

# Perspectives

*Keeping you informed and engaged about macroeconomic trends and market events*



## New Year, Old Risks

*“The stock market is a device for transferring money from the impatient to the patient.”*

—Warren Buffett

**THE NEW YEAR HAS BROUGHT A HUGE RISK OFF TRADE**, with equities down across the world and a safe haven rally in the U.S. Treasury and other core bond markets. In our view, this sharp downturn is a classic case of the market being overwhelmed by too many shocks: multiple geopolitical stories, weakness in Chinese markets, another drop in oil prices and modestly weak data. But the sum is a lot worse than the parts.

As has been the case since last summer, China has been center stage in the latest selloff. China rang in the New Year with modestly weak data, another dip in the yuan and a big drop in the mainland equity market. While China is a challenge, we continue to believe global markets are over-reacting to Chinese financial and economic weakness.

For example, much of the mainland Chinese stock market’s volatility has been driven by technicals. A key driver of downward pressure was the expectation that a large shareholders’ sales ban was going to come to an end on January 8 (this has now been pushed back). After a great year of performance—you may be surprised to know that despite a volatile 2015, the Chinese A-shares market was one of the best performing globally, finishing the year up 5.6% vs global equities down 2% (In Q4 alone, China A-shares recovered 16%)—concerns grew that company management teams and insiders could take profit which would lead to selling pressure. Couple these concerns with the ill-timed introduction of poorly structured circuit-breakers meant to forestall Chinese mainland stock market crash-

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The new year has brought a huge risk off trade, with equities down across the world. This sharp downturn is a classic case of the market being overwhelmed by too many shocks: multiple geopolitical stories, weakness in Chinese markets, another drop in oil prices and modestly weak economic data. But the sum is a lot worse than the parts.

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The U.S. economy is poised to enter 2016 with solid momentum: GDP growth is trending at a post-crisis high of 2.5% with improved labor markets and a recovering housing market supporting a consumption-led recovery. The Fed’s projected course will be slow and steady.

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Europe, Japan, and the U.K. have the potential to solidify the globe’s resilience to slowing growth in the developing world. But each region faces some formidable risks to their outlook, with terrorism, a refugee crisis, more Greek debt problems, the limits of “Abenomics,” and a potential “Brexit” clouding the horizon.

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While the slowdown in manufacturing is undeniable, Asia is bringing millions and millions of people into middle-class lifestyles—providing a huge tailwind to the growth of the service and consumer-focused industries and businesses. Emerging markets may have challenges but opportunity exists at current valuations for a long-term investor.

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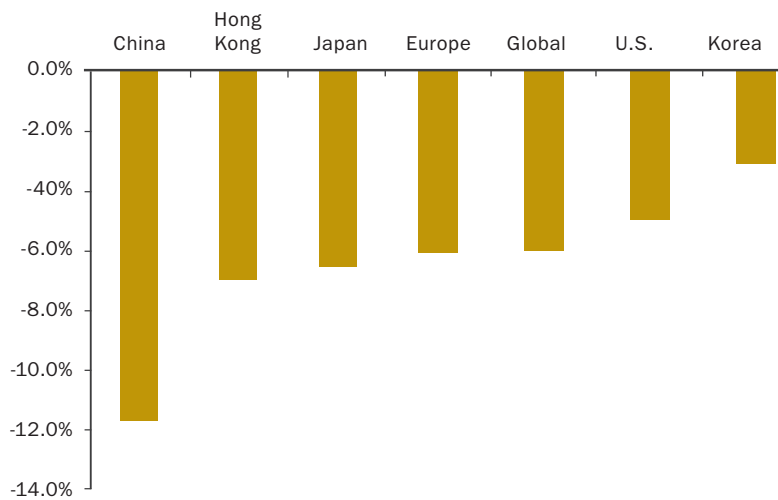
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Equities down across the world (% YTD as of January 8, 2016)



SOURCE: Bloomberg.

es, and one can understand the context behind this year’s downslide.

As for slowing economic data, there have been no surprises in the numbers released, which continue to paint the picture of an economy in the midst of a fundamental shift from manufacturing to service-oriented consumption. While the new year brought a weak Caixin manufacturing and services data report, with a particularly soft new order (forward-looking) component, other recent Chinese data releases have shown stabilizing or even improving trends. The official manufacturing PMI released last week (which includes large state-owned enterprises in contrast to the Caixin survey) showed resilience, and the service PMI climbed to a 16-month high. More importantly, retail sales in China increased by 11.3% in December of 2015, their largest gain since December 2014, as sales grew by double-digits in categories including office supplies, home appliances, building materials, furniture, personal care and cosmetics, and telecommunications equipment. Yet despite positive evidence of an expanding services economy, markets are worried, especially as the government is willing to offer only modest, targeted stimulus measures in order avoid inflating debt even further and as it implements structural reform.

The markets have, by far, the most angst about continued yuan devaluation with speculation that there is an unofficial strategy to offset weak exports and to boost a weaker-than-expected economy. Despite aggressive intervention the currency is down 6.0% since last July though a further slide is possible as China slowly opens up its capital account and maintains easy monetary policy. However, government officials maintain their agenda is only to let currency fluctuate according to the dynamics of the exchange market, and point to the yuan’s recent inclusion in the so-called special drawing rights basket of the International Monetary Fund as confirmation of their goal to have a global reserve currency, not a currency war.

For global capital markets, the root challenge is a deep uncertainty about what is really happening in China. Many investors—with some justification—question all Chinese statistics. In particular, GDP appears to be artificially smoothed and since no “source data” is available it is very hard to confirm whether the shift towards a service economy is really happening. How will we know when China has turned? There is also considerable uncertainty about Chinese policy intentions. Is the government going to allow the

equity market to fully correct or will they intervene? Do they want a free floating exchange rate and an open capital account or do they want to heavily manage their currency? The Chinese have said they want to reduce bad debt and overcapacity, but how will they do that without damaging growth? Ultimately, are they willing to do a TARP-type bailout to clean up balance sheets?

While these are all important questions, the obsession in markets is overdone. China’s economy has not suddenly collapsed; it has been slowing since 2010. Hence a lot of the shock from China—in terms of both commodity markets and its close trading partners—has already happened. Moreover, looking ahead, the “hard landing” everyone is talking about is 3 or 4% growth.

