thomson Datastream, Schroders Economics Group. 20 December 2015. Monthly data since 1975.

We looked at the last eight Fed tightening cycles and found that the trade-weighted dollar was on average weaker after three and twelve months (see chart 11 above). Weakness tended to be concentrated in the first few months after tightening. However, this is a small sample and in half the cases the dollar was stronger after a year.

Moreover, this time appears to be different: it is early days, but so far the dollar has firmed since the Fed raised rates. Our central view remains that the currency will be supported by the interest rate differential in favour of the US, particularly against the euro (see chart 12).

Chart 12: Rate differentials support USD vs. the euro

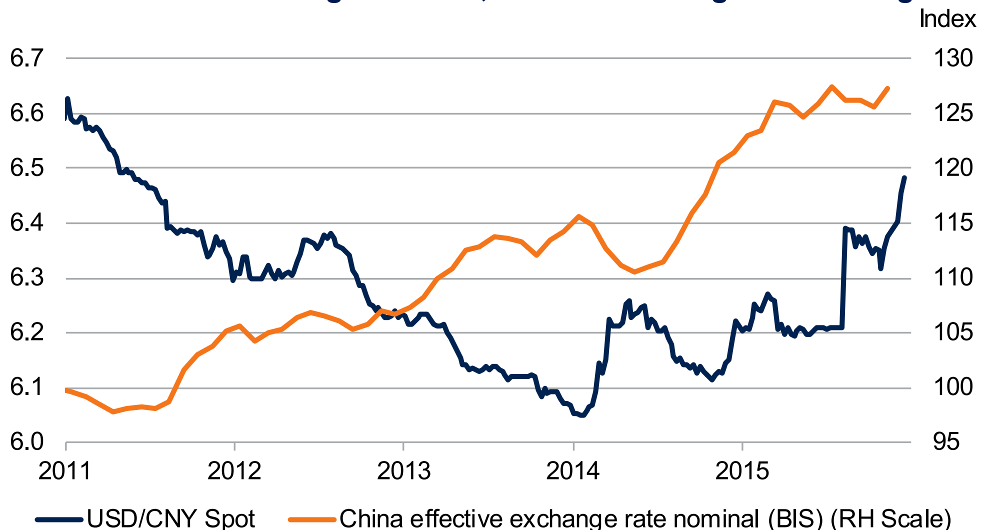


Source: Thomson Datastream, Schroders Economics Group, 17 December 2015.

China factor to strengthen the dollar

The added factor which is likely to support the dollar is the potential for a new currency arrangement in China. Whilst there has been no official announcement of a move away from tracking the US dollar, the PBoC published a paper on 11 December highlighting the merits of an effective exchange rate, a basket of currencies against the renminbi (RMB) which "offers a more comprehensive and accurate way to assess market conditions". Should the yuan (CNY) start tracking a trade-weighted basket, then dollar strength against majors such as the EUR or JPY will be magnified by appreciation against the CNY. Recent moves suggest this may have already begun with the CNY weakening against the USD following a pick-up in the effective exchange rate in November (chart 13).

Chart 13: China: tracking the dollar, or the trade-weighted exchange rate?



Source: Thomson Datastream, Schroders Economics Group, 18 December 2015.

It is worth noting that in contrast to August, the markets have taken the latest move in the CNY with equanimity. This may not last, but suggests that after the fall-out in the summer, investors are now better positioned for CNY weakness. Such a move goes alongside the inclusion of the Chinese currency in the IMF's Special Drawing Rights basket, and the PBoC's stated desire to move the currency towards a floating arrangement over the medium term.

Markets now seem more relaxed about CNY depreciation

Whilst the PBoC has highlighted the relative strength of growth, high productivity and other fundamentals which should support the currency, the drop in foreign exchange reserves over the past year indicates that these factors are being outweighed by capital outflows at present. Consequently, the near term path for the CNY is likely to be lower.

The principal consequence of this would be an intensification of deflationary pressure in the rest of the world as a result of greater competition from China. This reinforces our view that inflation will not be a problem for the developed economies in 2016 and that there will be further losses in industries which compete directly against China. Such a development would also suppress interest rates and tend to exacerbate the split between a strong service sector and a weak manufacturing industry.

