Fort Washington
Investment Advisors, Inc.

A member of Western & Southern Financial Group

JANUARY 2016

Nicholas P. Sargen, PhD
Chief Economist

2016 Outlook: Growth Divergence to Continue

Highlights

- The U.S. economy overcame a slowdown abroad and a strong dollar last year, while the unemployment rate dropped to 5.0%, which enabled the Federal Reserve to begin tightening monetary policy while Europe, Japan and China eased policies. This pattern will likely continue into 2016: The U.S. appears poised to grow above the 2.2% trend since mid-2009, while only modest improvement is expected for Europe and Japan, and China's economy appears considerably weaker than the official growth target of 6.5%.
- Financial conditions tightened somewhat in the past year, but they remain supportive of overall growth, and corporate credit spreads could narrow if default risks priced into markets prove excessive. U.S. equity market returns could stay subpar for a second consecutive year, however, as profit growth appears sluggish. Following two years of strong appreciation, the U.S. dollar's rise in 2016 is likely to be more muted, with the focus shifting to pressures on China's currency
- One risk to the forecast is the possibility that problems in energy/mining could intensify and result in more widespread defaults if oil prices fall further. In the emerging markets, the key issues are whether China's slowdown will remain gradual or intensify, and whether Brazil can avert a full-blown crisis. One of the main uncertainties in Europe is how it will cope with the influx of refugees from the Middle East.

The U.S. Economy's Underlying Resilience

With the U.S. economic expansion now six and one half years old, a natural question is how much further it has to go, especially considering that the Fed has begun to tighten monetary policy when growth in other parts of the world is either sluggish (Europe and Japan) or slowing (China and other emerging economies). While some observers are fearful that Fed tightening is a mistake and will ultimately be reversed, our take is that the U.S. economy is on solid footing, and the expansion is likely to continue for several more years. This conclusion reflects three primary considerations: (i) inflation is not an immediate threat that will cause the Fed to tighten policy precipitously; (ii) financial conditions remain generally supportive of the economy; and (iii) the economy is well diversified and not heavily reliant on demand from abroad.

U.S. Inflation is Well Contained

One of the main factors that will influence the pace of monetary tightening in the coming year is the prospect for U.S. inflation. On this score, there is little to indicate that inflation is an immediate concern. The Federal Reserve's preferred measure of core inflation (which excludes volatile food and energy components) is the personal consumption deflator. It has accelerated somewhat in the past year and is currently running at about

1.9%, while the headline rate as measured by the consumer price index is lower at about 1.3%. Key measures of inflation expectations, however, such as the five year forward rate and that derived from TIPS yields have declined in the past six months.

Moreover, there is still considerable slack in the economy, which suggests it is operating below its productive potential. It is widely accepted that the potential growth rate is lower than the 3%-3.5% trend rate that prevailed in the post-war era until the 2008 Global Financial Crisis, partly due to a slowing in the growth of the labor force and the pace of productivity growth. Nonetheless, while some economists believe the long-term growth rate is below 2%, we suspect it is closer to the recent trend of 2.2%.

In any case, bottlenecks that typically occur in the late stage of an expansion are not evident thus far. The rate of capacity utilization at 77%, for example, is well below the threshold level of 83% that in the past has been associated with accelerating inflation. And while the traditional measure of unemployment has fallen from a peak of 10% in 2009 to 5.0% recently, wage pressures have been modest thus far. Looking ahead, one of the key issues is whether the relationship between unemployment rates and inflation rates – the so-called Phillips curve – which has been absent throughout the expansion will reappear as the unemployment rate continues to fall. Our assessment is that this is possible, but will probably be muted as workers who are currently working part-time will transition to become full-time workers.

Still, one may ask why the Federal Reserve felt compelled to boost the federal funds rate at the end of last year. Our assessment is that Fed officials wanted to signal to the markets that the emergency conditions that prevailed after the financial crises were over and the economy is now functioning normally. Going forward, Fed officials have been clear that they will proceed cautiously in raising interest rates and that any further hikes will be data dependent, and they will also be mindful of conditions abroad. Whereas the consensus among Fed officials (based on projections they make at FOMC meetings) is that the funds rate will rise by a full percentage point in 2016, our own take is that the funds rate will rise by 50-75 basis points, which is in line with market expectations.