Furthermore, China’s linkages into the global economy and the markets are a lot smaller than is hyped in the press. Their closest trading partners are clearly vulnerable and have already been hurt, but Chinese growth has very little impact on the U.S. or Europe. When you turn over a product in China it does not say “made in the USA.” Exports to China comprise only about 1% of U.S. and Euro area GDP. And while the yuan is an important currency, the markets are acting as though it is much more important than currencies for other major markets. Surely the roughly 30% drop in the euro in 2014-15 or 50% drop in the yen in 2012-14 were bigger shocks to the global economy than a 6% move in the yuan. China is not eight times more important than Japan or five times more important than Europe. But, in a market looking for a reason to consolidate, China does provide a host of uncertainties.

Briefly, the story for the other shocks is similar. North Korea’s claim of successfully testing a hydrogen bomb was concerning but “sabre rattling” by Kim Jong-un is not new. It is telling that the South Korea stock market is down the least of major markets to start the year despite this news.

On a similar vein the escalating war of words between Saudi Arabia and Iran could be viewed as a major risk to oil supply, triggering a surge in oil prices and shocking global growth. However, oil prices have instead fallen on the assumption that the “war” will be “fought” by pushing up oil supply, driving down income for each country. By this pretzel logic, trouble in the Middle East is no longer bad for the world because of reduced oil supply but because of increased supply. Really?

We continue to be puzzled by the angst about low oil prices. When oil prices drop

there is a one-for-one transfer of spending power from producers to consumers, so as a first approximation, falling prices should not impact global growth. Indeed, lower oil prices stimulate global growth by shifting income to people with higher propensity to spend. In the short-run this stimulus could be offset by the dramatic drop in the mining sector and financial contagion, but that effect should fade. At worst the net effect should be neutral.

In summary, we view risks to global growth from China and these other recent shocks as more psychological than real. China has many tools (fiscal and mone-

tary) at its disposal as it charts a multi-decade course to a more balanced economy. Growth indicators across the world remain reasonably healthy. Solid data in Europe and another strong U.S. jobs report seem to have been trampled on the flight to the exit. Of course bad markets can undercut confidence and spending, creating their own “fundamentals.” However, we expect the economy to remain reasonably healthy unless the market turmoil continues for an extended period. Overall, we look for a replay of last summer when market volatility barely dented global growth, and markets rebounded when cooler heads prevailed.

## **GLOBAL ECONOMIC OVERVIEW: Sustained Weak Growth (but not a Crash)**

A further deceleration of activity in key emerging and developing economies overshadowed a modest recovery in developed countries in 2015. This deceleration was accompanied by further declines in commodity prices, subdued global trade, bouts of financial market volatility, and weakening capital flows. All told, global growth was a disappointment, now estimated at a slower-than-expected 2.4% pace in 2015.

With performance so uneven in 2015, one has to wonder where global growth slows or regains traction in 2016. Our bet is on the latter. We believe the United States remains in a very long (if slow) economic expansion driven by robust consumer spending and investment in the non-oil private sector. The unemployment rate has dropped to lows seen during previous recoveries, and prospects of strengthening wage growth amid tight labor market conditions support a positive outlook for 2016. While a strengthening U.S. dollar and weakening external demand are weighing on exports and manufacturing activity, these factors support a very gradual tightening cycle by the U.S. Federal Reserve that should sustain an expansion.

A return to growth in the euro area has been supported by both strengthening domestic demand and exports. Pickups in credit and intra-European

trade growth point to a broadening recovery. While growth in Japan remains fragile, key developments like rising female labor force participation has boosted employment rates and is helping to offset demographic pressures. In both regions, fiscal and monetary policy remain highly accommodative and will provide critical support to maintaining and expanding the economic expansions underway.

To be sure, China is likely to slow further and commodity-dependent emerging economies may struggle. We expect the Chinese economy to stabilize, however, and also believe oil is in the midst of a bottoming process, which should prevent further significant commodity-related damage. Furthermore, emerging market economies are not one size fits all: many are net commodity importers, pursuing economic reforms, and/or have strong consumers, reduced current account deficits, and are benefiting from secular themes. Philippines, India, Vietnam, and Mexico are examples of such emerging countries on the rise. On balance, the global economy should accelerate modestly in the coming year, defying expectations of a return to recession that recent market action may seem to suggest is in the offing.

## **U.S. ECONOMY: Slow but Steady**

The U.S. economy is poised to enter 2016 with solid momentum. For 2015 as a whole, growth is estimated at 2.5%—the highest annual rate in the post-crisis period. Solid labor market conditions continued to support a consumption-led recovery, with job creation averaging more than 200,000 per month in 2015 and the unemployment rate falling to 5% in the final quarter of 2015. While labor market participation has trended down, and is unlikely to recover much as the number of baby boomers approaching retirement age increases, the quality of jobs are getting better, with more of the jobs created being full-time positions. Nominal personal income is projected to grow 5.1% in 2016, up slightly from 4.6% in 2015, thanks to cheap commodities, low interest rates, and gradually rising wages. This improvement in employment and earnings will continue to support consumer confidence and household formation, both of which have risen back to levels that have, in the past, supported healthy gains in home sales and spending on big-ticket items.

In contrast, business investment remains under pressure. Activities related to oil and gas exploration should continue to contract in 2016, although at a much slower pace than this past year.

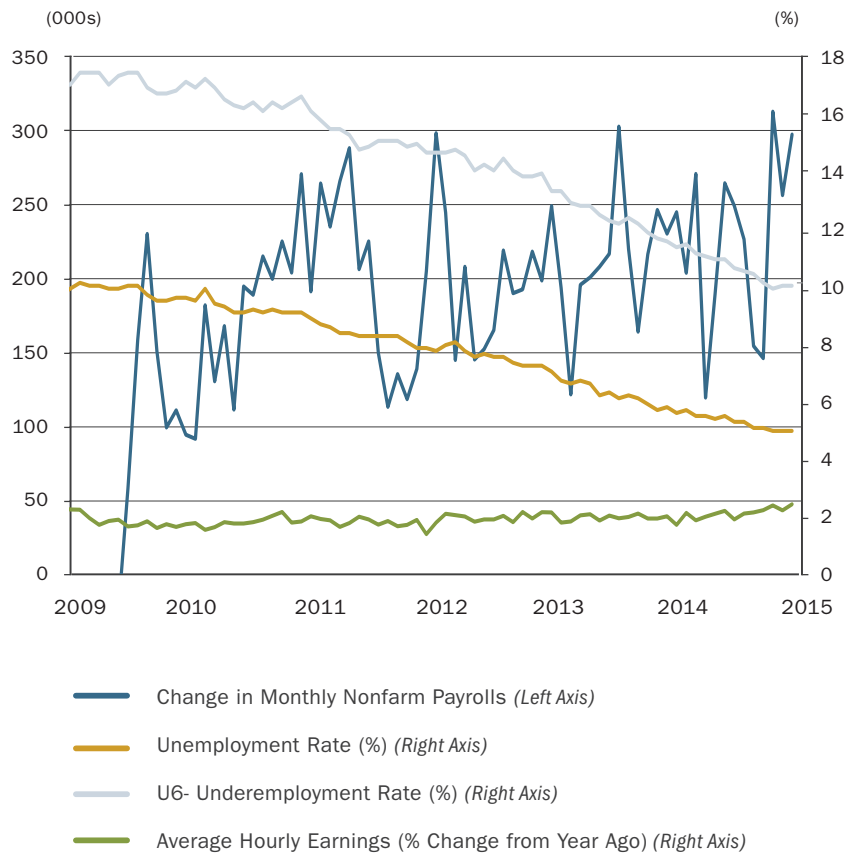
The consensus view on energy prices has changed a great deal over the past year. Hopes that U.S. production would quickly decline and allow prices to rebound have faded away, and the new mantra is that oil prices are likely to stay low for longer. The International Energy Agency (IEA) recently noted that it does not expect oil prices to rebound back above \$80 a barrel before 2020.

