Prospects 2016

Six Risks / Six Opportunities

Oxford Analytica Client Conference Call Summary— 12 January, 2016

Introductory remarks

In 2016, Oxford Analytica considers business and market-based risks will be secondary to political and policy-driven risks. Therefore, this conference will cover a broad range of geographies, sectors and topics. Within each one, our Analysis team will highlight three key risks and three key opportunities for the year ahead.

Graphic analysis: Key risks and opportunities in 2016: 1

https://dailybrief.oxan.com/Analysis/GA207535/Key-risks-and-opportunities-in-2016-1

Graphic analysis: Key risks and opportunities in 2016: 2

https://dailybrief.oxan.com/Analysis/GA207536/Key-risks-and-opportunities-in-2016-2

Middle East, Alison Baily

In the first couple of weeks of 2016, several key risks and opportunities for this region have already been brought to international attention. Many of these are concentrated around the escalation between Iran and Saudi Arabia. The execution of a prominent Shia cleric in Saudi Arabia and the storming of the Saudi embassy is Iran have drawn attention to such risks.

There have been media concerns regarding the potential of direct conflict between the two countries. However this is unlikely to occur. Neither country is likely to act in a way that would potentially shut off the Strait of Hormuz, which would compromise their ability to export oil.

Instead, we will witness increasing volatility in key proxy theatres in the region, meaning that there will be more conflict in Yemen and Syria and the undermining of already slow-moving international efforts to try to resolve these conflicts as the two countries demonstrate reluctance in cooperating with each other.

The year will likely bring increased radicalisation, further refugee outflows from Syria, and the ensuing ripple effects of this on fragile neighbouring economies, in particular for Jordan, Lebanon, and the Kurdish regions of Iraq.

On the opportunity side, investors should look to Iran. The lifting of sanctions open up the economy, and there is strong progress on the nuclear deal in the country. The potential of the Iranian economy has long been discussed, and the government is eager to attract foreign direct investment and expertise, especially into its oil and gas sector. Other potentially lucrative areas of the Iranian economy include the automotive industry, construction, and aviation.

Looking to the Gulf States, whilst we are expecting to see cutbacks in spending due to reduced oil revenues, overall planned construction projects are going ahead and so this sector of the economy will not be hit as hard as some predict.

Recently, we have seen new proposals for privatisation of certain state-owned enterprises in Saudi Arabia, most notably the prospect of sections of state-owned oil company Aramco being put up for sale. We are also likely to see initiatives to privatise sections of the healthcare and education sectors, which will form investment opportunities.

Finally, oil production and oil exports in Iraq are set to increase further this year, and will be insulated from the ongoing conflicts further north in the country.

Graphic analysis: Political risks dampen Middle East investment outlook

https://dailybrief.oxan.com/Analysis/GA206244/Political-risks-dampen-Middle-East-investment-outlook

West Europe, Brigid Fowler

Migration flows and populations continue to be found across all areas of the globe; those in Europe comprise a tiny proportion.

Migration flows out of Syria and East Africa are unlikely to stop anytime soon, because of the nature of the conflicts and economic environments in those regions. The risks and opportunities for Europe will depend on the scale and duration of these flows, and where migrant populations settle.

One of the main risks of ongoing migratory flows will be to the Schengen system of borderless travel. Several Schengen member states have already reimposed border controls, which can be extended if a case can be made for 'exceptional circumstances'. These restrictions will impede cross-border flows of goods, services and people. The longer such restrictions persist, the more companies and individuals will assume that there will be no return to the status quo ante.

The second group of risks concerns a more securitised and less open European society and politics. This involves the rising influence of anti-immigrant parties over policy, increased risk of terrorist attacks, intensified social divisions, and restrictions on civil liberties on security grounds.

Finally, Europe risks compromising its international image. It has already been subject to significant international criticism for its response to the refugee and migrant influx thus far. The way in which Europe manages the challenge in 2016 will be scrutinised around the world, especially in sending regions and political allies like the US.

