Global Connections

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2015 Outlook – Tough Choices Ahead

While the year-end equity rally continues apace, it is time to look ahead into next year and assess the challenges and opportunities 2015 will bring. We will begin with the macro backdrop, discuss the policy implications extending from that backdrop and address the tough choices policymakers face as a result. We will then consider the financial market implications, contemplate the tail risks investors face and conclude with some favored investment options for the year ahead. Bottom line: 2014 returns make 2015 a tough call.

To assess the future, it helps to understand the past. We have spent the past six years or so battling the fallout from the Great Financial Crisis (GFC). This fallout includes broken growth models around the globe, both developed and emerging, leaving the world to await the next great growth model. In the interim, monetary policy has been the preferred weapon of choice to buffer the fallout, with fiscal policy sidelined due to political gridlock.

Lower-for-Longer Growth World

The result is a world where growth is lower but lasts longer than historically has been the case. This is true across both the developed and emerging economies. Within the developed economies, the US leads the way, entering its 6th year of lackluster economic recovery. The UK remains the canary in the coalmine, an example of how high relative interest rates and a strong currency curtail growth. Europe and Japan battle a toxic combo of recession and deflation.

The emerging economies continue their struggle with stagflation. China remains a wet blanket on global growth, notwithstanding its recent rate cut. Outside China, Asia faces an Iron Triangle: a much more competitive Japan, a slowing China and a stronger US dollar – a tough set of conditions. In Eastern and Central Europe, Russian sanction fallout and weak oil prices coupled with core Europe's difficulties present policymakers with significant challenges. Latin America faces commodity-related pressures in Chile, Peru and Brazil while Argentina and Venezuela suffer from governance questions. Mexico's reform program offers potential to unlock economic growth and rising asset values, but weak oil is a negative.

The lack of a global growth locomotive creates a dynamic that leaves every country to fend for itself (see "Every Country for Itself," published on May 30, 2014). Policy divergence is the order of the day. The Fed is finished with QE and the BOJ has just doubled down on its QEE process, while the ECB represents the muddle in the middle. China's recent rate cut has raised investor hopes of another major stimulus. This seems quite unlikely, given that the 2009 stimulus package is viewed within China as a major policy error.

We are in a fixed-pie world with insufficient demand growth and heated price competition. Country-level pricing is determined by FX values – beggar-thy-neighbor-risk is rising. This competitive pricing logic is already visible in the commodity markets. First in iron ore and more recently in oil, dominant producers have expanded production into weak-demand markets, leading to rapid and significant price declines.

Tough Choices

Policymakers face difficult decisions at every turn. Should the US attempt to be a global growth locomotive? What can policymakers do to protect against external weakness? Are rate hikes the correct Fed move? At what level does a strong dollar hurt rather than help?

The US may be able to grow alone but is highly unlikely to be a global growth locomotive. The Fed would like to raise rates in order to provide a cushion in case the economy weakens but will not be in any great rush to do so: lower oil + strong dollar = lower inflation = no rush to raise rates. The degree of dollar strength is one of 2015's key questions; understanding domestic demand dynamism (low oil boosts consumer demand but hurts capex) sheds light on how comfortable policymakers will be with dollar strength. A contrarian view suggests the Fed stays on hold in 2015, capping the USD advance, supporting financial asset prices and underpinning the economy.

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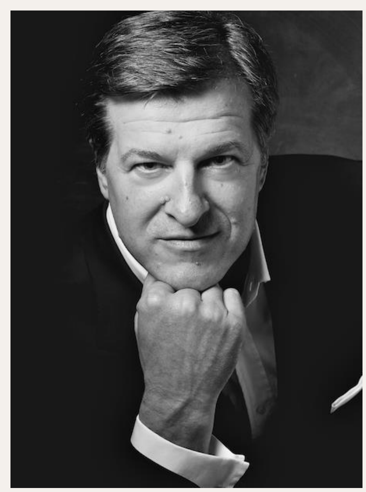

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China's surprise is not its slowdown but that its currency has been one of the world's strongest in 2014. Should RMB strength continue? What happens if it does not? Should President Xi stimulate further – where will the new jobs come from (jobs rather than GDP are what really count in China)? Do recent rate cuts signal a policy shift or a buffering of an increasingly challenging adjustment process? Pressure continues to build on China's policymakers as growth slows at home and abroad while debts pile up both onshore and off. China is becoming an exporter of capital as corporates and individuals seek greener pastures abroad.

