

Risks to emerging markets

Aside from U.S. high yield, emerging markets have been especially shaken up by recent turbulence. For emerging markets as a whole, the sell-off on the back of falling oil prices does not reflect deteriorating macro-economic fundamentals. Most emerging markets are net importers of oil. The same basic logic holds as for developed markets: lower oil prices should be a net plus for net importers. The problem is that the costs of oil-price declines are immediate and concentrated for producers. The benefits to consumers and corporates occur with often long and variable delays. In terms of market sentiment, gains will probably continue to be overshadowed by troubling headlines from leading oil producers, such as Venezuela, Russia and Brazil, struggling to adjust. For Venezuela, for example, oil accounts for 91% of export earnings. Oil dominates all parts of the economy: growth, exports and fiscal accounts. In an already fragile political environment, this is causing instability. Russia too was already in recession before the most recent decline in oil prices. At current oil prices and exchange rates, its budget deficit would rise above 5% of GDP, as Elke Speidel-Walz, our Chief Economist for Emerging Markets, points out. Brazil, by contrast, is a net importer, but exposed through Petrobras. In all these places and elsewhere, it is possible to come up with plausible scenarios, in which lower oil prices could trigger political instability, leading to further knock-on effects.

The same is true in OPEC countries. Gulf producers have so far cushioned the blow by drawing down their vast holdings of foreign assets – probably contributing to financial-market volatility in the process.

Opportunities in developed-market equities

Given our overall assessment of how the fall in oil prices will impact key parts of the world economy, it should come as no surprise that we maintain our overall constructive, longer-term view for global equity markets. After a very poor start for markets in 2016, we have revised down our end-2016 forecasts for the major developed-market (DM) equity indices. The end 2016 forecast for the S&P 500 Index is now 2,080 (previously 2,170); for the STOXX Europe 600 Index it is 370 (390); for the MSCI Japan Index it is 1,000 (1,030). We keep our DM valuation forecasts unchanged, but lower our DM earnings assumptions. DM earnings growth will be affected by commodity prices, emerging markets' problems and manufacturing weakness but we still expect developed-market earnings to grow in aggregate by around 5% this year. Looking beyond the immediate future, this leaves us constructive on DM equities in the longer term. We believe that the Eurozone and Japan offer rebound potential of greater than 10% to end-2016 for investors with sufficient risk budgets. We are more pessimistic about emerging-market (EM) equities. We believe that EM aggregate earnings will fall further in 2016 and remain underweight this sub asset class.

However, recent turbulence suggests that investors will indeed need to be very tactical – and very selective. Clearly, 2016 is not proving a year for "Buy and Hold".

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