Europe will be compromised politically and economically if it comes to be seen as a bulwark of anti-Muslim sentiment, and the EU's foreign policy objectives would be especially compromised in the Middle East and Africa.

However, the migrant flows into Europe also present opportunities. There will be an increase in public spending associated with the arrival of these peoples, creating opportunities for firms providing relevant goods and services.

In the longer term, the influx could offer a demographic boon. While the numbers involved are not sufficient to compensate for Europe's long-term demographic decline, and there are grave doubts about whether these populations will be quickly integrated into labour markets, they could contribute positively to the European economy in the future.

Finally, if well-managed, the presence of such populations would provide cultural and economic opportunities for Europe arising from strengthened links with sending countries.

Graphic analysis: Anti-immigration parties to shape policy and politics

https://dailybrief.oxan.com/Analysis/GA205958/Anti-immigration-parties-to-shape-policy-and-politics

Turkey, Mike Taylor

Turkey has the opportunity of improving relations with the EU in 2016. If Turkey can noticeably reduce migration flows from Turkey across the Aegean, the EU will pay substantial amounts in return, and the collaboration would bolster mutual confidence.

There is a possibility of Turkey becoming very useful to the EU regarding energy supply. The EU is looking to diversify sources of oil and gas away from Russia, and the Middle East provides an alternative. Turkey is, therefore, well-placed geographically to form an energy hub for Europe, although this depends on origin countries.

A further opportunity arises from the possibility of a peace deal over Cyprus. The recent election of a Turkish-Cypriot leader, who appears to be less subject to Ankara's central control than his predecessors, has vocalised his willingness to compromise with Nicosia.

If so, it could pave the way for the large reserves of gas under the sea in the eastern Mediterranean to be exploited. This gas could be piped via Turkey from Cyprus. However, this is contingent on a peace deal between Greek- and Turkish-owned sides of the island.

Finally, Turkish growth presents an opportunity. Turkey has a strong internal market and can survive fairly well on domestic demand. The Turkish government's projection of 4.5% growth for 2016 seems excessive due to the number of unknowns, but there are lots of investment and construction projects underway.

Risks faced by Turkey involve internal security and regional instability, as demonstrated by the the bomb attack in Sultanahmet district in Istanbul this morning. The attack targeted a tourist area and resulted in the death of nine German tourists, who were probably deliberately targeted. This has implications for the Turkish tourism industry.

Secondly, Erdogan's determination to increase his Presidential powers implies an increased risk of authoritarianism. This is bad news for those hoping for an improved business climate based on tackling corruption and improving judicial performance.

Finally, the US Fed's interest-rate hike poses a risk of capital outflows. Turkey has benefited in the past few years from low interest rates in the United States, attracting inflows of short-term capital seeking a bigger return. This could well reverse, which would negatively impact the balance of payments. Turkey has endured falling oil prices fairly well, but a fall in the lira as well means that it has not benefited as much as it ought to have as a net oil importer.

Russia, John McLeod

Foreign policy will play a large role among the concerns of investors in Russia this year, given the effects on the domestic economy.

There is little possibility that the situation in eastern Ukraine will be resolved, since Russia lacks the will to observe the Minsk agreements in full. Moscow sees issues like Ukrainian constitutional reform and physical control of the border as issues it can play on rather than seek swift solutions. This could mean that sanctions on Russia will remain for some time.

In Syria, Russia is seen as a partner in the war on Islamic State group, but there are dangers. By accident or by over-reaching itself, Russia could aggravate the conflict and worsen relations the West. It is involving itself in a complicated regional dispute where it is seen as partisan and siding with Iran.

The management of the Russian economy poses a further risk. We are likely to witness stagnation or a shallow recession this year. The need to manage ongoing foreign policy objectives will distract from the need for structural reforms, so the economy will continue to be dominated by quasi-state entities with little competition.

Finally, the drain on reserves is a risk. Russian financial reserves are split between the Reserve Fund and the Welfare Fund. The Central Bank is voicing concerns that the Reserve Fund could be reduced to one-third of its present size at the end of 2016. The economic outlook is generally gloomy.

