

# Schroders TalkingEconomics



## 2014 review and themes for 2015

January 2015

In this month's Economic Viewpoint, Keith Wade, Chief Economist & Strategist, Azad Zangana, Senior Economist and Craig Botham, Emerging Markets Economist give their views on:

In summary:



- Geopolitical risk returned in 2014, having a significant impact on markets. Central banks were busy going in opposite directions and contributed to volatility. Oil prices dominated the end of the year, plunging Russia into crisis, but leaving some upside risks for 2015.
- Investors saw good returns from both government bonds and equities. Shrinking flows of government debt instruments may have helped lower yields against a backdrop of growing liquidity. In equities, only the US index outperformed in US dollar terms.
- The latest fall in oil prices moves the cost of energy well below

the assumptions we used just a month ago. Overall the clear implication is that growth will be stronger and inflation lower.

- Some might term this a 'disinflationary boom' and that is our first theme for 2015. The three other themes are: the 'desynchronised cycle', where the US continues to lead the world economy; 'Japan: winning the currency war', where Japanese firms use the latest move in the JPY to gain market share; 'Back to the 1990s' whereby the Federal Reserve is distracted by external events, keeps policy too loose and fuels a domestic bubble.

### Geopolitical risk and USD dominate

2014 will probably be remembered for the rise in geopolitical risk more than the performance of markets. Sharp sudden falls in emerging market currencies were a theme for the year. In Ukraine, unrest developed into a civil war and Russia annexed Crimea. Another source of political risk came in the form of ISIS in Iraq/Syria. The fall in oil prices may go down as the single most important development of 2014. Accommodative supply faced with weaker demand pushed oil prices some 42% lower over the year.

Central bank actions were very mixed. New Federal Reserve (Fed) Chair Janet Yellen brought an end to the Fed's quantitative easing (QE) programme and signalled monetary tightening in 2015, all without significant market volatility. Meanwhile, the European Central Bank (ECB) loosened monetary policy and is ending the year by seriously considering whether to start buying sovereign debt in early 2015. The Bank of Japan (BoJ) surprised most economists and investors in October by increasing its target of asset purchases to 80 trillion yen per year.

Relative monetary policy stances drove currency divergence. The outperformance of the US economy and end of QE purchases helped drive the US dollar up against its main trading partners (+11.8%). The euro effective exchange rate depreciated, but more aggressive monetary stimulus in other countries meant that the depreciation was relatively small. One of those more aggressive countries was Japan, which saw the BoJ's increased quantitative and qualitative easing (QQE) programme help trade weighted Japanese yen fall 7.4% over the year. Government bonds were the best performers, but equities were close behind. Demand and supply dynamics were a key factor behind US Treasury moves, especially with supply limited by Fed purchases. For US dollar investors, the only major equity market worth investing in was the S&P500.

### Lessons from 2014



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We have identified some lessons from 2014 worth considering for the year ahead. Firstly, not only can geopolitics act as a major downside risk to individual markets, but it can quickly spread to hurt global sentiment towards risk assets. The year also reminded us that positives from geopolitical risk exist, with gains seen in India after the election.

Secondly, government bonds are not immune to the laws of demand and supply. While government bond yields often reflect general risk appetite, 2014 showed that like any other asset, when supply is restricted and demand is plentiful, the price will rise (and yields fall). Global liquidity has been an important factor, and may continue to be so next year.

After starting the year with lofty earnings expectations, European equities significantly underperformed amid a lack of growth and fears over deflation. European equities still appear on the expensive side, so have markets learned their lesson?

In emerging markets, the Fragile 5 are still fragile. A lack of reforms left those reliant on overseas capital exposed in 2014. As the Fed tightens monetary policy, beware of this group. Once again, the majority of policymakers have shown they are not afraid to waste a good crisis. India was the exception in 2014 rather than the rule. Meanwhile, investors have learnt that not only is slower growth possible in China, but the government may be powerless to do more than cushion the fall. A soft landing still looks the most likely outcome.

Finally, oil prices can fall without a crisis. Unlike 2008, the fall in oil prices has not been caused by fears of a global recession. Relatively small falls in demand and increases in supply have led to the dramatic fall in prices.

