The Key Issues Driving Markets in 2016

A lot has been written over the years around the need for individuals to ignore short term market fluctuations, to ignore the "noise" and focus on longer term returns. Investments are made with an end goal in mind – even if the decision is not consciously made, there is an objective in terms of the return expected and the time horizon within which one wants that return to materialise. For example, an investor may be looking for a return of 5% higher than inflation for the next 10 years. This should mean that short term movements in the value of the investment has no relevance – if the market falls by 10% in the next 6 months, but recovers to provide the required return over the 10 year time period, does it really matter? Investor behaviour means it often does matter – the urge to sell investments that have underperformed over the short term can result in not achieving the long term investment goal. The need to stick to a financial plan or a long term investment strategy is exacerbated during times of market volatility, and 2016 looks to be shaping up as a year to test even the calmest of investors.

While short term market movements are not something we focus on, it does highlight the current uncertainty in global markets. We would expect that the significant volatility experienced at the start of the year in equity, bond markets and currencies to continue into 2016. This article highlights some of the issues that we expect to have the most material impact on investors.

Chinese Growth

The main driver of all the volatility at the start of 2016 has once again been China, with the Shanghai Composite Index (SSE) down close to 15% in the first few days of trading in 2016. This has been driven by 2 factors. The first is the People's Bank of China lowering the reference point of their currency against the dollar – the devaluing of their currency was taken by the market as a strong signal that growth is slowing more quickly than expected and that the authorities feel a more competitive currency is needed to spur Chinese export growth. The market has reacted sharply to these actions as the general consensus is that the SSE is very expensive and current equity prices can only be justified by high Chinese growth.

The second reason for the sharp fall has been a technical one: Chinese authorities introduced "Circuit Breakers" into the market. In simple terms, the stock market is closed if the market falls by more than a particular amount in a day, which on the SSE was 7%. There are also interim levels where the market is halted and then re-opened to try arrest the slide. On 7 January 2016, the market closed 25 minutes after it opened (with only 14 minutes of trading possible because of trading being halted as it fell). The issue with these Circuit Breakers is that they create significant selling pressure with investors rushing to get their sales in before markets shut, which in turn creates downward pressure on prices. The Chinese authorities announced the scrapping of the "Circuit Breaker" mechanism on 8 January.

Any negative news relating to Chinese growth always leads to global growth concerns with impacts on global asset markets across the board. The impact is more pronounced for commodity driven economies (due to China making up a large part of demand for commodities) and emerging markets (due to the contagion impact as investors take risk off the table), and South Africa (SA) is certainly no exception.

US rates

The US started the much anticipated rate-hiking cycle in December 2015 by pushing the Federal Funds Target Rate (Fed rate) up by 0.25%. It is widely believed that was only the start with more increases to come in 2016. There is significant uncertainty around how quickly rates will be raised and the impact it will have on the economy. The levels of Quantitative Easing in the US is not something previously attempted, and as it unwinds, no one really knows what the consequences will be for the US economy and asset prices.

Opinion is divided as to whether the US economy is strong enough to withstand interest rate increases. The economy has been supported by record low interest rates for a number of years, and an increase in interest rates will increase the cost of borrowing. Increases in interest rates normally slow growth and inflation, but the challenge arises if the economy stalls and enters a recession (especially if rates are hiked too quickly). Many commentators are concerned that the US economy still faces challenges on many fronts, and that interest rate increases may need to be reversed. Given the impact of US rates on the global economy and on global asset prices, the uncertainty around their future levels leads to volatility.

The risk for SA and its currency is that higher interest rates in the US leads to investors taking capital out of SA (and other emerging market countries) and redeploying it in the US. Effectively, as US rates rise, the yield paid on investments in the US rises, which means investors who were investing elsewhere in search for yield, are no longer prepared to take the risks associated with emerging markets as the additional yield above "safer" US investments is narrowed. This capital exiting SA investments will have a negative impact on the Rand.

Oil prices

The other global issue that is causing material uncertainty is the oil price. The oil price (represented by Brent Crude) has fallen below $34 a barrel in early January 2016. In 2014, the price peaked at close to $120 with the consensus view appearing to be a price of between $70 and $80 a barrel. The range of potential outcomes for the future oil price is very wide – some believe it is headed to below $20 a barrel, while others are holding on to their $70-$80 longer term view. The impact of this is to again introduce significant volatility into global markets.

Many economies rely heavily on oil revenue (e.g. Norway, Russia, Nigeria). These countries have seen government revenue plummet in line with the oil price, which in turn has had a negative impact on many of their currencies.

The Rand

The Rand has been hit from all sides, including the following:

- Rating agencies have expressed concerns around the economy and the continuing increase in debt as % of GDP. SA hasn't followed Brazil to junk status, but is one rating above junk with a negative outlook. The impact on the bond market and the currency would be very significant.

- The current account deficit has continued to widen over the past 2 years.

- SA still has a material portion of the real economy linked to commodities, and the drop in commodity prices as China demand falls has had an impact.

- Chinese concerns also result in a contagion effect for all Emerging Market economies

- The first increase in US rates may only have been 0.25% but it has signalled the Fed's intention, and this has led to foreign investors starting to disinvest from SA assets.

- SA growth continues to slow which has a negative impact on the international investors' demand for local equities and bonds

- SA interest rates are still relatively low, mainly as a result of the fact that inflation has been fairly muted (mainly due to the oil price falls) but also because of growth and unemployment concerns.