Financial Conditions are Supportive

Another consideration is that financial conditions are generally supportive of the economy, although conditions tightened somewhat last year. Thus, even though the Fed has begun to raise interest rates, short-term rates are still near record lows while intermediate and long-term bond yields remain unusually low. The U.S. stock market also is near record highs, and household net worth has reached an all-time high of $85 trillion, reflecting the recovery in the stock market and the housing market. The strength of the U.S. dollar has both positive and negative effects, as it benefits U.S. households by boosting purchasing power while it hurts U.S. exporters and detracts from overseas profits of U.S. multinationals.

The main area where conditions have deteriorated is in credit markets. While credit is still available on favorable terms to highly-rated companies, those in the energy and materials space have been adversely impacted by declines in prices of oil and raw materials, and yields on bonds that are below investment grade have spiked. The outlook for the high-yield sector will be primarily influenced by default rates, and whether they exceed or fall short of expectations that are priced into markets. Currently, markets are pricing in default rates for energy/mining companies to rise about 20% in 2016, while those for non-energy companies will approach 4%. In setting monetary policy, therefore, we believe that the Fed will take market conditions into account, as the transmission mechanism for monetary policy since the onset of the 2008 financial crisis has mainly been through financial markets.

A Well Diversified Economy

Thus far, the U.S. economy has been able to withstand the slowdown abroad very well, partly because exports account for only 10% of GDP. Apart from energy and mining, the main sector that has softened is manufacturing, which has been flat since mid-2015. However, it accounts for only 12% of overall economic activity, as compared with the services sector, which represents the vast majority, and where growth continues to be solid. In our view, this is no accident, as the U.S. economy is primarily geared to domestic demand rather than to foreign demand. Consumer spending, for example, which accounts for nearly 70% of aggregate demand, has been growing at a 2.5%-3% rate, as households have benefited from lower energy prices and from income derived from new jobs creation. The main areas of weakness have been business capital spending, which has been curtailed by problems in energy and mining, and net exports, which have been impacted by the strong dollar and soft demand abroad.

If history is any guide, this pattern is likely to continue for a while longer. The only instances in which external shocks have propelled the U.S. economy into recession were periods of oil price spikes, which were equivalent to tax increases for U.S. households and businesses. Prior to the Great Recession, the worst downturns occurred in the aftermath of the first and second oil shocks in the 1970s and early 1980s, when the Fed tightened monetary policy considerably to counter high inflation. By comparison, oil price declines such as those in the mid-1980s and mid-late 1990s were associated with above average U.S. economic growth, as the Fed pursued accommodative policies. The principal difference today is that the shale oil revolution has left the United States less reliant on foreign oil, but domestic energy producers have borne the brunt of lower oil prices.

Key Risks to the Outlook

While the U.S. economic environment is likely to remain benign in the coming year, we are also cognizant of several risks to the forecast including: (i) the possibility that further declines in oil and commodity prices could exacerbate defaults in U.S. energy companies and worsen conditions in commodity exporting countries; (ii) the risk of a more severe slowdown in China; and (iii) problems in Europe that could be exacerbated by an influx in refugees from the Middle East and North Africa.

Risk of Further Declines in Oil and Commodity Prices

When oil prices plummeted in the second half of 2014, our assessment was that they would have a net positive impact on the global economy, because they would transfer income from countries in the Middle East with high saving rates to other parts of the world where saving rates are lower. As noted above, one of the primary beneficiaries has been U.S. consumers, whose annual outlays for energy goods and services have fallen by about $150 billion, from $650 billion in the year prior to the price drop to $500 billion currently. At the same time, it is also apparent that other countries that are net oil importers have not benefited as much as was anticipated for a variety of reasons. Prominent examples are China, which is discussed subsequently, and Brazil, whose economy has suffered from a combination of weak commodity prices and mismanagement of the economy that has culminated in the worst downturn in the post-war era.

