Russell Investments

SIGNPOSTS FOR 2016

Seeking steady absolute returns in volatile investment markets

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Signposts for 2016

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As 2015 draws to a close, we look back on a challenging year for investors, and look ahead to the year to come. Term deposit rates have dwindled from a lowly 3% back in January 2015 to levels now that, at closer to 2%, are outright meagre. The Australian sharemarket has broadly tracked sideways over the year as a whole. The resources boom has continued to unwind. And Australia's standing in the global economy has been heavily marked down, with a further 10% fall in the local currency.

As we consider the prospects for 2016, it's time to 'hope for the best, but prepare for the worst'. We take a look at "Signposts for 2016" – designed to help guide you in your search for steady absolute returns, in what we expect will continue to be volatile investment markets.

1. Living with lower returns and higher volatility

The years immediately following the Global Financial Crisis of 2008 still felt quite traumatic for investors. But we can now all see, with the benefit of hindsight, that the Australian and global securities markets performed well in the period 2009 through 2014. Lower returns and higher volatility struck in 2015, however, with plenty of ups and downs but with little price appreciation overall.

2016 will not, in our view, be a time to simply just buy and hold traditional investments such as shares and bonds. A continued environment of lower returns and higher volatility, if not worse, is again in prospect for 2016.

> Active management, downside protection, and a broader palette of assets, currencies, exposures and strategies will all be needed to face the year with confidence. Likely too, we are entering a year where investors will be pondering their absolute results, come December 2016, rather than their peer relative outcomes.

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2. Focus on Absolute Returns

Leaving ZIRP

A major reason for caution, and a major reason that security valuations will be sailing into headwinds in the coming year, is that the U.S. will almost certainly be 'leaving ZIRP'. 'ZIRP' is the 'Zero Interest Rate Policy' introduced to the world by the U.S. Federal Reserve in 2008/9 as a temporary measure when unemployment was 10% and that – against all expectations – is still in place in the U.S. today with unemployment down at 5%. We are now confident at last that rates will be leaving the floor in 2016, or even as soon as December 2015. That makes a whole new backdrop for investment management.

An expensive world

A second reason for investor caution and for a focus on absolute returns in 2016, is that an extended period of near-zero interest rates globally and of historically low interest rates in Australia, has pushed asset prices to very elevated levels. From the Central Banks' point of view, that's all part of the plan – the wealth effects associated with higher asset prices encourage consumers to spend and the sharemarket effects allow the corporate sector to recapitalise. The bad news for investors is that the outlook for securities prices in 2016, will be much more volatile than the outlook for world economic growth.

Quite apart from a need to focus on absolute, rather than relative returns, investors will – yet again – need to do all in their power to reduce the costs of trading.

> At Russell Investments in 2016, we'll be looking at customised factor portfolios; at tax awareness; and at investing currency exposure strategies in our ongoing attempts to implement desired investment exposures cost effectively. We'll also be working our global trading desks harder than ever in the relentless search for transactional efficiencies.

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Wall Street

The U.S. sharemarket is traditionally the pacesetter for global markets, including Australia's and we don't believe that things will be any different in 2016. After rising dramatically and almost tripling in value, between 2009 and 2014, the U.S. benchmark S&P 500 Index lost momentum and plateaued in 2015. Valuations are high, profit growth is slowing and the strong U.S. Dollar is adding a drag to the American economy – so Wall St will pose a significant risk to investors in 2016. Russell's view is that continued economic growth and a softly-softly approach to tightening monetary policy, will allow U.S. equities to resume an upward path.

Unfortunately, our 'most likely case' is also our 'best case' – it's easier to envisage things turning sour in the world's leading equity market, than it is to see how the outcome could be significantly better than 'acceptable'. Furthermore, the same considerations apply to the U.S. Treasury Bond market – after enjoying a huge run over a period of many years, it has lost all its positive momentum in 2015. Consequently, conditions are becoming much less supportive in the year to come – this also has a big influence on the Australian bond market.

So if there's one area where investors need to 'hope for the best, but prepare for the worst' – it's in the U.S. share and bond markets.

Investing in funds that rely solely on sharemarkets rising will not be a complete strategy for 2016. Instead, we will continue to rely on diversified sources of returns that are less dependent on traditional assets, e.g. innovative strategies that take advantage of the volatility risk premium to provide more defensive income and capital preservation; and downside protection strategies to control risk and protect the portfolio from large market setbacks that are hard to recover from. We would also see the passive bond funds, which are increasingly popular in Australia, as embodying significant interest rate risk.