- Domestic concerns have damaged foreign investors' sentiment towards SA. These concerns relate mainly to political and growth policy uncertainty.

In summary, the world is currently experiencing significant uncertainty on various fronts. The range of outcomes in markets and currency levels is wider than at any point since the Global Financial Crisis in 2008/09. The benefits of diversifying your assets across geographies, asset classes and fund managers are even greater at times of such uncertainty and volatility. Before making any investment decisions in 2016, it is crucial to remember the initial objective of any investment and test whether short term volatility is impacting decision making for a longer term outcome.

31 December 2015

Sector		1m	3m	6m	YTD	1yr	3yr pa	5yr pa	10yr pa	10yr Vol
LOCAL MARKET INDICES (In Rands)										
FTSE/JSE All Share Index (ALSI)	ZAR	-1.7%	1.7%	-0.8%	5.1%	5.1%	12.3%	13.0%	14.1%	15.5%
FTSE/JSE SA Listed Property	ZAR	-6.1%	-4.7%	1.3%	8.0%	8.0%	14.0%	17.0%	17.5%	16.9%
SA All Bond Index (ALBI)	ZAR	-6.7%	-6.4%	-5.0%	-3.9%	-3.9%	2.1%	6.1%	7.0%	7.3%
SA Cash Index (SteFI)	ZAR	0.5%	1.6%	3.2%	6.5%	6.5%	5.8%	5.8%	7.3%	0.6%
Balanced Benchmark [2]	ZAR	-0.8%	2.9%	3.9%	9.2%	9.2%	13.7%	14.0%	13.4%	7.0%
SA Inflation (1 month lag)	ZAR	0.1%	0.3%	1.8%	5.0%	4.8%	5.3%	5.5%	6.1%	1.4%
GLOBAL MARKET INDICES (in USD)										
Global Equity (MSCI World)	USD	-1.9%	5.1%	-4.2%	-2.7%	-2.7%	7.5%	5.4%	2.8%	16.4%
Emerging Markets Equity (FTSE EM)	USD	-2.1%	0.3%	-18.5%	-15.2%	-15.2%	-6.0%	-4.5%	4.3%	23.6%
Global Bonds (Barclays Global Bond Index)	USD	0.5%	-0.9%	-0.1%	-3.2%	-3.2%	-1.7%	0.9%	3.7%	5.6%
Global Cash	USD	0.0%	0.1%	0.1%	0.2%	0.2%	0.1%	0.2%	1.6%	0.6%
MAJOR INDICES BASED TO RANDS										
FTSE/JSE All Share Index (ALSI)	ZAR	-1.7%	1.7%	-0.8%	5.1%	5.1%	12.3%	13.0%	14.1%	15.5%
Global Equity (MSCI World)	ZAR	5.5%	17.8%	22.3%	30.3%	30.3%	31.4%	24.9%	12.4%	13.4%
Emerging Markets Equity (FTSE EM)	ZAR	5.2%	12.4%	4.1%	13.6%	13.6%	14.9%	13.2%	14.0%	15.4%
COMMODITIES										
Gold (US Dollars)	USD	-0.2%	-5.7%	-10.1%	-12.0%	-12.0%	-14.2%	-5.8%	7.5%	19.4%
Gold (Rands)	ZAR	7.2%	5.7%	14.7%	17.8%	17.8%	4.8%	11.7%	17.6%	21.6%
Currencies (positive return = Rand weakening)										
Rand / Dollar	ZAR	7.5%	12.1%	27.7%	33.9%	33.9%	22.2%	18.6%	9.3%	16.3%
Rand / GBP Pound	ZAR	5.2%	9.0%	19.6%	26.6%	26.6%	18.3%	17.1%	7.7%	14.4%
Rand / Euro	ZAR	10.5%	9.1%	24.5%	20.2%	20.2%	14.6%	13.7%	8.4%	13.9%

Spot Rates

		31-Dec-15		10-Jan-16	Latest Quarter	1 Year Ago	5 Years Ago	10 Years Ago	20 Years Ago
USDZAR	Currencies	Rand/US$	Rand	16.12	15.46	11.45	6.62	6.32	3.65
GBPZAR		Rand/GBP	Rand	23.54	22.55	17.95	10.31	10.89	5.66
EURZAR		Rand/EUR	Rand	17.83	16.80	13.99	8.84	7.48	4.33
AUDZAR		Rand/Aus $	Rand	11.35	11.25	9.45	6.76	4.64	2.72
LIUS6M	Rates	Libor 6m $	US$	0.85	0.85	0.36	0.46	4.70	N/a
RPOR		Prime	Rand	9.75	9.75	9.25	9.00	10.50	18.50
SAREP1		Repo Rate	Rand	6.25	6.25	5.75	5.50	7.00	N/a
ALIY		All Bond Index Yield	Rand	9.23	9.38	8.24	8.58	9.40	13.31
DGLDS	Commodities	Gold ($/oz)	US$	1,103.56	1,060.82	1,183.15	1,421.40	517.10	387.20
PALL		Palladium	US$	505.00	547.00	798.00	797.00	258.00	130.75
PLAT		Platinum	US$	879.50	891.00	1,209.00	1,770.00	970.50	399.50
BRSPOT		Oil (Brent Crude) $	US$	33.55	37.28	57.33	94.75	57.63	18.32
EINF	Inflation	SA Inflation	Rand	N/a	4.80	5.30	3.50	3.60	6.90

data provided by Profile Data Analytics and INET BFA