Therefore, investment tied to the energy boom continues to unwind. Orders for steel pipes, which are used for drilling, railcars utilized to haul fracking materials, sand and oil, and heavy industrial equipment, used to prepare and operate drilling sites, have all declined considerably over the past year. Demand for trucks, oil field equipment and mining machinery have also fallen. Slower global economic growth and the stronger dollar are also taking a toll on investment spending. Businesses are understandably reluctant to expand production capacity during a time when demand remains weak relative to prior expectations and profit margins are being squeezed. The farm sector is also getting squeezed by lower commodity prices and, thereby, purchases of farm equipment have tumbled.

Slower global economic growth means that international trade will likely continue to be a drag on U.S. GDP growth in 2016. Though the pace of appreciation will slow, the major currencies trade-weighted dollar could rise another 5% in 2016, making it even more difficult for U.S. exporters to compete against producers overseas.

Yet some of the headwinds facing the economy over the past few years may lessen appreciably in 2016. While energy prices might move lower from time to time, they are unlikely to plummet from current levels, so the positive effects on household purchasing power from lower energy prices are likely to more substantially offset the negative effects of reduced energy production. Fiscal policy will also be more supportive

**Labor market strength supports sustained U.S. economic growth**



SOURCE: Bloomberg.

of growth, now that a federal budget deal has been enacted that allows for modest gains in defense and non-defense discretionary outlays. State and local spending should also rise a little more rapidly, reflecting rising tax receipts and easing budget pressures in most states.

The housing market was able to resume its recovery in 2015 as a result of solid job growth and persistently low mortgage rates. Existing home sales are close to regaining a 5.5 million annualized rate, while new home sales are growing 10% a year. Housing starts are on pace to return to the historical average of 1.5 million by the end of 2017. Most impressive, all of these gains occurred without broad based wage growth. Perhaps the next leg higher in the housing market comes along with a pickup in wage inflation.

Regarding overall consumer price inflation, the renewed fall in oil prices and the strengthening dollar are exerting downward pressures. Excluding food and energy, core inflation stayed below 2% and is projected to rise only gradually in 2016. For this reason, though U.S. monetary conditions are set to tighten further in 2016, we anticipate only three or four further hikes by the Fed. And we reject the assertions that these modest increases will derail the positive trajectory of U.S. or global economic growth. As Fed Chairwoman Janet Yellen said in the press conference following the historic increase, “The Fed’s decision today reflects our confidence in the U.S. economy... We see an economy that is on a path of sustainable improvement.”

## DEVELOPED INTERNATIONAL ECONOMIES: Getting Out of Low Gear

Also in search of sustainable growth are the economies of Europe and Japan, who together with the U.K. have the potential to solidify the globe’s resilience to slowing growth in the developing world. Unfortunately, each region faces some formidable risks to their outlook in 2016, with terrorism, a refugee crisis, more Greek debt problems, the limits of “Abenomics,” and a potential “Brexit” clouding the horizon.

On the bright side, the euro zone grew by around 1.5% in 2015 as quantitative easing from the ECB, a healthier banking system and some relief from budgetary austerity all contributed to improved results. The most encouraging feature of the past 18 months has been the relative strength in the periphery of the euro zone – notably Italy, Ireland, and Spain – and the pickup in domestic demand due to expanding credit, higher consumer confidence, and the fall in the price of oil. In contrast, while net exports should benefit from the cumulative weakening of the euro to date, a growth slowdown in the euro zone’s major trading partners may limit their contribution to growth in 2016.

We think that headline inflation will increase from roughly zero in 2015 to about 1% in 2016 on a weaker euro and oil prices, but believe that with current monetary policy settings, core inflation is unlikely to recover to the level consistent with the ECB’s definition of price stability. As such, there will be pressure on the ECB to recalibrate the size and pace of QE, opening the door to a possible expansion of the existing program (the ECB generally under-delivered on QE expansion at its December meeting versus both market expectations and its own messaging).

While prospects for the euro zone are improving, the question remains whether they will improve fast enough to head off anti-euro sentiment. Performance is still very uneven across countries, and unemployment remains very high. All this provides fertile ground for protest parties that see the European contract as a hindrance, not a help. The resolve of Europeans was sorely tested in 2015, first by the Greek debt default, then by the refugee crisis. Both situations will remain in the headlines this year: the flow of migrants is

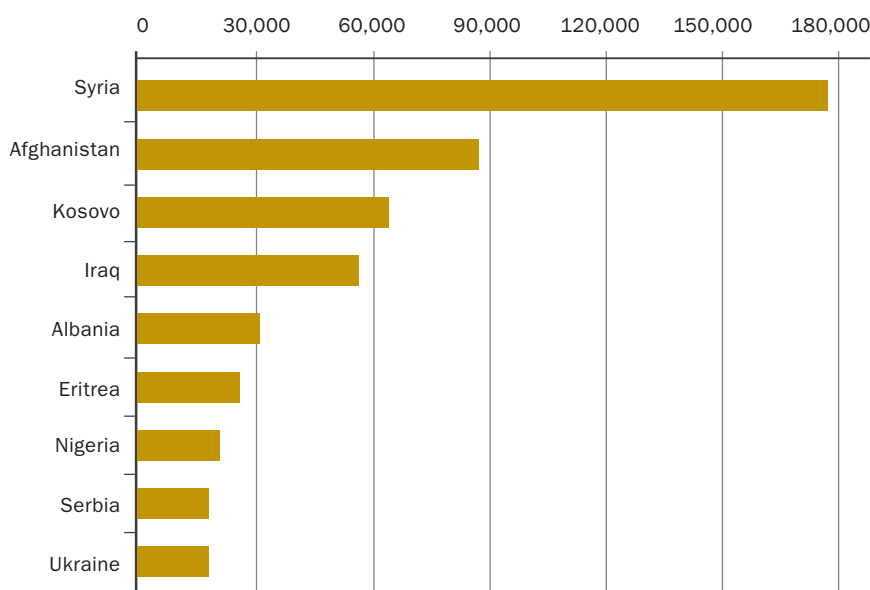
unlikely to abate, and Greece faces critical milestones in the months ahead. Sadly, we cannot rule out the continuation of extremist activity, which threatens the spirit of pluralism. Though we acknowledge these risks, it is our view that positive economic momentum will illustrate that Europe is more than the sum of its members and head off those who would tear it apart.

