Top Five Macro Themes for 2016

By Laura Sarlo, CFA, VP, Senior Sovereign Analyst & Aimee Kaye, Sovereign Analyst

Some big trends that drove markets in 2015 seem set to stay with us into 2016. The US dollar is poised to keep trending stronger, China's economic transition and structural slowdown look set to continue, central bank balance sheets and policy actions should remain critical to capital market performance, and total global economic growth should continue to inch higher.

What factors could look different in the coming year? The Fed's nascent rate-tightening cycle and an ongoing strong dollar mean fewer dollars circulating in the world economy—and at a higher cost. For some emerging market (EM) countries, higher capital costs and economic strain are igniting new political tensions. Will we see continued headwinds for EM, or can change restore investors' interest? A number of drivers—including slashed capital expenditures by global commodity companies, greater awareness of China's transition away from heavy industry and confidence that policymakers will head off severe downside risks—have many looking for supply-side adjustments that can potentially allow key commodity prices, especially oil, to stabilize in 2016.

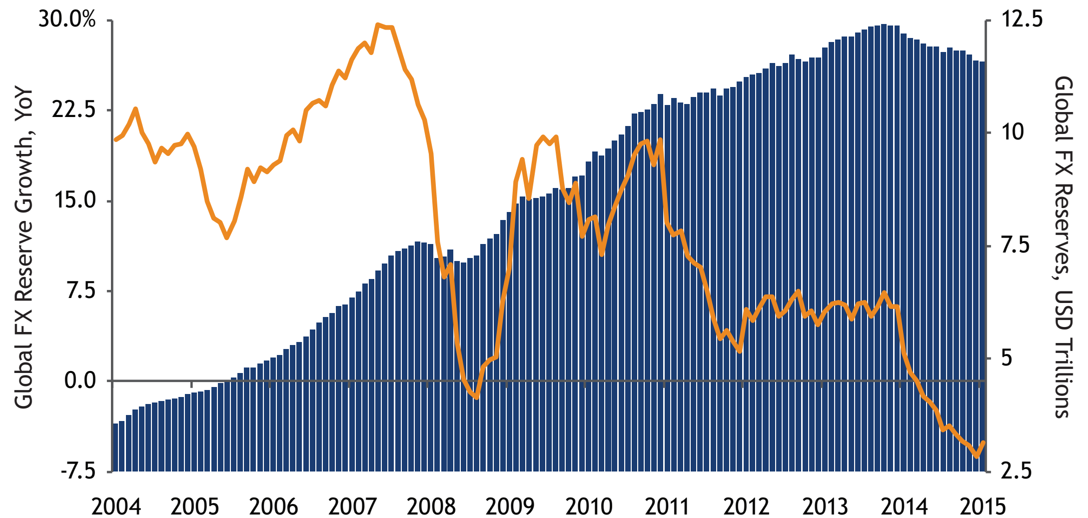
TOP FIVE MACRO THEMES FOR 2016

1. Tightening US Dollar Liquidity Is a Fact of Life for 2016
2. Global Growth Outlook: Steady as She Goes
3. Ongoing Structural Slowdown in China Constrains Global Inflation
4. Hangover From QE Leaves Financial Markets Fragile
5. Long Climb Back From GFC Fuels Political Stress That Can Harm Asset Markets

