What to look out for and expect in 2015

2014 was a year of two halves, at the risk of sounding clichéd. It started well, with equities fuelled by low global interest rates and market volatility. It then turned sour mid-year. Talk of US policy tightening and concerns about global growth's underpinnings – exaggerated in my view – allied to mounting geopolitical tensions in Russia and the Middle East led to far more volatile markets (The global growth story – cause for concern, not panic). Equities and oil prices collapsed although the former has staged a late-year rally.

Many of these themes will remain key in 2015, in my view. The Russia conundrum clearly has further to run and we now await Putin's next move. Low oil prices have generated a new world order, for now at least. Talk of a China "hard-landing" refuses to go away. Religiously-motivate terrorist attacks, Ebola and cyber warfare are proving tough to eradicate.

New themes, including USD strength and uncertain and potentially game changing elections in Greece and Nigeria (February), the UK (May) and Argentina and Thailand (October) are likely to keep investors guessing. The list below – which sets out some of the themes to focus on next year and importantly what to expect – cannot of course be exhaustive. The "unknown unknowns" are both a challenge and an opportunity.

It leaves me to wish you a happy festive season and a prosperous new year.

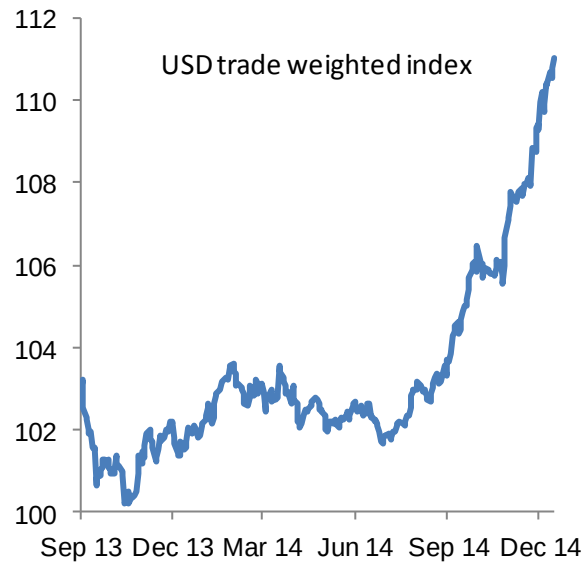
Olivier

- **Strong dollar – Little US can or will do about it**
- **Give Fed and Yellen benefit of the doubt**
- **Low oil prices have generated a new world order, for now at least**
- **UK elections – Multitude of possible outcomes…few particularly appealing**
- **Greek elections – A sense of déjà vu**
- **China "hard landing" – What exactly are we talking about?**
- **Emerging Market elections – Possible game changers but tough economics**

❖ Strong dollar – Little US can or will do about it

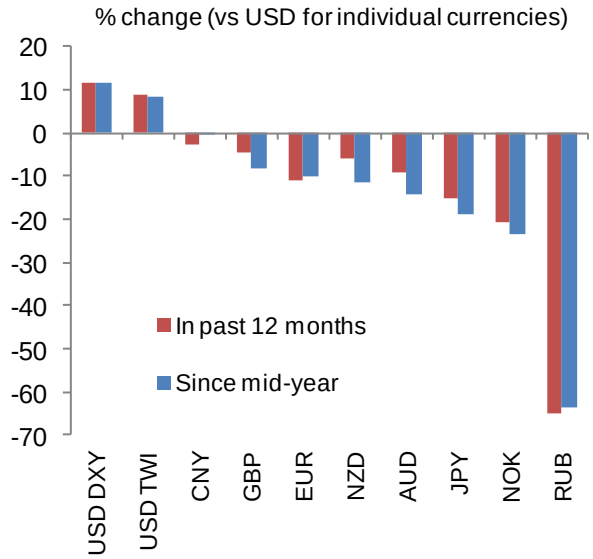
The USD has appreciated about 8% since mid-year on a trade-weighted basis[1] and an even more dramatic 11.5% on the narrower DXY basis[2] (see figures 1 and 2). Furthermore, there seems to be an increasingly entrenched view that diverging Fed and ECB monetary policies in 2015 will continue to push EUR/USD lower.

