Top Five Macro Themes for 2015

By Rick Harrell, Senior Sovereign Analyst

The global economy is in the midst of a major rebalancing. In the years since the Great Recession, the financial and household sectors in the US and other advanced economies have been saving, retrenching and deleveraging, acting as a drag on global demand.

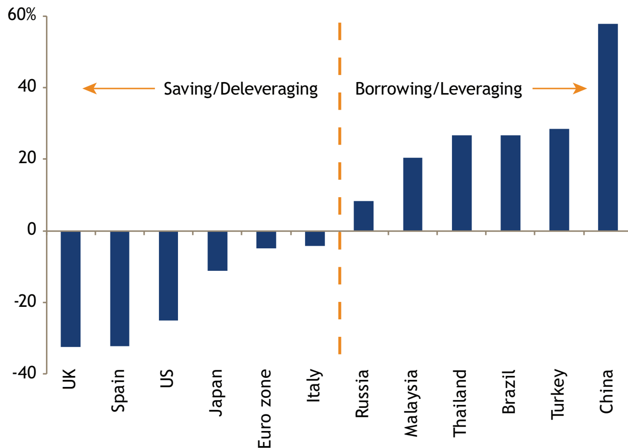
Meanwhile, China and other emerging markets have fueled growth by borrowing, spending and leveraging. Now the credit cycle is turning, and the new growth engine over the next few years could be our old favorite: the US consumer. The time has come for emerging markets and commodity producers to save and delever.

TOP FIVE MACRO THEMES FOR 2015

1. The Shift in the Global Credit Cycle Should Favor Developed Market Consumers
2. Echoes of Late 1990s
3. Redistribution and Rebalancing from Oil Drop
4. "Waiting for Godot" and Rising Rates
5. Emerging Markets: New Leverage on the Block

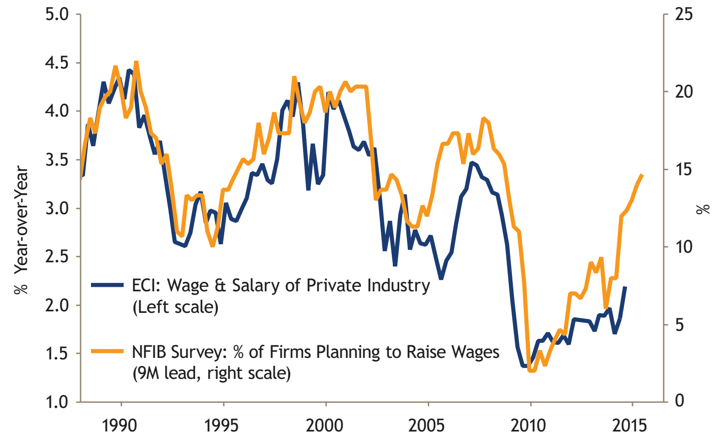
1. The Shift in the Global Credit Cycle Should Favor Developed Market Consumers

FIVE-YEAR CHANGE IN PRIVATE CREDIT/GDP



Source: BIS, national sources, as of December 29, 2014.

