For professional investors only

2015 Closing Bell

December 2015

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Chief Economist

2015 has been a year of drama and volatility in global financial markets. Excitement was easy to find, good returns were rather more elusive. Equities produced the best returns, occupying the top 15 places in our asset return league table. This is partly due to the inherent volatility of equities: they are also well represented in the 'ugly' category. But it also reflects the poor performance of other asset classes.

The key to achieving decent returns this year has been to avoid the many potholes and secure the occasional prize. The biggest potholes were commodities and emerging markets. Combining the two was a recipe for horrendous returns: in US dollar terms the Brazilian BOVESPA is down 38% so far this year, the South African All Share index is down 27% on the same basis even after President Zuma's u-turn on appointing a new Finance Minister.

High yield hits a pothole

With stock markets outperforming and bond yields very low, the search for yield should have supported credit. In fact supply has been strong while investors have begun to worry about liquidity with the result that credit underperformed and spreads widened. This was a relatively orderly process until the past few days when the US high yield market was hit by the collapse of two mutual funds. This has revived memories of the two sub-prime fund suspensions that affected Bear Stearns and BNP Paribas in 2007, a full year before Lehman went under. Our 2016 Outlook will be sent out early in the New Year but for the record, we do not expect history to repeat itself. Indeed, the market is protected to some extent by its short duration and the high yield itself. This is evident in performance, with year-to-date returns of -3% in the US and -0.3% in Europe.

The collapse in the oil price and other commodities lies at the heart of these problems. This is partly a function of supply: a lagged response to the lofty heights that prices reached just a few years ago, plus – in the case of shale oil – new technology. But it also reflects reduced demand from China which is rebalancing from a boom in commodity-intensive manufacturing and property to an economy more focused on services. In many cases, demand for commodities is rising and prices are well below the cash costs of production. Prices have yet to find a floor, however.

But what of the prizes?

Peripheral Europe was one: better growth and powerful support from the European Central Bank (ECB) created a virtuous circle of improving financial conditions. The Italian FTSE MIB index has returned a respectable 13% so far in 2015 and 30-year Italian bonds have delivered 18%. The benefits of sticking to the painful bailout conditions were demonstrated by the contrast between equities in Portugal which returned +12% and Greece at -29%.

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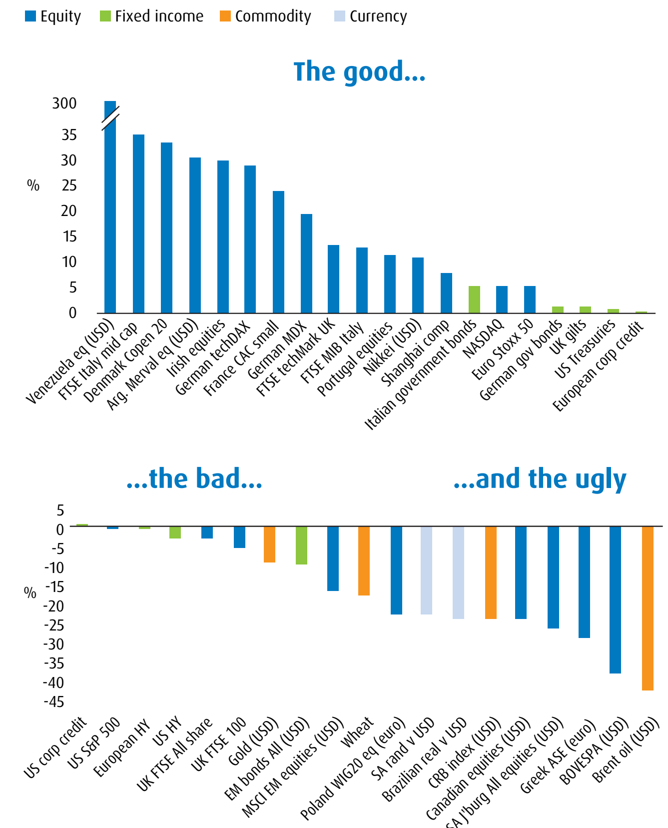
Total returns (%) year-to-date (11 December 2015)



Source: Bloomberg, Deutsche Bank and BMO Global Asset Management calculations
All returns are in local currency except where stated otherwise

Tech was another successful theme. The strong performance of the FANGs (Facebook, Amazon, Netflix and the stock previously known as Google) is well documented but even the European tech sectors did well with the German and UK tech indices up by 29% and 13% respectively.

Central banks continue to dominate

Central banks, as ever, exerted a powerful influence on financial markets. As the year began, the ECB, led by its President Mario Draghi promised much and then over-delivered on its version of Quantitative Easing (QE). As the year ended, they cut their deposit rate further into negative territory and extended QE. This may have disappointed elevated market expectations but it has left the yield on one-third of eurozone government bonds in negative territory. A key issue for markets is whether the uber-dovish Draghi has had his wings clipped by the hawkish group of five ECB members comprising the two representatives from Germany and the central bank governors of the Netherlands, Estonia and Lithuania. If so, the hurdle for further ECB easing has been raised. It may be unnecessary anyway: credit conditions are easing and both gross domestic product (GDP) and industrial production are growing throughout the euro area, led by Italy and Spain.

For most of 2015, the markets have been trying to guess when the US Federal Open Market Committee (FOMC) would finally raise rates. In the event, the FOMC have left it until their final meeting of the year. Never has a quarter point rise in an interest rate been so eagerly anticipated. Fed-watchers are now moving smoothly onto a new guessing game, over the pace and ultimate destination of future rate hikes. The hawks point to the low level of unemployment and signs of emerging inflation pressures from rent, wages, medical costs and base effects. The emergency that caused the FOMC to cut rates to near-zero is now over and it is time, they argue, to raise rates back to more normal levels. The doves note that signs of inflationary pressures are largely in the eye of the beholder and that US financial conditions have already been tightened by dollar strength and widening credit spreads. They point to the long list of central banks who have raised rates in recent years only to be forced to change course: the ECB and the central banks of Australia, Canada and Sweden, to name just a few.

Politics another source of volatility

Politics was another major influence on markets. New governments in Argentina and Venezuela explain why their equity markets top our league table of performance. But political forecasting almost makes economic forecasting look easy and we wonder if anyone was able to predict the ups and downs of either the Greek Prime Minister earlier this year or Jacob Zuma more recently. It is easy to forget that Greece dominated global markets for much of the first half of 2015 and that we arguably came within half an hour of Greece leaving the euro. Perhaps the key lesson was that Europe's firewall stood the test.

Politics could be an even more powerful source of uncertainty in 2016. The UK will probably hold its Brexit referendum and there are national elections in Germany, Japan and, of course, the United States. We like to use betting odds to monitor the likely outcomes of political events: they are usually a better guide than opinion polls. These imply that there is a 40% chance of the UK voting to leave the EU and a 12.5% chance that Donald Trump will be the next US President.

Finally, we would like to wish you and your family a pleasant break over the festive period. Enjoy the peace and tranquillity while markets are closed. 2016 looks set to be another year of challenge and volatility.

Steven Bell, Chief Economist
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BMO Global Asset Management

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