Year-end Look Ahead and Backward

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2014 Was a Year to Forget

As 2014 ends we look forward into 2015. World economic growth disappointed all public and private forecasters in 2014. In October 2013 the International Monetary Fund (IMF) had forecast that world growth would accelerate significantly from 2013 (2.9%) to 3.6%. It didn’t for a variety of reasons such as: adverse weather in the US, economic depressing sanctions between the EU and Russia, political jousting in the Pacific causing serious uncertainty throughout the Asian region, unrealistic assumptions over the impact of the consumption tax increase in Japan, un-pragmatic macro policy in the EU, and slumping domestic activity in China. Consequently, the IMF revised their global forecasts for 2014 down on three separate occasions finally settling in at 3.3%.

Firstly, 2014 was filled with exogenous shocks that frustrated economic prognosticators and threatened world order in Syria, Iraq, Ukraine and the western pacific. Secondly, there were misjudgments about the economic costs associated with structural political changes in many important emerging markets. Nevertheless, global growth has been slowing each year since 2011 and the IMF has consistently forecasted that growth will pick up substantially in the following year. In their latest forecast they have once again been optimistic, forecasting that global growth would accelerate to 3.8% in 2015.

IMF Forecasts of Global GDP Growth*

While it is impossible to predict exogenous shocks, it is therefore necessary to count on some shocks happening in 2015. There are several factors that bear close scrutiny:
One positive shock from 2014 that will bear economic fruit in 2015 is the plunge in oil prices. If oil prices remain at present depressed levels global economic growth will benefit. The IMF assumed that oil prices would average $99 per barrel.

Another positive factor for 2015 is that monetary policy is likely to remain accommodative even in places where that accommodation will be slowly receding.

Significant depreciation in many foreign exchange valuations should help slumping economic trade in depressed economies.

Potential GDP growth may keep slipping, especially in the advanced countries that are experiencing population decay, high and rising dependency ratios and intransigent structural deficiencies.

Corruption, transparency and the lack of pragmatic legal systems daunt emerging markets and are the focus of several new governments. Efforts to address these impediments undermine prospects for short-term growth.

The many geopolitical disruptions that occurred in 2014 are unlikely to be resolved in 2015 - they are more likely to simmer. New provocations should always be assumed to erupt and they will damage economic confidence.

On balance, global growth in 2015 is very unlikely to exceed its rate of growth in 2014. Global recession is unlikely, but deflation is expected to be experienced in several key economies in 2015.

**The Great Wealth Transfer of 2014**

The dramatic decline in oil prices during the second half of 2014 (West Texas Intermediate prices plunged more than 40% to $60 per barrel in December 2014) created a massive shift in wealth from oil producing countries to oil importing countries. The economic effects from this wealth transfer will become far more pronounced in 2015 than they were in 2014. Quite simply prices plunged because the demand for oil declined alongside slower global economic growth in 2014 against the available supply.

Income losses from falling oil prices will cause serious roadblocks to economic growth in 2014 to all oil exporters such as Russia, Venezuela and most Middle Eastern countries. These countries will find that their economies are pushed to the edge of recession. And, if oil prices are sustained at present levels it will create serious budget shortfalls as most oil producing countries built their budgets on the assumption of significantly higher energy prices. As a result, lower oil revenue will lead to delayed fiscal spending plans, countries’ debt ratings being lowered, and borrowing costs raised substantially. In addition their currencies will depreciate further and for those countries that defend their currencies values against a
benchmark – their sovereign reserves will be depleted.

Oil importers are the biggest economies in the world, such as the EU, Japan, China and the US. They will receive a substantial boost from lower oil prices because consumers will benefit. Lower oil prices leave consumers with more disposable income to spend because the demand for oil is price inelastic. Estimates of the net positive benefits from lower oil prices to global GDP growth made by the world’s most respected institutions range from plus 0.5% to 1%.

Among the alternative side effects from lower oil prices will be a reduction in global inflation. Lower energy prices will decrease costs of travel, shipping, agriculture, production of petrochemicals and other products which use oil for production or delivery. It also raises the risks of future deflation in economies presently bordering on zero inflation such as Japan and the EU. Nevertheless, lower global inflation will reduce inflation expectations, decrease long-term bond rates, and cause central banks in economies flirting with deflation to extend monetary stimulus well into the future.

