What you may have missed and why it matters

Here's a recap of the financial and economic news you may have missed over the Christmas period – and how it changes my core views (or not).

- **US GDP growth in Q3 was revised up but Fed rate hike still unlikely before mid-year**
- **UK GDP growth in Q3 was revised down, Nationwide house price growth slower but still positive in December and opposition Labour party still leads opinion polls**
- **Greece will hold elections in the coming month with a likely Syriza victory putting in doubt the country's bailout-out package and potentially its future within the eurozone**
- **Russia's GDP contracted for the first time in five years in November and inflation spiked in December; the economy and President Putin are stuck between a rock and a hard place**
- **Korea data point to robust economy but policy-makers unlikely to take any chances**
- **Oil prices continue to edge lower, dollar only marginally stronger**

Figure 1: Price action over festive season and in 2014

	Change 23-31 Dec	Change 2014	Note
	% unless indicated otherwise; For currency crosses + sign implies USD appreciation		
S&P 500	-1.2	11.4	Closed 53 times at a record high in 2014
Dow Jones	-1.1	7.5	Closed above 18,000 for the first time ever
FTSE 100 (GBP-terms, ex-dividends)	-0.5	-2.7	First annual loss since 2011, one of the worst performing developed indices
CBOE volatility index (VIX)	na	0.0	Average vol almost unchanged from 2013 but ended year higher
MSCI emerging market index	-0.1	-4.6	Another disappointing year after 9% fall in 2013
EUR/USD	0.9	8.1	EUR forecast to weaken further in 2015
USD/JPY	-0.6	13.8	USD/JPY traded above 120
GBP/USD	0.1	5.6	GBP/EUR only up modestly despite signs of strong UK economy
USD/RUB	1.3	73.1	Central bank has for now stopped RUB collapse, not reversed it
USD/KRW	-0.4	3.9	Record trade surplus supporting KRW
Greek 10-year bonds, %	+128bp	+133bp	Trigger of early elections has seen Greek yields spike
Bloomberg Commodities Index	-3.0	-17.0	Price of crude, gasoline and copper contributed to commodity price slump
Oil (ICE Brent Crude) $/barrel	-6.9	-48.1	Oil price crash has divided the world into winners and losers
Gold, $/oz	0.5	-3.7	Gold held up better than most commodities

Source: CBOE, Bloomberg, FT

➢ US growth revised up but Fed hikes still unlikely before mid-year

We knew US growth was strong in Q3 but the upward revision to an impressive 5% annualised, announced on 23 December, took even the most optimistic by surprise and saw the Dow Jones soar through the 18,000 barrier for the first time. Growth likely slowed in Q4 but the IMF's 3.0% forecast for the full-year looks pretty safe.

This provides a bit of a conundrum for the Fed. But it has to look further than just headline US GDP growth and rate hikes are still unlikely before mid-year in my view:

- CPI-inflation has been running at or below the Fed's 2% target since January 2012, falling to 1.3% yoy in November; the Federal Reserve Bank of Minneapolis argues that, based on market option pricing, the probability of inflation falling below 1% next year has risen to a 5-year high of 72% and that changing market expectations should matter to policy-makers.
- Low (and likely to stay low) crude oil prices;
- Perhaps unsurprisingly given the above, the Dallas Fed manufacturing index fell to 4.1 in December from 10.5 in November; the Chicago PMI fell to a five-month low of 58.3;
- A strong US dollar;
- Geopolitical uncertainty; and
- The housing market is recovering rather than soaring. Pending home sales rose 0.8% mom in November, but from a slightly downwardly revised October index, and 4.1% yoy (Figure 2).

The Fed will also have a somewhat more dovish make-up in 2015. Dovish members Evans, Lockhart, and Williams and centrist member Lacker will replace the hawks Fisher, Plosser and Mester and the dove Kocherlakota (the rotation of voting members at the Fed is yearly).