EMPLOYMENT COST INDEX VS. FIRMS PLANNING TO RAISE WAGES



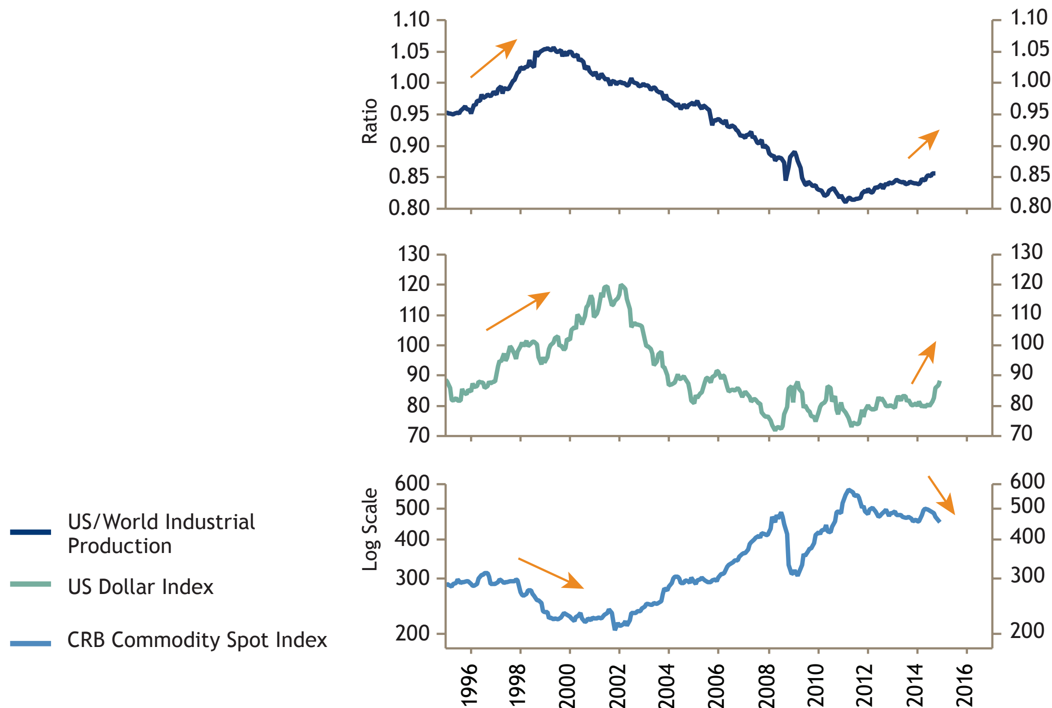
Source: Thomson Reuters Datastream, as of September 15, 2014.

- In the wake of the global financial crisis, emerging market (EM) leverage drove the global economy while consumers in the US and Europe retrenched and delevered. Now the global credit cycle is turning away from EMs and toward the US consumer, which looks poised to reclaim its role as a global growth engine.
- Jobs in the US are being created at the fastest pace since 1999,[1] and slack in the labor market has started to vanish rapidly. There are now early signs of upward wage pressure as industry surveys show more firms plan to raise wages soon. Interest rates are low, the household balance sheet is generally in great shape, real incomes are rising, and there is pent-up housing demand. These developments should support US consumer demand, but steady wage growth is a key variable. In Europe, we might see some positive surprises out of consumers in the years ahead as unemployment peaks and fiscal retrenchment eases.
- This shift suggests investing in growth assets in developed markets while looking for credit market assets that can benefit from saving and deleveraging.
- The US is advancing to the later stages of the credit cycle, but this period can last a while. Our measure of the corporate financing gap is moving higher, which, along with a firming job market, indicates increased leverage and potential pressure on margins. While this could be an early warning signal for credit spreads, the economy is beginning to grow above trend, which should lead to better profit growth and prolong the cycle. Against this backdrop, we expect risk appetite to be well supported and companies to begin investing for future growth opportunities. This implies equities outperform credit in 2015.

[1] *Source: Bloomberg.com, January 9, 2015.*

2. Echoes of the late 1990s

US GROWTH ACCELERATING, DOLLAR STRENGTHENING, COMMODITIES WEAKENING

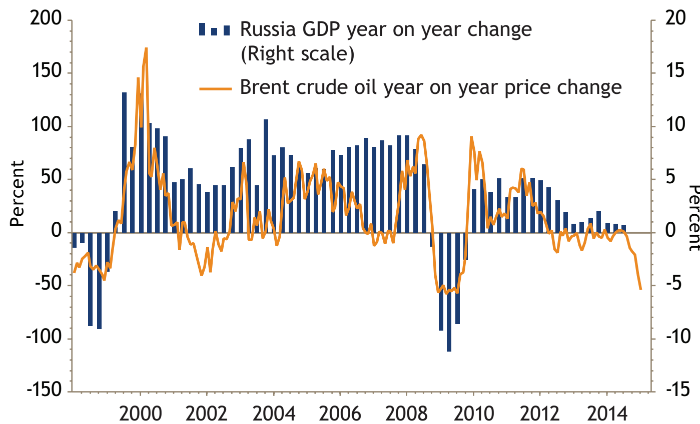


Source: Thomson Reuters Datastream, CPB, Federal Reserve, data as of December 31, 2014.

