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2016 Year Ahead - Global Investment Outlook

After Struggling in 2015, Global Equity Markets likely to post Modest Gains in 2016 Supported by QE Stimulus from ECB & BoJ, Rate Cuts & Fiscal Stimulus in China, Modest Rate Hikes by Fed & BoE, Improved GDP Growth, Earnings Rebound & Fair Valuations

Bond Yields likely to Drift Higher in 2016 with Strengthening GDP Growth, Fed & BoE Rate Hikes. Low Inflation, ECB & BoJ QE Buying & Safe Haven Demand Likely to Limit Rise in Bond Yields

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John Praveen's *2016 Year Ahead Global Investment Outlook expects global equity markets to post modest gains in 2016 with QE stimulus from the ECB and BoJ, further rate cuts and fiscal stimulus in China, modest rate hikes by the Fed and BoE, improved GDP growth, earnings rebound and fair valuations.*

Stocks: Global stock markets struggled in a volatile 2015 with modest gains in Europe and Japan while U.S. and U.K. stocks declined. ***Developed market stocks rose 0.2% (in local currency) in 2015. Emerging market stocks struggled, down -8% in 2015.***

Global equity markets are likely to post modest gains in 2016 driven by: 1) Plentiful Liquidity & Low Interest Rates with the ECB and BoJ continuing QE buying with potential for further QE expansion, further rate cuts and easing measures in China while rate hikes by the Fed and BoE are likely to be gradual and modest reflecting confidence in these economies; ***2) Improved Global Growth*** with solid GDP growth in U.S. & U.K., Eurozone growth improves further & Japan rebounds after weak 2015. The growth outlook among emerging economies remains mixed with China uncertainty, improved GDP in India & other oil & commodity importers. Brazil, Russia and other oil & commodity exporters are likely to continue to struggle; ***3) Earnings Rebound*** with global earnings growth expected to strengthen in 2016 to around 8% driven by healthy growth in developed economies. Profit margins remain solid and expected to provide support for earnings growth; ***4) Reasonable Valuations*** with stock P/E multiples below long-term average, and stocks remain cheap relative to bonds. ***We look for modest gains by global stock markets in 2016. Our target for U.S. S&P 500 index is 2250 by year-end 2016. We expect bigger gains in Eurozone & Japan.***

Bonds: Bonds yields are likely to drift higher in 2016 with improved GDP growth and rate hikes by Fed & BoE but offset by low Inflation, QE Stimulus by the ECB & BoJ, and safe haven demand. Bond yields are likely to be under upward pressure from: 1) Improved GDP growth in the developed economies. The growth outlook among Emerging economies remains mixed; 2) The U.S. Fed continuing to hike rates and the BoE beginning rate hikes in early 2016; 3) Inflation recovering from the low levels in 2015; and 4) Bond valuations remain expensive relative to stocks with a wide yield gap. ***However, bonds are supported by:*** 1) QE stimulus with the ECB extending QE program in December and likely to further expand asset purchases in 2016, the BoJ likely to adopt further easing measures in 2016; 2) While inflation is expected to rise in 2016 with fading base effects, it will still remain low and below central bank targets as oil and commodity prices continue to struggle; and 3) Safe haven demand with elevated geopolitical tensions in the Middle East and terrorism fears.

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Market Outlook: Global Equity Markets likely to post Modest Gains in 2016 Supported by QE Stimulus from ECB & BoJ, Rate Cuts & Fiscal Stimulus in China, Modest Rate Hikes by Fed & BoE, Improved GDP Growth, Earnings Rebound & Fair Valuations

Bond Yields likely to Drift Higher in 2016. Yields likely to Rise with Improved GDP Growth & Rate Hikes by Fed & BoE. Low Inflation, QE Stimulus by ECB & BoJ likely to Limit Rise in Bond Yields

2016 Stock Market Outlook: Global stock markets were volatile and mixed in 2015 with modest gains in Europe and Japan while U.S. and U.K. posted modest declines. ***Developed market stocks rose 0.2% in 2015 while Emerging Market stocks continued to struggle, down -8% in 2015.***

Looking ahead, global equity markets are likely to post modest gains in 2016 with the ECB and BoJ continuing QE buying with potential for further QE expansion, fresh rate cuts and fiscal stimulus in China, modest rate hikes by the Fed and BoE, improved GDP growth, earnings rebound and fair valuations.