Turning to the U.K., strong domestic demand should continue to drive growth in the range of 2% to 2.5% over 2016. Consumer spending should remain strong, and the renewed fall in oil prices may mean the benefits of higher real incomes will not dissipate as quickly as initially thought. U.K. unemployment has fallen rapidly, and is close to a 5% equilibrium level. Yet with inflation still low, there will be no rush to raise the policy rate, especially given that wage growth has slowed slightly in recent months. The start of the U.S. tightening cycle will likely depreciate the sterling and provide some relief for exporters.

The key domestic risk to the U.K.’s outlook surrounds the potential “Brexit” (British exit from the European Union) referendum in Q3 2016. Whilst not our central expectation, a vote to leave would likely reduce GDP by 1%–1.5% in the twelve months thereafter, thereby skewing the risks to the downside over our cyclical horizon. With recent polls showing a close call and no firm date for the decision, uncertainty looms.

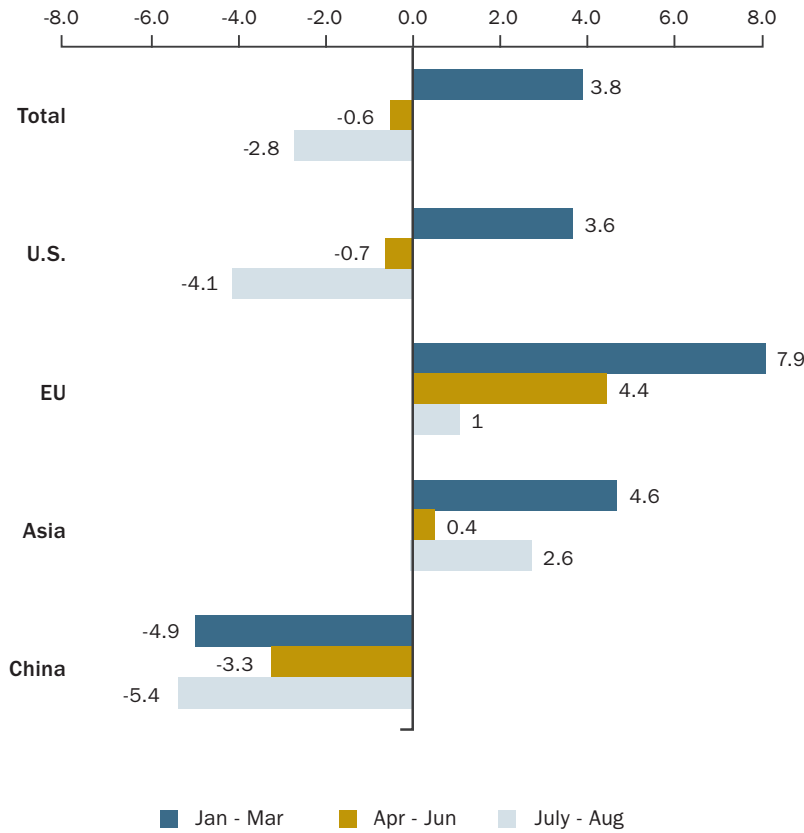
Skepticism about Japan is familiar, but we view the country’s recent pick-up to 1% growth as sustainable in 2016, supported by a gradual rise in wages and a recovery in consumer spending. The relatively weak yen should continue to help the nation’s exports, particularly in services. Steady exports to the U.S. and the euro zone should offset some of the drag from lower regional demand. Inflation will remain very low, averaging perhaps 0.4% for the year as a whole. Certainly, the BoJ’s target of 2% inflation by early 2017 looks optimistic. Importantly, unemployment remains at a cycle-low 3.3% and real incomes are grow-

### 2015 Applicants for EU Asylum Hail from Hotbeds of Conflict, Violence, and Poverty



SOURCE: Bloomberg.

Japanese exports expected to rebound after Q3 slide (yoy, %)



SOURCE: Bloomberg.

ing at close to 2%. What's more, Prime Minister Shinzo Abe recently approved a 3% hike in the national minimum wage.

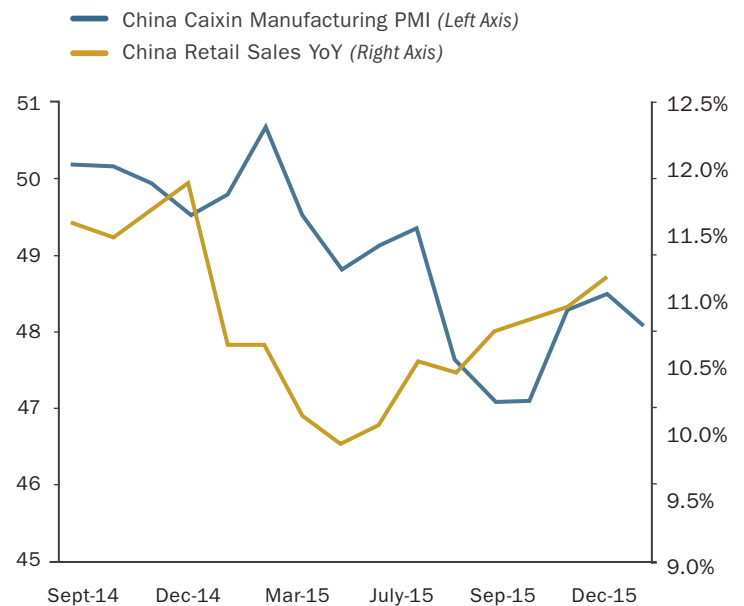
The BoJ's mid-December tweaking of its quantitative and qualitative easing (QQE) program suggests that the bank will hold off for a while on any major monetary stimulus. It likely will wait to see if the consumer recovery can strengthen as the year unfolds. However, wage growth may well disappoint, in which case we expect a more significant expansion of QQE at mid-year. Fiscal stimulus – albeit a relatively modest round – is also in the cards, with a ¥3.3 trillion supplementary budget headed for parliamentary approval in January and a mildly stimulative budget for the new fiscal year that begins in April.