- The anticipated shift in the global credit cycle to favor the US consumer harkens back to the late 1990s. The US is currently accelerating faster than much of the rest of the world economy. And as the US economy outperforms, so does the dollar. Though the dollar's recent appreciation has been fast and furious, we expect this will continue to be a driving force in global markets in 2015.
- The dollar is a critical price in world markets and reflects the rebalancing underway in the global economy. Secular moves in the dollar have historically been inversely correlated to commodities. With the ascent of the dollar likely to remain a trend for a while, the commodity supercycle looks set to continue its descent. Oil prices have collapsed, and imports are getting cheaper with a strong dollar, putting more money in the pockets of US consumers.
- There is a dark side to dollar strength. Nearly 20 years ago, a strengthening dollar broke many fixed exchange rates in EMs and precipitated the Asian financial crisis and Russian default. Right now, turmoil abroad caused by the dollar's strength could eventually come back to bite the US, as was the case in the late '90s when the crisis in EM created a deflationary shock that caused the Federal Reserve (the Fed) to cut rates despite an otherwise strong US economy. But those rate cuts in a strong economy fueled the late '90s consumption boom in the US and Europe and a bubble in "New Economy" stocks.

3. Redistribution and Rebalancing from Oil Drop

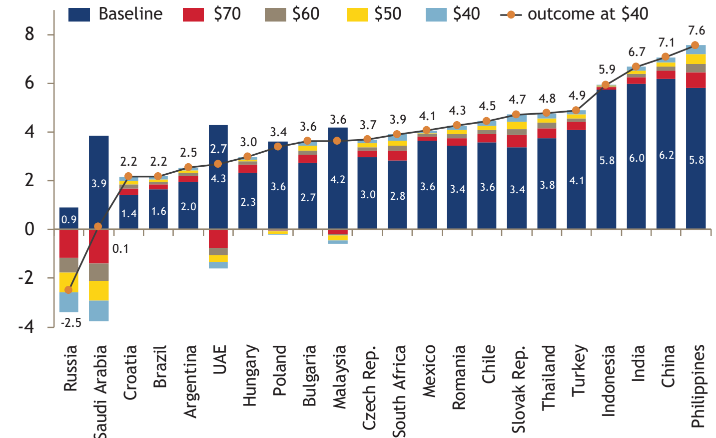
RUSSIAN GDP AND THE OIL PRICE



Source: Thomson Reuters Datastream, as of January 1, 2015.

GDP GROWTH UNDER BASELINE & OIL SCENARIOS

Baseline and Impact on Average Growth, 2015-2016



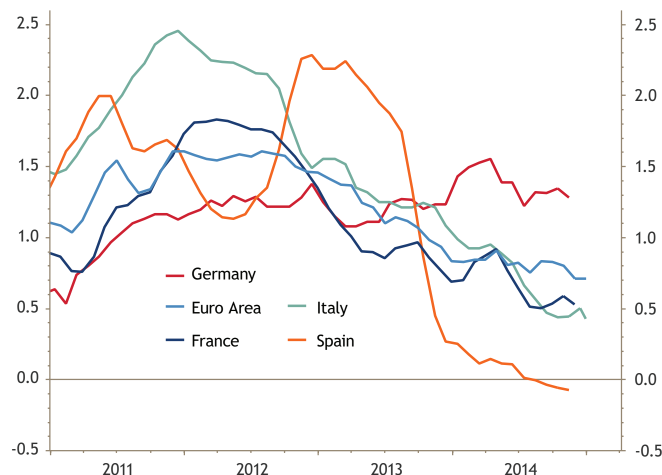
Source: Oxford Economics, Haver Analytics, as of December 9, 2014.