1) Stocks supported by Liquidity & Low Interest Rates with QE Stimulus from ECB & BoJ, Further Rate Cuts and Easing Measures in China and Modest Rate Hikes by U.S. Fed and U.K. BoE: Global stock markets remain supported in 2016 by low interest rates and plentiful liquidity with the ECB and BoJ continuing QE buying and potential QE expansion, further rate cuts and easing measures in China while rate hikes by the Fed and BoE are likely to be gradual and modest. Emerging central banks will be on Fed watch in 2016, waiting to assess the impact of Fed rate hikes on capital flows to Emerging Markets and on EM currencies before responding with rate cuts or hikes as needed. There is scope for rate cuts in Asia & EM Europe with weak growth and low inflation.

The U.S. Fed is expected to continue the interest rate normalization process in 2016 after initiating rate lift-off in December 2015. The Fed ended the zero interest rate policy reflecting its confidence in the strength of U.S. domestic economy and easing concerns about global growth outlook. The U.S. economy is on a firm footing with GDP growth around 2.3% in 2015 and on track to strengthen to 2.8% in 2016 driven by solid consumer spending. ***However, the Fed is likely to hike rates during 2016 at a gradual, measured pace since inflation remains low and below Fed's 2% target. The Fed is likely to lift the Fed funds rate to around 1% at 2016 year-end.***

The BoE is likely to begin hiking U.K. rates in Q1 2016, following the Fed rate lift-off in December. Like the Fed, BoE rate hikes in 2016 are likely to be gradual and modest as the BoE seeks to "balance two fundamental forces - domestic strength and foreign weakness."

The ECB is expected to continue QE buying in 2016. The ECB launched full-fledged QE buying in Q1 2015 and extended the program in December 2015. At the December meeting, the ECB cut the deposit rate by 10bps to -0.3% (from -0.2%), extended the duration of its asset purchases to March 2017 from September 2016 previously. The ECB left the quantity of asset buying unchanged at €60bn per month. The ECB move disappointed markets that were expecting more aggressive easing. ***However, ECB President reassured markets by emphasizing the ECB's willingness to do more in future, if needed. With its balance sheet still below 2012 level, the ECB has scope to further expand the QE buying program in 2016. Further since Eurozone inflation remains well below 2% target, the ECB is likely to further expand QE buying in 2016.***

The Bank of Japan (BoJ) left monetary policy unchanged in 2015 despite weak growth, negative inflation and market expectations of expanding QE buying in Q4. ***However, the BoJ is likely to adopt further easing measures in 2016 with modest GDP growth and inflation remaining negative. Further, QE expansion by the ECB and further rate cuts in China are likely to put pressure on the BoJ to expand QE stimulus.***

China's PBoC is likely to undertake a series of stimulus measures including cuts in interest rates and RRR and liquidity injections through pledged supplementary lending (PSL), medium-term lending facility (MLF) and other open market operations. Along with PBoC monetary easing, the government is likely to continue speeding the implementations and funding of infrastructure projects and various policies to support growth. ***The Reserve Bank of India (RBI) is likely to cut interest rates*** to support growth with inflation expected to remain below its 5.7% target. ***However, further rate hikes are likely in Brazil*** to fight inflation and support the currency. ***Mexico has already started rate hikes and is likely to continue to follow the Fed*** with further rate hikes.

