China and oil: the key issues for 2016?

David Hillier of Insight Investment explains the role China and oil can play in the investment market over the year ahead

It has been a challenging start to the year. Equity markets have fallen substantially, market volatility has risen, and the oil price has continued to decline. Pessimism abounds and uncertainty reigns. Against this backdrop, it is helpful to identify the key issues driving markets. Today, it looks like China and oil will play a big role over the year ahead.

A number of questions loom over markets. On the monetary policy front, US rates have been raised for the first time since 2006. With inflation low and global growth only moderate – partly because of the Chinese slowdown – it is unclear whether it was the right time to start hiking rates. It is also unclear whether US rates will rise as slowly as markets expect, or if they will rise slightly faster, as the Federal Reserve expects.

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Events in China will answer these questions, at least partly. Chinese GDP growth has slowed to a 25-year low of 6.9 per cent. This has had a marked impact on global trade, commodity prices and production: data suggests that US manufacturing growth has dropped to its lowest level since 2009, and a similar pattern has emerged across other developed and emerging economies, highlighting the strength of the Chinese growth transmission mechanism.

China's decision to manage the renminbi against a basket of currencies, as opposed to just the US dollar, has not helped. It seems the boost to activity that some emerging economies gained from weakening their exchange rates will start to unwind. That means they will come under pressure this year as they face both the impact of a weaker yuan and higher US rates.

A supplementary question is whether there has actually been a sharper slowdown in China that would justify the recent commodity price weakness. This has yet to be resolved, so will occupy market minds for some time to come. The commodity price decline is affecting emerging market suppliers, and this looks likely to continue for now, or until there is more clarity on what is happening in China.

This brings us to the oil price. The European Central Bank's recent quantitative easing decision was influenced by the fear that low headline inflation would lead to a deflationary spiral. Similar concerns have been expressed elsewhere. However, these should diminish as last year's oil price falls start to drop out of inflation numbers. Whether one considers headline or core inflation figures, it seems markets will have to deal with rising inflation – something that has not happened for quite some time.

That could change if the price of oil continues to fall. The big question here is whether Saudi supply will be constrained, and what impact Iranian production will have now that sanctions have been lifted. Along with the impact on inflation, the impact on economic growth would be significant. A lower oil price would further harm oil producers, but it would support economic growth elsewhere, particularly oil importers such as China and India.

In terms of economic growth, it looks like being a year of moderate growth in the key developed markets. US rates should rise further, but only gradually, and policy should be unchanged throughout the year in the eurozone. For emerging markets, conditions are likely to be difficult in the first half of the year as concerns over the slowdown in China linger and commodity prices stay weak as a result. Higher US rates may prompt an outflow of assets, and the benefits of competitive exchange rate devaluations look set to unwind.

We expect risk assets to be sensitive to economic data, which will be driven in large part by China; and the oil price will no doubt drive investor sentiment globally. It seems certain that it will not be an easy year for investors. Strategies with the flexibility to range across asset classes and dynamically manage risk will be better placed than long-only managers who would be buffeted by increased volatility.

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