- The rise in oil and commodity prices since the early 2000s took money from the pockets of consumers, but that drag was papered over by the borrowing and spending boom. Once the ability to borrow ended after the financial crisis, global demand was crushed because commodity producers, especially OPEC, saved their income rather than spending it.
- The nearly 60% plunge in oil prices should stimulate consumption growth. It will keep a lid on inflation, boosting real incomes. And lower interest rates reduce debt-service costs, allowing consumers more capacity to borrow and spend on the back of generally improved household balance sheets.
- But financial markets can experience initial dislocations as economic gains are redistributed from oil producers to consumers. The obvious losers are oil-exporting nations such as Russia, Venezuela and Nigeria. The timing for Russia is particularly inauspicious since its economy was already reeling from sanctions related to the conflict in Ukraine. In addition, much of Latin America and other resource-dependent economies should struggle as the descending phase of the commodity supercycle continues.
- But not all is dark for EM. As net energy importers, most emerging Asian economies stand to benefit from lower oil. This region is also expected to deliver the strongest growth worldwide this year. Moreover, close links to global manufacturing and the US consumer are advantages that should enable emerging Asia to outperform its peers.
- For the US, lower oil is a net positive. Even though the oil industry was a key growth sector during the recovery, it is still quite small (less than 2% of GDP). Total employment in the oil and gas sector accounts for only 0.5% of all jobs in the US.[2]

[2] *US Bureau of Labor Statistics, December 2014 employment data, as of January 9, 2015.*

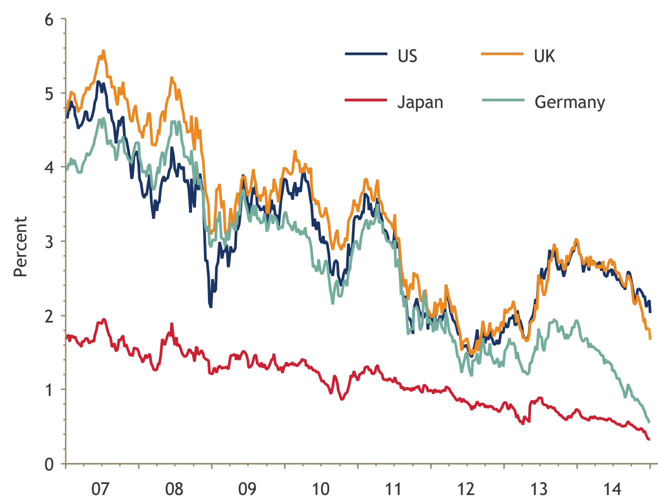
4. "Waiting for Godot" and Rising Rates

EURO AREA CORE INFLATION
3-month Smoothed Annual Percent Change



Source: Thomson Reuters Datastream, as of November 14, 2014.

10-YEAR GOVERNMENT BOND YIELDS



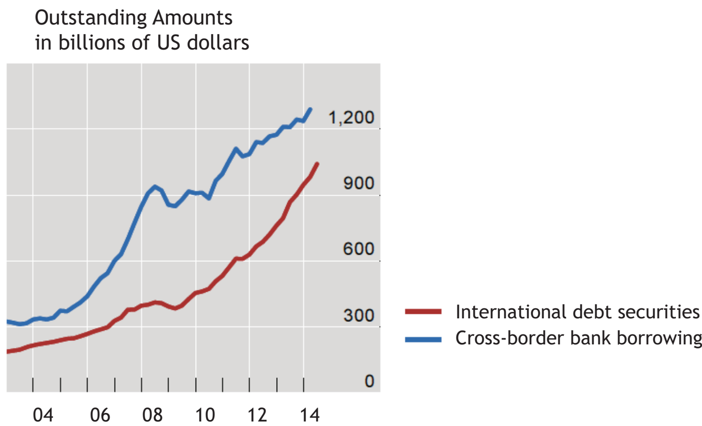
Source: Thomson Reuters Datastream as of January 1, 2015.