2) Improved Global GDP Growth: Global growth is on track to modest improvement in 2016. Earlier in 2015, global growth was disappointing and uneven with healthy growth in the U.S. and U.K., improving growth in Eurozone, but weak growth in Japan with Q2 GDP contraction. Emerging Economies struggled as China growth continued to decelerate and oil and commodity prices remained weak. ***Developed economies are expected to post modest improvement in GDP growth in 2016 with solid GDP growth in the U.S. (2.8%) and U.K. (2.6%), steady improvement in Eurozone (1.8%) and Japan GDP rebounding (1.5%). The growth outlook among Emerging economies remains mixed.*** China is likely to avoid a hard landing with fiscal and monetary stimulus, but growth uncertainty is likely to persist. GDP growth is likely to improve in India & other oil and commodity importers. However, Brazil, Russia and other oil and commodity exporters continue to struggle in 2016.

U.S. GDP growth is expected to strengthen to around 2.8% in 2016 after posting around 2.3% growth in 2015. GDP growth in 2016 is expected to be driven by solid consumption spending and a pick-up in business investment spending. Housing remains healthy with starts expected to pick up. Trade is likely to be a smaller drag with lower oil prices and as exports pickup with improving growth in Eurozone, Japan and Emerging Asia. ***Eurozone growth is on track to steady improvement with GDP growth expected to strengthen to around 1.8% in 2016 from 1.5% in 2015.*** Eurozone growth is expected to be driven by ECB rate cuts and QE extension in late 2015 and likely further expansion of QE buying in 2016, improving financial conditions, falling unemployment and weak Euro. ***Japan's GDP growth disappointed in 2015*** as the impact of China slowdown offset the positive benefits of weak yen, low oil prices and BoJ QE stimulus. ***Looking ahead, the Japanese economy is likely to post a modest rebound in 2016 with GDP rising to 1.5%*** with low oil prices and rising wages supporting consumer spending, and the weak yen boosting exports. Business spending is likely to benefit from prospects for further reforms by the Abe administration.

The growth outlook among Emerging economies remains mixed. China's GDP growth is expected to slow further to around 6.5% in 2016 from around 7% in 2015 as Chinese policy makers continue to rebalance the economy away from fixed asset investment, capital spending and exports to consumption spending and services. The risk of a hard landing is mitigated by further fiscal stimulus, rate cuts and easing measures by the PBoC. ***India's GDP growth remains in an uptrend and is expected to strengthen to around 8% YoY in 2016 from around 7.5% in 2015*** with interest rate cuts, boost from lower oil & commodity prices, smaller China exposure and increased infrastructure spending. ***GDP growth is expected to pick up in Korea to around 2.9% (from 2.5% in 2015) and in Taiwan to 2.4% (from 1.3% in 2015).*** While weak China demand is likely to weigh on Korea and Taiwan's export growth in 2016, consumption growth is likely to pick up with government spending to support growth. ***The Brazilian economy is expected to remain in recession in 2016 with GDP likely to contract around -3%.*** Brazil fell into deep recession in 2015 with GDP contracting around -4% with weak domestic demand, BCB rate hikes and fiscal consolidation. ***Mexico's economy is expected to continue to strengthen in 2016 with GDP rising 2.8% after 2.4% in 2015.*** Growth is expected to be supported by rising domestic demand with consumption and investment spending rising. With commodity prices expected to be low through 2016, trade will likely remain weak. ***Russia's economy is expected to have bottomed in Q4 2015 and on track to recover in 2016 to around 0.5% YoY with stabilization in consumer and investment demand.*** However, there are risks to the fragile recovery with oil prices likely to remain low, having sunk to 7-year lows in December 2015. ***Turkey's GDP is expected to recover modestly to around 3% in 2016 from 2.8% in 2015*** supported mainly by private consumption growth.

3) Earnings Rebound in 2016 after Disappointing Earnings Growth in 2015: Global earnings posted a modest 1% growth in 2015, disappointing expectations for solid growth at the beginning of the year due to big drags from Energy and Materials sector earnings with continued weakness in oil and commodity prices. ***Global earnings growth is expected to strengthen in 2016 to around 8% with a modest rebound in Emerging Markets (+9%) and with solid earnings growth in the U.S. (8%), Eurozone (7%) & Japan (7%).*** Earnings growth in 2016 is likely to be driven by healthy growth in developed economies with solid GDP growth in the U.S. & U.K., steady improvement in Eurozone growth and Japan rebounding after weak growth in 2015. Profit margins remain solid and expected to provide support for earnings growth.