1. Tightening US Dollar Liquidity Is a Fact of Life for 2016

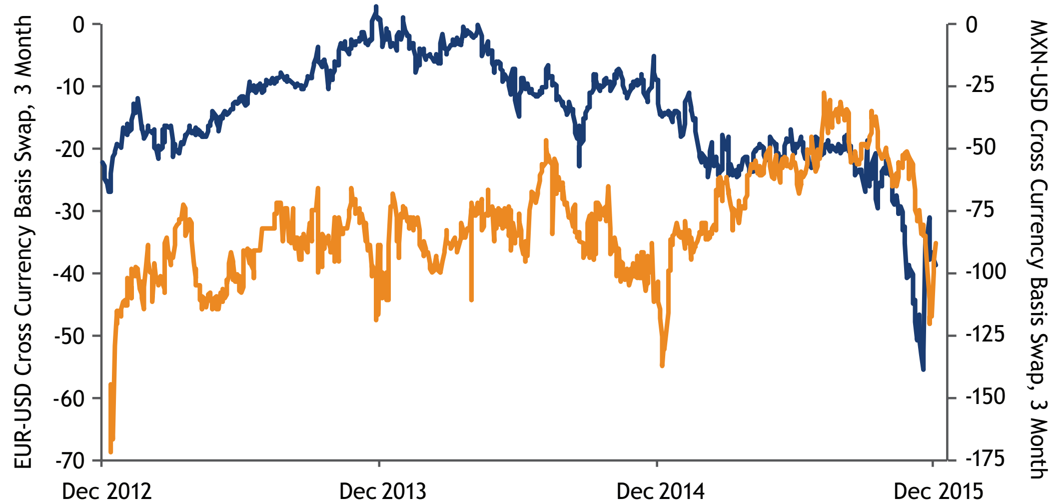
GLOBAL FX RESERVE ACCUMULATION IS DECELERATING

Source: Haver Analytics, data as of 12/16/2015.



FOMC TIGHTENING & STRONGER USD LIFT FUNDING COSTS FOR EM & HY BORROWERS

Source: Bloomberg, data as of 12/16/ 2015.

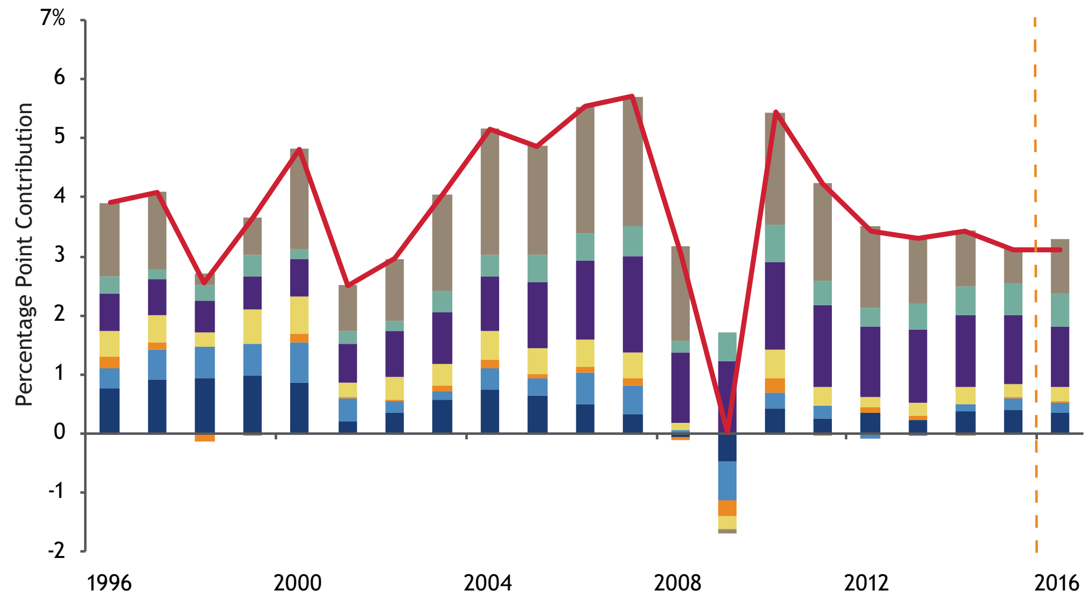


- Global foreign exchange (FX) reserves are shrinking under the weight of a strong US dollar and the collapse in global trade. As central banks accumulate fewer US dollars or shed reserves, the dwindling supply of dollars in the global economy will lead to higher dollar funding costs and reduced access to dollar lending.
- Borrowers who are highly leveraged to US dollars are likely to feel the pinch of tighter dollar liquidity. Countries and sectors that loaded up on cheap dollar-denominated debt, including high yield and segments of the EM private sector, will be areas to watch.