- We may be waiting a long time for rising rates, in large part because Europe and Japan continue to diverge from the US. Euro area demand remains stagnant, and the economy is flirting with deflation. This will eventually lead the European Central Bank (ECB) to throw everything it can behind efforts to boost asset prices and inflation expectations. We expect sovereign quantitative easing to be on the menu in 2015, and growth could finally pick up (though mildly) as a weaker euro, lower interest rates and cheaper energy should all stimulate growth. But mounting political risks related to anti-euro sentiment and the potential for a new wave of peripheral sovereign crises could undermine the recovery.
- The Bank of Japan (BOJ) increased the pace of its already aggressive monetary expansion program and recently added fiscal stimulus to the mix in order to balance the negative impacts of last year's consumption tax hike. Excess savings from the corporate sector will need to trickle down to consumers via higher real wages for Abenomics to make a lasting impact on economic growth.
- The ultra-easy monetary policies in Japan and the euro zone are in stark contrast to the US, where the Fed is on course to raise rates this year. This divergence in monetary policies can act as a drag on longer-term US yields, which would otherwise be in a rising trend consistent with improving US fundamentals. Investors should remember the global nature of modern financial markets and that half of the outstanding stock of US Treasurys is owned by foreigners.[3] Developments around the globe matter for US yields.
- However, low interest rates will continue to support a resurgent consumer in the US, and eventually in Europe and Japan, potentially leading to upside growth in late 2015 and 2016.

[3] *US Treasury Department, as of October 31, 2014.*

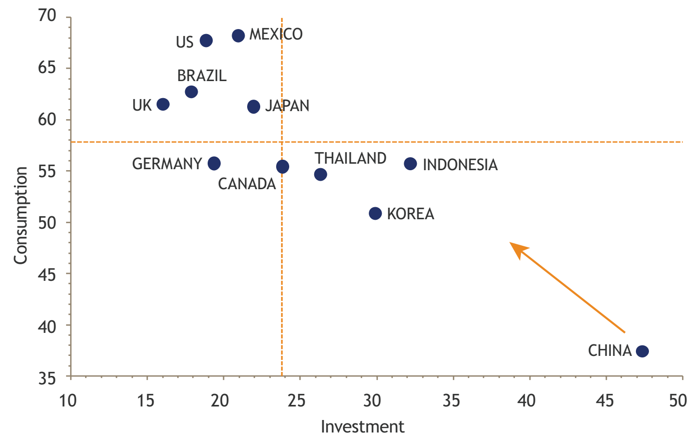
5. Emerging Markets: New Leverage on the Block

EM PRIVATE CROSS-BORDER BANK BORROWING AND INTERNATIONAL DEBT ISSUANCE



Source: Bank for International Settlements consolidated banking statistics and international debt securities statistics, data as of September 14, 2014.

CONSUMPTION VS. FIXED INVESTMENT
% of GDP



Source: Thomson Reuters Datastream, Oxford Economics, data as of December 31, 2013, for GDP comparison.

- EMs rescued developed markets after the financial crisis. They had the capacity to borrow and spend and became the global growth engine, led by China. But now the credit cycle is turning, leverage is high, and the income growth needed to service the debt is decelerating.
- The buildup of external liabilities (debt payable in a foreign currency, typically US dollars) has surged in many EM firms. The Bank of International Settlements and the International Monetary Fund have flagged this as a top global financial stability risk presently. As the US dollar (and eventually interest rates) rises, it will be more difficult for firms to service this debt. The potential for asset-liability mismatches to crop up on EM corporate balance sheets has caused credit risk premiums to stay elevated in this asset class. With the combination of tighter US dollar liquidity, weakened exchange rates and slower growth, we expect this risk premium to persist.
- However, this buildup in dollar leverage may not necessarily end in widespread financial crisis a la 1997-1998. Most EM countries now have flexible exchange rate regimes, and their currencies have been steadily depreciating for the past two to three years. And most EM central banks have a stronger capacity to deal with disorderly currency moves given high levels of reserves.
- China is another key risk factor for EM, and the world economy at large. Proxies for Chinese GDP imply growth is already well below the official 7.5% target. A credit-fueled investment binge propelled growth during the last decade, but policymakers know they cannot rely on this model any longer. Ultimately, growth will need to come from consumption, but this rebalancing act is a difficult feat. We can expect measured easing from China as it tries to micromanage a cyclical recovery while undergoing a secular downshift in growth.
- EM assets offer a healthy risk premium through higher interest rate spreads, low equity multiples and cheaper currencies, but given where they are in the global credit cycle, it is a well-deserved risk premium. Credit assets could do well for EMs that are in the credit repair part of the cycle and offer high yields.

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Disclosure

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