Japan will continue to struggle with the challenge of sustaining economic vitality in a society that is aging rapidly. For this reason, we applaud the shift in fiscal policy goals evident in Abenomics II with its three new arrows: cash transfers to the elderly and poor, an increase in the minimum wage, and an expanded program of child care and elder care to increase labor force participation.

**CHINA & EMERGING ECONOMIES:**  
Bear in a China Shop

China remains both a source of strength and worry for the world economy. It is undeniable that there has been a significant slowdown in the core industrial side of its economy which continues to have a significant disinflationary effect on the globe. However, services have been more resilient and account for a much larger share of GDP than a decade ago. China's ongoing challenge is to manage this cyclical slowdown without undermining the structural move to a more consumer-oriented economy. More than most emerging market economies, it also needs to find a way to unwind the financial excesses built up from the post-crisis credit boom. It is for this reason we have not seen the kind of emphatic fiscal and monetary response to economic weakness from the Chinese authorities that we saw in the global financial crisis. Instead, authorities have acted to support the economy with successive reductions in interest rates and reserve requirements for banks, along with an expansion in certain parts of the budget.

China's growing retail sales arguably more important than slowing manufacturing data



SOURCE: Bloomberg.

In the latter part of 2015 there were signs that these steps were helping to stabilize China's economy, as a booming services sector supported the addition of 13 million new jobs in 2015. And China's new five-year plan, which is focused on balanced, inclusive, and sustainable growth, points to a growth slowdown of—at a minimum—a very respectable 6.5%. A stabilization of growth at or near such levels would provide support for commodity prices and could reduce the pressure for the authorities to use further exchange rate depreciation to revive net exports and tackle deflation.

As for the rest of the emerging markets complex, the outlook for 2016 is not altogether encouraging. Producers of commodities and oil are unlikely to get much relief in the year ahead, given the supply glut for raw materials. Many emerging economies received substantial foreign investment to develop their resources; few planned well for the possibility that the capital could be withdrawn. Some borrowed to fill funding gaps, but falling revenues and weak currencies will make the debt hard to repay. Central banks in some areas will be under immense pressure to monetize that

debt, at the expense of hyperinflation.

This could lead to increased political turmoil and potentially increased authoritarianism. Extreme views and militarism could result. (In some markets, it already has.) The Middle East is riven with sectarian violence, which is unlikely to abate. That creates tremendous potential for event risk.

On the negative side, Brazil seems the poster child for emerging market mismanagement and may struggle to host the Summer Olympics this August. On the positive side, India continues to prosper with a service orientation, strong reform agenda, and disciplined monetary policy.

## GLOBAL MARKET OUTLOOK: A Rollercoaster Ride to Nowhere

Happy New Year!? Few investors were sorry to see 2015 go, with its stomach-churning moves ultimately ending up with major indices close to where they started. Even though many of the broad metrics appear unchanged on the year, there has been a great deal of portfolio damage below the surface. Most investors with broadly diversified exposure actually underperformed the flattish U.S. stock benchmark as the rout in commodities extended to master limited partnerships, high yield bonds, and emerging markets while strength in the U.S. dollar obscured

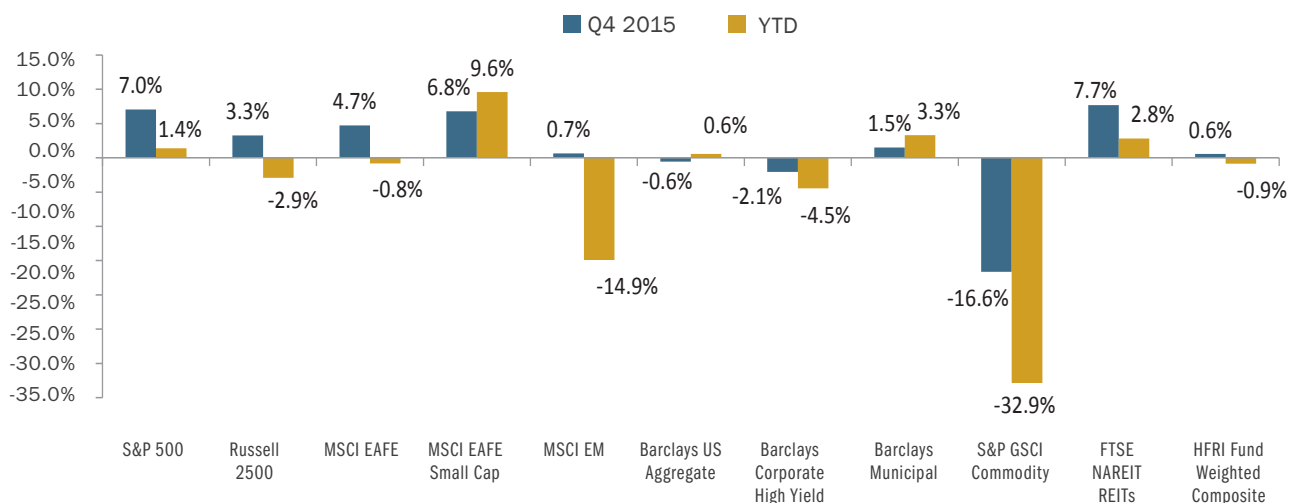
gains for investors who did not hedge their currency exposure in international markets. Similarly, investment grade bonds as measured by the Barclays U.S. Aggregate Bond Index offered little offset to mediocre stock returns as credit spreads widened on fears of growing issuance, weak valuation support, poor market liquidity and mounting anxiety about the first Federal Reserve hike in nearly a decade. And even with market volatility up materially from 2014's docile levels, hedge fund returns were down. Turning in a surprising star performance were

REITs, which surged ahead of the S&P at year-end, supported by improving fundamentals and the sector's upcoming inclusion as an eleventh sector within Global Industry Classification Standard (GICS).

### U.S. Equity Returns Recover with Narrow Breadth

The S&P 500 Index recorded a total return of 7% in the fourth quarter, enabling the index to salvage a 1.4% return for the year. The market was led higher by a recovery in large cap companies, and growth once again dominated

### Fourth Quarter Market Recovery Not Enough to Salvage 2015 Returns



SOURCE: Bloomberg.

value, with a performance differential of 5.1% vs. -4.1%, respectively, for the year. Merger & acquisition activity remained a key theme with Pfizer and Allergan agreeing to combine to create the world's largest drugs company by sales. Small caps continued their struggle relative to larger cap companies, ostensibly over concerns that rising rates and the extra cost of debt will squeeze the margins of small operators.