One positive factor is that Russia has refrained from using gas exports as political leverage, as has happened in the past. This is incentivised by its need for continued revenue.

The government is also aware that it needs to maintain social stability ahead of a parliamentary election in September. Recently-announced spending cuts of around 10% exempt public-sector and army pay and pensions.

The government will probably need to revise the budget more comprehensively in the future, but it will be aware of the need to avoid angering a populating already hard-hit by sanctions on food and other imports.

Finally, unemployment remains at a low level. This is mostly due to demographic factors given Russia's ageing population. At the lower skilled end of the market, there has been some shedding of labourers, but often of foreign nationals, in particular migrant labourers from Central Asia.

Graphic analysis: Putin will face numerous challenges in 2016

https://dailybrief.oxan.com/Analysis/GA206728/Putin-will-face-numerous-challenges-in-2016

Oil prices and the commodity market, Vanessa Rossi

We are at risk of seeing more examples of what has happened in Venezuela, that is to say witnessing more economies more or less in a state of collapse. Smaller oil-exporting economies, in particular, are vulnerable to severe disruption through exchange rates, financial flows, and budget squeezes, meaning that domestic economies will be hard-hit.

In the long-term, larger economies such as Russia will be affected too, particularly by problems relating to difficulties in attracting short-term investment, which will lead to prolonged supply shortages in the future. In the short-term, larger economies tend to have larger financial bases to tide them over and compensate for the lack of external investment, which is why smaller economies are more vulnerable. Venezuela deteriorated over a period of some years, and we could see similar trends occurring over a shorter time frame for other economies.

Secondly, we have already seen a much sharper fall in oil prices than was predicted. The fall was enhanced by the mild European winter, among other factors, which weakened demand. Prices may dip into the 20-30 dollars/barrel range in the short-run.

It is equally plausible that we start to see some rebound, but the current weakness of the economy and markets mean that a higher price is unlikely to be sustainable, where there are lots of factors to deflate prices.

Thirdly, internal security costs and welfare budget cuts caused by internal warfare problems mean that oil-producing countries are being forced into providing high levels of exports even while prices are low to keep revenues flowing. If one country suddenly changes tack and stops supplying, for example by limiting other budgetary costs, there is a risk of a sharp upwards price spike. Although this would not last long, it would be disruptive and lead to heavy volatility in oil prices.

In terms of opportunities, governments could use the low prices to end fuel subsidies. Fuel subsidies are an inefficient method of providing welfare support and phasing them out would not produce immediate budgetary benefits, but in the long term would be a boon.

Secondly, low energy prices could lead to more investment in gas and other more environmentally friendly options that coal.

Finally, economic diversification is likely to occur in oil-exporting countries to counter the effects of dependence on this sector of the economy. The benefits of this will be slow, but will manifest.

Graphic analysis: Cheap oil risks long-term Middle East stability

https://dailybrief.oxan.com/Analysis/GA205401/Cheap-oil-risks-long-term-Middle-East-stability

Monetary policy, Vanessa Rossi

Monetary policy faces the risk of the US Fed mishandling of a series of policy rate rises. While the Fed is expected to handle this smoothly, this is not a certainty.

Secondly, China faces a more difficult task in controlling its monetary policy than it did in the late 1990s, which saw a similar global crisis. It is unclear how low China is hoping to take its exchange rate. China has even intervened on its offshore renminbi exchange rate and there is a great deal of uncertainty over what all these signals mean.

Similar uncertainty is directed towards Chinese stock market adjustments. Moreover, the global economy is currently dependent on central bankers to make the appropriate policy decisions, but we may be reaching the limits of what we can get from economy policy.

Regarding opportunities, low inflation means there is potential for still low bond yields. Despite the Fed rate hike, it may be that bonds yields stay low. Less turbulence in the bond markets would mean less turbulence in other financial markets.