**China’s Growth Rate is Questionable**

In contrast to a decade ago when the rest of the world believed that economic growth in China was much stronger than the 10% plus growth the government was reporting, the rest of the world today believes that growth is weaker than the announced rate. Recently the government announced they would reduce their expected growth for 2014 from 7.6% to something lower and probably decrease their target for 2015 as well. The IMF has forecast growth of 7.1% in China for 2015.

While the government’s effort will help manage national expectations downward it probably does not reflect the true decrease in China’s actual economic growth. Other broad measures of economic activity such as industrial production and utility utilization have been slumping over the past several months, suggesting that the decrease in GDP is greater than the authorities proclaim.

![China: Industrial Production (y/y) is Declining](image)

The domestic problems disrupting economic growth in China are numerous, especially questionable credit extensions by banks. Externally China’s biggest export markets (the EU and Japan) are predicted to stagnate in 2015, shrinking China’s external surplus and limiting the economy’s growth. The government’s emphasis on reducing corruption has slowed many forms of spending and distracted top officials from
focusing on growth. Earlier this year they promised to ignore growth volatility in an effort to focus on reform and accept lower growth. Unfortunately growth slowed more than they expected.

Chinese officials must also contend with rapidly slowing inflation. Inflation decelerated down to 1.5% in October from a year ago and is likely to fall further as low energy prices work their way through the economy. If inflation decelerates much further China also will be worried about the global scourge of deflation.

The government has hard evidence about the true rate of growth and is quickly modifying their non-interference policy and making last minute changes to macro policy in order to stimulate economic growth. The People’s Bank of China has already cut interest rates twice and more recently has reduced reserve requirements in the hope of stimulating bank lending. More stimulative policy changes are anticipated for next year. Nevertheless, it will be difficult for the Chinese economy to grow at 7%, even if 7% becomes their official target.

**New Governments in ASEAN Need to Invigorate Domestic Economic Growth**

Newly elected leaders in the region’s largest economies will have much work to do to invigorate domestic demand to counter the expected slowdown in external demand from the world’s largest economies. Moreover, their efforts to structurally reform their economies, invest in infrastructure and reduce corruption while very noble in the long-term will probably create short-run hurdles to growth. The economic growth slowdown in China plus stagnation in two major developed markets (EU and Japan) for south Asian products indicates that growth in external demand will diminish greatly in 2015.

The two largest economies in South Asia (India and Indonesia) have new leaders promising domestic reform and structural changes to their economies. Naturally they are needed, but the rewards from their efforts, if carried out, will take years not quarters. Growth rates in India and Indonesia are slipping from relatively high rates in the past few years, reflecting losses in external markets and little new in the way of fiscal or monetary stimulus. Further slippage is highly likely in 2015.

In Singapore macro prudential polices are expected to remain in place through 2015, weighing further on real estate and diminishing residential construction incentives for at least the next year or two. Economic growth is not expected to accelerate from 2014 and will probably remain in the 2% to 3% region for the next two years.

**The EU Is On the Brink of Recession**

Easier monetary policy will not save the EU from another recession. The drop in oil prices might, if price reductions are
sustained, however, it comes with a cost: deflation. Deflation is on the EU doorstep and economic growth prospects are miniscule at best. More macro stimulus is necessary, but may not be sufficient.

EU economic growth subsided in Q4 to an estimated rate of 0.1% with little hope for acceleration in the next quarter as the economies of the core countries are now struggling. Purchasing Managers Indexes for manufacturing and service sectors are hovering around 51, a barely positive reading suggesting that the present stagnation in the EU could easily slip into recession next quarter. Growth prospects for 2015 are negligible: zero growth is forecast.

The EU is flirting with deflation now. The harmonized EU CPI is sputtering at an annual rate of 0.3% from a year ago. This is woefully below the ECB target of just under 2%, and painfully close to below zero. EU economic activity grew less than expected in November after heavy discounting prompting firms to cut prices again to revive consumer spending during the Christmas season. Their actions threaten to cause deflation in the EU zone soon.