Among the sectors, stocks tied to U.S. consumers fared best while commodity-sensitive areas were the worst performers. Consumer discretionary and consumer staples led the market higher in 2015, while energy and materials were the worst performers. For the quarter, the materials and healthcare sector came out on top, followed by technology where the "FANGs"—Facebook, Amazon, Netflix, and Google—led the way, particularly Amazon following very strong third-quarter results. Renewed weakness in crude prices

weighed heavily on the energy sector, while utilities also performed poorly as benchmark bond yields rose over the period in anticipation of the Fed raising rates.

**Japan and Small-Caps Save the Day**

Eurozone equities delivered positive returns overall in the quarter, despite a poor month in December. Equities were buoyed during October and November by hopes that the ECB would announce substantial further monetary policy easing. However, the announcement in early December left the market disappointed. While the timetable for purchases was extended from September 2016 to March 2017, the €60 billion per month amount was left unchanged. The euro was 2.8% weaker against the dollar over the quarter but strengthened in December. Automobile stocks were particularly strong in the fourth quarter, rebounding from the weakness experienced in the wake of the Volkswagen emissions scandal and also

supported by strong demand for autos (new passenger car registrations in the EU rose 13.7% year-over-year in November). The food, beverage, and tobacco sub-sector was another gainer amid the takeover of SABMiller by Anheuser Busch InBev. Pharmaceutical stocks were the laggards.

Japan was the real standout performer among the developed international markets in 2015, followed closer by smaller capitalization European and Japanese stocks. News that Japan had avoided a technical recession in Q3, swinging from a -0.8% GDP print to 1.0% number, was a huge relief and rallying cry to the stock market. Smaller cap European and Japanese stocks benefitted from exposure to the recoveries of domestic economies in Europe and Japan, and being insulated from the slowdown in China. At the other end of the spectrum, Australia struggled given its commodities exposure and as a major trading partner to Asia. For their part, Spain and the U.K. were impacted by political uncertainty as general elec-

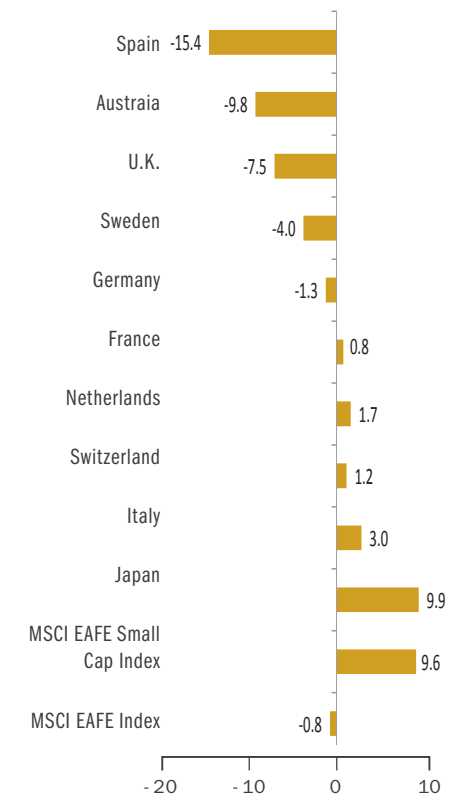
**U.S. Stock Valuations Look Topy in Certain Sectors**

S&P 500 Index Industry Metrics				
	P/E Ratio (TTM)	P/E Ratio (NTM)	Dividend Yield (%)	EPS Growth (%)
S&P 500 Index	19.3	18.5	2.2	9.8
Consumer Discretionary	21.7	21.6	1.6	12.9
Consumer Staples	22.0	21.6	2.7	8.3
Energy	18.0	19.9	3.8	8.5
Financials	15.2	14.8	2.2	9.7
Health Care	22.0	21.7	1.5	9.4
Industrials	18.7	17.4	2.4	9.0
Info. Tech.	20.2	19.2	1.7	10.7
Materials	19.1	17.7	2.7	8.7
Telecom	24.9	13.4	5.2	6.8
Utilities	16.7	16.3	3.9	4.8

*P/E ratios are based on trailing 12 months earnings (TTM) and the consensus forecast over the next 12 months (NTM). EPS Growth is a measure of forecasted earnings growth over the next 5 years.*

**Japan Shines While Spain Sinks in 2015**

2015 Country & Index Returns (%)



SOURCE: Bloomberg.



tions left Spanish Prime Minister Mariano Rajoy’s conservative party without a majority, and the U.K. braced for a referendum on EU membership.

**Asia rebound ain’t enough to save EM**

Emerging market equities increased in value in the fourth quarter, although a stronger U.S. dollar and concerns over slowing growth in China, which put pressure on commodity prices, served to weigh on returns. Emerging Asian markets performed relatively well. Indonesia was the best performing index market, with a 6.4% appreciation in the rupiah supporting returns as Q3 data indicated a narrowing in the country’s current account deficit. China posted a solid gain as the People’s Bank of China provided support to the economy with moves to cut the interest rate, the reserve requirement ratio for banks, and removal of a deposit cap that limited the rate banks could pay to savers. In emerging Europe, equities were mixed, as Hungary surged while Russia and Greece slid on declining oil prices and renewed concerns over the banking sector, respectively.

In Latin America, weakness was broad-based thanks to commodity price declines and tightening monetary policy across the region. Chile proved most resilient as macro data indicated some recovery and GDP growth climbed 2.2% year-over-year. In contrast, economic data in Brazil continued to deteriorate and fiscal governance came into focus in

the quarter as the budget was changed several times from a small surplus to a deficit. This political wrangling caused a downgrade of Brazil to non-investment grade by two rating agencies which then prompted the finance minister to resign in December. Impeachment proceedings against President Dilma Rousseff also commenced in December.

**Corporate Bonds in Crisis; Munis & Treasuries Market’s Only Salvation**

The dual themes of heightened volatility and anemic returns plagued fixed income investors in 2015. The Fed’s decision to raise rates meant longer-term rate sensitive areas of the market experienced meager results for the year. Among sectors, government-backed and high quality securitized bonds like mortgage-backed and asset-backed securities were among the best performers in the quarter and through the year while credit-sensitive bonds struggled.

