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LIFTOFF

Whether you're using "liftoff" or "lift-off," December 16, 2015, was a major event for global markets. Given that it had been telegraphed for months, perhaps it was the big event for 2015 – and possibly for 2016 as well. Still, despite putting markets on notice that December is "a live possibility," Federal Reserve Chair Yellen's 25 basis point rate hike, the first since June 29, 2006, was nonetheless fraught with anticipation and debate, no doubt spurred by the incessant "yes, no, maybe so" Federal Reserve rhetoric throughout 2015.

To be sure, the global macroeconomic backdrop, highlighted by sluggish growth despite strong infusions of monetary and fiscal policies, coupled with a U.S. economy that seems unable to power itself beyond modest growth, added to the heated discussion of the Fed's timing. Indeed, among the chief concerns for markets in early 2016 is how many rate hikes – if any – will be employed by the Federal Open Market Committee (FOMC) of the Federal Reserve, and where the path of interest rates finally will finish. Still-falling commodity prices, especially oil, the dollar's moves, and weaker than expected earnings, have complicated the picture, as have mixed projections on China's ability to stabilize growth.

Interestingly, it was on December 16, 2008, that the FOMC, with Chairman Ben Bernanke at the helm, introduced the zero interest rate policy (ZIRP) by establishing a target range of "0 to ¼ percent" for the federal funds rate. The accompanying description of the economy in the Fed's statement was fairly morbid: labor market conditions were deteriorating; consumer spending, business investment and industrial production were declining; financial markets were quite strained; and credit markets were tight. "Overall, the outlook for economic activity has weakened further. Meanwhile, inflationary pressures have diminished appreciably." Moreover, the committee expected to maintain the unprecedented zero interest rate level for "some time."

By March 2009, the S&P 500 would touch its intra-day low of 666, the Fed would continue, in various guises, its quantitative easing programs, and "some time" would become seven years to the day.

In the intervening years, the unemployment rate was halved from 10 percent to 5 percent in 2015, and the economy added 13 million jobs after losing over 8 million during the recession. Importantly, wages are finally gaining as the employment landscape improves. With jobless claims at historically low levels, and wages inching higher, the Federal Reserve's job mandate "to create an environment of sustainable economic growth" has been satisfactorily met with the tightening labor

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market. Further, the U.S. consumer has stepped up spending as personal income continues to rise along with consumer sentiment. Lower gasoline prices dipping below \$2/gallon have put more cash in consumer's pockets, helping to lift spending and consumer expectations.

With the stronger dollar, and a continuing slowdown in China, commodity prices remain weak, helping to keep inflation low. For the Federal Reserve to raise rates during the course of 2016, even gradually, as Chair Yellen stresses, inflation needs to continue rising to satisfy the Fed's inflation target of 2 percent.

OIL PRICES IN THE FED'S CALCULATIONS

But lower prices have become a symbol of muted global demand, and oil prices in particular have become the symbol of the slowdown, despite the fact that there has been an ever-increasing supply that may take a year or more to remedy. The Organization of the Petroleum Exporting Countries (OPEC) policy, as formulated by Saudi Arabia, has been to oversupply global oil markets and force prices lower in order to shut down expensive producers, particularly those in the U.S. and Canadian shale fields.

One year after announcing the policy, supply still outstrips demand, and West Texas Intermediate (WTI) crude prices have fallen from US\$76/barrel in late November 2014 to under US\$36 in December 2015.

OPEC significantly lowered projections for oil demand, projecting that \$100 barrel of oil will not return until 2040 at the earliest. According to OPEC, slower economic growth, energy efficiency, and carbon tax would affect demand.

Expectations that OPEC – Saudi Arabia, the de facto head of OPEC and its largest producer – would announce a change in policy, that is, a cut in production, remain remote, despite the toll that policy is taking on its finances. Saudi Arabia, long known for its dollar diplomacy and generous domestic welfare spending, has resorted to tapping into its rich sovereign wealth fund as well as raising funds in the global bond market. In addition to its domestic budget, the kingdom has become increasingly involved in the war in Yemen, placing additional financial pressure on the budget for 2016. With oil exports of 7 million barrels a day, 90 percent of its fiscal revenue typically came from the exports, while the profits made up 40 percent of its gross domestic product. The International Monetary Fund (IMF) recently warned that the kingdom must implement significant reforms in order to fund budgets over the next five years. Public projects are being placed on hold, and bonds are

being issued for the first time in nearly eight years. It has been estimated that if the kingdom were to maintain its domestic and international spending obligations, it needs \$121 barrel of oil.

Despite the pressure from other OPEC members who are struggling with lower prices, Saudi Arabia appears resolute in keeping prices lower for a while longer. Publicly, officials have said that they would welcome cutbacks in production, but they wouldn't act alone, and maintaining their market share is paramount.

Oil prices could certainly move higher very quickly against a backdrop of military developments in the Middle East. For example, Yemen has recently targeted Saudi oil fields and any potential disruption of supply would swiftly push up the price with the so-called "risk premium."

Stock markets have been whipsawed by oil's movements as has the high yield bond market, in which energy companies comprise nearly 20 percent of holdings. Banks with heavy exposure to the oil sector have come under pressure, while cutbacks in capital spending and personnel continue to downsize the sector. Consolidation among companies is expected to be an important theme in 2016.

