Random Note 1/2014

2014 Macro Outlook

Is USA normalizing and Europe going to follow Japan in a deflation path?

While 2013 was characterized by generalized liquidity injections across the globe, we expect 2014 to see more differentiated monetary policies. Indeed, the US and their close partner the UK are on the way of normalization. Both have already started to withdraw their non-conventional measures and we expect that their fiscal and monetary policies will return to pre-crisis course by end 2014. Meanwhile, we don't think that it will be the case for the Eurozone and Japan. Despite improving competitiveness and unemployment, the Euro-area is still struggling with low growth and a **stability pact** that gives little room for a proper fiscal policy in most of the countries. We expect the ECB to keep a very accommodative stance for an extended period of time in order to support the recovery and prevent the Euro to rise at a level that would threaten the economies. This stance could be an obligation if the deflation risk increases. In Japan, the BoJ should continue to struggle with an aging population issue, the risk of rising rates on the financial system suitability and above all, the energy price issues. Indeed, Abenomics by weakening the Yen is helping exports but at the same time it is weighting on energy costs, imports and competitiveness. Japan is aware that it is playing one of its last cards and it will likely continue to increase its monetary supply until the non-energy inflation data take root.

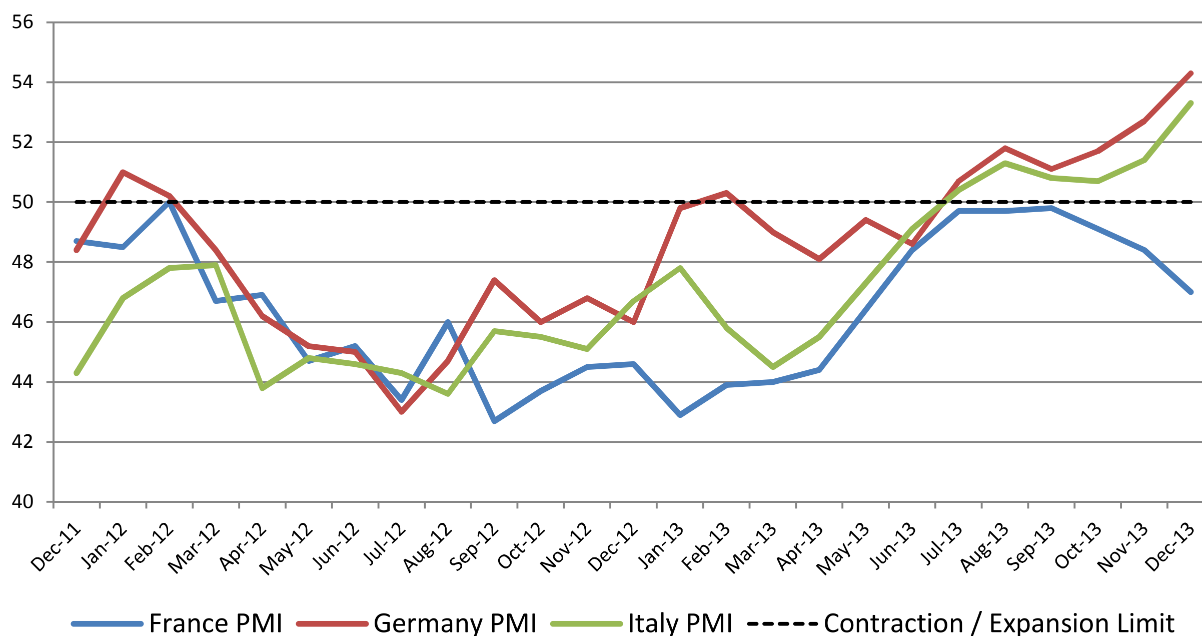
Equity markets

After such an historic year we do not expect a spectacular year for 2014 but we share the bullish view. This should be helped by continuing recovery (although it won't be in straight line), low risk premiums asked by investors and still accommodative central bank policies despite underlying normalization. P/E is still very interesting compared to risk free assets. Historically we had the same P/E when interest rates were much higher and economies in slowing path. The central banks will not be excessively aggressive as long as the level of growth and/or inflation is not worrying. The gap dividend yield weighted with the risk will stay interesting compared to fixed income risk free products.

In 2014, Ireland and Portugal should manage to consolidate or exit their bailout programs, even if Portugal could ask for a support line for some times. Spanish economy is recovering thanks to competitiveness gains (so called domestic devaluation) and unemployment is decreasing. We can hence say that many problematic countries have put in place reforms and made progress in the domestic devaluation. Italy has an historical high Debt/GDP ratio but should be, even with a fragile recovery, able to manage it. Spreads should also tighten due to investors' continued research of yield, low risk perception and a low risk premium demanded.