4) Reasonable valuations with P/E Multiples rising modestly but remain below long-term average, stocks remain cheap relative to bonds: Developed Market stock valuations inched higher during 2015 with stocks rising modestly during the year but earnings growth slowed in 2015. However, stock P/E multiples remain below long-term averages. The P/E multiple for Developed Markets rose modestly to 19.3X at the end of 2015 from 18X at the beginning of 2015.

Emerging Market stock valuations trended lower during 2015 with EM stocks falling -8% during the year. The EM P/E multiple is now at 12.9X from 13.2X in early 2015. EM valuation multiple remains below the long term average valuation multiple. ***Stock valuations remain cheap relative to bonds.*** The earnings yield on U.S. stocks eased modestly to 5.4% from 5.5% at the end of 2014, while the 10-year Treasury yield inched higher to 2.23% from 2.17%. The yield gap between U.S. stocks-bonds narrowed to 3.16% from 3.31%, still well below the long-term average yield gap of 2% (20 year average). Eurozone stocks yield gap relative to bonds has decreased over 2015. The earnings yield on Eurozone stocks is now at 3.7% down from 4.5% at the end of 2014 while the 10-year Bund yield is at 0.58% from 0.54% resulting in a yield gap of 3.1%, which is slightly below the long-term average of 3.3% (10-year average). Japanese stock yield is at 5.9% and JGB bond yield at 0.33% with a yield gap of 5.6%, well above the last 10-year average of 4.1%.

Bottom-line: ***Global stock markets struggled in a volatile 2015. The developed markets eked out a 0.2% gain in 2015 led by Japan (+8.1%) and Eurozone (6.1%), while Emerging Markets declined -8% (as of December 31).***

Looking ahead, global equity markets are likely to post modest gains with QE stimulus from the ECB and BoJ, further rate cuts and fiscal stimulus in China, modest rate hikes by the Fed and BoE, improved GDP growth, earnings rebound and fair valuations. Global stock markets gains in 2016 are likely to be driven by: 1) Plentiful Liquidity & Low Interest Rates: The ECB and BoJ continue QE buying with potential for further QE expansion, further rate cuts and easing measures in China while rate hikes by the Fed and BoE are likely to be gradual and modest. Emerging central banks will be on Fed watch in 2016 waiting to assess the impact of Fed rate hikes on capital flows to Emerging Markets and on EM currencies. There is scope for rate cuts in Asia & EM Europe with weak growth and low inflation. However, further rate hikes are likely in Brazil to fight inflation; ***2) Improved Global GDP Growth:*** After disappointing and uneven growth in 2015, global growth is on track to modest improvement in 2016 with solid GDP growth in the U.S. (2.8%) and U.K. (2.6%), steady improvement in Eurozone (1.8%) and Japan rebounding (1.5%). The growth outlook in Emerging economies remains mixed. China is likely to avoid a hard landing with fiscal and monetary stimulus, but growth uncertainty is likely to persist. GDP growth is likely to improve in India & other oil and commodity importers. However, Brazil, Russia and other oil and commodity exporters continue to struggle; ***3) Earnings Rebound:*** After disappointing earnings growth in 2015 with big drags from Energy and Materials sector earnings, global earnings growth is expected to strengthen in 2016 to around 8% with a modest rebound in Emerging Markets (+9%) and the U.S. (8%), Eurozone (7%) & Japan (7%). Earnings growth in 2016 is likely to be driven by solid GDP growth in the U.S. & U.K., steady improvement in Eurozone growth and Japan rebounding after weak growth in 2015. Profit margins remain solid and expected to provide support for earnings growth; ***4) Reasonable valuations with P/E Multiples rising modestly but remain below long-term average, stocks cheap relative to bonds:*** Developed Market stock P/E multiples inched higher during 2015 with stocks rising modestly but earnings growth slowed in 2015. However, stock multiples remain at discount to long term averages. The P/E multiple (trailing) for Developed Markets rose modestly to 19.3X at the end of 2015 from 18X at the beginning of 2015. Emerging Market stock valuations trended lower in 2015 with the EM P/E multiple at 12.9X from 13.2X in early 2015. EM market P/E multiple remains below long term average. Stocks remain cheap relative to bonds but the earnings yield gap continues to narrow as bond yields inched higher and equity earnings yields declined as P/E multiples rose.