3. Divergence Calls for Diversification

Geopolitics

In a year where most investment markets have been no worse than skittish and rather flat, the six o'clock news cycle has shifted focus from financial meltdowns to geopolitical disarray. The various humanitarian crises being unleashed in Eastern Europe and the Middle East are extremely distressing, affecting millions of lives. For investment markets in 2016, however, we believe these geopolitical catastrophes will not be game changers.

We are slightly less confident about the situation in our own Asia-Pacific backyard. The first key watchpoint will come early in the year, on January 16, when Taiwan goes to the polls. The ruling Kuomintang (KMT) nationalists – the party of Sun Yat Sen - face almost certain defeat. In recent years, there has been considerable rapprochement between the KMT and the Chinese Communist Party, and the likely shift to Tsai Ing-wen's Democratic Progressive Party will need to be carefully managed. Watch out for that one in the New Year.

Tensions are also elevated in the waters to the south of Taiwan, with territorial claims being pursued by a range of players in the South China Sea. Hopefully, cool heads will prevail.

The upcoming 2016 U.S. elections will be worth watching closely but we do not expect a significant immediate impact on markets. If a Democratic candidate is elected into office it would likely be accompanied with a Republican majority in the Senate and have little impact on markets. A Republican win could see more market volatility with the possibility that the U.S. Federal Reserve Chair Janet Yellen may be replaced in 2018.

The number and pace of rate rises will provide an insight into how quickly the U.S. economy and inflation are returning to 'normal' levels.

Policy dispersion

Monetary policies around the world, like geopolitical agendas, are heading in divergent directions. In the case of monetary policy though, there's method in the madness. We expect to see Janet Yellen and the U.S. Federal Open Market Committee (FOMC) raise cash rates a few times over 2016. The number and pace of rate rises will provide an insight into how quickly the U.S. economy and inflation are returning to 'normal' levels.

Meanwhile, we expect central banks in economies such as the Eurozone and Japan, which are earlier in the economic recovery cycle than the U.S., to keep their feet on the monetary stimulus accelerator through much, if not all, of 2016. China too, will likely remain in rate-cutting mode. Meanwhile, Australia is in something of a 'no-man's land', and we may well see the official cash rate locked at 2% through much of the year ahead. Any further cuts from the Reserve Bank of Australia would be a sign that that the potentially downbeat facets of the Australian economy – commodities, housing, rural, Chinese demand – have taken a darker turn than we now expect[1].

1. Discussed further in 5th signpost.

Currencies

> Divergent monetary policies suggest fluid and divergent currency outcomes across the world. Investors can best capture these returns via absolute return and active currency strategy processes.

Our expectation is that the U.S. Dollar will strengthen further – although the bull market in that currency is by now getting a little long in the tooth; the Japanese Yen will in our view be weak, although it is becoming quite good value at current levels; and the Chinese Renminbi will likely continue a moderate downward path from overvalued levels. After several years of dramatic falls, the Australian dollar is now approaching reasonable value, and we look for only a modest downtrend in 2016.

4. Where are the Income Opportunities?

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Income investing and the Australian dividend conundrum

For many investors, especially for those who are focused on income (e.g. retirees or those close to retirement) whose objective is to move from 'saving from their earnings', and to start 'earning from their savings', an expensive world with low yields is a disturbing landscape.

> Part of the solution is to invest in yield strategies such as corporate credit, dividend-yield shares, or Exchange Traded Funds (ETFs) focused on income and dividends. Systematic strategies are also a good option to consider to access yield in this way. For example, at Russell Investments, we employ global high yield, options-writing strategies, and currency-hedging income strategies.

When thinking about income investing, it's easy to look at the generous franked dividend yields on Australian shares and gravitate towards these headlines. Investors should be aware though that the payout ratio in Australia is currently at a record high, and that dividend growth in coming years may be sub-par as payout ratios drop back to normal (from around 80% to 60%). So it's helpful to take advantage of the Dividend Conundrum and the income opportunities it offers but be aware that future dividends may be at risk, e.g. for resources stocks. Instead, diversify across multiple sources of income from different assets, sectors and geographies.

> We also highlight the enhanced value of cash holdings in the current investment environment. From Russell's portfolio managers' point of view, whilst the headline interest rate on cash may be miserly, cash offers significant opportunistic value in choppy markets where buying opportunities do indeed exist, but are often fleeting.