Figure 1: USD is up about 8% since mid-year against its trading partners' currencies



Source: St Louis Fed

Figure 2: Only Chinese renminbi has held its ground vs USD



Source: Marketwatch.com

There are a number of implications for the US and its trading partners.

i. A stronger USD will, all other things equal, reduce US imported inflation and potentially competitiveness and export growth. At the margin this is more likely to push back rather than bring forward any Fed monetary tightening, in my view

ii. Further USD appreciation may see the Fed and US Treasury intensify calls for its major trading partners to support their currencies or at least not pursue policies that weaken their currencies. But I think there is little the US will or can do:

- First, the US is not a particularly open economy and thus less currency-sensitive than very open economies reliant on exports (see Figure 3).

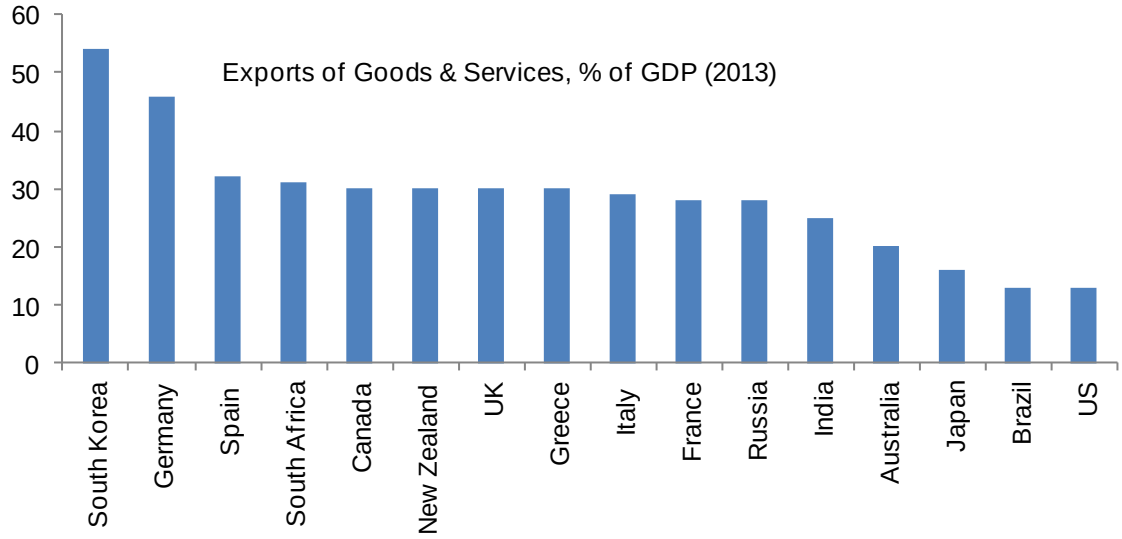
[1] A weighted average of the value of the U.S. dollar against the currencies of a broad group of major U.S. trading partners, which include the Euro Area, Canada, Japan, Mexico, China, United Kingdom, Taiwan, Korea, Singapore, Hong Kong, Malaysia, Brazil, Switzerland, Thailand, Philippines, Australia, Indonesia, India, Israel, Saudi Arabia, Russia, Sweden, Argentina, Venezuela, Chile and Colombia (See http://research.stlouisfed.org/fred2/series/DTWEXB/downloaddata).

[2] A weighted average of the value of the U.S. dollar against the currencies of significant US trading partners, including the euro, Japanese yen, Canadian dollar, British pound, Swedish krona and Swiss franc.