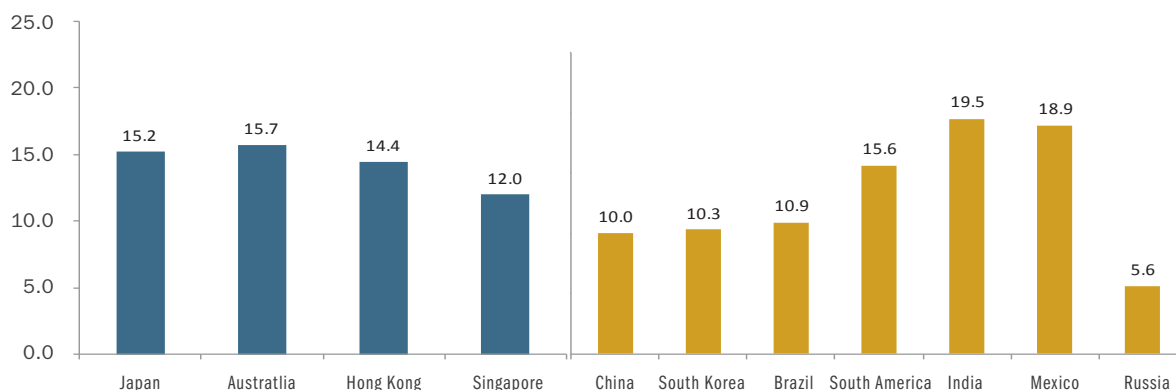
The rout in corporate credit kicked off mid-year in 2015 as the global oil-and-commodity crisis weighed on energy and mining companies and raised the specter of rising defaults. As risk aversion took hold in Q3, spreads widened indiscriminately on broader concerns related to recession risk. The high-yield bond market lost 2% (and more than 4% for the year) as concerns about the energy sector--among other factors--put pressure on the category. Liquidity worries were

highlighted by the abrupt closure of Third Avenue Focused Credit mutual fund in December. It is highly unusual for a mutual fund to freeze redemptions in this manner, which raised concerns about the liquidity of the entire high yield market and some worried foreshadowed a credit crisis to come. However, it has since been widely acknowledged that this fund was invested in a distressed debt strategy in many ways not suitable for the mutual fund format. Spreads have stabilized for now, albeit at much higher levels, in the 7% to 8% range for junk bonds and 3.7% for investment grade debt.

Insulated from this volatility, municipal bonds were the lone bright spot for fixed income investors during the year. Returns were boosted by light issuance, strong demand for tax-free income, and improving credit fundamentals, outside of the deterioration and ultimate default of Puerto Rico, which has been well telegraphed for years.

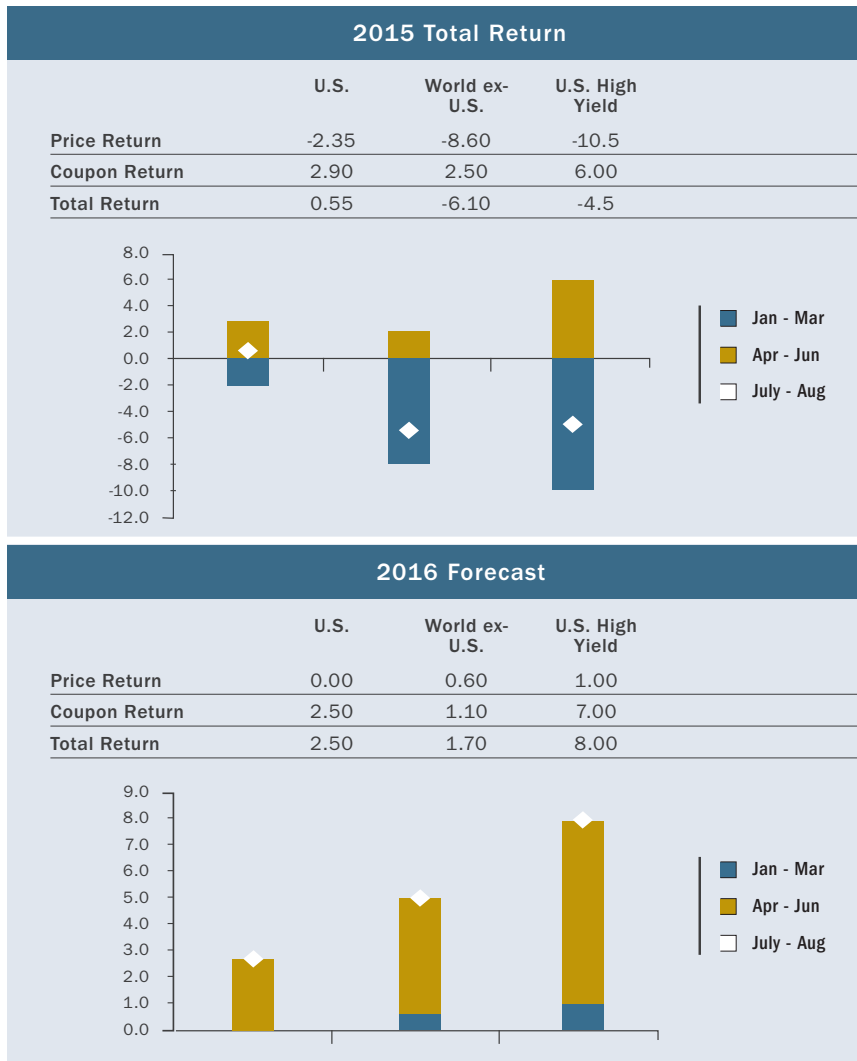
Indeed, the end of 2014 marked a pivotal turning point for munis, when Moody’s upgrades exceeded downgrades for the first time since the financial crisis. And this trend continued last year. Through the first three quarters of 2015, the ratio of upgrades to downgrades was 1.08x, soaring from 2014’s 0.64x ratio. Since 2011, measures of financial solvency have improved in every consecutive year, evidencing the improving budgetary performance across

**Asia Pacific and EM Forward P/E Ratios Stand Out as Attractive Despite the Risk**



SOURCE: Bloomberg.

2016 Should Be More Favorable for Bonds Assuming Stabilizing Spreads



SOURCE: Bloomberg.

the sector. Likewise, there has been an improvement in local government credit quality as a result of recovering tax revenues and stabilizing state funding in most states.

**Hedged strategies fumble again**

After lagging the long-only markets since the Great Recession, hedged strategies once again struggled to make the grade in 2015. Quantitative macro and CTA strategies struggled in the quarter, though year-to-date returns reflected an improved environment for trading interest rates, volatility, and macro headlines. Credit and credit-sensitive event-driven strategies were the weakest segment of the asset class, as high yield credit was caught up in market turmoil in the aftermath of the Third Avenue Fund closure. Equity hedge and relative value strategies were down, failing to participate in the recovery in most global equity markets in Q4. As always, it is important to note that strategy-specific characteristics, including net exposure, leverage, sector concentration, and idiosyncratic positions, contribute to large differentiation between the best and worst performing within the hedged strategy segment.

