Global Asset Allocation: The case for normalization

Key themes and catalysts for 2016:

After a record rise in the dollar, 2015 saw unusually negative US data surprises that were second only to 2008. **Five and a half of the first six months saw a prolonged and sustained period of negative surprises as the lagged impacts of the record rise in the dollar combined with a second severe winter and port strikes. Following a brief period of positive surprises, the August equity market correction saw sentiment indicators fall sharply and another two months of negative surprises ensued. Macro data surprises were worse only in 2008.**

2016 should see normal data surprise cycles, with a warmer winter an upside risk. **The sharpest nine-month rise in the dollar against the major currencies was responsible directly for the sharp move down in manufacturing and indirectly through the collapse in oil prices on energy-related capex. The divergence between manufacturing and resilient services has been closely tied to the pace of dollar appreciation and should begin to anniversary out with the former catching back up to the much larger latter sector.**

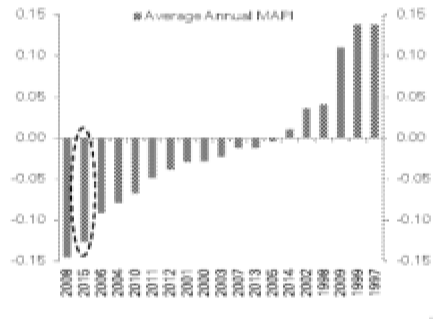
Underlying (private) US growth has been much stronger than headline GDP growth rates and it has been resilient. **Headline GDP growth in the US (2.0%) has been lowered by the shrinking government sector. With the peak in fiscal drag passed, we expect headline growth to lift towards private GDP growth (3.0%) if not higher given expenditure multipliers. The US recovery has also been resilient in the face of a variety of large shocks in recent years with, for example, the labor market remaining in its 2.4% ar recovery channel.**

Financial repression is reducing growth: rate normalization to raise incomes and lower the savings rate. **The traditional view that low rates represent stimulus focuses on the cost of household (HH) liabilities, but the asset side is much bigger (*Are Low Rates Raising The Savings Rate?*, Oct 2015). Of $100 trn of HH assets, cash alone is $10 trn and lower rates mean lower interest income of $360 bn (2% of GDP) before multipliers. Lowering the return on savings also raises the savings rate (1 pp of GDP). Corporate cash holdings are 3x short-term debt so earnings should also rise with rates, especially for the Financials.**

EM growth re-normalization is advanced: the question is whether it will be a soft or hard landing. **The multi-year outperformance of EM during 2001-2010 represented a confluence of four circumstantial factors: slack following late 1990s crises; dollar down cycle encouraged capital inflows and credit boom; dollar down cycle meant oil and commodity up cycle; interaction meant appreciating exchange rates, which checked inflation and lengthened the cycle; each factor went into reverse in 2010-2011 and looks to have a little further to run. Our baseline view has been that the EM growth spread or advantage will revert to its historical range, and we are almost there (*When Will EM Stop De-rating?*, Oct 2013). While EM growth has been slowing since the peak in 2010, the pace of deceleration slowed beginning in 2012 with the end of the European financial crisis. Our baseline view is that the pickup in developed markets growth, combined with the fact that EM FX has overshot the decline in relative growth, will see a soft landing in EM.**

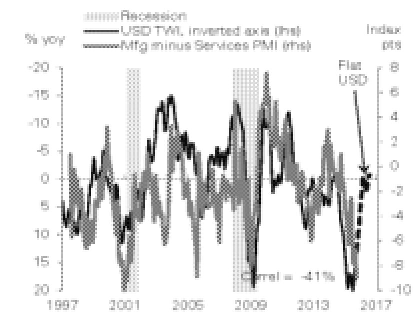
The relatively typical global economic recovery continues at trend-like global GDP growth rates. **Despite the angst and narrative of how weak global growth has been, 2015 marked the fourth year running of trend-like global GDP growth. Using market exchange rate weights, growth has actually been rising since 2012 and should move at above trend next year. Asynchronous global recoveries are typical. We view the current global recovery as being like the 1990s when asynchronization was the norm; not like the unusually synchronized 2003-07 recovery, which was the exception.**

Fig. 1: Big neg. surprises this year...



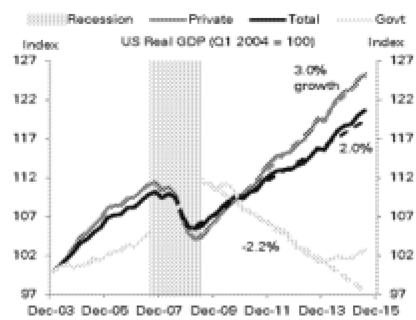
Source: Bloomberg Finance LP, Deutsche Bank Research

Fig. 2: ... reflected dollar's rise



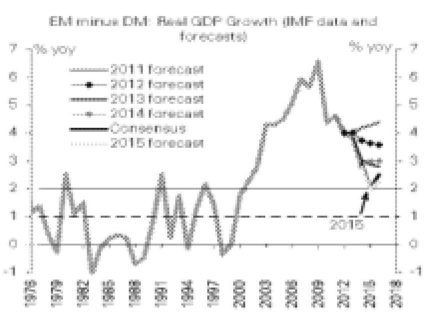
Source: Markit, Bloomberg Finance LP, Deutsche Bank Research

Fig. 3: Pvt. vs. headline growth



Source: BEA, Deutsche Bank Research

Fig. 4: EM growth normalization



Source: IMF, Deutsche Bank Research