INVESTMENT

A bumpy road

As global stock markets continue to react and recoil to heavy falls, Peter Carvill **lines up some investment predictions for 2016**

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The door on 2016 has opened to a landscape of uncertainty and change. Amidst a host of issues, many investors and pensions funds are thinking ahead and recalibrating their investment strategies.

The general prediction for the world's economy is that it will expand in 2016, if only marginally. A recent report from Willis Towers Watson, *Global Investment Committee: Secular Outlook 2015*, found that economic recovery in major economies had been 'uneven' and that across these sectors only a 'sluggish recovery' had been observed.

Scotiabank's *Global Forecast Update* gives a number of reasons for this: the slowdown in the Chinese economy, underperformance across Europe and in Japan, weaknesses in the commodity and manufacturing sectors, high debt burdens across the private and public sectors, an over-supply in the majority of commodity markets, and geopolitical strains.

Yet despite this, Willis Towers Watson found some reason to be celebratory, outlining that the global economy's mediocre growth stands in contrast to the changes witnessed in the financial markets.

The right approach

This discord leaves investors in a tricky place, raising questions about how they should allocate their investments this year.

Natixis Global Asset Management, in its *2016 in Focus* says the current market is one that favours active institutional management and that the assets likely to perform best this year will be equities, alternative investments, and stocks, while fixed-income returns will be suppressed by monetary policy and interest rates.

Pinsent Masons head of pensions research Raj Sharma says that one asset class expected to perform well in 2016 is infrastructure. "There will be more opportunities coming up in projects that are being built from scratch and the question of whether pension funds want to invest in that. It's a case of what it is that you're building because putting up streetlights is one thing while building a nuclear power plant is another. The opportunities are in things such as brownfield sites. We think there are opportunities there, whether they are in renewables, transport, or other infrastructure. The other opportunities are in property and real estate. For some people, that's an alternative to infrastructure where you can create steady, long-term cash flows."

According to Natixis Global Asset Management director and head of UK and Ireland institutional business Euan MacLaren: "From the point of view for institutional investors we are going to see outflows in the traditional bond markets and a drop in high yield. Where is that money going? I think we will see a switch or continuation to fixed-income but more towards unconstrained and the global macro side. On the asset side, I think we will see more money allocated institutionally. Equities look attractive after the high volatility of recent years."

Not every asset class is due a

boom year, though. Sharma says that 2016 for gilts and bonds will look the same as 2015, adding that investors will be looking at their portfolios and looking to diversify more. "I think the areas that may fare not so well," he adds, "are the hedge funds and private equity investments because they seem to have suffered a lot last year with redemptions. The fee structure, too, has come under a lot of focus. I think active management itself will also come under a lot of scrutiny."

The fortunes and failings of individual asset classes will take place against macroeconomic trends exerting pressure on the markets. In collating data for *2016 in Focus*, Natixis found that 42 per cent of respondents believed market volatility was the biggest risk to investment performance in 2016, concluding: "After a year in which we saw 56 days with 1 per cent movement in the S&P 500 between 1 January and 31 October, it should be no surprise that this weighs heavily on the minds of investors."

The same report found over half of respondents named geopolitical events as the most likely cause for market volatility, coming in the wave of terrorist attacks across the Middle East and Europe, the ongoing Syrian refugee crisis, and the forthcoming US presidential election.

"Geopolitics does have a growing impact on the volatility of the markets," says MacLaren, "not just from recent events, but from the whole of last year and this year. It has always been around but impacts have been on the daily volatility of the markets. But the fundamentals underpinning those markets remain strong."

China

A more worrying development has been the slowing of the Chinese economy. Natixis reports that 49 per cent of respondents thought that the issue would have an impact on volatility. They may have good reason to be worried: the main index in Shanghai lost 19 per cent of its value in the first fortnight of the year, and was accompanied by double-digit falls in Frankfurt and Tokyo, and drops of 8 per cent and 9 per cent in London and New York.

"With China," MacLaren comments, "we've had three or four years where price has divorced itself from the fundamentals of the underlying market, making pricing expensive. We've had a bubble and now we're getting the correction. It's the same as we've seen in Europe, but in a negative way. Consequenty, we see a lot of value in European equities in 2016."

MacLaren adds: "China's had a period of exceptional growth and I think this is a correction. Ten years ago, the average GDP in China was $1,000. Now, it's $10,000. If growth is at 5 or 6 per cent, that's still a good rate. Looking at where they came from, they're still growing, only it from a much higher base.

QE

Another issue on the horizon is the QE programmes put into place around the world. The Indiana Business Research Center recently released *Financial Markets 2016: The Groundhog Forecast*. The effects of the US QE programme, the authors opine, had ultimately been lower growth: "When the Fed started QE, it was argued that the lower interest rates would jumpstart business investment, encourage economic growth, and the wealth effect from higher asset prices would increase household consumption. What we have seen is the weakest post-recession recovery of the modern era. From the perspective of finance, this outcome isn't surprising. When stock and bond prices get bid up higher than they would without QE, their expected returns will be lower. With lower expected returns, businesses conserve cash and scale back investments; consumers save more and reduce spending. The net result is lower growth."

The report's authors added: "As investors, we face a serious challenge: How do we manage our portfolios in a QE world? One thing we have learned is that buy and hold is actually a pretty good QE strategy. Over the past five years of QE, the average return to the S&P 500 is about 14 per cent per year. This is well above the historical average of about 10 per cent. Our guess is that global QE will be a force at least through 2016. However, we need to be diligent in looking for signals suggesting the phase-out of QE strategies."

Oil

Another key issue for investors has been the long-dropping oil price. Recently, the international benchmark of Brent Crude fell 2.4 per cent per barrel, characterised as being close to its lowest point in the last 12 years. On a longer timeline, the price of oil has dropped three-quarters in the last 18 months due to an over-supply in the US in tandem with falling demand from Asia and Europe.

"The laws of supply and demand will come back there," says MacLaren. "It's a fact of life. It's an economic foundation. What we've seen are some defaults. But it does mean there is opportunity there for companies that are not so highly leveraged. But they're starting to look attractive in the market."

There can be little doubt that 2016 will be an interesting year for pension funds with regards to their investments. Where the markets will lead the industry cannot be predicted with 100 per cent accuracy. But what is likely is that there will be a bumpy road ahead. ■