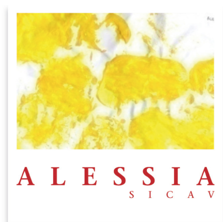


Random Note 1/2015

OUTLOOK 2015: TOWARD NORMALIZATION?

Will we finally see in 2015 the long awaited economic normalization? In this note, we will try to answer this question as well from the monetary policy perspective (normalization of interest rates and end of unconventional tools) as form the macroeconomic point of view (growth dynamic back in line with historical standards).

Main Macroeconomic Assumptions:

1. Growth in the **US** will approach its historical levels in a low unemployment environment. Surprises on the **inflation** front could lead to a more hawkish policy by the Fed than what is actually priced in the US yield curve. In this event, **Equities** should outperform **Bonds**. Competitive devaluation isn't an objective for the Fed, hence we believe that **FX** movement will continue to be driven by differences in monetary policies expectations.

2. **Oil** prices will consolidate at current levels

3. In **Europe**, the ECB will likely unveil its much anticipated QE program. This new accommodative measures will likely encompass the acquisition of sovereign debt on the secondary market but details and modalities remain very uncertain. As a result, the consequences of such a program on the real economy and financial markets remain highly speculative. However, we expected that **European stock markets** will benefit from the lower rate environment and could even outperform the US. The conjunction of monetary policy divergence and low growth outlook for Europe leads us to expect a **lower Euro/Dollar** exchange rate.

4. In **Emerging Markets**, countries such as **Russia** and **Brazil** will be hit by falling raw material prices and the abscence of a competitive manufacturing sector while other countries like **Turkey** and **China** will take advantages of lower commodity prices and their strong manufacturing capacity.

Economic environement of major world economies

USA

In the US, the recovery seems on track to match its historical levels. Unemployment is low and normalization is at the end of the tunnel. The largest uncertainties at the start of 2015 remain the evolution of inflation and the Fed's reaction in the event of rising prices.

The Fed considers a drop in consumer prices caused by the recent collapse of oil as a one-off event and should not react to it. It is also known that the FOMC uses the PCE (Personal Consumption Expenditure) which stands currently at 1.4% to assess the evolution of inflation. Furthermore, the United States aren't the most open economies in the world (a large amount of the goods consumed in the US are produced locally – please see chart 1) this should help the US to avoid importing the global deflationary pressures arising from slow economic cycle and lower commodity prices.

Chart 1 – Comparative Analysis between economic blocs

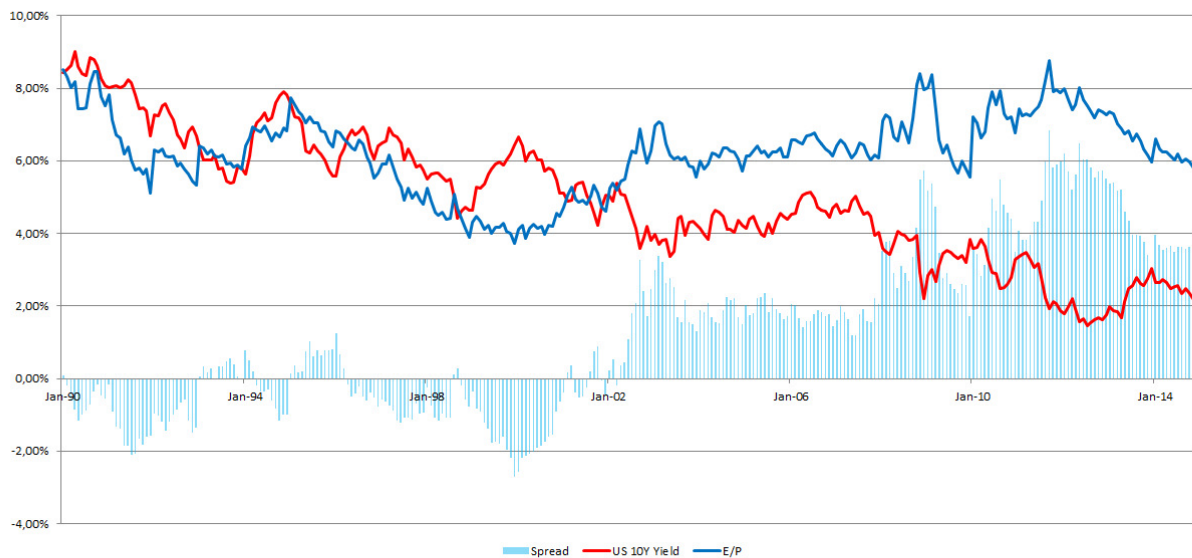
	Population in Million	GDP 2012 in Trillion US$	% of world GDP	Export % GDP	Imports % GDP
Eurozone	335	11	14%	27%	25%
EU (27)	506	17	21%	18%	17%
USA	314	16,7	20%	14%	17%
China	1,354	16,1	18%	26%	24%
India	1,200	6,8	7%	24%	31%
Japan	128	5	6%	15%	17%

Source: Wikipedia ,World Bank and BCE. GDP in PPP

In light of recent macroeconomic data on GDP, employment, capacity utilization (at the highest since 2008) and given that salaries have still plenty of upside potential, one can expect a pickup in inflation. Inflationary pressures may push the Fed to adopt a more aggressive policy than that is actually priced in the US yield curve.