More worryingly, there is also the risk that a persistent depreciation of the CNY will provoke another round in the currency wars. The BoJ is likely to be watching developments with great interest. Although we are not looking for an increase in QQE at this stage and are expecting the yen to remain stable against the dollar in 2016, the risks to this view are clearly increased by the recent developments in China. Furthermore, although at this stage the BoJ is confident that inflation will pick up and reach the 2% target, we have yet to see the acceleration in wage growth which would be needed to achieve this on a sustainable basis.

On this basis it is too early to call the turn in the US dollar, which could strengthen further in 2016 supported by interest rate differentials and developments in China, an outcome which is likely to weigh on commodity prices and emerging markets.

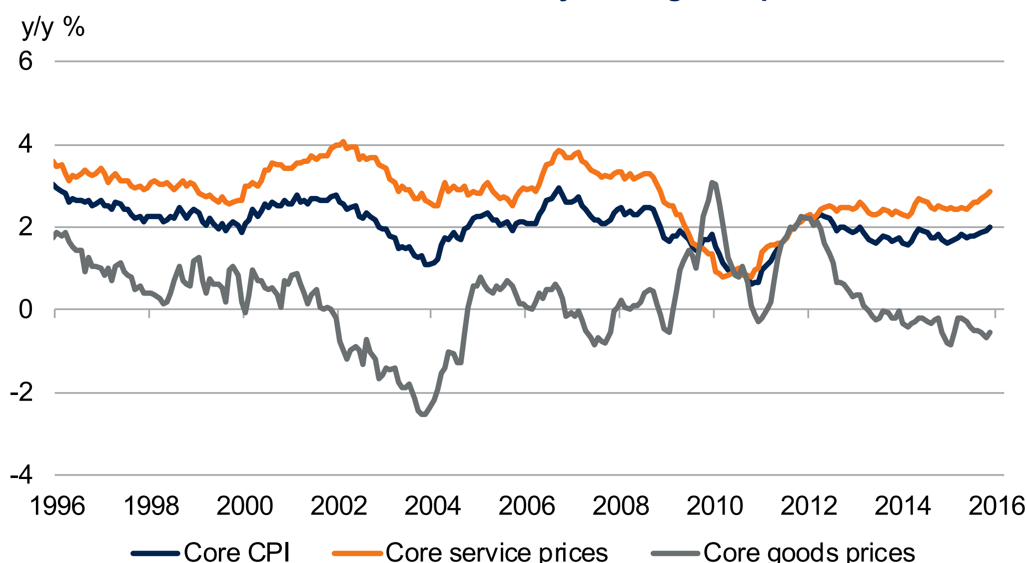
What might halt the dollar's ascent?

Investors would question dollar invincibility if the Fed hiking cycle was under threat. At present we forecast the Fed will pause to accommodate the presidential election, but thereafter rate rises resume and take the Fed funds to 2% in 2017.

Lower-than-expected inflation or a recession would give the Fed pause for thought

Barring unforeseen events, the most likely cause would be either a loss of confidence in inflation returning to target, or an outright recession. On the inflation front, whilst we see an intensification of deflationary pressure from China, this would primarily affect goods prices. Service sector prices are likely to remain robust and offset this to leave overall inflation relatively stable. In the US, for example, the divergence between goods and service prices is likely to increase (chart 14 on next page).

Chart 14: US service sector inflation buoyant as goods prices fall



Source: Thomson Datastream, Schroders Economics Group, 21 December 2015.

Credit sell off = US recession?

On the activity side, US recession remains a risk and is one of our scenarios. In addition to the increase in the Fed funds rate, financial conditions in the US have been tightened by the dollar and the sell-off in credit markets, where yields and spreads have been widening. The credit sell-off is a concern as it will increase the cost of capital; however it has been concentrated in the energy sector and we will need to see if there is a feed-through into wider bank lending. Our initial analysis suggests that credit spreads are more of a coincident rather than leading indicator of activity. The Conference Board leading indicator index (which does not contain credit spreads) continues to rise and currently signals moderate growth ahead.

Lower oil ≠ recession

Potential for upside growth surprise following latest decline in energy costs

The economic environment will remain difficult, but there are upside risks. At current levels the crude oil price is $10 below the assumptions used to construct our baseline forecast. Whilst well aware that lower oil prices are a mixed blessing, as discussed above, it is the case that lower oil prices do not cause global recessions. Indeed, there is scope for an upside surprise on consumption as the lower oil price keeps inflation lower and hence real incomes higher than previously expected.