- Second, the US has in the past focussed much of its criticism on the “undervalued” Chinese renminbi. But the latter has actually been flat vs the US in the past year and appreciated significantly against its major trading currencies. So not much for the US to complain about.
- Third, the currencies which have weakened the most (NOK, RUB) are those of oil exporting countries which have suffered a serious terms of trade shock. The Russian central bank has already hiked rates aggressively, compounding the economy’s brittleness.
- Fourth, while the euro is at the weaker end of a 5-year range it is arguably still over-valued for many of the eurozone’s weaker economies.

The US Treasury may repeat its (historically quite rare) criticism of Germany's tight fiscal stance, export-oriented policies and soft demand (see Report to Congress on International Economic and Exchange Rate). But it is likely to again get short change from Chancellor Merkel and Finance Minister Wolfgang Schauble. Similarly it will likely maintain its spotlight on "under-valued" emerging market currencies, but again with little noticeable impact, in my view.

Figure 3: Germany far more open economy than US



Source: World Bank

iii. While a weaker euro and more competitive exports may not be the ECB's primary goal, a weaker euro will help the eurozone's exporters, albeit to very varying degrees. Germany, an open economy which posted the world's largest current account surplus in 2013 ($255 bn), is likely to yet again be a key beneficiary of a weaker euro – even if German exporters argue (rightly so) that there's more to competitiveness than a cheap currency.

❖ Give Fed and Yellen the benefit of the doubt

Talk of Fed and BoE rate hikes in 2014 proved very premature and analysts, on average, now don't expect rate hikes until mid-year and Q3 2015, respectively.

There will be as many opinions on when the Fed should hike and how quickly as there are analysts. The concern will be that if the Fed leaves it too late, swayed by low oil prices, a strong dollar, weak growth in key economies and geopolitical tensions, it will then have to hike more aggressively. If it moves too early, encouraged by a buoyant US economy, the Fed could jeopardize global sentiment and growth. I tend to give the Fed and Janet Yellen, which have shown a degree of pragmatism, the benefit of the doubt.

In any case a number of other central banks, including the Bank of England (BoE), are likely to partly take their cue from the Fed. Analysts don't expect the first BoE hike, from the current record low of 0.50%, until Q3 2015. The UK economy is in good enough shape to absorb the impact of a slow and gradual hiking cycle in my view (Bank of England tempers rate hike scaremongering, 9 Dec 2014).

Figure 4: Major central bank policy meetings in 2015 (dates in brackets)

January	BoE (8)	BoJ (21)	ECB (22)	Fed (28)	RBNZ (29)		
February	RBA (3)	BoE (5)	BoJ (18)				
March	RBA (3)	BoE (5)	ECB (5)	RBNZ (12)	BoJ (17)	Fed (18)	
April	RBA (7)	BoJ (8)	BoE (9)	ECB (15)	Fed (29)	BoJ (30)	RBNZ (30)
May	RBA (5)	BoE (11)	BoJ (22)				
June	RBA (2)	ECB (3)	BoE (4)	RBNZ (11)	Fed (17)	BoJ (19)	
July	RBA (7)	BoE (9)	BoJ (15)	ECB (16)	RBNZ (23)	Fed (29)	
August	RBA (4)	BoE (6)	BoJ (7)				
September	RBA (1)	ECB (3)	BoE (10)	RBNZ (10)	BoJ (15)	Fed (17)	
October	RBA (6)	BoE (8)	BoJ (7)	ECB (22)	Fed (28)	RBNZ (29)	BoJ (30)
November	RBA (3)	BoE (5)	BoJ (19)				
December	RBA (1)	ECB (3)	BoE (10)	RBNZ (10)	Fed (16)	BoJ (18)	

Fed: US Federal Reserve; BoE: Bank of England; BoJ: Bank of Japan; ECB: European Central Bank; RBA: Reserve Bank of Australia; RBNZ: Reserve Bank of New Zealand

Source: National central bank websites

❖ Low oil prices have generated a new world order, for now at least

It's going to be hard to escape the theme of low oil prices. It has generated a new world order, for now at least, with clear losers (OPEC, Russia, Norway) and winners (including the energy-intensive industrialised Asian nations). The International Energy Agency (IEA), which accurately forecast falling oil prices in 2014, expects rising oil inventories in H1 2015 to put further downward pressure on prices. It points to both oil over-supply, the result of years of high prices and capacity building, and a slowdown in the growth of global oil demand (see OMR, December 2014).