**Real estate roars back**

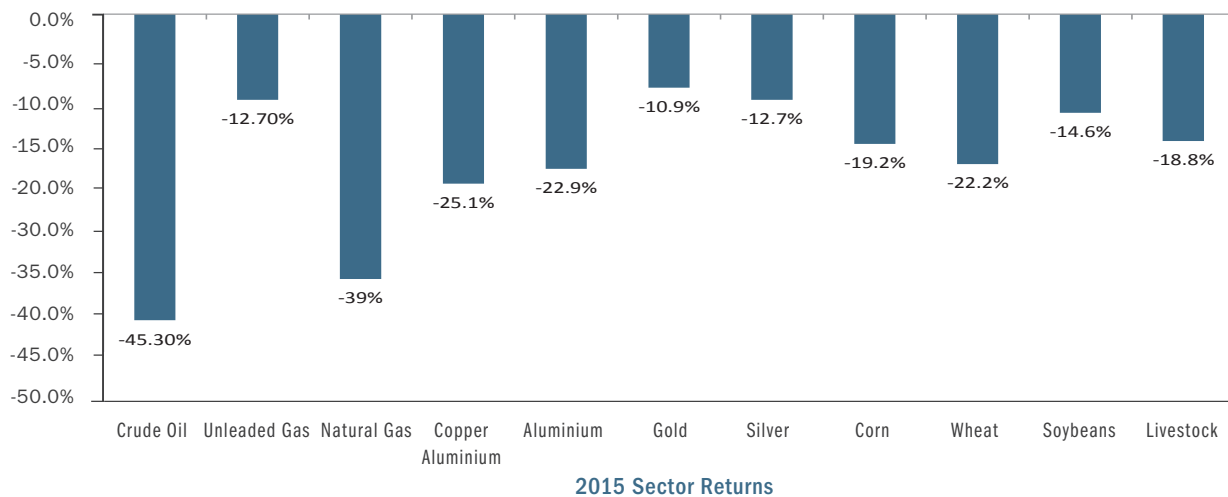
Real estate investments continued their rally in the fourth quarter, reflecting a growing perception that REITs may be undervalued. Investor concerns about the impact of rising interest rates on REITs depressed share prices in early 2015, which may have helped set the stage for their second half rebound. U.S. REIT returns were particularly strong, given the strength of the housing market, with sectors like self-storage, apartments, and manufacturing housing leading gains. Overseas REITs were strong except for the Middle East/Africa where geopolitical concerns and the negative wealth effect from falling oil prices weighed on returns.

Looking ahead, the potential negative impact of rising interest rates remains a key concern for REIT investors. However, the majority of REITs have improved their balance sheets since the last downturn and appear as a group to remain more conservatively leveraged than the last boom in the mid-2000s. Moreover, upcoming maturities for many REITs over the next few years still carry interest rates that far exceed current borrowing costs, so even a 100-basis-point rise in rates from here would have a negligible impact on cash flow, at least over the medium term. We see opportunity in the asset class at current levels, and particularly favor global exposure and real estate operators that are less sensitive to U.S. interest rates.

**Commodity Catastrophe**

Once again, commodities suffered breathtaking declines in the quarter, with the energy segment leading losses. Despite falling rig counts and lowered capital expenditure plans, production continued as drillers focused on their most lucrative wells to maintain cash flows. The most recent blow to oil fundamentals was OPEC's decision to maintain production levels at its annual November meeting, continuing the market share battle against non-OPEC producers. Meanwhile, markets have begun to price in Iran's imminent return to the global oil marketplace, which will add

Commodities Can't Seem to Find a Bottom



SOURCE: Bloomberg.

additional supply to an already-oversupplied market. Finally, the dollar's continued strength added to the headwinds.

Looking ahead, the Energy Information Administration (EIA) anticipates global demand for oil increased by 1.8 million barrels/day in 2015 – a 1.9% increase. This compares to its beginning-of-year 2015 growth forecast of 0.9 million barrels/day (1.0% increase) and 2014 demand growth of 0.8%. Unfortunately, though, slowly accelerating demand data was trumped by oil supply growth of 2.4% in 2015. While supply growth is expected to fade in 2016 (due to unconventional well depletion and reduced capital expenditures), high inventory levels mean oil markets will take time to return to equilibrium. Other sectors have faced similar headwinds in 2015 – with industrial metals down 30% and agricultural commodities down 15% (compared to the 40% decline in energy commodities). Overall, supply-demand imbalances in the energy and industrial metal sectors combined with expectations for continued dollar strength may keep commodities underwater for some time to come.

Looking ahead

Even the most patient of investors can have their fortitude tried by these abrupt swings in the markets. While it is entirely possible that the worst isn't over, we think investors have to stop thinking like

traders trying to pick a bottom and just keep a disciplined approach to investing. Discipline means riding the ups and downs. Markets correct to the downside quickly, but they correct just as quickly to the upside. If you firmly believe the fundamentals have shifted in such a way that a recession is imminent, or that earnings will be impaired, then you probably want to take some money off the table. But we don't believe that. Manufacturing activity might continue to be weighed down by adjustments in the oil industry and as a result of adjusting to a stronger dollar, but new export orders are picking up and the service sector remains in expansion.

With global growth accelerating, even modestly, earnings should recover. And if profits can expand even modestly, valuations are unlikely to be pressured. The bull market is maturing, which means the pace of gains is likely to slow. But we still expect equities will be able to outpace bonds, which may be hurt by rising yields.

Equity market leadership is likely to shift from secular, stable growth areas toward sectors primed to benefit from improving economic growth and rising bond yields. At the same time, we think it is reasonable to expect non-U.S. equities to make headway as global growth accelerates and as fears associated with Greece and China recede.

Overall, we expect 2016 will present difficulties for investors, but there are

reasons for optimism. If things go right and global economic growth broadens and improves, that should allow corporate revenues and earnings to strengthen. Such a backdrop, combined with still-low inflation and still-easy monetary policy, should be enough for equities to make further gains. And, given the rout in corporate credit, we have an improved outlook for total returns on bonds as credit spreads tighten in recognition risk aversion went a few steps too far. We would encourage investors to establish modestly overweight positions in equities, maintain core positions in bonds, and put aside their doubts about diversification.

While we are no doubt in the later stages of this economic cycle, the end is not (yet) nigh. Maintain both patience and selectivity to guide your investment strategy, and embrace the global investment opportunity set as markets mature and the landscape becomes more volatile and complex.

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