However, stock markets face several risks which could keep markets volatile. These include 1) Emerging Markets uncertainty as Fed continues interest rate normalization; 2) Elevated geo-political tensions in the Middle East & heightened terrorism fears; 3) Continued weak oil & commodity prices; 4) China growth concerns, hard landing fears and potential policy mis-steps; & 5) Brexit Fears (of U.K. leaving the EU).

Despite these risks, we expect modest gains by global stock markets with QE Stimulus from the ECB and BoJ and potential expansion of QE buying, further rate cuts and stimulus by China, and modest rate hikes by the Fed and the BoE. Further, improving GDP growth, earnings rebound, reasonable P/E multiples and stocks cheap relative to bonds, are likely to lift stock markets higher during 2016. We look for bigger market gains in the Eurozone and Japan relative to the U.S., U.K., and Emerging Markets. Our target for U.S. stock market (S&P 500 index) is to reach 2,250 by year-end 2016.

Bond Market Outlook: Yields to Drift Higher with Strengthening GDP Growth, Fed & BoE Rate Hikes

Bond yields were range-bound over the course of 2015, inching modestly higher from levels at the beginning of 2015. Low headline inflation with weak oil and commodity prices stoking fear of deflation, and core inflation contained kept downward pressure on yields through the year. Further, bonds were supported by the BoJ continuing their asset purchase policies, the ECB launching full-fledged QE in Q1 and extending it in late 2015, the Fed delaying hiking rates till December and the BoE delaying rate hikes into 2016. Bonds also received safe haven bid with Grexit fears, China concerns and geopolitical tensions. However, GDP grew at a modest pace in 2015, which offset the downward pressure on yields.

Bonds yields likely to drift higher in 2016 with improved GDP growth and rate hikes by Fed & BoE but offset by low Inflation, QE stimulus by the ECB & BoJ, and China rate cuts. Bond yields are likely to be under upward pressure from: 1) Improved GDP growth in the developed economies with solid GDP growth in the U.S. (2.8%) and U.K. (2.6%), steady improvement in Eurozone (1.8%) and Japan rebounding (1.5%). However, the growth outlook among Emerging economies remains mixed; 2) The U.S. Fed continuing rate hikes after moving off zero rates in December 2015 and the BoE beginning rate hikes in early 2016; 3) Inflation recovering from low levels due to fading base effects of low oil prices in early 2015. Developed economies inflation is expected to rise to 1.6% in 2016 from 0.5% in 2015. 4) Bond valuations remain expensive relative to stocks with a wide yield gap. ***However, bonds are supported by:*** 1) QE stimulus with the ECB extending QE program in December and likely to further expand asset purchases in 2016, the BoJ is likely to adopt further easing measures in 2016; 2) While inflation is expected to rise with fading base effects, it will still remain low and below central bank targets as oil and commodity prices continue to struggle; and 3) Safe haven demand with elevated geopolitical tensions in the Middle East and terrorism fears.

Investment Strategy:

Asset Allocation: *Overweight Stocks with modest gains likely in 2016. Modest Underweight in Bonds with Yields likely to rise*

Stocks – *Overweight* as global equity markets are likely to post modest gains with QE stimulus from the ECB and BoJ and potential expansion of QE buying, further rate cuts and stimulus by China, and modest rate hikes by the Fed and the BoE. Further, stocks are supported by improving GDP growth, earnings rebound, reasonable P/E multiples and stocks cheap relative to bonds.