Another positive point: ECB President Mario Draghi expressed a desire for a further expansion in quantitative easing. The extension unveiled in December was disappointing, but it is possible that in a slightly different financial environment this year, as things improve in US bond markets, this could be used to give an extra boost to the euro-area recovery, and would also help increase exports, pushing down the euro.

Finally, it may be that fears of damage to economic growth have been excessive. Equity markets may have overreacted, which would mean that there is scope on the upside.

Graphic analysis: Global monetary policy divergence will be key in 2016

https://dailybrief.oxan.com/Analysis/GA207494/Global-monetary-policy-divergence-will-be-key-in-2016

China, Benjamin Charlton

In China, maritime security poses a risk. There is brittle stability in the East and South China Seas. Thus far, there has been no loss of life or serious armed incident, but both are a possibility.

Recently, such events as Chinese aircraft landing on China's artificial islands, US commitment to more 'freedom of navigation' patrols near Chinese islands, and greater Japanese defence force involvement in the East China Sea dispute are all risk factors. The last three years have shown us that things can flare up quickly.

Another risk is the impact of the economic slowdown on domestic politics. Incidents of labour protests and other manifestations of labour activism have been dealt with by crackdowns on NGOs that act as de facto unions and channel workers' grievances. It is uncertain how these disputes will be managed once these NGOs are shut down. Large-scale layoffs this year may pose the greatest test for the public security apparatus since the late 1990s.

A related risk is if the effects of an economic slowdown start to spread to the Chinese middle class. So far they have been insulated. If they start to experience job losses on a large scale, they are a much more difficult constituency to control than the working class, who has borne the brunt of the slowdown so far, because they cannot be easily re-employed on state-funded construction projects.

Thirdly, elite politics poses a risk if President Xi Jinping goes too far in his purges and power-grabs. His anti-corruption campaign no longer appears to be a campaign, but has become the new status quo. He aims to tackle corruption as a public grievance, but also eliminate challenges to his power.

His actions over former President Jiang Zemin will be a significant test. If Xi moves against Jiang, he removes the last serious obstacle to conducting his political agenda as he wishes. However, a former President has never been prosecuted, and Xi could set a precedent which could leave him vulnerable to prosecution once he retires, creating a disincentive to leave office.

In terms of opportunities, consumer power in China remains high among the middle class. Premium high-quality goods imports remain strong. There is a possibility that there will be quality scares over domestic manufactured goods because of corner-cutting prompted by the slowdown, which might boost imports demand further.

The second opportunity is demand for capital goods: China still needs to automate, and if it is to escape the middle-income trap it needs more sophisticated equipment and related services.

Thirdly, there is an opportunity to receive Chinese overseas investment. China's One Belt One Road programme is firmly under way. Since there is no sign of huge infrastructure stimulus at home, over-capacity will be directed abroad.

Graphic analysis: Ambitious plans set China's course to 2049

https://dailybrief.oxan.com/Analysis/GA207337/Ambitious-plans-set-Chinas-course-to-2049

India, Megha Kumar

Prime Minister Modi came into power in mid-2014 promising a raft of liberal reforms, including a revision of the Land law that was passed by the Congress in 2013, and the implementation of a goods and services tax (GST) bill. Sixteen months on, neither bill has been passed.

The GST bill requires a constitutional amendment, which procedurally requires two-thirds approval from both Houses of Parliament, and approval by half of India's 29 states; the Land bill revision also requires approval from both Houses.

At present, the ruling BJP-led alliance governs 13 states and holds a clear majority in the Lower House. The main opposition party, the Congress, rules 19 states, and governs the Upper House. This points to more of the same legislative parliamentary gridlock which has stalled these bills.

Neither bill has promising prospects this year. Last year, Modi tried to revise the Land bill by deciding to implement some revisions through a land ordinance, but land ordinances expire after 90 days if not ratified by Parliament. He is unlikely to try this again, partly due to the widespread protests the ordinance sparked last time, and partly with one eye to the five upcoming state elections in 2016. Land reform is a contentious political issue.