A slight but gradual rise of the PCE deflator leading to a cautious attitude from the Fed leaves room for more upside in equity markets. In the Chart 2 we compare the E/P ratio of the S&P500 to the yields of the 10-year Treasury (the spread represents the risk premium for detaining equities). The underlying assumption is that Equities will be favored over Bonds as long as the E/P implies higher returns than the Treasuries in a context of robust economic growth and rising earnings expectations. The chart below shows that the gap is still large enough to absorb rising valuations and interest rates.

Chart 2. E/P and US 10-year yield.



Source: Bloomberg

On the currency front, the Fed has no incentive to devaluate the dollar. Furthermore, America's chronic trade deficit will benefit from lower energy import costs and overall the economy will take advantage of the increased number of investment opportunities. This analysis is supported by the fact that the US economy is based mainly on consumption and domestic production.

EUROPE

The ECB is likely planning to launch a government bonds purchase program. ECB's hope is that banks would rebalance their asset portfolio by exchanging government and other low risk/low yield bonds with assets (like loans) bearing higher yield and capital absorption. However, in the absence of investment alternatives bearing the same amount of risk and capital absorption, there is no certainty that the financial institutions will agree to sell their assets at their current prices. Another aspect to consider is that while governments bonds are easily financed by the ECB, other assets basically require recourse to deposits or bonds guaranteed or not by the same activities. If this swap goes the way expected by the ECB, the impact on European growth could be strongly positive. If government bond holders such as investment funds or insurance companies decide to reassess their portfolio allocations, assets class such as equity and corporate credit should benefit.

At the time being, we don't know the details of the implementation of such a program from the ECB. However, we expect that it be through a pro rata purchase, based on GDP or total debt of the individual issuing countries. As a result, we expect a significant effect on yields as well as on government bond spreads.

In this context, a purchase of 500 billion euros of securities would mean a purchase of about 150 billion of German bonds. This is comparable to the Japanese QE as the German debt that

matures in 2015 is 183 billion (according to Bloomberg data). Hence, to avoid the monetization of almost the totally of the new issuance, we expect the ECB to set the rules of the QE to limit the share of German bonds.

In the Table 3 we indicate for the main Eurozone countries their share to the area's GDP, the amount of public debt maturing in the next twelve months and the coverage rate through a hypothetical 500 Billion QE pro-rata to GDP.

Tabella 3 – Eurozone Data

	% GDP Eurozone	Debt Maturing in the next 12 months (M Euro)	500 M Euro x % GDP	% Coverage
Germany	28,6	183	143%	78%
France	21,6	297	108%	36%
Italy	16,3	338	81%	24%
Spain	10,8	208	54%	26%
Netherlands	6,35	63	32%	50%
Belgium	3,93	52	20%	38%
Austria	3,18	21	16%	76%
Greece	2,07	20	10%	52%
Others	7,16		36%	

Source: World Bank 2012. Please note that Lithuania and Latvia were not in the Eurozone

The rarity effect for German government bonds will be sizable and should benefit to all German issuers at all risk ratings. German government yields could as a result turn Japanese-like. Only a significant rise in US interest rates could compensate for this effect and generate a steepening of the European yield curve. .

As a consequence of the competitive devaluation of the Euro, portfolio reallocation effects, and more attractive performance differential between Stocks and Bonds in Europe than in the US, European stocks could outperform US even in the event of a weaker growth.

Chart 5 shows that the Equity risk premium in Germany remains well above that of the US despite a favorable interest rates dynamics.

Another factor supporting the European economy could arise from German fiscal policy which could take advantage of negative rates to ignite a public investment program that would benefit to whole Europe.