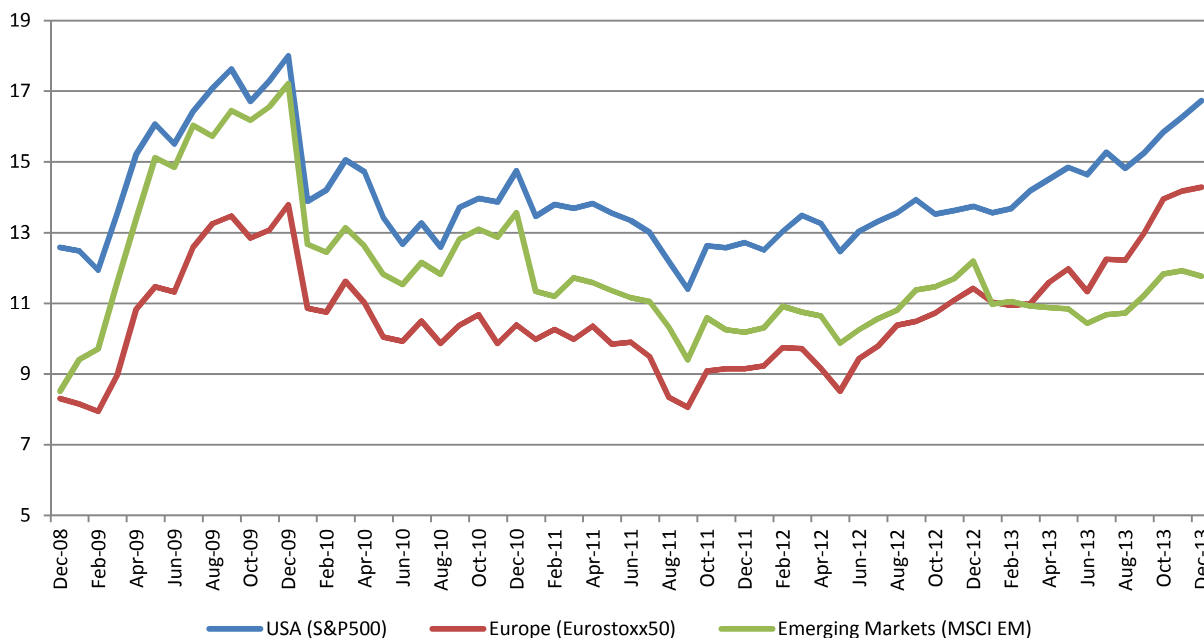
Fixed Income

Unless we see a reversal or a spike in inflation we found the present levels of interest rates in Europe and the USA are appropriate. Talking about tapering even if we have a reduction of $10Bn USD for the seven Fed meetings in 2014 we would still have added approximately $400Bn of liquidity in the market to the existing 4 trillion. The implied probability of interest rate increase in the US will depend from unemployment data, growth and inflation. Hence we could see some bond opportunities on the long side should we see a slowdown in unemployment numbers.



Emerging Markets

Mid-2013, hints of tapering triggered heavy outflows from Emerging Equities. This foreign capital didn’t came back since then and those markets seems nowadays less vulnerable to sudden risk aversion shifts and more attractively valued than many developed world markets. Further devaluation, growth pickup, commodity recovery could all be triggers that would benefit to emerging markets in local currencies. Once, the FX risk hedged, we think that some selective investment opportunities in equities will appear in the future. As an example, if China manage to reassure investors on the sustainably of its private and local debt load it could be an attractive investment opportunity in 2014. Structural changes are underway to move away the model from exports, credit-fuelled investments and construction of infrastructure and real estate. Inflation is still benign, monetary and fiscal policy are used to support growth, global recovery should provide support to exports, reserves are high and global RMB use is rising fast and it is now world’s second most used trade currency. Furthermore, Chinese leaders can use much more leadership than European authorities to resolve their debt issue.



Regarding fixed income, within many emerging economies, both exogenous (developed world low demand and global monetary policies) and endogenous (inflation and high consumption levels) triggers are pushing central banks toward a rate hike. But at the same times, they are trying to avoid doing it, fearing that it would kill their remaining growth potential and give them a competitive disadvantage thru higher FX rates. Market forces are pushing toward hawkish policies in part because investors needs higher rate to take FX risk, limit inflation outlook and current account deficits.