2. Global Growth Outlook: Steady as She Goes

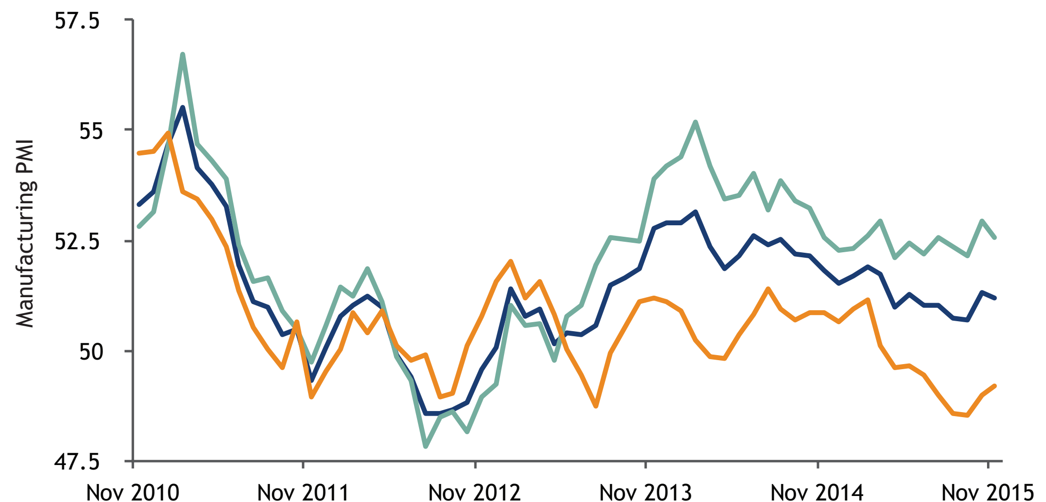
GLOBAL GROWTH LITTLE CHANGED FROM 2015

Source: Loomis Sayles Macro Strategies and IMF, data as of 12/20/2015.



DM ACTIVITY OUTPERFORMING EM ACTIVITY

Source: JP Morgan, Markit, Haver Analytics, data as of 12/16/2015.

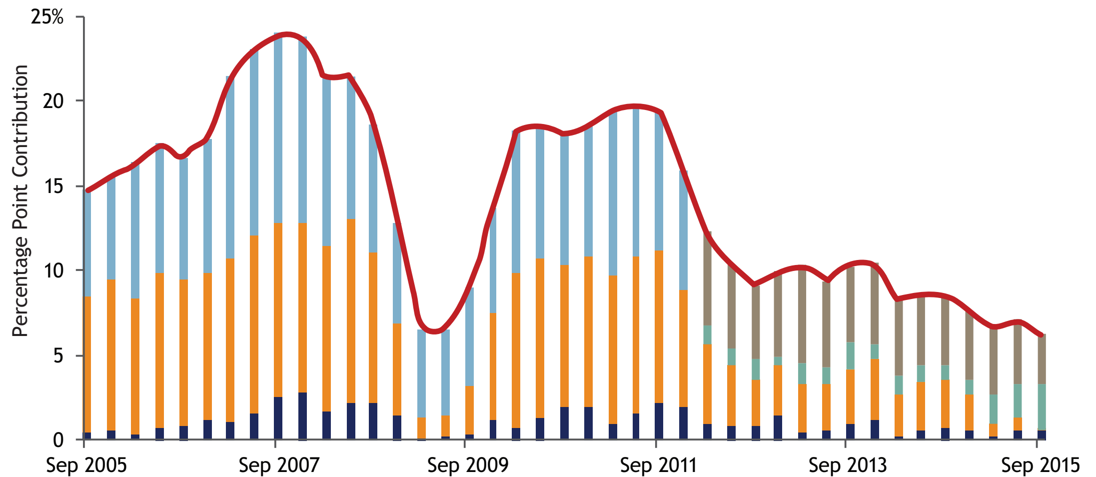


- Global growth looks set to turn in a repeat performance of roughly 3% in 2016. US GDP is holding steady around 2.4% and EM Asia is growing in the 2-6% range, but Europe and China are both growing somewhat more slowly.
- Accommodative monetary policy from the European Central Bank (ECB), Bank of Japan (BoJ) and People's Bank of China (PBoC) should continue, and may well expand, in 2016. With the US officially kicking off its tightening cycle, monetary policy divergence shows no signs of stopping in 2016. The US dollar should appreciate modestly in this environment.
- Economic data from developed countries continue to outpace results from the emerging world. The decoupling in developed and emerging market activity, as reflected in Purchasing Managers' Index (PMI) measures, is an indicator to monitor. Will growth reconverge? And if so, in which direction?