For the US there may be scope for a further gain as evidence that oil prices are set to stay low for longer could reverse the increase in the savings rate seen in recent months. Some attribute the increase in savings to consumer doubts about the sustainability of lower oil prices: the longer prices remain low, the more likely it is that households will factor the windfall into their permanent income and spend.

Themes for 2016

Pulling these (and a few other) strands together we can identify five themes for 2016:

1. The desynchronised cycle continues. Monetary tightening in the US; easing or loose policy pretty much every where else.
2. Emerging markets continue to struggle. A stronger US dollar and persistent weakness in China will keep pressure on commodity prices and the emerging economies. Investors will also be deterred by downgrades and an increase in defaults.

3. China enters the currency war. This may already be happening. Gradual depreciation of the CNY means deflationary pressure for the West and a challenge to competitors.
4. Services vs. manufacturing split. An environment of desynchronised global activity, low oil prices and a firm dollar will temper increases in inflation and interest rates. International sectors will be pressurised, whilst domestic service sectors should continue to thrive.
5. Political uncertainty. It is a US presidential election year and the UK may vote on EU membership, factors which will create uncertainty and weigh on investment decisions as firms and households delay decisions until the uncertainty lifts. Growth will be temporarily weaker, or in the event of a Brexit or Trump presidency, the uncertainty will be just beginning.

Schroder Economics Group: Views at a glance

Macro summary – January 2016

Key points

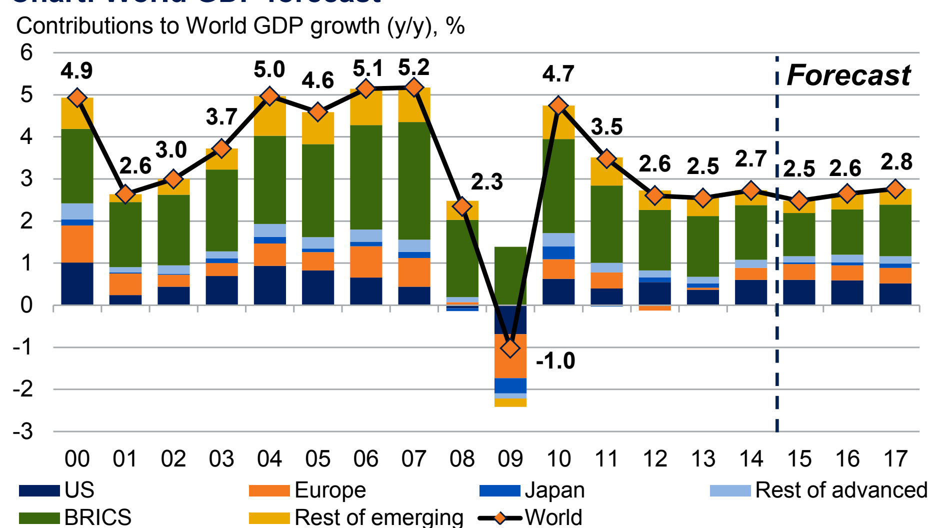
Baseline

- 2016 global growth is now forecast at 2.6%, with expectations revised down across all markets. As 2015 growth is projected to reach 2.5%, this marks a slight acceleration, but essentially reflects the lack of momentum we are seeing in global demand and the problem of excess inventories. 2017 offers a slight acceleration to 2.8% as EM and Europe improves, but ultimately, the square-root recovery continues.
- The US Fed is expected to look through the low headline CPI inflation rate and focus on a firmer core rate and tightening labour market. After hiking in December 2015 we expect the Fed funds rate to rise to 1.25% by end 2016 and 2% by end 2017, where it peaks.
- UK recovery to continue, but to moderate in 2016 with the resumption of austerity. Interest rate normalisation to begin with first rate rise in August 2016 after the trough in CPI inflation. BoE to move cautiously, hiking 25 bps per quarter, peaking at around 1.25% in February 2017 when weaker activity will force a pause.
- Eurozone recovery continues in 2016 but does not accelerate as tailwinds fade and the external environment drags on growth, before picking up in 2017. Inflation to turn positive again in 2016 and rise modestly into 2017. ECB to keep rates on hold and continue sovereign QE through to March 2017.
- Despite the weak yen, low oil prices and the absence of fiscal tightening in 2015, Japanese growth has disappointed. A limited pick-up is expected in 2016 as wages rise, but Abenomics faces a considerable challenge over the medium-term to balance recovery with fiscal consolidation. The external environment does not help either. Despite this, we do not expect the Bank of Japan to increase QQE.
- Emerging economies benefit from modest advanced economy growth, but tighter US monetary policy weighs on activity, while commodity weakness will continue to hinder big producers. Concerns over China's growth to persist, further fiscal support and easing from the PBoC is likely.