The GST bill's prospects are more mixed. Modi is attempting to bring the Congress on board – the bill was originally a Congress policy - but political wrangling continues to hold the bill back. The bill may be tabled in the Monsoon session of Parliament in March, but any final outcome will be much diluted.

Overall, the BJP will act according to the state election results of the next six to eight months. Of the five due, four are especially important, but the BJP is unlikely to do well in any. Its greatest hope of success is in Assam. However if it wins there, it would be as part of a coalition with its allies. This means that the constitution of the Upper House will not change significantly in 2016 or 2017.

However, there are many other reforms that can be pushed through which do not require parliamentary consent or the consent of state legislative assemblies, such as divestment of state-owned enterprises, the easing of restrictions on foreign direct investment, and a host of tax cuts for investors.

To see the opportunities India offers, investors need to map the sub-national level much more diligently. Several states have used indirect tax as a lever of industrial policy. Some states have introduced labour reforms because reforms at the centre are stuck.

The centre is likely to create opportunities in line with states. India will be a fast-growing economy, and is likely to touch 7% growth this financial year and probably in the next. It requires investment in manufacturing and infrastructure, and will welcome foreign investment.

Graphic analysis: India faces complex route to reforms in 2016

https://dailybrief.oxan.com/Analysis/GA207095/India-faces-complex-route-to-reforms-in-2016

Brazil, Jill Hedges

Brazil's GDP contracted by approximately 3.7% in 2015, and is forecasted for a further 3% contraction this year. A recovery of less than 1% growth is forecast in 2017. Brazil's economy is still largely a closed one, dependent on demand and corporate spending, as well as its state-owned enterprises such as Petrobras.

The Petrobras scandal is becoming increasingly complex in terms of the resulting political fall-out and the money involved, meaning that Petrobras cannot take a leading role in sustaining the economy. The involvement of most major construction companies in the Petrobras scandal also means that investment in infrastructure will be constrained in the near-term.

Commodity prices will also continue to struggle. Iron ore accounts for about half of Brazil's mineral exports, so continued low prices, and the slump in Chinese demand for goods, mean more bad news for 2016.

The perception that attempts to impeach President Dilma Rousseff represent 'playing politics' indicates a widespread disillusionment with the political system overall. All parties are seen as being corrupt. It is rumoured that the president of Brazil's lower house put into motion the impeachment proceedings to deflect attention from his own corruption allegations.

The government has no chance of instituting reforms leading to greater austerity because of its unpopularity. Austerity makes little economic sense anyway, because there is very little stimulus for the economic outside the public sector.

In terms of opportunities, prospects are dim, but the impeachment process will probably be unsuccessful and Rousseff will probably remain in office. If she emerges strengthened from this scandal, she is more likely to gain support from her own party to institute fiscal reform.

In the short-term, fiscal reform would deepen the recession, but in the long term would increase investor confidence.

The victors of the 2018 elections will inherit the current situation, so while there is current political instability, if impeachment is blocked, the government might become more cohesive as politicians rally together to tackle the economy.

Graphic analysis: Low approval can hobble Latin American presidents

https://dailybrief.oxan.com/Analysis/GA205502/Low-approval-can-hobble-Latin-American-presidents

Africa, William Attwell

Low commodity prices continue to pose the biggest risk for African countries. Mineral exports other than oil are also being affected, for example copper in Zambia and the DRC, and gold in Ghana and platinum in South Africa. There are public financial implications for this, in particular debt distress in states that have borrowed heavily on external markets in recent years.

Continued low global commodity prices will have implications for the development models of these economies in 2016. They have thus far focused on commodity revenue-funded projects and fiscal expansion to build up investor excitement over prospects for sectors such as consumer spending in many African economies, and well as for infrastructure development.

However, this model is starting to falter. Infrastructure projects are being stalled, for example Nigeria's railway projects, ports in East Africa, and the oil pipeline linking Uganda with the East African coast.

Against this economic backdrop, Africa faces a number of political transitions. 2016 will see general elections in Congo-Brazzaville, Zambia, and Benin, as well as political party transitions.