Chart 4 – Dax E/P and German 10-years Bund yield

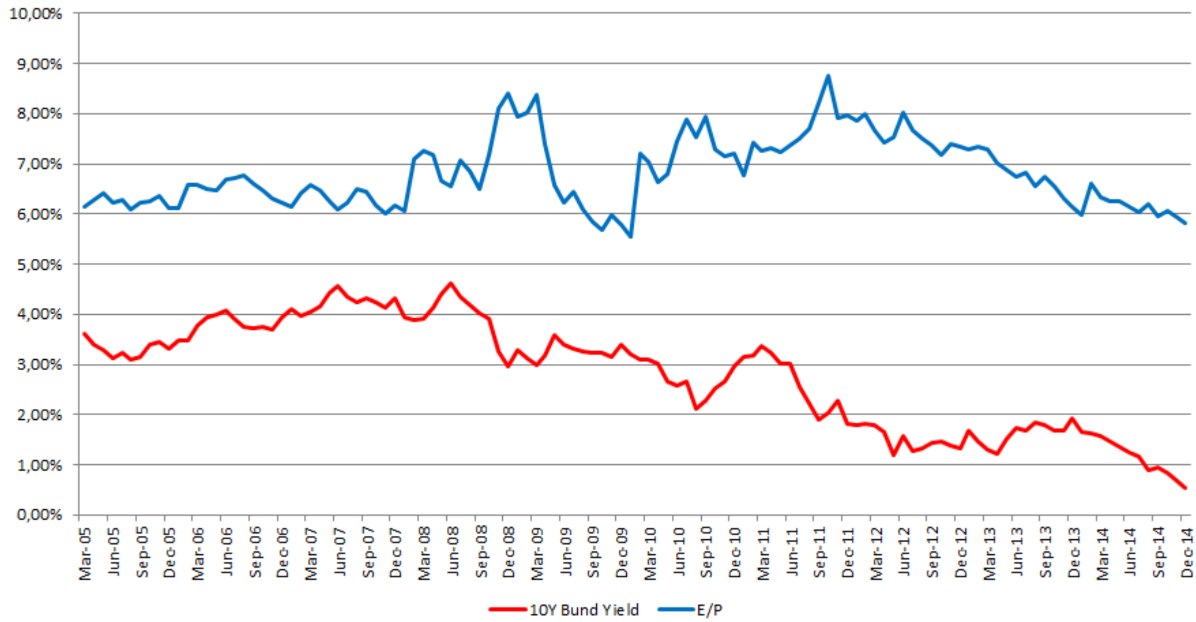
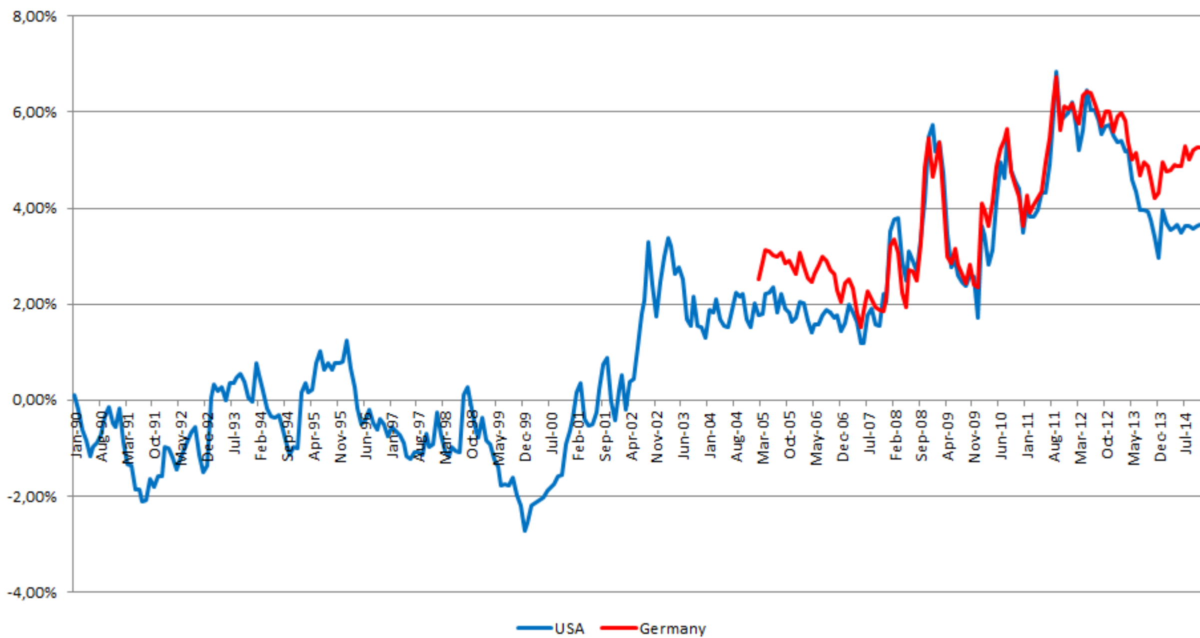


Chart 5 – Dax and S&P500 Equity Risk Premium



Source: Bloomberg

The Euro should continue to weaken against the dollar due to ECB's monetary policy and continuous low growth in the area. The level of hawkishness from the Fed will weight on the velocity and extent of this depreciation.

Greece should experience a new period of crisis, at least at the beginning of the year. However, the consequences on Risk appetite and European growth remain hard to forecasts. Syriza is leading the polls but has yet to win the election, to form a coalition government and then turn election slogans into actions.

Emerging Markets

In Emerging Markets the keywords will be selection and differentiations. Countries such as Russia and Brazil will be hit by falling raw material prices and the absence of a competitive manufacturing sector while other countries like Turkey and China will take advantages of lower commodity prices and their strong manufacturing capacity. However, we also note that China is home of some of the largest imbalances in the current global economy (Real Estate, shadow financing, local governements finances ...) and will have to address them smoothly but efficiently. Furthermore, in our view, a decrease of the Chinese growth rate below 7% should be considered as a phenomenon of normalization rather than a negative surprise.

CONCLUSION

In this analysis we saw mostly elements of normalization that would be positive for the economy but one should not forget that there are still numerous potential threats to the markets. Currently, Fed decisions, tensions in Greece, Ukraine and Russia as well as imbalances in China all have potential to disrupt the markets.

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