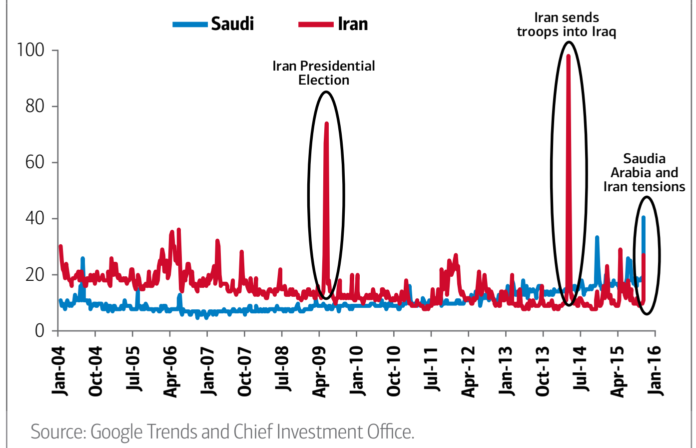
Waves of Fear

The new year has begun with a shock for investors — with equity markets around the world, as measured by the MSCI All-Country World Index, down around 3.3% so far this year (through January 6). Persistent waves of fear over weaker-than-expected economic growth in China and extreme volatility in its stock markets, contagion from rising geopolitical uncertainties in the Middle East and North Korea, and the possibility that the U.S. profit margin story is over have added to volatility and pushed markets much lower. Traditional market catalysts, like cheap valuations and monetary stimulus from central banks, have been replaced by the recent spate of surprising and unsettling events around the world.

Exhibit 1: Google searches by the keywords "Saudi" and "Iran" have spiked.



Source: Google Trends and Chief Investment Office.

Many negative surprises…

In China, the source of most of the surprises, trading was suspended for a second time this week, as significant intra-day stock market declines triggered newly implemented circuit breakers after a surprise Chinese currency devaluation. Adding to the surprises, the trading suspension was lifted on the same day it was implemented!

Beyond China, geopolitical tensions escalated around the world. After Saudi Arabia cut its diplomatic ties with Iran, Iran responded by banning all Saudi imports and accused the Saudis of bombing Iran's embassy in Yemen — signaling that the verbal dispute had turned into something bigger (see Exhibit 1). Further steps in North Korea's nuclear testing have added to geopolitical tensions and investor fears. With volatility trending above average, we expect it to remain persistently higher going forward, as a combination of higher starting market valuations, gradually rising interest rates in the U.S., a bumpy adjustment path to lower growth in China, and persistent geopolitical concerns (see the December 8, 2015, Weekly Letter, **Geopolitical Risks in 2016**) will contribute to investors' sense of fragility in markets.

…but also several positives

Lost in these waves of fear, investors may have overlooked strength in the markets' fundamentals, like improving economic and survey data in Europe and signs of rising inflation and stronger consumer spending in the U.S. Also blurred among the negative headlines is a shift from fiscal drag to fiscal stimulus (as reflected in the spending bill passed by the U.S. Congress last month). For longer-term investors, this presents an opportunistic entry point into those higher-quality companies among large-cap segments that have fallen recently with markets. We believe those companies with stable or growing earnings, low leverage, strong free cash flow and high credit ratings should prove more resilient in the face of continued volatility. Outside the U.S., European and Japanese industries related to consumers, health care and technology should benefit from improving domestic economies, slightly faster growth, accommodative monetary policies, and a corporate focus on shareholder value and maintaining profit margins in a low revenue growth world.

A "low and slow" pace to higher interest rates in 2016 should not pose outsized risks to diversified bond portfolios, and we think the current level of bond spreads will resist gradually rising

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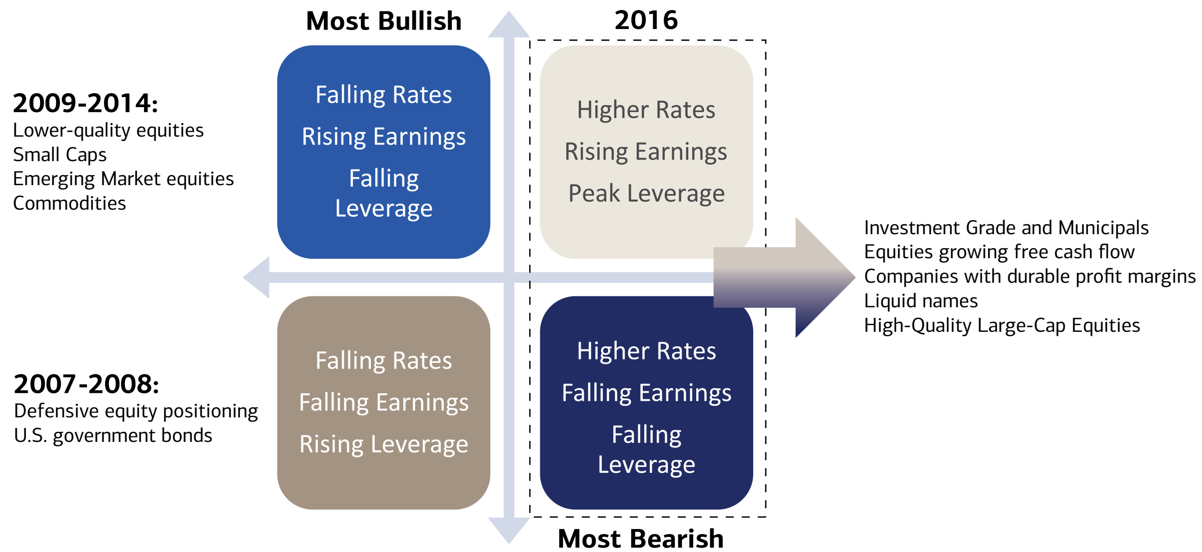
Exhibit 2: We favor municipals and U.S. Investment Grade bonds



Source: Chief Investment Office.

rates. Our preferred sectors remain high-quality municipals and U.S. Investment Grade bonds, where spreads should tighten (see Exhibit 2). However, with a low revenue growth environment, the outlook for High Yield is challenging, given its higher exposure to commodity-related sectors, and we would continue to reduce exposure here. High Yield default rates should also pick up this year.

A world of lower returns and higher volatility should present opportunities for many alternative strategies that benefit from strong trends (up or down). For qualified investors, we think alternative strategies like Equity Long Short and Managed Futures can be good complements to traditional stock and bond portfolios in turbulent markets.

Our tactical guidance is anchored in our central scenario of a world economy that — despite waves of fear — will muddle through 2016 on the back of consumer spending, still-accommodative monetary policies, an emergence of fiscal stimulus, and the durability of large-cap profit margins.

At the start of the year, markets have begun what we believe is a capitulation process as we move from the middle of the economic cycle toward later stages. While market psychology is currently fragile, we think investors can be patient and look for encouraging signs, like stabilizing Chinese growth, a bottom in energy prices, and a calming of geopolitical risks, throughout the year.

We think investors should [1] ensure that portfolios are appropriately diversified and extended overweights in equity allocations are trimmed for risk management purposes; [2] favor developed equity markets like Europe and Japan, and maintain an underweight in Emerging Markets until we see greater clarity on Chinese growth; and [3] within equities, get "paid to wait" with large-cap high-quality, low-leverage, dividend-paying stocks in sectors like Health Care, Consumer and Technology.

For more on our outlook for 2016, please refer to the December 2015 Monthly Letter, **2016 Outlook: You Can Go Your Own Way**, and the Winter 2016 **CIO Outlook** magazine.

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