Bonds – *Modest Underweight* as bond yields likely to drift higher in 2016 with improved GDP growth in the developed economies and rate hikes by Fed & BoE, but offset by low Inflation, QE stimulus by the ECB & BoJ, and China rate cuts.

Global Equity Strategy: *Eurozone & Japan likely to Outperform U.S., U.K. & Emerging Markets*

Eurozone: *Overweight* as Eurozone stocks are likely to outperform with solid gains in 2016 with the ECB extending QE buying program, which is likely to be further expanded during the year, improving GDP growth and solid earnings growth.

Japan: *Modest Overweight* as Japanese stocks are expected to post modest gains in 2016 with GDP growth rebound after the weak 2015, BoJ likely to expand QE stimulus, and the Abe administration likely to step up on reforms.

Emerging Markets: *Emerging Market stocks are likely to remain mixed in 2016 with neutral outlook in EM Asia and EM Europe while Latin America is likely to continue to struggle.* EM Asia stocks are likely to remain volatile with improving GDP growth, strengthening earnings outlook, scope for further central bank rate cuts. However, China remains a wild card. While all EM central banks are on Fed watch, Asian central banks have scope to cut rates with low inflation. However, the growth outlook for EM Europe and Latin America remains weak with Brazil and Russia remaining in recession. Brazil's central bank is expected to hike rates further with inflation remaining high. Continued weakness in oil and commodity prices remain a negative for Brazil, Russia and other exporters.

U.S.: *Modest Underweight as U.S. stocks are expected to post relatively modest gains in 2016 with solid GDP growth and earnings rebound offset by Fed continuing rate normalization in 2016.* U.S. GDP is expected to strengthen to around 2.8% in 2016. Earnings are expected to rebound to around 8%. While Fed is expected to raise rates at a measured pace, the rate hikes are likely to lead to multiple compression and limit market gains. ***We expect the S&P 500 index to post modest gains, reaching 2250 by 2016 year-end. However, U.S. stocks are likely to underperform Eurozone and Japan which are likely to post bigger gains.***

U.K.: *Underweight* as U.K. stocks are likely to underperform with the BoE expected to start rate hikes in Q1 2016.

Global Bond Market Strategy: *Eurozone Bonds & JGBs Likely to Outperform U.S. Treasuries, U.K. Gilts & Emerging Market Debt*

Eurozone: *Overweight* with the ECB likely to expand QE buying in 2016 after extending the program in December, while inflation remains low and GDP growth remains modest.

Japan JGBs: *Modest Overweight* as JGBs have a modestly favorable outlook in 2016 with the BoJ likely to expand QE buying, modest GDP growth, and low inflation. However, JGB yields remain low which limits the potential for gains.

EM Debt: *Neutral* as outlook for EM debt remains cautious with mixed growth outlook and uncertainty about the impact of Fed rate hikes.

U.K. Gilts: *Underweight* with modest GDP growth and the BoE starting rate hikes offset by low inflation.

U.S. Treasuries: Modest Underweight as yields are likely to come under upward pressure from strengthening U.S. GDP growth, uptick in inflation, and Fed rate hikes, albeit modest.

Global Sector Strategy:

- ***Overweight:*** Financials & Information Technology;
- ***Modest Overweight:*** Consumer Discretionary & Industrials;
- ***Neutral:*** Healthcare & Consumer Staples;
- ***Underweight:*** Energy, Telecommunication Services, Materials & Utilities.

Currency Strategy: US$ Remains Firm against Euro & Yen, Gains against EM Currencies

- ***Overweight: U.S. Dollar*** remains firm with solid U.S. GDP growth & Fed continues rate hikes.
- ***Underweight: Euro & Yen*** to remain modestly weak with ECB & BoJ QE buying/expansion; ***A$ & C$*** continue to struggle with weak oil & commodity prices.
- ***Underweight: Emerging Market & Commodity currencies*** as they continue to struggle amidst Fed tightening, growth concerns, weak oil & commodity prices & political uncertainties.

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