What may perhaps be harder to forecast is possible US military involvement in Syria, market sentiment and if/when OPEC countries finally react to the collapse in the price of their main export. More of this in future blogs.

❖ Greek elections – a sense of déjà vu

It feels like we're back in 2011 again with Greek yields spiking, equities plummeting, the threat of early elections and talk of Greece potentially defaulting on its debt and ultimately exiting the eurozone. But, importantly, the EU and ECB (led by Germany) and IMF have historically shown a willingness and ability to compromise in order to "save" Greece and the eurozone. My core scenario is that this will not change in 2015.

Prime Minister Samaras is trying to coble support for his presidential candidate, Stavros Dimas, who needs support from 200 (out of 300) parliamentary deputies in today's vote (19.00 local time). Failing that, he will require a 3/5 majority (180 seats) in a third and final parliamentary vote on 29 December. The ruling coalition only has 155 seats.

Failure to vote Dimas in as president would trigger early elections in February. The FT notes that "*opinion polls suggest an early election would be won by the hard-left Syriza party, which wants to negotiate a substantial writedown of Greece's sovereign debt with international creditors*." A debt-to-GDP ratio of about 170%, three-year yields near 10% and weak GDP growth are a potent mix for a populist opposition also calling for increased public spending.

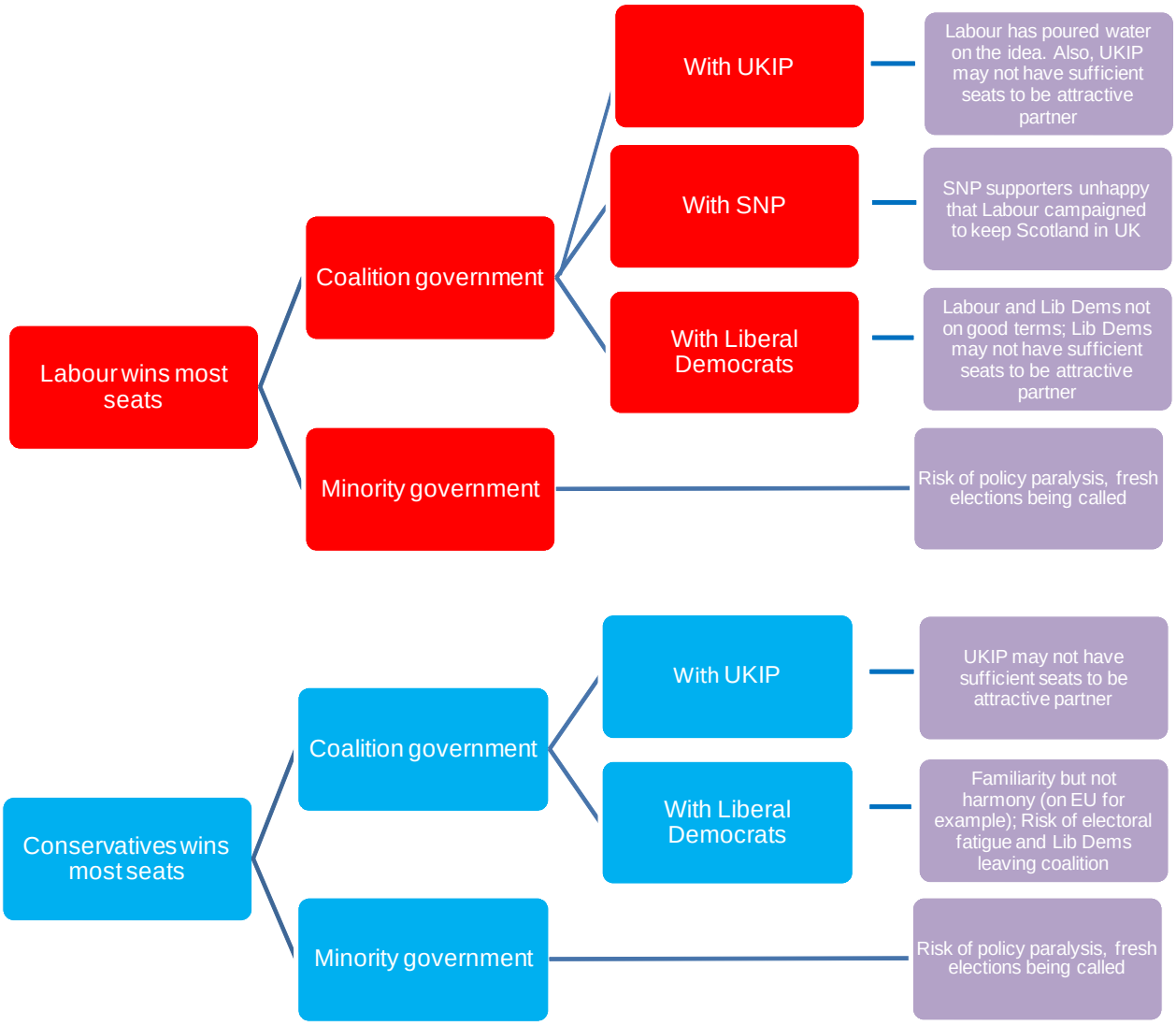
If parliament does not vote through Dimas as the country's head-of-state, recent history tells us there are many ways this could play out. For starters, I would expect feverish debate about what Syriza could realistically push for in terms of debt write-offs and whether/how this impacts the existing bailout-package which still has EUR 15bn to disburse. It is not unfeasible that once again the eurozone has to choose between a significant restructuring and/or write down of Greek debt or letting Greece leave the monetary union – not be the backdrop that eurozone leaders hoped for as they grapple with relaunching growth.