## Lower oil prices: good or bad for the world economy?

Since we put together our baseline forecast, the oil price has fallen considerably, such that Brent crude is now some \$20/barrel below its starting point in mid November. The gap narrows to \$17/barrel two years out, but is still considerable and based on our models would imply a further boost to global growth of around 0.5% and a reduction in inflation in 2015 of about 1%. Lower oil and energy costs act like a tax cut to consumers who are likely to accelerate spending.

Financial market reaction suggests that the outcome will not be so favourable, with equity markets and bond yields both declining in a clear warning that the world is headed in a more deflationary direction. One market concern is that lower oil prices reflect lower demand in 2015. Another debate is whether the benefit to consumers will be outweighed as the energy industry slashes capital expenditure. In addition there is increased country risk as oil states such as Russia, Nigeria and Venezuela find they have to cut expenditure. Nonetheless, the benefits to consumer spending and business through lower energy costs are set to outweigh these factors in our view.

## Four themes for 2015

### Disinflationary boom

At this stage we are not revising up our growth forecasts but are giving a clear indication of the direction of travel: higher growth and lower inflation. On the basis that oil prices stabilise, the effect on inflation will be temporary. Given the prospect of our forecasts for growth having to be revised up and inflation down in coming months, the world economy would look like it is enjoying a disinflationary boom. It is possible that global growth hits 3.3% in 2015, the best since 2011. Although low inflation might give central banks pause on policy rates, longer yields may rise, particularly if unemployment falls more rapidly as growth strengthens. Equities should benefit from stronger earnings but look for a rotation in markets away from the bond proxy companies, who focus on pay-outs, toward cyclicals (i.e. stocks that are sensitive to changes in the overall economy).

### Desynchronised cycle

This theme has been running for much of 2014 with the US leading the global upswing and the Fed poised to be the first of the major central banks to raise interest rates. The macro question is whether one economy can break away when the rest of the world is still treading water? The answer is still yes in our view. The external sector is relatively small as a share of US GDP and the recovery has been led by stronger domestic demand. This theme suggests a continuation of a stronger US dollar, weaker commodity prices and weaker emerging market equities. The implications for bonds are harder to gauge. Certainly the short end of the US yield curve<sup>1</sup> does not seem priced for the Fed tightening profile we expect. However, Treasury supply has slowed and the search for yield remains strong outside the US. This suggests a flatter yield curve in 2015, with yields on short-dated bonds rising by more than long-dated bonds.

### Japan: winning the currency war

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<sup>1</sup> The yield curve is a curve showing yields or interest rates across different contract lengths or bond maturities. The short end of the curve refers to securities with shorter-dated maturities.

If Abenomics has achieved anything it is a weaker yen. Thus far, Japanese exporters have used the fall in the yen to increase their profit margins and have kept their foreign prices stable. Higher profits have boosted the Japanese equity market but the downside has been that export volumes have not responded. This should now change: Japanese exporters may well cut their prices to gain market share. This would help boost exports, thus reinforcing the recovery in the economy. This should see Japan reversing the long term decline in its share of global trade. The downside to this theme would be felt by competitors of Japanese companies who would lose market share.

### **Back to the 1990s**

We have described the attraction of the US dollar above. An important element of this is the divergence of monetary policy. Alongside this the US is also an attractive destination for real investment in terms of foreign direct investment and equity portfolios. In the late 1990s we saw the US dollar strengthening alongside equity markets as international investors poured money into US tech stocks. The result was the tech bubble. One factor which fuelled this was the loose monetary policy of Alan Greenspan's Fed.

Back in 1998 the Fed cut rates following the Russia default. Although the domestic economy was robust at the time the Greenspan Fed allowed itself to be distracted by external events. The same could happen again today with Russia looking increasingly precarious as oil prices weaken and capital flees the economy. We are not looking for a repeat of the Asia crisis of the late 1990s, but sluggish growth in China and the eurozone could weigh on global inflation and Fed deliberations. Janet Yellen may see such events as reason to hold off on rate tightening, keeping rates at close to zero and helping to fuel a liquidity bubble.

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