Figure 2: US pending home sales ticking up slowly

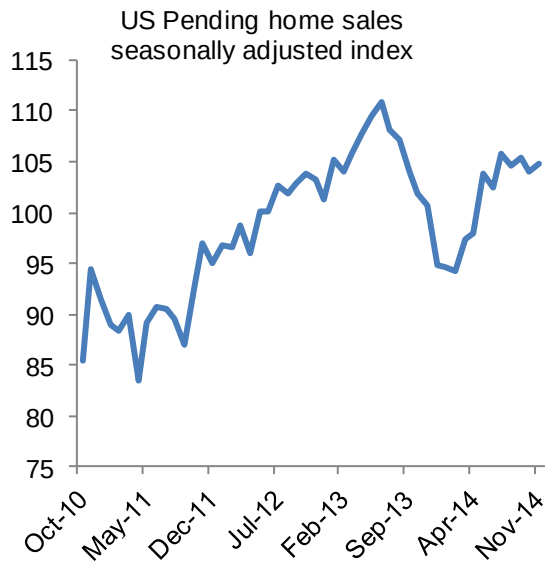
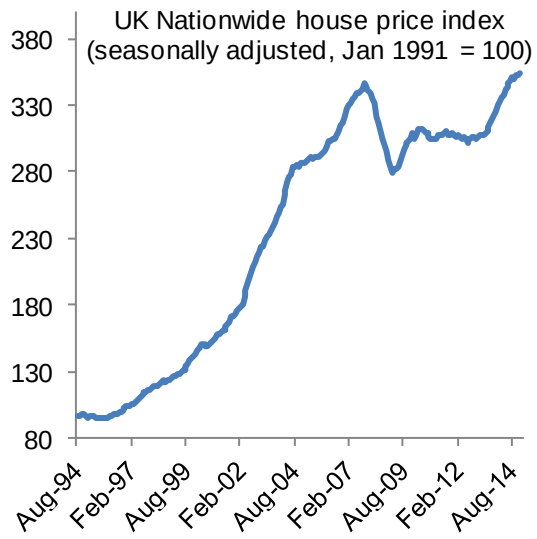


Figure 3: UK house prices hit a record high this year



Source: National Association of Realtors *Source: Nationwide*

- **But no such luck for UK economy…and Prime Minster Cameron**

The news was less rosy on the other side of the pond, with the ONS on 23 December revising down GDP growth in Q3 to 2.6% year-on-year from the earlier estimate of 3.0%. Not the Christmas present PM Cameron had hoped for with elections only a little over four months away and reinforces my view and that of analysts that the Fed will hike rates before the Bank of England.

The latest opinion polls, admittedly now 10 days old, still have the opposition Labour Party ahead of the Conservatives by a couple of percentage points. Labour is on course to win the elections but fall short of a parliamentary majority. I would argue that a hung parliament is a sub-optimal outcome from a policy-making point of view, regardless of your political bias (see What to look out for and expect in 2015). Whilst most political analysts expect Labour to form a coalition with one of the smaller parties, the Financial Times' core scenario is more dramatic: a Conservative-Labour national unity government for the first time in over 80 years.

And no update would be complete without mentioning the UK property market. The Nationwide house price index posted a 0.2% mom increase in December, so price increases are slowing (Figure 3). Meagre wage growth, the new stamp duty thresholds and uncertain general elections may all be weighing on further house price increases near-term, but 2014 will be remembered as the year when property prices hit record highs.

- **Greece heading for early elections, eurozone for some turbulence**

Prime Minister Samaras failed in the third and final parliamentary vote on 29 December to cobble support for his presidential candidate, Stavros Dimas who was 12 votes short of the 180 needed. Constitutionally this triggers early parliamentary elections as early as 25 January. Recent opinion polls suggest the hard-left Syriza party will win, even if it falls short of a majority.

The Greek stock index tanked and 10-year yields spiked 130bp on the news with Spanish and Portuguese bonds also hit. The euro has been choppy but so far held up quite well against a slightly stronger USD. I now expect feverish debate about what Syriza could realistically push for in terms of sovereign debt write-offs with international creditors 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. This is not the backdrop that eurozone leaders hoped for as they grapple with relaunching growth. But we cannot ignore European policy-makers' ability and willingness in the past to secure last-minute agreements to keep Greece within the European family.