❖ UK elections – Multitude of possible outcomes…few particularly appealing

The 7th May general elections are likely to be the closest thought and hardest to predict in recent memory. What is reasonably clear at this stage, even if 10 weeks is a long time in politics, is that neither of the main parties is likely to win a majority of seats. Beyond that it's anyone's guess. But I do expect policy-making to suffer whether a minority or coalition government leads the country, as well as greater sterling volatility in the run-up and immediate aftermath of the vote, with the risk tilted towards currency weakness.

Figure 5: Multitude of election outcomes…few particularly appealing

(assumes that neither party wins majority vote)



Source: www.olivierdesbarres.co.uk

Recent polls still have the opposition Labour Party only marginally ahead of the ruling Conservatives on around 32-34%, with support for both parties pretty static. Cameron tried to take on the EU and Germany

(by for example threatening a referendum) but has ultimately struggled to win over hard-core UKIP voters (UK Elections, the EU and immigration: Cameron Faces uphill battle, 28 Nov 2014). Moreover the government has not been particularly effective at capitalising on the relative strength of the UK economy or question marks about Ed Miliband's leadership qualities (UK's solid economic metrics drowned out by EU and immigration debate, 1 Dec 2014).

Most election models forecast, based on current opinion polls and the vagaries of UK electoral geography, that Labour will win more parliamentary seats than the Conservatives. But they attribute a 50-90% probability that both parties will fall short of the 326-seat majority (a hung parliament) and that Labour will either form a coalition or minority government (see electionforecast and Electoral Calculus).

