

2016 Outlook – “Crude Awakening”: DM consumer gain is EM producer pain

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2016 will contrast the rise of Developed Markets (DM) consumers against the demise of Emerging Markets (EM) producers, as the correction in commodity markets deepens. The view is bullish for a broad range of equity strategies targeting DM, most notably Europe. Selective value strategies with a bias towards commodity importers offer opportunities to position bullishly in EM.

Developed market economies are in much better shape today. Underpinned by structural change the Eurozone is rebalancing: growth is becoming consumer-led and starting off at an early inflection point, will accelerate economic output and solidify the recovery. Underscoring the strengthening consumer theme is a dovish Fed orchestrating a soft rising US rates cycle. It allows moderate wage pressures to feed through in a tightening labour market but not cut short sentiment in risk assets. Fiscal stimulus will reinvigorate consumer and businesses spending in Japan, with increases in the minimum wage and cuts in corporate taxes amongst the key drivers for 2016. Coupled with corporate Japan focused on raising firm value, Japanese equities receive a re-rating boost.

Emerging market economies are forced to restructure. Commodity exporter countries must cut budgets in the face of lower revenues and rising refinancing costs. Aggressive monetary stimulus measures are expected to accommodate EM producers' slow and painful unwinding of excess capacity: this as slumping commodity prices incentivise state-owned enterprises to overproduce to protect market share and safe jobs. Looming industry consolidation and debt restructuring will replace the indiscriminate hunt for yield with targeted allocations into quality plays only.

Chart 1 summarizes our 2016 outlook; resilient consumer spending on falling energy costs.

The table below and paragraphs that follow frame the macro themes around key asset classes, and the specific style and sector strategies that suggest bullish and bearish positioning.

Investors sharing this sentiment could potentially play the themes using WisdomTree Europe's range of UCITS ETFs and short and leveraged ETPs. The corresponding tickers are included in the table.

Eurozone: consumer-led recovery We are bullish European equities across the board, favouring small-caps to position around Eurozone's domestic demand led recovery and large-cap dividend payers offering superior yield relative bonds as the ECB stands pat on QE. Against expectations of more Fed tightening foreign investors seeking a broad European equity exposure should consider the downside risk

the increased monetary policy divergence poses to the euro. A hedged Eurozone equity exposure should be considered.

Dovish ECB: Euro weakness through rhetoric, not action No major change in existing monetary easing measures is expected. Following TLTROs, near zero to sub-zero policy rates and QE, all options are exhausted. What remains is rhetoric, which Draghi will reduce to “all options remain on the table”, in an attempt to talk down the euro. Suggestions by the Fed to delay rate hike expectations will likely be countered by dovish talk from Draghi. Until 2017, the euro will remain fundamentally and artificially weak. Foreign investors seeking exposure to Europe should consider hedging their foreign exchange risk.

UK - Brexit and BoE tightening fears overshadow resilient consumer Lower energy prices, a tightening labour market and climbing wages will remain UK's key drivers for spur consumer-led in 2016. The real threat in 2016 is the upcoming EU referendum with political uncertainty surrounding a possible 'Brexit' seen as undermining sentiment in sterling safe havens. UK Gilts are also subjected to risks of the BoE looking to prepare to tighten monetary policy as the housing market remains robust and consumer credit is in danger of overheating. At this point in the commodity cycle, UK high dividend yielders offer value opportunities that relative to Gilts offers a historic high premium.

US: Consumer resilient to rising rates The stance on more tightening by the Fed is seen perceived as soft in terms of costs to consumers, which the slump in commodities, most notably in energy prices, overwhelmingly offsets such fears. Discretionary spending is seen as being encouraged. We are selectively bullish on US equities, favouring small-cap strategies over large-cap strategies to play the strength of US consumers, even exports and reduced capex spend will slow down US economic momentum. Large-caps' are prone to a weakening profit outlook as higher interest rates fundamentally supports a stronger dollar. Until wage rises accelerate and feed higher inflation expectations, the US yield curve is expected to flatten. It moderates our bearish view on longer dated US Treasuries for H1 2016, potentially offering opportunities to short.

Japan: re-rating of Japanese equities – structural reforms by the government, Abenomics' 3rd arrow, coupled with active encouragement of policymakers for improved corporate governance spurs corporate Japan into raising firm value. Corporate Japan's increasingly willing to re-leverage and invest, as well as reverse cash-hoarding to offering dividend policies that offer competitive alternatives to JGBs is laying the foundation for developing the equity ownership culture. Japanese institutional investors serving households will rebalance their portfolios away from money markets and fixed income and into equities. The re-rating of Japanese equities in 2016 continues.

EM: more monetary stimulus and painful restructuring Slumping commodity prices mean inflation-adjusted interest rates for commodity exporters are too high, and more monetary easing is expected to help unwind overcapacity. China will allow a controlled weakening of the yuan, in addition to further policy rate cuts. More corporate downsizing, debt restructuring and defensive M&A is expected in 2016. SOEs are expected to benefit from government support, while wholly private-owned and small business will focus on cost cutting, divestitures, debt restructuring and consolidation. *All data is sourced from WisdomTree Europe and Bloomberg, unless otherwise stated.*

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