Risks

- Risks skewed towards deflation on fears of China hard landing, currency wars and a US recession. The risk that Fed rate hikes lead to widespread EM defaults would also push the world economy in a deflationary direction. Inflationary risks stem from a significant wage acceleration in the US, or a global push toward reflation by policymakers. Finally, conflict in the Middle East could hit oil supply, leading to a jump in inflation and a hit to growth.

Chart: World GDP forecast



Source: Thomson Datastream, Schroder Economics Group, November 2015 forecast. Please note the forecast warning at the back of the document.

Schroders Baseline Forecast

Real GDP

y/y%	Wt (%)	2014	2015		Prev.	Consensus	2016		Prev.	Consensus	2017
World	100	2.7	2.5	↑	(2.4)	2.5	2.6	↓	(2.9)	2.8	2.8
Advanced*	62.4	1.7	1.9	↑	(1.8)	1.9	1.9	↓	(2.2)	2.1	1.9
US	24.7	2.4	2.4	↑	(2.3)	2.5	2.4	↓	(2.7)	2.5	2.1
Eurozone	19.0	0.9	1.5	↑	(1.3)	1.5	1.5	↓	(1.7)	1.7	1.6
Germany	5.5	1.6	1.5	↑	(1.3)	1.7	1.7	↓	(2.1)	1.8	2.1
UK	4.2	2.9	2.3	↓	(2.5)	2.4	1.9	↓	(2.1)	2.3	1.6
Japan	6.5	-0.1	0.6	↓	(0.7)	0.6	1.1	↓	(1.8)	1.3	1.5
Total Emerging**	37.6	4.4	3.5	↑	(3.4)	3.5	3.9	↓	(4.1)	3.9	4.2
BRICs	23.6	5.5	4.4	↑	(4.1)	4.3	4.6	↓	(4.7)	4.7	5.2
China	14.7	7.3	6.9	↑	(6.8)	6.9	6.3	↓	(6.4)	6.5	6.2

Inflation CPI

y/y%	Wt (%)	2014	2015		Prev.	Consensus	2016		Prev.	Consensus	2017
World	100	2.7	3.1	↑	(2.9)	3.1	3.7	↑	(3.3)	3.6	3.9
Advanced*	62.4	1.3	0.4	↓	(0.5)	0.2	1.4	↓	(1.7)	1.3	1.9
US	24.7	1.6	0.3	↓	(0.6)	0.2	1.6	↓	(2.3)	1.7	2.1
Eurozone	19.0	0.4	0.1	↑	(0.0)	0.1	1.3	↑	(1.1)	1.0	1.6
Germany	5.5	0.8	0.2		(0.2)	0.3	1.5		(1.5)	1.3	1.6
UK	4.2	1.5	0.1	↑	(0.0)	0.1	1.3	↓	(1.6)	1.1	2.2
Japan	6.5	2.7	0.9	↓	(1.1)	0.8	1.0	↓	(1.1)	0.7	1.8
Total Emerging**	37.6	5.0	7.6	↑	(7.0)	7.9	7.4	↑	(6.1)	7.4	7.3
BRICs	23.6	3.8	4.6	↓	(4.8)	4.5	3.6	↓	(3.8)	3.5	3.4
China	14.7	2.0	1.6	↑	(1.4)	1.5	1.9	↓	(2.0)	1.7	2.1