In Angola, the continent's second-largest oil producer, the ruling party is considering what a transition would look like should 72-year-old President Dos Santos, who has been in power since 1979, step down.

Mugabe in Zimbabwe is also an aged president. While he has made no public statements about stepping down, factions within his ruling party are also starting to consider a transition plan.

Factions within Zuma's ruling party in South Africa appear to consider him a political liability, and may promote replacements.

Moreover, there are continuing constitutional and political transitional discussions on the continent, such as negotiations over the constitutional status of Zanzibar in Tanzania, Somalia's ongoing federal process, and the contestation for state resources in South Sudan.

Risks also include the rise of Islamist politics in West Africa, in particular Boko Haram's movements in north-east Nigeria and surrounding countries. Chad has struggled to see off potential threat from insurgents. Gambia is emerging as a conservative Islamic state, and the dispersal of Boko Haram supporters has led to terrorism over a wide geographical area.

Furthermore, the recent conflict in Burundi is threatening to reignite a Great Lakes regional crisis, as tensions between Hutu and Tutsi once again threaten to boil over.

However, resource extraction states form a possible economic opportunity. There is also scope for consulting firms to help governments manage the commodity downturn.

Graphic Analysis: High-risk Africa elections portend volatility in 2016

https://dailybrief.oxan.com/Analysis/GA207844/High-risk-Africa-elections-portend-volatility-in-2016

'Brexit', Brigid Fowler

There are risks inherent in the UK's decision to hold an EU membership referendum, and subsequent risks and opportunities dependent on its outcome.

The referendum will probably be held in September of this year, although it could happen as early as late June. The most probable outcome will be a relatively narrow victory for the 'In' campaign.

There are risks involved even in the event of an 'In' result, as the holding of the referendum will have lasting implications for the UK's international standing: many of the country's political allies cannot understand why it would even contemplate leaving the EU.

Other risks pertain to the renegotiated membership that Prime Minister David Cameron might secure in coming weeks. Cameron's handling of the referendum has been governed as much by his desire to get a significant 'In' vote, as winning at all.

The short-term risk within the UK is that the Conservative Party becomes ungovernable if prominent figures have backed an exit, or a large share of the party has.

There is also a longer-term risk that this issue will not be settled by just one referendum, and further negotiations and referendums will ensue.

Within the EU, the short-term risk is that renegotiating membership for the UK will divert resources, and the longer-term risk arises from the implications of the precedent which has been set that a member state can threaten to leave as a negotiating tactic.

Rather than opportunities arising from an 'In' vote, we should consider them more as risks averted or mitigated. This applies to the disconnect between the electorate and the political elite.

An 'in' result will also put to rest one – but only one -- of the reasons that Scotland might leave the UK. It would also represent a badly needed vote of confidence in the EU. However, the bloc would continue to face plenty of challenges.

Graphic analysis: Cameron likely to seek EU membership poll in 2016

https://dailybrief.oxan.com/Analysis/GA203298/Cameron-likely-to-seek-EU-membership-poll-in-2016

Cyber-security, Katerina Fytatzi

Data privacy considerations will continue to dominate cyber-security policies in the coming year.

EU privacy rules will be going through the formal approval process in 2016, keeping up tensions between the EU and US requests for foreign nationals' data, including that of Europeans.

Data will also be a main target for cyber-crime. 2015 was a year of several high-profile data breaches, including Talktalk, Ashley Madison, and Wetherspoons. It is possible that this year will see even more substantial breaches.

A third risk comes from the fact that cyber-crime is likely to diversify with the proliferation of electronic devices, and will present companies with a further challenge to secure these new technologies.

There are several opportunities that arise from data protection. First, the targeting of personal data will lead to greater demand for encryption.

Privacy concerns will also bolster the development of EU-based cloud facilities, especially as EU users seek to avoid the risks inherent in US-based data storage.

Lastly, greater awareness of threats online will increase demand for cyber security both from companies and from consumers, driving investment in the sector.