At the December 16 press conference following the release of the Fed's statement, Chair Yellen underscored that the FOMC sees the strengthening U.S. dollar and weaker energy prices as transitory factors that will dissipate in the medium term. She added that if oil prices stabilize, inflationary pressures should rise, allowing the Fed to continue raising rates:

"We are not looking for them to revert back to higher levels but only to stabilize."

Conversely, she added that if oil prices and the U.S. dollar "move in persistent and significant ways that are outside our expectations, we will be ready to act. We would pursue a more accommodative policy if oil prices or the U.S. dollar aren't able to stabilize."

CHINA – THE MILLION YUAN QUESTION

China's currency devaluation in August sent already jittery markets into a tailspin, despite the official explanation that authorities wanted market forces to determine the pricing of the yuan. While the devaluation was relatively narrow, it was most likely in response to the IMF's directive that there needed to be "greater exchange rate flexibility" if the yuan were to be included in the IMF's Special Drawing Rights (SDR) basket, considered an important milestone for China after being refused the status in 2010. The IMF did approve the yuan's inclusion within the basket that includes the dollar, the euro, the British pound and the Japanese yen. For the

Chinese, though the IMF approval is highly symbolic, it does help pave the way towards its currency being treated as a global reserve currency.

Christine Lagarde, the head of the IMF, stated that the decision is an “important milestone in the integration of the Chinese economy into the global financial system. It is also recognition of the progress that the Chinese authorities have made in the past years in reforming China’s monetary and financial systems.”



More recently, and apart from the IMF, the People’s Bank of China (PBOC) has signaled that it would allow the yuan’s exchange rate to move against a different basket of currencies rather than exclusively against the dollar. This basket includes the dollar, euro, and yen along with 10 other currencies. With the dollar gaining strength over the year as currency markets anticipated the Fed’s rate move, the yuan similarly gained strength, hurting China’s export potential. According to the PBOC, allowing the yuan to be referenced against the basket would help “keep it stable at a reasonable equilibrium.”

China’s leadership has been searching for both fiscal and monetary solutions to the marked slowdown in the economy. From double-digit growth that propelled the boom in commodity prices to the single digits that have brought prices down, each plan and proposed plan has been a global market mover. The transition towards a consumer-led economy has been difficult, with analysts looking for signs of stabilization. While the economy is weaker than official figures of 7 percent growth, recent data suggest that the hard landing scenario may be avoided. The consumer is picking up spending thanks to government stimulus for the housing market and auto industry.

The Central Economic Work Conference (CEWC) highlighted “forceful” fiscal policy and “flexible” monetary policy. Although increased consumer spending is the goal, the government, fighting “strong downward pressures,” has

resorted to public projects to promote growth, including large-scale highway infrastructure projects. Two focal points from the CEWC were to increase government spending and lower financing costs. Fiscal and monetary stimulus will continue to be key themes in 2016 with important consequences for China’s trading partners, commodity markets, as well as global markets in general.

Dealing with the build-up of debt, which the McKinsey Global Institute states has grown dramatically since 2007, is going to pose another risk for authorities. According to McKinsey, China’s debt-to-GDP ratio is 240 percent. While analysts are looking for signs of bond failures, Beijing is increasingly referring to “innovative financial policies” to reduce debt. Again, how Beijing manages its debt problems will have a broad effect on markets globally.

Market turmoil following China’s August currency move clearly kept the Fed from liftoff at its September meeting. In its statement, the FOMC mentioned “Recent global economic and financial developments may restrain economic activity somewhat and are likely to put further downward pressure on inflation in the near term.” At the press conference that followed, Chair Yellen mentioned China specifically six times, and alluded to China another 10 times when she referred to “global” markets and “heightened concerns about growth in China.”

EARNINGS, MARKETS, AND THE BULL/BEAR TUG OF WAR

One of the more immediate concerns for investors is how markets will respond to a Fed projecting four rate hikes in 2016, the Presidential election, rising geopolitical tension, the sluggish macroeconomic backdrop, and forecasts for slower earnings. Should top-line revenue growth surprise to the upside, despite slowing for the last couple of quarters, it would provide a much-needed boost for investors. Clearly, this is going to

be a market with stock-specific forecasts that provide opportunity both domestically and abroad where stimulus is still being implemented. Similarly, fixed income markets will

be increasingly opportunistic. The move towards monetary normalization requires a return to fundamentals, something markets haven’t had to rely on as long as the Fed helped underpin the market with quantitative easing. Even a gradual approach to the rate cycle so lauded by Chair Yellen will be upended if the economy surprises with stronger data, particularly with regard to wages.



The bull/bear tug of war centers on those who fiercely think the economy will continue to expand, albeit modestly, and that earnings will keep pace versus those who pound the table claiming that the economy cannot remain isolated from the global slowdown and will soon succumb, bringing down 10-Year Treasury yields along with earnings and the market.

The bears fervently believe that the Fed made a mistake in raising rates and will be forced to admit it, joining the group of central banks that raised rates only to reverse course.

To be sure, this could very well be a challenging year, requiring tactical moves along the way. But any market adjustment would provide opportunity, and opportunity is the stuff of markets. 2016 will be no exception. 🌐

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