Apart from these considerations, it is also apparent that whereas the benefits from lower oil prices are dispersed across a broad spectrum of households and businesses, the costs are highly concentrated in energy producers and countries that are heavily dependent on a small number of commodities. Therefore, we are monitoring conditions among domestic energy producers and commodity exporting countries closely for signs of stress.

Risk of China's Slowdown Intensifying

Another issue that surfaced last year was concern that China's economic slowdown could intensify. This occurred when China's policymakers first tried to jaw-bone the Chinese stock market higher and then tried to arrest a steep sell-off by imposing a ban on sales of stocks by large institutions. Soon after, the authorities announced they would allow the Chinese currency to fluctuate within a wider band than before, which caused market participants to question whether China was trying to depreciate its currency. By year's end, some of these worries had faded as the stock market stabilized; however, the start of the New Year has seen renewed pressures on China's stock market and currency that have spilled over to global markets.

In our view, the main risk in China is not with the stock market, where the links between the market and the economy are not very close, but rather with the property market, where there is a substantial excess supply of apartment buildings that were financed with government-backed credits. While the property bubble has not burst yet, the risk remains high, especially if credit conditions tighten. Meanwhile, the central bank has responded by easing monetary policy and has flexibility to lower interest rates further. Still, the Chinese government has accepted that a further slowdown of the economy is inevitable, and the official growth target for the next five years has been lowered from 7% to 6.5%. We believe the actual growth will be considerably lower, although lack of transparency makes it difficult to ascertain by how much.

Europe Confronts a New Challenge

Just when the Euro-zone managed to dodge the risk of a "Grexit" in June, it has encountered a new challenge with an influx of refugees from Syria and other parts of the Middle East and North Africa. The situation poses two sets of problems for European governments: (i) Do they have the capacity to absorb the influx which is estimated to be in the vicinity of one million refugees? And (ii) How will the electorate respond to the influx when France is slated for Presidential elections in 2017 and the United Kingdom will hold a referendum on whether to remain in the European Union later this year or next.

On the economic front, the encouraging news is that Germany's labor force has grown rapidly since reforms to the labor market were introduced in the mid-2000s, and it has the capacity to absorb a large influx of immigrants, which have averaged more than one million people in the past two years. One problem, nonetheless, is that it is much easier to assimilate people from the Eastern European bloc than unskilled workers from the Middle East. The main challenge for Europe is that a backlash to the refugees is evident in a rise of nationalism and populism in various European countries, especially France, Holland and the Eastern bloc. Some observers are also concerned that the outcome of the U.K. referendum on the European Union (EU) is likely to be very close, and concerns over refugees and terrorism potentially could tip the scales in favor of a "Brexit." Meanwhile, Prime Minister Cameron is negotiating with the EU to try to obtain more favorable conditions for Britain to remain a member and reportedly is considering calling a referendum later this year. Considering the much greater importance of the U.K. to the EU than Greece, markets could become volatile if the outcome is in doubt.

Investment Implications

Weighing these considerations, our investment strategy is to maintain overweight positions in risk assets given solid economic fundamentals, accommodative financial conditions and reasonably attractive valuations. While the Federal Reserve is likely to raise interest rates gradually as the economic expansion continues, we view this as positive for risk assets, as confidence improves that the U.S. economy has escaped the legacy of the financial crisis. That said, nervousness about Fed tightening will likely add to market volatility at times, and we are monitoring the risks abroad closely.

Within fixed income portfolios, we are maintaining overweight positions in corporate bonds (investment grade and high yield) versus treasuries, as credit spreads more than compensate for likely default risks. While treasury yields appear too low for an economy that is normalizing, they could remain relatively low even as the Fed tightens monetary policy gradually. Within equity portfolios, we favor higher quality names and are positioned more defensively than in the past, as profit margins have begun to recede from record levels and the breadth of stock market gains has narrowed considerably.

Fort Washington
Investment Advisors, Inc.

A member of Western & Southern Financial Group

303 Broadway, Suite 1200 • Cincinnati, OH 45202-4220
tel 513.361.7600 • toll free 888.244.8167 • FortWashington.com