More monetary stimulus will be forthcoming. It will lead to further reductions in long-term interest rates once the ECB begins to purchase long maturity government securities, especially with no inflation on the horizon. QE will also depreciate the value of the Euro in 2015 – hopefully this stimulation will add to export growth. Nevertheless, the combination of poor economic growth prospects, ultra-low interest rates and a depreciating currency will cause serious capital outflow from the EU.

The EU yield curve reflected by yields on German bonds resembles the Japanese yield curve, one that has been buried in deflation for decades. In Japan long-term pension fund investors had been obliged to invest in government bonds. No such regulation exists in Germany, or other EU sovereign issuers. Rates in Europe are so low that five European countries sovereign debt are presently yielding less than comparable maturity US Treasuries.
Any further instability in the Ukraine, or other former Soviet eastern European countries will add to potential EU investor dissatisfaction, absorb policy-makers attention which will distract them from deciding on necessary economic reform, and hence destroying business and consumer confidence.

Japan Fell Back Into Recession

In a flash Abeconomics went from a startling success into a ruinous recession. There was no surprise that a rise in the consumption tax would lead Japan back into recession just as it did in 1997, the last time the Japanese government tried to raise consumption taxes. After two damaging quarters of negative GDP growth the government has made some bold promises and provoked the Bank of Japan into escalating its purchases of JGBs. Consequently, more Yen are being created and their exchange value is rapidly depreciating. Yields on JGB are falling as well. Abe also postponed the next round of consumption tax increase for another year, promised more fiscal initiatives, and called a snap election to gain some political power.

One of the biggest structural changes in the past year was the liberalization of the official pension systems investment policies. They are no longer required to invest only in JGBs. They are now free to invest in equities. With the government’s fiscal stimulus programs, the federal government will have to attract more funds than in past years and this should eventually raise interest rates in Japan. A rapidly depreciating currency, ultra-low interest rates and some institutional liberalization should cause capital to flow out of Japan.

Lower oil prices will help and some rebound in consumer spending is anticipated in the fourth quarter following the consumer retreat in the past two quarters. Both events should dig the economy out of recession. Economic growth next year is expected to be between flat and 0.5%.

However, deflation is hovering and the fall in energy prices and lack of final demand will probably push the economy back into deflation and smother any progress Abe made with the economy in his first year. Inflation in Japan is presently running at a year on year rate of 2.9% and is rapidly headed lower from its recent peak rate of 3.7% in May. Wages remain depressed and will not support positive inflation.

US Growth Needs a Boost from Business

The US is saddled with a lame duck president and a hostile congress that Republicans are in total control of. Political antagonism implies that there will be few policy initiatives introduced, or enacted in the next two years. The situation in the Middle East is deteriorating. It will absorb more of the president’s attention and create a struggle for renewed commitment of limited resources from a hostile congress that is devoted to reduce spending.
The US economy is gathering momentum for sustained growth, but at below average growth rates. This slow-speed economic growth path has been achieved under the aegis of extremely low interest rates, highly accommodative monetary policy, no inflation, a 43% reduction in energy costs, and a spectacular advance in the national stock markets.

The unemployment rate has tumbled down into acceptable territory and the economy is producing 2.5 million new jobs per annum. The employment situation is now similar to what it was in the middle of the last expansion, as shown in the chart below. This will create positive real income growth, further raise consumer confidence, and produce consistent growth in consumption spending.

**US Monthly changes in Employment and the Unemployment Rate**

Another stabilizing factor for the US economy going forward is the reduction in the budget deficit. Apart from the political rhetoric, the federal budget has shrunk down to 2.6% of GDP, a level below the EU’s strict criteria for fiscal prudence. Thus there is little need for further fiscal drag upon the economy in 2015.

Corporations continue to increase profits, and have built-up massive sums of uncommitted funds, but they have not decided to invest these funds in new operations. As a result, the uncommitted pools of capital have been used for stock buy-backs and increased dividend payouts. The net result was to reinforce and enlarge the embarrassing wealth gap in the US, thus fuelling additional political agitation.

Acceleration in US GDP growth in 2015 will depend crucially upon a substantial pick up in business investment. Present increases in employment guarantee sufficient income growth to maintain consumption and to increase wages fast enough to prevent deflation. Business needs to contribute more to GDP than it has in the past 4 plus years of business cycle expansion to raise the bar for growth.