Europe's tough choices revolve around one of two paths – full-blown ECB-led QE or a German-led policy reversal, which includes significant fiscal stimulus. Anything less than one of those two choices and the EU is likely to fall back into recession. Oil price collapse coupled with German economic pain increases the odds of QE early next year.

Japan is unique in that its tough choices have already been made. The fight against deflation remains the fight that must and will be won. The Abe government's decision to call a snap election and postpone the sales tax increase until 2017 provides Japan with a two-year runway to demonstrate success on the economic front.

Emerging economies face multiple challenges. Broadly speaking, the question is which model will be followed – the quick policy response model of India and Indonesia (oil price falls = fuel subsidy cuts) or the refusal-to-face-reality model of Russia, Venezuela and others? The rewards go to those who take action.

What has been true since 2009 remains true as we enter 2015: the US and China, past liquidity providers and current strong currency enablers, hold the keys. When/if they decide to no longer allow others to devalue and undercut them is a key 2015 question.

2015 Macro Tail Risks

Three tail risks stand out

1. The competitive pricing logic visible in the commodity markets spreads to manufacturing and unleashes a deflationary wave that swamps the global economy. The catalyst could be a Chinese devaluation. The huge amount of USD debt taken on by Chinese companies over the past 24-36 months may limit the magnitude but perhaps not the event.

2. The economic soufflé argument whereby the global economy implodes due to a full-blown EU recession, China growth collapses, and there is a loss of faith in central banks or a US recession.

3. At the opposite end of the growth spectrum, the US overheats, the Fed is seen as behind the curve, rates shoot up, stocks and bonds sell off and a reverse-wealth effect puts the US and the global economy in the deep freeze.

Financial Market Implications of a Lower-for-Longer Growth World

There are 5 main implications one can draw from such a world

1. Increased FX volatility – hedging becomes part and part parcel of any cross-border investment decision. The performance spread between hedged and unhedged Japanese equity, for example, has been huge.

2. Continued growth and expansion of cross-asset or multi-asset investing. Low growth and a tough return environment lead asset owners to prize flexibility.

3. Within fixed income, flexibility leads to the rise of the unconstrained manager and continued allocation to nontraditional yield opportunities. The search for yield continues – think real estate, infrastructure, alternative credit and structured credit vehicles.

4. Equity is likely to see a crossover from focus on share buybacks to capital expenditures. The focus on underlying sales/earnings growth rather than financial engineering gathers pace.

5. Emerging market asset owners look to globalize their portfolios as they become too big for the domestic market and more aware of external opportunities (see "Emerging Market Portfolio Globalization: The Next Big Thing," published on July 17, 2014).

Crowded Trades & Episodic Volatility

Combining #2-3 above together with the reduction in the role of banks as liquidity providers creates a worrisome picture of crowded trades, reduced liquidity and episodic volatility. This is becoming a major issue in the fixed income space in particular, where as one manager recently put it: a 4-point loss can become a 40-point loss and there is nothing one can do about it. Think about what flash crashes do for risk appetite!

Regulators are ok with this state of affairs as the banks, the former providers of liquidity, are no longer active and hence no longer exposed to such losses (see "Tempest in a Teapot – What Does It Tell Us?," published on October 31, 2014). For asset owners and managers alike, this is a new part of the game and one that deserves some thinking round the holiday fire. Large, long-term investors may decide to ride through some of this volatility. Mark-to-market investors, however, face a more tricky decision tree: to try and trade around such positions, to reduce position sizes or to take fewer positions.

