THE
Envestnet Edge
INSIGHTS FROM ENVESTNET | PMC

OCTOBER 2016

In a 2-2-2 world, look for modest economic growth and expansion

The post-election outlook has investors questioning the state of the global economy, volatility, corporate earnings, and the direction of interest rates. This month, we forecast modest growth and expansion as we examine prospects for China and emerging markets, volatility, corporate earnings, and the future of the global economy.

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At long last, the presidential election of 2016 is entering its final stages. In one form or another, this election has occupied an outsized place in American life since the middle of 2015, by far the longest and most extensive political campaign we've ever experienced. Much of this campaign season's noise will have little impact on markets, the economy, interest rates, economic growth, or the fate of companies. In many respects, there is an inverse relationship between the furor of this election and its clear impacts—particularly if Hillary Clinton and the Democrats win.

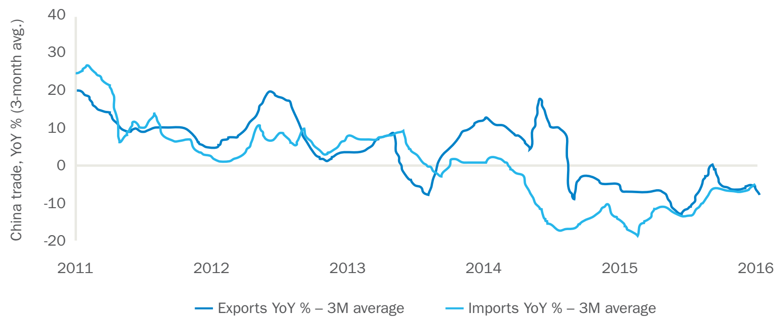
So what should we be attending to as we look past the election? Investors should ask at least four major questions: (1) What lies in store for China and emerging markets? (2) What market volatility should we expect? (3) What are the prospects for corporate earnings and revenue growth? And, 4) What is the general arc of the global economy and markets over the next few years?

Each question is distinct, of course, but the composite answer is quite simple: barring some global economic crisis, the landscape appears relatively placid. Certainly, bouts of concern and volatility will appear, but overall, we remain in a period of stasis, with a bias towards modest growth and expansion.

China

After a flurry of concern at the beginning of the year over China's health, the world's second largest economy has largely faded from the headlines. But data released in mid-October that showed a sharp slowing of exports and imports re-ignited anxieties (Figure 1). Given the higher degree of China's opacity due to its more closed system and questionable data, investors worldwide have quickly seized on any indication that trouble may lie ahead. And China is burdened by high levels of shadow debt, oversupply of housing and infrastructure, and a gradual shift in its economic activity away from the export-dependent and government-led infrastructure spending that characterized the system from the mid-1990s until recently.

Figure 1:
China's Slowing Exports and Imports



Source: MarketWatch.com

Figure 2:
Volatility (VIX) 2016 YTD

Source: Yahoo Finance. Data through 10/17/2016.

That shift, however, means that weak export numbers do not augur the same danger that they might have even five years ago. More of China's economic activity is domestic in nature and revolves around a still growing middle class and its needs. That also means less demand for the raw material imports that had been so prominent for years, which explains, in part, the roiling collapse of commodity and energy prices since 2013.

The shift in China, then, combined with global oversupply of raw materials, was a key element in the volatility that surrounded emerging markets equities and debt until early this year. However, as oil prices have stabilized and much of the "hot money" has fled those markets, the emerging world has been one of the strongest investment theses this year. Barring a new collapse in oil prices that seems unlikely at this stage, both China and the emerging world look relatively attractive, though the gaudy returns off of extreme lows offered this year should not be taken as a harbinger of future gains. Modest expectations are more in order.

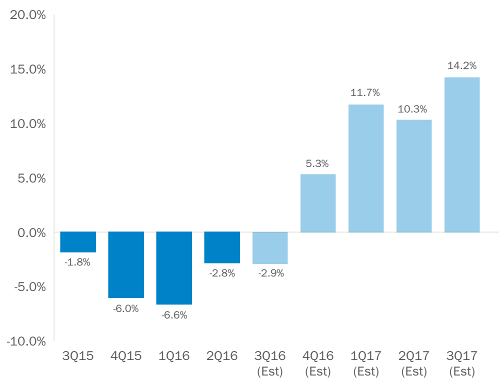
Volatility

Although one wouldn't know it from the headlines, we have been in a period of remarkably low volatility this year. The VIX (a decent measure of equity market volatility) has been muted, especially when compared with the years following 2008 (Figure 2). There were spikes in both January and July, but the baseline has been low. Bond markets have been similarly stable, despite potentially unsettling events, such as the United Kingdom's Brexit vote in late June.

Lack of volatility has been a source of investment pain for many alternative and hedge funds, but it has been something of a boon for active managers, driving out some of the distortions of programmatic and algorithmic trading and allowing more focus on company fundamentals.