Interest rates

% (Month of Dec)	Current	2014	2015		Prev.	Market	2016		Prev.	Market	2017	Market
US	0.50	0.25	0.50	↑	(0.25)	0.52	1.25		(1.25)	1.10	2.00	1.62
UK	0.50	0.50	0.50		(0.50)	0.58	1.00	↓	(1.50)	0.91	1.25	1.30
Eurozone***	0.05	0.05	0.05		(0.05)	-0.13	0.05		(0.05)	-0.19	0.05	1.30
Japan	0.10	0.10	0.10		(0.10)	0.17	0.10		(0.10)	0.01	0.10	0.47
China	4.35	5.60	4.35	↓	(4.60)	-	3.50	↓	(4.00)	-	3.00	-

Other monetary policy

(Over year or by Dec)	Current	2014	2015		Prev.		2016		Prev.		2017
US QE ($Bn)	4484	4498	4489	↓	(4504)		4507	↓	(4522)		4525
EZ QE (€Bn)***	133	31	649		(649)		1369	↑	(1189)		1549
UK QE (£Bn)	371	375	375		(375)		375		(375)		375
JP QE (¥Tn)	365.4	300	387	↓	(389)		404	↓	(406)		404
China RRR (%)	18.00	20.00	17.00	↓	17.50		15.00	↓	16.00		13.00

Key variables

FX (Month of Dec)	Current	2014	2015		Prev.	Y/Y(%)	2016		Prev.	Y/Y(%)	2017	Y/Y(%)
USD/GBP	1.49	1.56	1.53		(1.53)	-1.9	1.50		(1.50)	-2.0	1.50	0.0
USD/EUR	1.08	1.21	1.08		(1.08)	-10.7	1.02		(1.02)	-5.6	1.02	0.0
JPY/USD	121.5	119.9	120.0		(120.0)	0.1	120.0		(120.0)	0.0	115.0	-4.2
GBP/EUR	0.73	0.78	0.71		(0.71)	-9.0	0.68		(0.68)	-3.7	0.68	0.0
RMB/USD	6.48	6.20	6.40	↑	(6.30)	3.2	6.60	↑	(6.40)	3.1	6.80	3.0
Commodities (over year)												
Brent Crude	37.1	56	53.5	↓	(55)	-4.2	48.5	↓	(55)	-9.4	54.6	12.6

Source: Schroders, Thomson Datastream, Consensus Economics, December 2015
Consensus inflation numbers for Emerging Markets is for end of period, and is not directly comparable.
Market data as at 21/12/2015
Previous forecast refers to August 2015
* **Advanced markets:** Australia, Canada, Denmark, Euro area, Israel, Japan, New Zealand, Singapore, Sw eden, Sw itzerland, United Kingdom United States.
** **Emerging markets**: Argentina, Brazil, Chile, Colombia, Mexico, Peru, Venezuela, China, India, Indonesia, Malaysia, Philippines, South Korea, Taiw an, Thailand, South Africa, Russia, Czech Rep., Hungary, Poland, Romania, Turkey, Ukraine, Bulgaria, Croatia, Latvia, Lithuania.
***The forecast for ECB policy interest rates and QE w as updated in December.

Updated forecast charts – Consensus Economics

For the EM, EM Asia and Pacific ex Japan, growth and inflation forecasts are GDP weighted and calculated using Consensus Economics forecasts of individual countries.