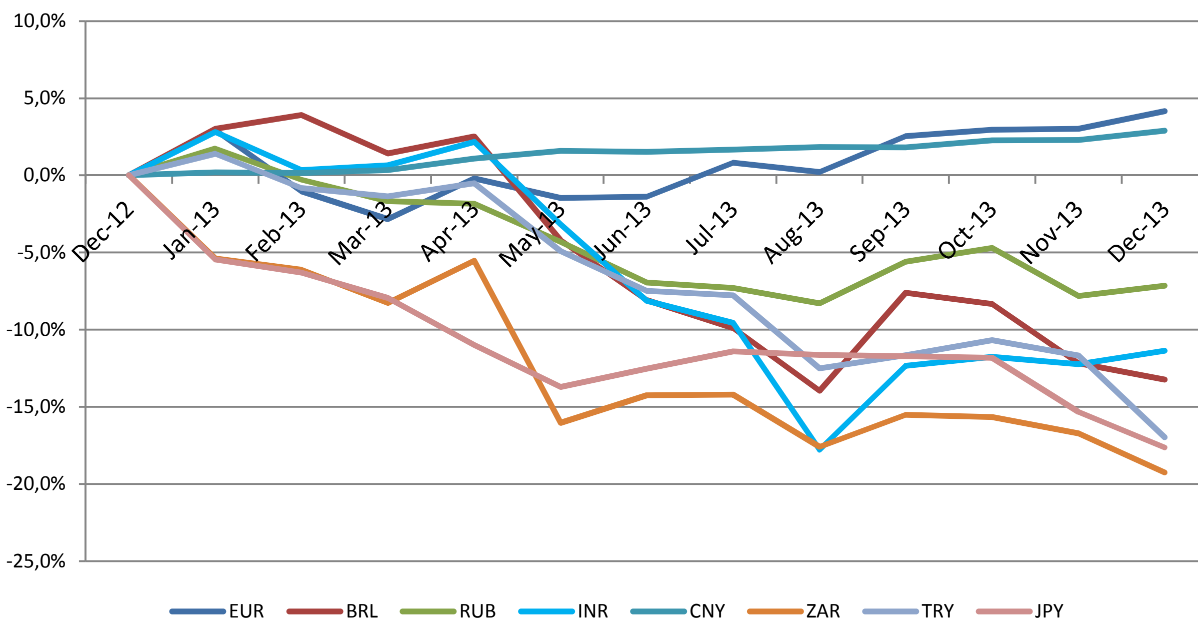
Devaluation is the current trend for most emerging currencies. However, after this currency cycle, there could be a moment where higher interest rates and FX devaluation would lead to very interesting FX rate/yield parity.

	GDP 2013 (e)	Trade Balance (USD Bn) 2013 Cumulated YTD	Current Account (%GDP) 2013 Average	Interest Rates	Inflation
Brazil	2,4%	2,6	-3,3%	10,0%	5,80%
Russia	1,7%	147,2	2,4%	5,5%	6,50%
India	4,2%	-145,7	-4,9%	7,75%	11,20%
China	7,6%	234	2,2%	5,58%	3,00%
South Africa	1,8%	-7,8	-6,0%	5,0%	5,30%
Turkey	4,0%	-89,7	-6,6%	3,5%	7,40%

Forex

The consensus view is currently that Fed Tapering, higher interest rates, stronger US economy and continued ECB accommodative policy will lead the US dollar to appreciate against the Euro. However it should not be overlooked that the US still have a huge current account deficit that will be affected on one side by the shale gas revolution and manufacturing relocation and on the other side by increasing domestic demand. Furthermore, we believe there will a return to Europe of money invested in US dollar during the 2010-2012 crises. Those factors could in turn weight on the USD.

Continued recovery in the UK should benefit to the GBP. The Yen has historically been influenced by the huge Japanese current account surplus but this has changed after Fukushima and for the future we could have an exchange rate dependent mainly from growth, interest rate differentials, core-inflation and monetary policy. We see an opportunity in the EUR/CHF since the Swiss Franc is still highly valued despite the drop in global risk aversion, the weight of current levels on the economy and financial outflows triggered by the end of banking secret.



The only sizeable correction of 2013, in June, was triggered by the announcement by the Fed's chairman that a tapering was possible before the end of the year. Investors were aware that the rally over the first half of the year was mostly supported by Fed's liquidity supply. However, as the end of the year neared, markets were less and less sensitive to tapering-linked news and even rose when it was finally started end December. Nowadays, we see the tapering story already mostly priced in the market and investor's attention will now likely turn to the interest rate outlook. More precisely, unemployment threshold indicated by the Fed will likely draw significant attention. Many thinks they will lower it from 6,5% to 6% in order let growth take a firmer foot before they act. We shouldn't underestimate the possibility that the consequence of such a decision could be as important for the direction of many asset classes as the last May Bernanke announcement about tapering.

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Data Source: Bloomberg

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