In 2015 monetary policy will begin an extended period of withdrawing exceptional easy monetary accommodation. Eventually the end of QE should cause the Treasury yield curve to steepen from its present slope. However, if inflation expectations remain as depressed as they presently, there will be little upward movement in the slope of the yield curve. Expectations for the monetary authorities to raise the fed funds rate 2015 have been well embedded in the term structure and the expected gentile rise in the Fed funds rate in 2015 should not stress the
economy, nor the fixed income market. Long-term interest rates are more likely to rise than fall in 2015 and the yield curve should flatten in a low inflation word.

Stock prices, which benefitted from excessive monetary ease over the past few years, should lose some of their luster in 2015 once the Fed begins raising interest rates. Nevertheless, equity values should be supported by faster growth, adequate corporate profit growth, and very low interest rates. There are no alternative investments that are likely to challenge US equities in 2015 for investor attention. Moreover, capital outflow from the EU and Japan should flow into US investments.

Conclusions

The IMF world growth forecasts look too optimistic again. The EU and Japan have too much to overcome without sufficient macro policy incentives. Deflation is more likely in both areas than an improvement in their growth rates. China is a quagmire with official growth targets likely to be greater than what the economy is able to achieve. ASEAN countries will be looking internally for growth, as external sources are all retreating. The US is forecast to grow faster than in 2014, but it does not have the private sector strength to reach 3% growth without fiscal support, which is unlikely to be forthcoming. Global growth should rise minimally to a projected 3.4% in 2015. Deflation rather than inflation is more likely to capture policy makers’ attention in 2015. Global macro policy will continue to be supportive of economic growth, maybe insufficiently, and not to become an impediment to growth in 2015. Currencies are anticipated to keep adjusting in favor of the dollar given its relatively stronger economic growth projections and improved current and fiscal imbalances. The gentle rise in US interest rates, appreciation of the US dollar, and determined policy action to deflate real estate prices in many Asian capitals should reduce the inflow of capital to all Asian markets. Present geopolitical tensions will not disappear, may intensify sporadically, and new ones might develop. All will add to uncertainty and create more volatility in financial markets.

For more information, please contact camri@nus.edu.sg
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Source: Bloomberg

**APPENDIX**

**GLOSSARY OF KEY TERMS (Source: Bloomberg, with tickers in parenthesis. In US$ where applicable)**

**S&P500**: capitalization-weighted index of the prices of 500 US large-cap stocks (SPX)

**FTSE**: capitalization-weighted index of the prices of the 100 largest LSE-listed stocks (UKX)

**NIKKEI**: capitalization-weighted index of the largest 225 stocks of the Tokyo Stock Exchange (NKY)

**HANG SENG**: capitalization-weighted index of companies from the Hong Kong Stock Exchange (HSI)

**STI**: cap-weighted index of the top 30 companies listed on the Singapore Exchange (FSSTI)

**EUR**: USD/EUR exchange rate: 1 EUR = xx USD (EUR)

**YEN**: YEN/USD exchange rate: 1 USD = xx YEN (JPY)

**CMCI**: Constant Maturity Commodity Index (CMCIPI)

**Oil**: West Texas Intermediate prices, $ per barrel (CLK1)

**3MO LIBOR**: interbank lending rate for 3-month US dollar loans (US0003M)

**10YR UST**: 10-year US Treasury yield (IYC8 – Sovereigns)

**10YR BUND**: 10-year German government bond yield (IYC8 – Sovereigns)

**10YR SPG**: 10-year Spanish government bond yield, proxy for EU funding problems (IYC8 – Sovereigns)

**10YR SGS**: 10-year Singapore government bond yield (IYC8 – Sovereigns)

**US ISM**: US business survey of more than 300 manufacturing firms by the Institute of Supply Management that monitors employment, production inventories, new orders, etc. (NAPMPMI)

**EU PMI**: Purchasing Managers’ index for the 17 country EU region (PMITMEZ)

**JP TANKAN**: Bank of Japan business survey on the outlook of Japanese capital expenditures, employment and the overall economy, quarterly index (JNTGALLI)

**CHINA IP**: China’s Industrial Production index, with 1-month lag (CHVAIYO)

**LC**: Local Currency

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