So where are today's crowded trades? Some have speculated that Japanese equity is a crowded trade or long-duration UST… the USD is seen as a crowded trade, and US High Yield has certainly been called a crowded trade or a bubble throughout 2014. I disagree – Japanese equity is under-owned by domestic and foreign investors alike, even with very compelling valuation. The long end of the UST curve is as rich as it has been in years relative to its G-10 peers – hard to see a crowded trade there. The USD while up roughly 10% in 2014 remains close to its long-term lows as any chart will show, while US HY has seen multiple liquidations over the past year.

Tough Choices for Investors

The US equity market may be a crowded trade. It has been the place to be since the bottom in 2009 and was the place to be in 2014, outperforming the rest of the world on a USD basis as well as a local currency basis. USD strength, the S&P's relentless rise and the rally in long-duration UST all suggest heavy ownership of US assets. In turn, that suggests a tough choice for investors – stay long US assets or shift abroad?

On the fixed income side, the tough choice a year ago was to be long or short duration. Most chose to be short and were wrong (see "2014 and the Fight Against Deflation," published on November 25, 2013). In 2015 the decision may be whether one should go down the quality curve and back into high yield.

Commodities are another area where hard choices may have to be made. Down four years running and with money pouring out of the space, the choice to invest some time if not capital in exploring bottom-fishing commodity ideas is one to consider.

4 Investor Tail Risks

1. Technology stocks sell off hard, driven by US private market mispricing or a Chinese tech company explosion. Note that US early-stage Venture Capital is up well over 30% this year while capital commitments in the tech space are at levels last seen in 2007 and before that in 1999-2000. With tech and social media a poster-child for US equity, such a pullback would be a major surprise.

2. The dreaded bête noire of financial markets – an unexpected US rate spike that leads to big selloffs in both stocks and bonds… last year few expected rates to decline; today few expect them to rise sharply.

3. With the Fed no longer in support mode, earnings disappointments could shock a fully priced US equity market.

4. Reminiscent of 2013, the year-end 2014 run-up sets up perfectly for a Q1 2015 selloff, with even the "smart money" (hedge funds) at their highest US equity net long position in close to two years.

Preferred Investment Ideas

Fade US equity strength and add to non-US DM hedged equity positions remains the investment idea of choice to enter 2015. Hedged Japanese equity provides exposure to the one developed economy where the tough choices have been made. The fact that the market is cheap & under-owned by domestic and foreign investors alike only adds to the conviction. Use yen rallies to add to positions.

Alongside hedged Japanese equity lies hedged European equity positions. Cheap and the opposite of crowded, especially by foreign investors, European equity could do very well if the ECB initiates QE. Europe's woes are very well known. Long-time readers will recognize the hedged, non-US DM equity argument as one employed over the course of 2014. While the US has led YTD, hedged non-US DM equity has been the leader off the mid-October lows.

In fixed income, the choice lies between staying with IG quality or going back into high yield and other USD spread product instruments such as MREITS and Preferreds. If the Fed surprises and stays on hold throughout 2015, spread product should do quite well. The energy risk in HY seems priced in, with the recent oil price action showing signs of being overdone. Non-traditional yield plays are likely to gain further interest.

The commodity space has been challenging for many, including your author: right-sizing positions in the gold miners and uranium has occupied too much attention this year. A strong dollar and weak oil haven't helped. 2015 commodity opportunities may lie in beaten-down energy and industrial metal assets that offer compelling yields.

Within EMs, USD debt remains the focus. On the equity side, country selection is critical, with interest in those countries with policy support and solid fundamentals. Mexico remains atop the list, though clearly growth needs to be reignited. Indonesia and India have shown adroit policy responses to the fall in oil prices; continued policy responses such as that would be very positive. China has surprised of late, as domestic investors shift to stocks from property – while not a buyer at present, devaluation would likely accelerate that shift.

Finally, an early stocking-stuffer of ideas that are on the radar screen: EM distressed debt, EU logistics plays, greenfield infrastructure investments, volatility and inflation hedges.

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