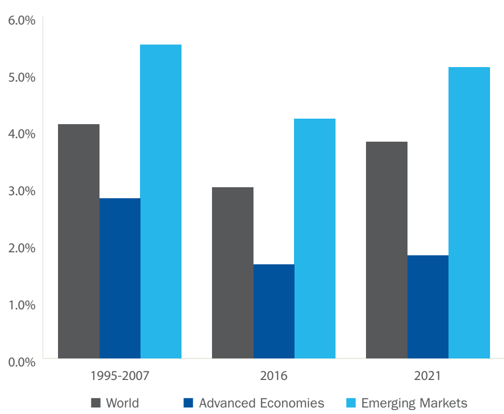
Expecting a continuation of low volatility, however, is likely a mistake. The change factor of a new president in the United States, renewed concerns about how Brexit proceeds, pivotal upcoming European federal elections in both France and Germany, and the prospects of slightly rising interest rates (triggered by modest wage growth in the United States and less easy money from central banks) all suggest that volatility could rise in the next year. Equities have nonetheless been drifting upward, and if the bond market is hit by

Figure 3:
Projected Quarterly Earnings Growth (YoY)



Source: Zacks Investment Research Inc.

Figure 4:
Subdued Economic Global Growth



Source: IMF World Economic Outlook, via The Telegraph

rate increases (however mild), increased volatility could eventually create more equity momentum in 2017.

Earnings and revenue growth

After multiple consecutive quarters of earnings contraction, the S&P 500 moved (barely) into positive territory for the third quarter of 2016 (Figure 3). On the downside, it is possible that this will be another quarter of earnings declines, continuing a pattern going back to 2014. But growing revenues indicate that we are nearing a positive trend.

Revenue growth is key. As many analysts have noted, companies can generate positive earnings through a variety of non-organic methods such as stock buy-backs, cost cutting, and creative (though legal) accounting legerdemain. At some point, however, growth must come from demand for the goods or services that a company offers, and that means growing top line revenue. It's happening in many sectors, and losses in the energy and materials sectors appear to have stabilized.

But the overall earnings and revenue picture is not rosy, largely because the global environment remains muted. But neither is the picture particularly grim; in multiple sectors and subsectors ranging from technology to specialty consumer goods and services, prospects are quite bright. Valuations constitute an on-going debate, but corporate balance sheets are relatively clean, and the business models of most are fairly lean; that is a recipe for gains, volatility and externally triggered sell-offs notwithstanding.

The global context

All of these variables are unfolding in a global context. According to the International Monetary Fund (IMF), global GDP is running around 3% annually, with higher growth in China and the emerging world, and lower growth in the developed economies of the United States, the EU, and Japan (Figure 4). That has been the case for many years, with the only real change coming from slightly higher U.S. growth, marginally better EU activity, and slower expansion in China and other emerging economies. The red flag for the IMF is the trillions of dollars of sovereign debt that have accumulated since the 2008-2009 financial crisis, along with a legitimate concern that with global interest rates hovering between 2% and zero, central banks' ability to do much more to fuel growth or protect economies in a time of duress is much more limited.

That said, in spite of a globally sour climate of anxiety and concern, along with rising xenophobia and nationalism, we are still in the middle phases of a great global transformation of the world's economies into middle-class societies. That means billions of people who have homes, and can afford not just basic necessities, such as food and clothing, but also "discretionary" items, such as phones, mopeds, cars, and health care services that would have been out of reach just a few years ago.

Ironically, we are in a world of markedly low inflation, low interest rates, and modest growth. It is, in fact, a 2-2-2 world for the global economy: 2% growth, 2% inflation, and 2% interest rates, more or less.

The 2-2-2 world isn't especially sexy or dramatic, but it creates a stable sphere for economic activity and markets. It means that volatility is likely to be contained rather than contagious when it arises: contained in the sense that it burns out rather than spins out. And it means that forecasts of great peril (along with hopes of sudden acceleration) are both likely to be incorrect.

The nub

For investors, all of this means a reaffirmation of the "don't be a hero" philosophy. This year, as we have been saying for months, has amply rewarded diversification as an investment mantra. It has not rewarded alternative, concentrated, or shoot-for-the-moon strategies, or high-frequency algorithms. Those investments may have their day, but the global macro context augurs against them doing particularly well over an extended time. The 2-2-2 world will dictate more modest outcomes, with a burgeoning global middle class carrying more weight over time than the excruciating noise of politics, or the waves of genuine anxiety and insecurity that wash over not just the United States, but many parts of the world. ■

October Takeaway:

Although rapid growth has slowed, the market and global outlook remain relatively attractive. For 2017, the combined factors of a new US administration, Brexit, elections in major Eurozone countries, rising wages, and the prospect of higher interest rates point to higher market volatility. Corporate earnings have been sluggish in some sectors, but technology and consumer goods and services are poised to prosper from clean balance sheets and lean business models. Despite anxiety and concern on the global stage, the continued emergence of the global middle class points to further market gains. Modest interest rates, low inflation, and moderate growth augur for stable economic activity and growth.