3. Ongoing Structural Slowdown in China Constrains Global Inflation

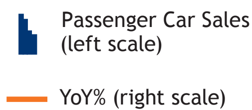
STRUCTURALLY SLOWER CHINA TRANSITIONING AWAY FROM HEAVY INDUSTRY

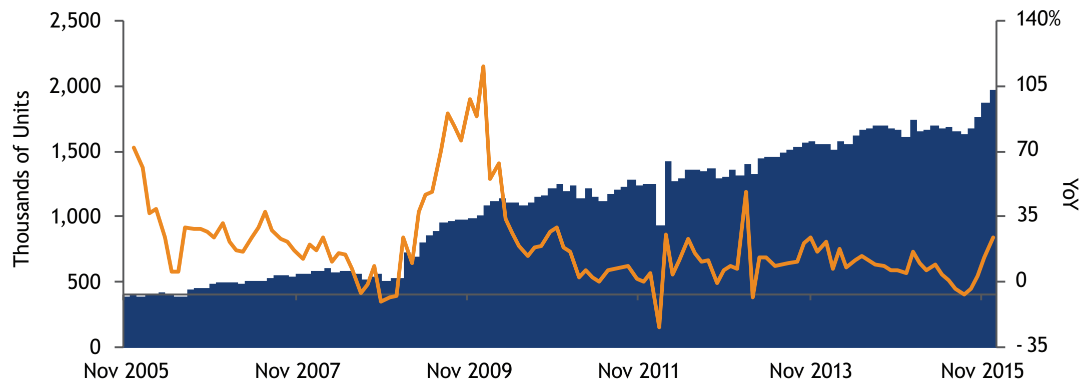
Source: NBS, data as of 12/16/2015.



CHINA'S CONSUMER & SERVICES SECTOR SOLID

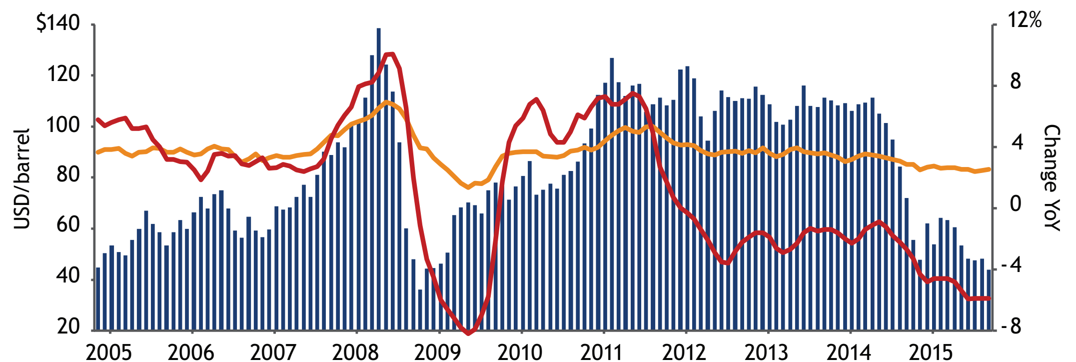
Source: CEIC, data as of 12/20/2015.





CHINA'S IMPACT ON COMMODITIES KEEPS A LID ON GLOBAL INFLATION

Source: EIA, IMF, NBS, Haver Analytics, data as of 12/16/2015.

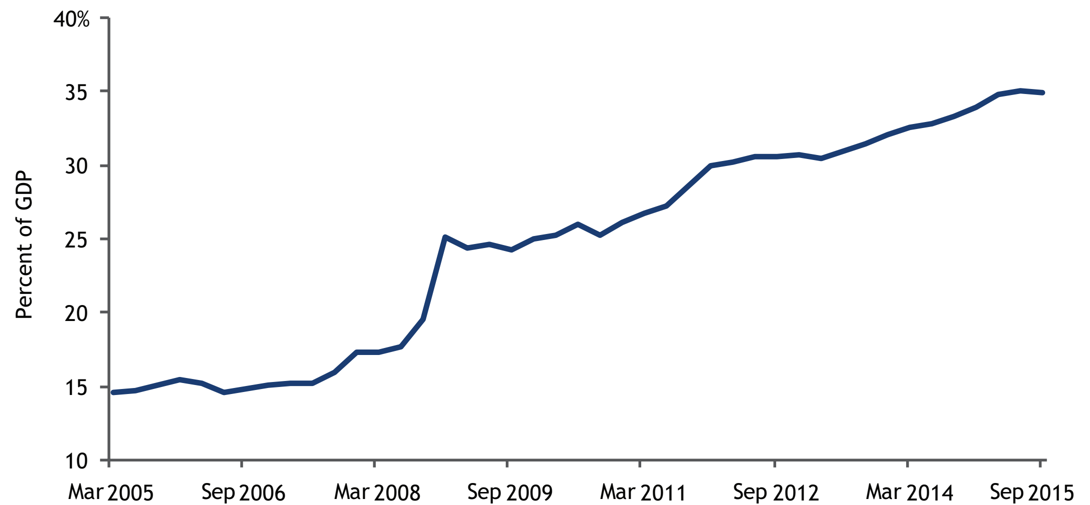


- Concerns about China's economic fortitude have been a dominant theme in recent months. While growth in China is undeniably slowing, we do not think a disastrous hard landing is at hand. As the country transitions away from its industry- and investment-led growth model, relative strength in its services and consumer sectors have bolstered overall activity.
- China itself is feeling fewer ill effects from its economic transition than its trade partners around the globe—particularly commodity producers. The structural slowdown underway in China has reduced global commodity prices and seems to cap global inflation trends. We expect inflationary pressures to remain contained as a large-scale reversal of this trend looks unlikely in the near term.