Australia versus the world

With the Australian All Ordinaries Share Index still trading down at 2008 levels, you could be forgiven for thinking that Australian investors are owed a catch-up to the rest of the world. We are no better than neutral in our views of the relative attractiveness of Australian versus Global equities however. Relative to earnings, Australia has traditionally traded at a chunky discount to global bourses, but that is not the case today and we are trading at relatively expensive levels.

A circumspect, actively managed approach to the local / international decision will be appropriate in 2016, in our view.

Australian banks

At least when all else fails, Australian bank shares can be relied upon to deliver an unfailing stream of fully-franked and ever-growing dividends, right? Yet again, investors will need to hope for the best on this front, but prepare for the worst. The sharp falls in bank shares since the first-quarter 2015 highs, mean that we are no longer calling out the risks of dramatic falls. Headwinds will persist in 2016 (and beyond) however, as the banks are beset by regulatory demands and disruptive technology.

A portfolio of the big four Australian banks will be no substitute for a globally diversified, dynamically-managed multi-asset approach to investment in the period ahead.

5. Risks at Home

The commodity cycle

The bull markets in global shares and bonds may be losing their upward momentum and aging rapidly; but commodities have been ravaged by a bear market of falling prices for years now. The Reserve Bank of Australia's index of commodity prices relevant to Australia, has already halved in the first half of this decade. In 2016, our view is that persistent oversupply in resource markets, and to a lesser extent the slowdown in the Chinese construction industry, will keep commodity prices low. Weak iron ore prices will continue to keep Australian export profits under pressure and weigh on Australia's fiscal deficit. However, the bear market is aging, too, so look out for increasing signs of disruption as markets finally begin to find a new equilibrium.

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The housing cycle

The Australian resources sector, may be getting worse at a slower pace in 2016; but the second great leg to Australian economic prosperity – housing – is at risk of a meaningful slowdown. Dwelling approvals in Australia normally cycle between about 100,000 a year in recessions and 200,000 a year, briefly at the peak of a boom. But over recent times, approvals have been up in the stratosphere at 220,000 a year. This has been a major reason why, despite the end of the resources boom, employment and retail sales have – so far – remained robust.

> We're not forecasting a housing crash in 2016 and expect the sector to gradually unwind. It's one to watch though – as with Wall St, the risks are skewed to the downside.

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El Nino

Continuing the watchpoints for Australia, 2016 is likely to be an El Nino year. This is the situation where warm water currents off South America lead to drought in Australia and further problems for our still-influential rural sector. Given that many regional areas have already been wracked by drought over much of the 2010s so far, another El Nino event will be pushing many communities to the brink in the coming year. We'll know the worst by late December 2015 / early January 2016, by watching ocean temperatures off the coast of Ecuador. The outcome will impact crop yields, export volumes and regional economic activity.

A federal budget – and a federal election!

With incoming Australian Treasurer Scott Morrison's maiden budget due in 2016 and Prime Minister Malcolm Turnbull's maiden Federal election in that role likely following not long afterwards, we are not expecting any market-spooking fireworks in the Budget. That said – continual downgrades to Australia's nominal GDP forecasts, and likely tax scare campaigns, will make it an interesting year. Retirees hoping that legislative stability will finally grace Australia's superannuation system in 2016, are likely to be disappointed.

6. Keep your eyes open for the Good News

China

At Russell Investments, we've been in the soft landing camp regarding China throughout 2015 and the GDP data has indeed remained strong at close to 7% growth. In 2016, we expect the Chinese GDP data to hold up in excess of 6% real GDP, although we expect particular individual sectors – such as steel and construction – to throw off some fairly dire statistics.

> To make sense of it all, we'd be watching the interaction between China and the rest of the world, that is, the import and export data.

The Chinese consumption data has already started to improve in recent months and our expectation is that, after a rocky 2015, both imports and exports will firm in 2016.

Emerging markets

So where's the good news for 2016? One area of hope for investors is the Developing World. Emerging nation currencies took a beating in 2015; yields are high; equities are cheap; profits are at cyclical lows and monetary policies are overwhelmingly stimulatory. Risks are still also high however, with a number of these regions afflicted with collapsing commodity prices or otherwise in recession. Debt levels are high and dangerous.

> We may not be quite through the woods with this investment opportunity just yet, but at least it provides a value candidate in what we described above as an expensive world. Russell's portfolio managers will be watching this one closely in 2016.

One area of hope for investors is the Developing World. Risks are still also high however... but at least it provides a 'value' candidate in ...an 'expensive world'.

For further details, look out for Russell's 2016 Global Market Outlook, a comprehensive analysis by Russell's global investment strategists, coming early January 2016 on www.russell.com.au.

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