The emergence of a 4-5 party system means many possible coalition permutations, none particularly attractive in my view (see Figure 5). The ruling Liberal Democrats, the Scottish National Party (SNP) and UK Independent Party (UKIP), still comfortably third in opinion polls, don't enjoy particularly good relationships with either of the two main parties (Labour still ahead of Conservatives but UKIP is potential kingmaker, 29 Nov 2014). The SNP and UKIP will be wary of the damage done to the Liberal Democrats' popularity since they became junior coalition partners.

Of course the allure of being in power may prove too strong. But the above scenario does raise the spectre of a minority government having to form informal alliances with one or more parties in order to get bills through parliament. The risk is of policy paralysis leading to an eventual dissolution of parliament and new elections. Either a minority or coalition government would thus be sub-optimal, in my view.

❖ China "hard landing" – what exactly are we talking about?

The question of whether China's economy will suffer a hard-landing has stuck ever since Chinese GDP growth peaked above 10% in 2010. The fact that China's economy is the world's second largest has understandably compounded markets' concerns about China's ability to fine-tune growth.

But talking about a hard-landing without properly defining it seems counterproductive. China's leadership will arguably have a different definition from say an Australian mining company, an equity trader or even the Fed governor. Defining the parameters of a hard-landing is particularly important as China transitions from a low-valued added export and infrastructural investment model, where GDP growth was the ultimate target, to a model where high-value export and investment, demand, quality of life, social cohesion and the sustainability of growth are target variables. So whether GDP growth is 7% or 7.5% may ultimately be a poor indicator of whether China's economy is hard-landing and a broader set of variables more relevant.

The Chinese government and central bank have repeatedly shown a willingness and ability to introduce new measures to support the growth rate which they think is commensurate with their targets. The central bank's recent injection of about $80bn into the five largest banks via a 3-month lending operation and

reports of further injections point to concerns about slowing credit growth and bank liquidity but also an ability to do something about it. That's not to say that policy miscalculations won't happen.

But if markets are going to worry about growth they would do better to focus on the eurozone. The ECB's potential quantitative program is arguably too little too late, Germany is showing little sign of tweaking its growth model in order to help reflate some of its poorer neighbours and few of the eurozone's heavyweights are showing much appetite for much overdue structural reform.

❖ Emerging Market elections – possible game changers but tough economics

Scheduled elections in Nigeria, Argentina and Thailand are possible game changers but the economic background to these economies is particularly challenging for whoever forms the next governments (See Figure 6).

Nigeria

According to Africa Practice, *next year's elections are particularly significant in their potential to be the first truly contested elections featuring a viable opposition since the transition to civilian rule in1999.* But it reminds us that *Nigerian politics is not based on competing ideology but rival interests and ambitions.*

The elections also come at a very challenging time for Nigeria, Africa's largest oil producer. The central bank recently devalued the currency 8.5%, widened its trading band to 10% and hiked interest rates 100bp to 13%. This was in response to falling oil prices and presumably pressure on its forex reserves (which are down to $35bn) and crude account savings (down to $4bn). Unless oil prices recover, this cycle of currency weakness, higher rates and pressure on reserves could extend and the government – whoever that may be after February – forced to take more painful fiscal measures.

Argentina

This may be the tightest presidential race since 2003, with three candidates – Macri, Massa and Scioli – polling over 20% each. The hand they inherit after the October elections is likely to be a tough one to play. Argentina in July defaulted on a small share of its debt, inflation is rampant and the central bank is under pressure to devalue the currency of South America's second largest economy.

Figure 6: Election timetable 2015, selected countries

Country	Date	Type	Note
Greece	Early February	General	If parliament fails to elect president on either 23 or 29 Dec
Israel	17 March	General	
Nigeria	14 &18 Feb	Presidential & National Assembly	
UK	7 May	General	Initial results likely released that evening
Argentina	25 October	Presidential	
Thailand	October (earliest)	General	Elections to take place under new constitution