2016: Transitions, inflections and evolutions…oh my!

1. China

- Transitioning from external/export model to an internal/consumer focus
- Evolving capital market infrastructure
- Debt overhang
- Balance of payments crisis

2. Energy

- Demand remains strong…but supply is even stronger
- US has become the swing producer
- Credit markets pricing in defaults which will surely come

3. Monetary Policy

- Fed hikes in December by 25bps…remains data dependent
- The removal of QE acts as additional tightening
- Transparency/Talking heads adding noise & uncertainty…not helpful!

The New Year is off to a rocky start as investors digest falling equity markets, further declines in the price of oil, heightened concerns over China's economic stability and rising geo-political tensions. It seems safe to assume that the widely expected "January effect" on risk assets will be skipping markets this year. In our view, this recent market activity is reflective of several long-term market transitions which will be playing out across the global in 2016 and beyond. To explore this idea in more detail, let's start with China.

China is an economy in transition from an external/export focus to an internal consumption/service-focused model. In addition, the world's second largest economy is currently navigating the maturation of its financial infrastructure. This transition from central planned to market-driven will take place over several years, and will clearly not be a smooth ride. Recent missteps, including tight equity-market circuit breakers on a retail oriented bourse and a less-than-transparent plan to adjust the long-term yuan peg, have all contributed to the heightened uncertainty regarding future economic growth and the ability of China's leaders to pull off this evolution without a major short-term adjustment.

Global energy sectors are also transitioning to the new supply/demand reality of the oil markets. New countries coming online, advancing extraction technologies and the commitment of current producers to maintain market share, have all boosted the supply of oil well in excess of current demand. The ensuing dramatic drop in the price of oil has caused substantial weakness in shares of energy-related stocks, currencies of energy exporters and credit spreads on energy debt. This transition to a more-balanced supply/demand picture will also take some time, as the market heads toward maximum storage capacity and as high-cost producers shutter projects.

Last but not least, monetary policy in the U.S. is also transitioning from zero rates and extraordinary measures to higher interest rates and tighter (but not tight) policy.

Along the way, the U.S. Federal Reserve must not only find the right terminal policy rate that reflects the challenges of a potential "New Normal" economy which is characterized by slower growth and lower inflation than history would suggest, but that must also identify the right path to get there.

This transition will not only be slow to play out but will be highly dependent the data, including on steady (if not strong) economic growth and inflation finally approaching the Fed's 2% target. So what should investors do in this market environment? Sell and go to cash? Take advantage of lower prices?

Here at SEI we think the first thing investors should do is to reaffirm their goals, their time horizons and most importantly their risk tolerance. It is natural for investors to have short memories during an extended bull market, and even allow the risk in their portfolios to rise during times of muted volatility and high returns.

Consider the fact that the S&P 500 Index exhibited roughly 15% volatility, as measured by the standard deviation of daily returns during calendar year 2015. This is roughly equal to the long-term historical average volatility of the broad equity market. Even the negative start to 2016 is hardly unique for this or any bull market. In fact, since March 2009, the S&P 500 Index has experienced five independent periods with losses greater than 8%, three of which were greater than 10%. Investors uneasy with this level of volatility should revisit, and perhaps rebalance, their strategic asset allocation to ensure that their risk tolerance is accurately reflected. In addition, we believe active management can have a meaningful effect on asset class returns during periods of volatility, and would recommend a more active approach where appropriate.

The market has reacted strongly to the uncertainty surrounding many of these issues; however, we feel that this recent correction is not harbinger of an extended bear market. The level of economic activity and improving employment picture, particularly in many parts of the developed world, are simply not suggestive of recession. Valuations are slightly above long-term averages, but they are far from stretched. And central banks, including the Federal Reserve, are maintaining highly accommodative monetary policies. The market may struggle to discount the uncertainty of China's real rate of economic growth or where the bottom in oil prices may be, however we still firmly believe that a well-diversified portfolio that is accurately reflective of your risk tolerance is still the right strategy for 2016.

The Outlook: More of the Same, but With More Uncertainty

The good news

- Global economic activity continues to grind higher, with developed, commodity-consuming countries leading the way.
- Inflation continues to run well below target in most countries, encouraging pro-growth monetary and fiscal policies. Ongoing declines in commodity prices highlight the extent of excess capacity globally.
- Although China continues to face immense challenges over its debt and economic structure, we see early signs of economic stabilization owing to increased monetary and fiscal stimulus, supply-side economic reforms and a managed decline in the country's currency, the renminbi.
- We still favor international equity exposure over the U.S., long-U.S. dollar positions and a pro-cyclical orientation, although conviction levels are somewhat lower versus early 2015.
- Given our assumption that the world will avoid recession, we view recent equity-market declines as buy-on-the-dip opportunities

The bad news

- The bulk of developing countries continue to struggle as a result of weak Chinese demand, the plunge in commodity prices and generally sluggish trade flows.
- Markets have reacted poorly to the European Central Bank's policy move in early December, perceiving it as not aggressive enough. The Fed's first interest rate hike since 2006 in mid-December has contributed to market skittishness.
- China's decision to devalue the renminbi may hurt the economic competitiveness of other developing Asian nations. We could see a round of competitive devaluations within the region.
- Geopolitical concerns are looming large at the start of 2016. The increasing tension between Saudi Arabia and Iran has worsened the oil price bust because it reduces the chances of any agreement within OPEC to limit production.
- The U.K. referendum on continued membership in the European Union and the U.S. presidential campaign also may add to market volatility this year.