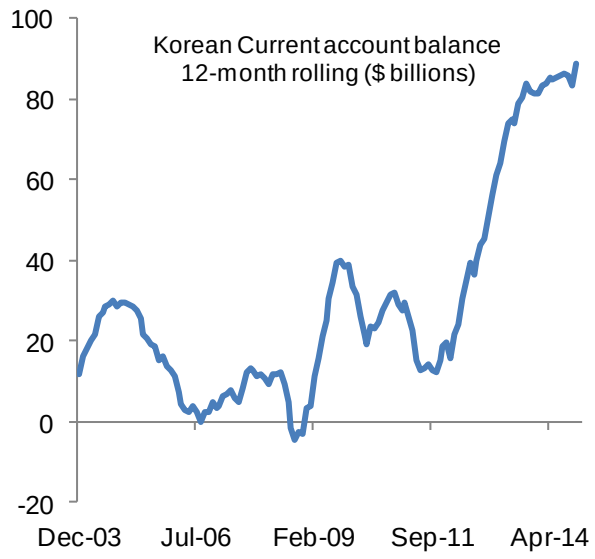
I recently argued that a key theme for 2015 is potentially game changing elections, including in the UK, Greece, Israel, Nigeria, Argentina and Thailand (http://www.olivierdesbarres.co.uk/what-to-expect-in-2015/). So far, this is (sadly) proving true. In Israel, dozens of politicians, including confidantes of Avigdor Lieberman, the foreign minister, have been detained in a corruption investigation that could shake up elections [on 17 March], according to the UK Times.

- **Strong Korea data unlikely to deter growth-supportive policies**

The trade surplus rose to $5.8bn in December due to a 3.7% yoy increase in exports and 0.9% yoy contraction in imports. The current account surplus surged to an all-time high of $11.4bn in November, thanks largely to a fall the $-value of oil imports (Figure 4). The surplus for 2014 is likely to exceed the central bank's $81.4bn forecast and 6.5% of GDP. Industrial output (seasonally-adjusted) and retail sales rose 1.3% mom and 1.9% mom, respectively, in November.

This has provided support for the won but the central bank (BoK) has both the room and the incentive to cut its 2% policy rate and lean against rapid or sustained currency appreciation in a bid to maintain export competitiveness and put a floor under economic growth. CPI-inflation fell to 0.8% yoy in December, a 15-year low, while regional and global growth concerns persist. The next BoK policy meeting is on 15 January.

Figure 4: Korean current account surplus at record high



Source: Bank of Korea

Figure 5: Russian inflation at six-year high

Source: Stat Bureau

- **Russia – caught between a rock and a hard place**

Somewhat unsurprisingly GDP shrank 0.5% mom in November, the first monthly contraction in 5 years, according to Economy Ministry data out on 29 December, while CPI-inflation jumped to 11.4% yoy in December from 9.1% yoy in November (Figure 5). The sharp fall in oil prices, rouble collapse and

international sanctions are clearly starting to bite. This leaves policy-makers, including President Putin, between a rock and a hard place in my view.

If the central bank hikes rates further to support the currency and combat inflation, it stymies already weak growth. If it lets the rouble weaken, inflation will rise further and the benefits to the economy from a more competitive currency will be minimal as the bulk of its exports are USD-priced commodities.

Of course President Putin could give in to international demands and have the embargo lifted but this would be a massive loss of face and would do little to reverse the damage done to the economy from low oil prices. Alternatively, he could play double or quits and extend Russia's territorial ambitions but the likely costs to the domestic economy need to be weighed against any nationalist popular support. The longer the status quo, the greater the pressure on Putin to do something. I admit to not being smart enough to predict with any degree of conviction how the knife will fall. That very uncertainty is perhaps what Putin is counting on.

Whatever the outcome, the Russian economy is paying the price of years of isolationist foreign policies, capital outflows and over-reliance on commodity exports. I think the history books will sadly portray Russia as one of the great economic underachievers of the past 20 years.

- **Crude oil prices continue to edge lower**

Oil prices have continued to fall despite the reported destruction of over a million barrels of oil by a fire at Libya's main oil port. The ICE Brent crude future traded as low as $55.8/barrel on 31 December, due in part to a slightly stronger USD and EIA data released on 24 December showing an unexpected surge of 7.3 million barrels in U.S. crude oil inventories to 387.2 million in the week ending 19 December. This was only partly reversed by a 1.75 million barrel fall in the week to 27 December.