4. Hangover From QE Leaves Financial Markets Fragile

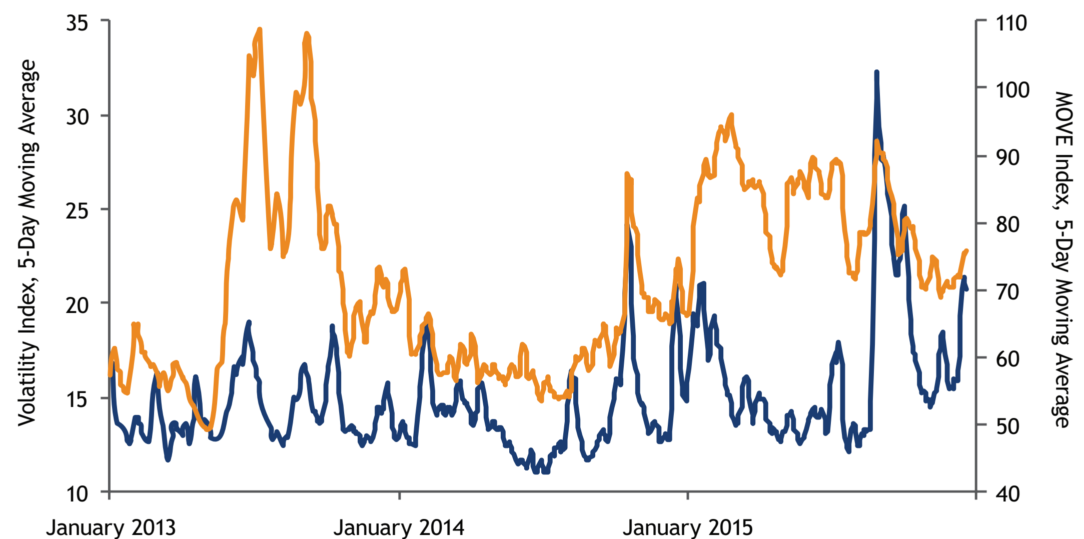
CENTRAL BANKS' BALANCE SHEETS SURGE RELATIVE TO ECONOMY SIZE

Source: Haver Analytics, data as of 12/21/2015. Indicates total assets on central banks' balance sheets against the aggregated GDP.



FINANCIAL MARKETS TO SEE HIGHER VOLATILITY & INVESTORS CAN CAPITALIZE ON LIQUIDITY OPPORTUNITIES

Source: Bloomberg, data as of 12/17/2015. Volatility Index illustrates the market's expectation of 30-day volatility. MOVE Index represents volatility in 1-month Treasury options.