Chart A: GDP consensus forecasts

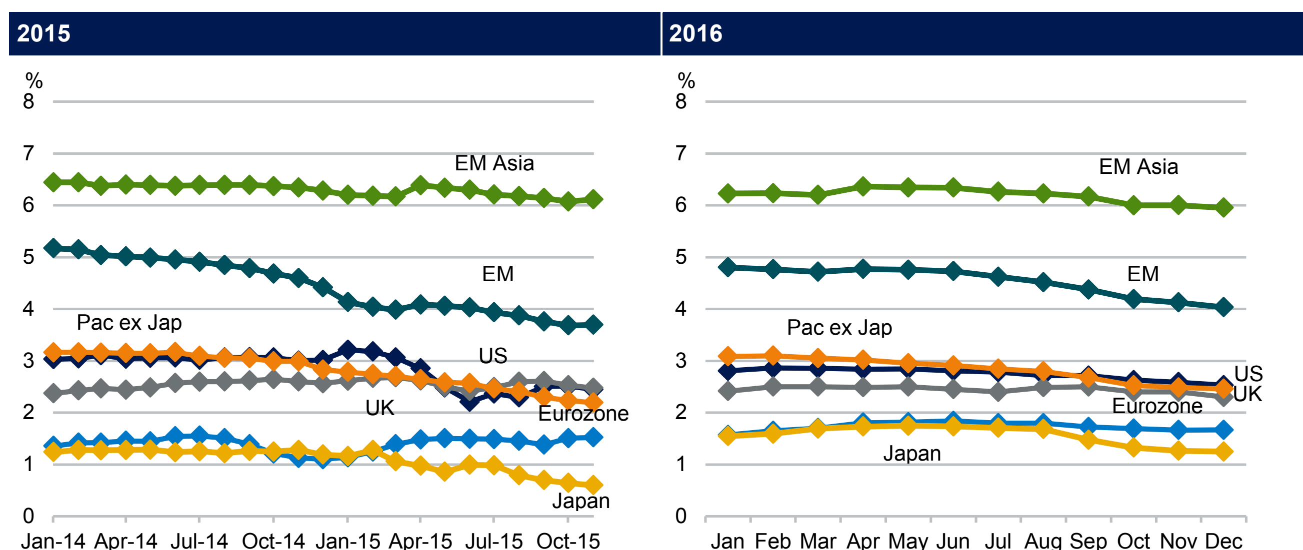
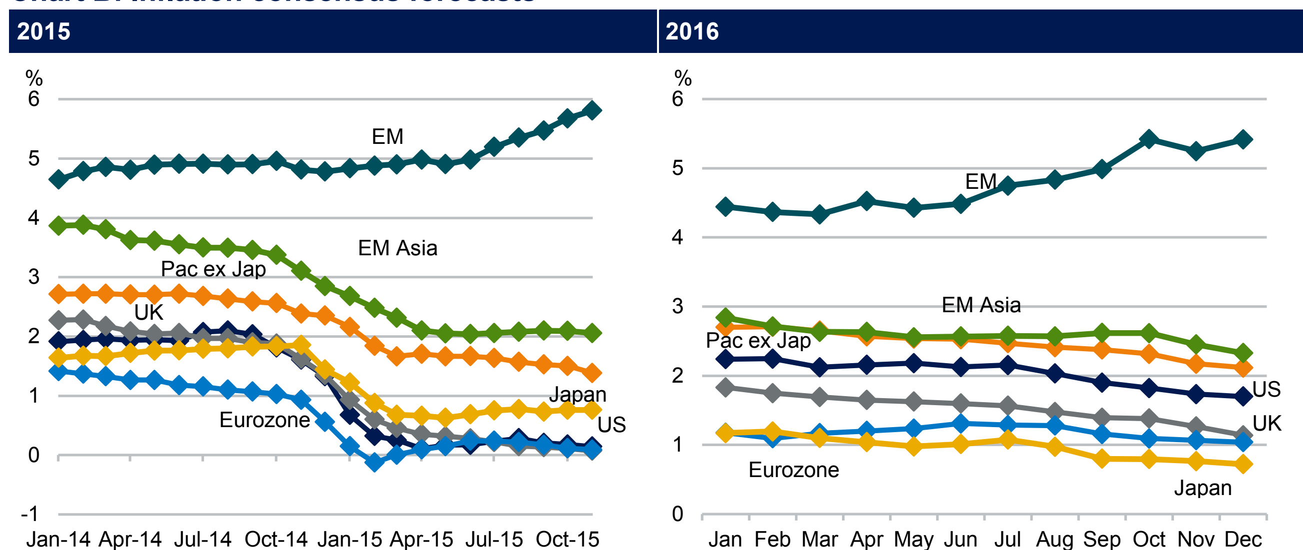


Chart B: Inflation consensus forecasts



Source: Consensus Economics (December 2015), Schroders.

Pacific ex. Japan: Australia, Hong Kong, New Zealand, Singapore.

Emerging Asia: China, India, Indonesia, Malaysia, Philippines, South Korea, Taiwan, Thailand.

Emerging markets: China, India, Indonesia, Malaysia, Philippines, South Korea, Taiwan, Thailand, Argentina, Brazil, Colombia, Chile, Mexico, Peru, Venezuela, South Africa, Czech Republic, Hungary, Poland, Romania, Russia, Turkey, Ukraine, Bulgaria, Croatia, Estonia, Latvia, Lithuania.

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