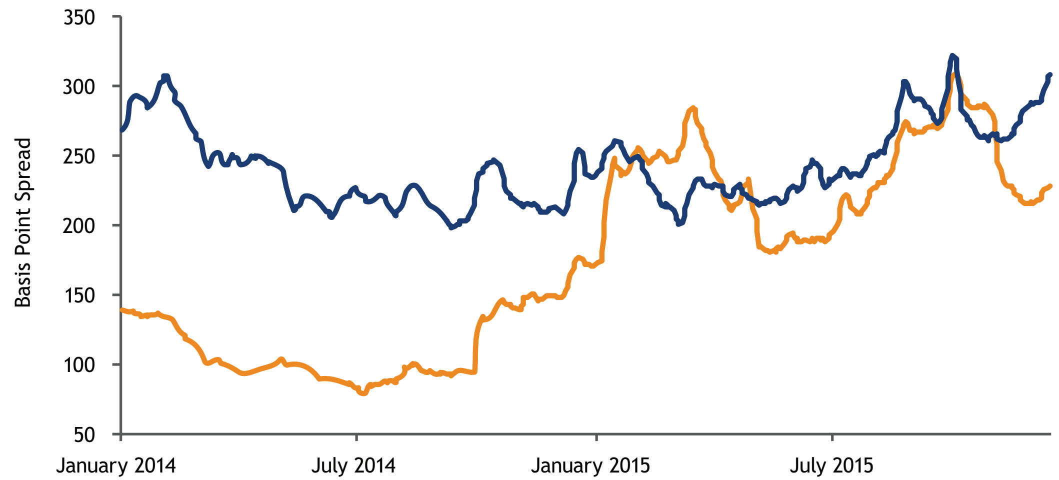


- Following years of unprecedented monetary accommodation and intervention, central banks have become meaningful owners of global bond markets. The downside? Policymakers' efforts to make real economies less fragile have arguably left capital markets more so.
- Central banks are holding massive quantities of certain assets, leaving other market participants with much smaller float. Volatility and correlations across assets have risen as investors try to front run central banks and pile into one-way trades.
- Increased market fragility does not appear to be fleeting. More than seven years after the global financial crisis, central banks' balance sheets have ballooned, and they look set to remain large for years to come.

5. Long Climb Back From GFC Fuels Political Stress That Can Harm Asset Markets

POLITICS CAN DRIVE MARKET PERFORMANCE

Source: Bloomberg, data as of 12/16/2015.



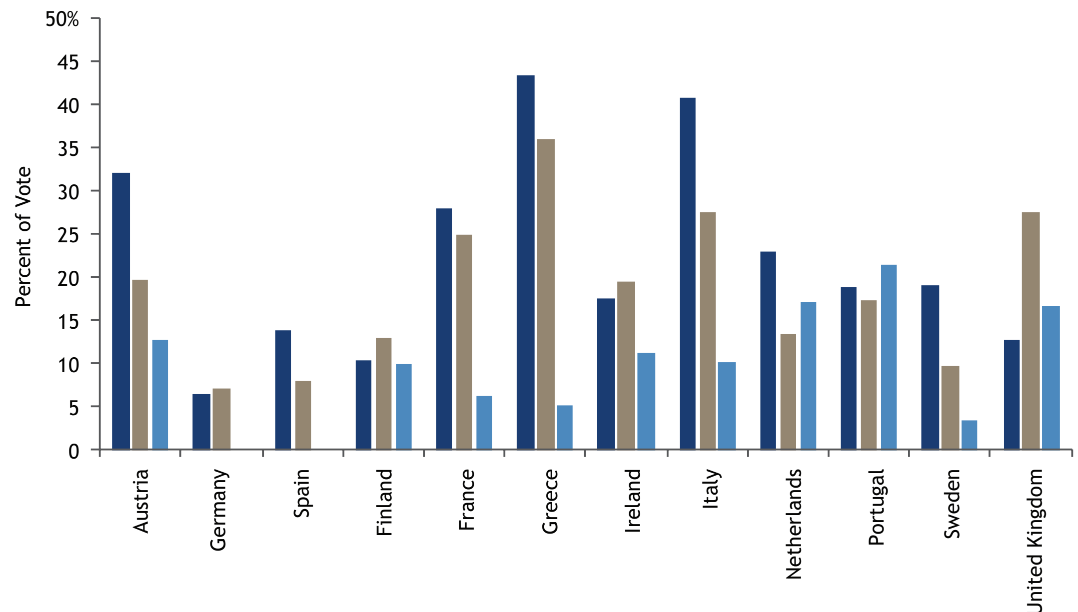
Malaysia
Ratings:
Moody's A3, S&P A-

Indonesia
Ratings:
Moody's Baa3, S&P BB+

SLUGGISH RECOVERY FROM FINANCIAL CRISIS HOLLOWS OUT POLITICAL CENTER IN DM

Performance of Extreme Parties

Source: Polls: Eurasia. Election results: European Parliament, as of 12/16/2015. http://www.europarl.europa.eu



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- EM countries have benefited from a deluge of capital inflows over the past decade. Years of inexpensive funding obviated any drive for structural reform and enabled surging credit expansion, particularly in the private sector. As dollar liquidity tightens and economic conditions deteriorate, access to capital gets tougher. Political stresses are budding in some EM countries.
- Political dynamics can have important impacts on asset market performance. For example, A-rated Malaysian bonds have sharply underperformed split-rated Indonesian debt principally due to an investment fund scandal that has ensnared Malaysia's prime minister.
- In developed economies, the largely underwhelming post-crisis recovery has hollowed out the political center, and more extreme political parties have gained ground in each election cycle.

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Disclosure

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MALR014440