Insights from 2014 of significance for 2015

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Summarising the past year and comparing it with the "prophecies" is always approached with a sense of both pleasure and pain. The previous review of the year (in Swedish) identified 16 factors that would colour 2014. The principal message was that global growth **was bumping along the bottom** but that in many cases it was a case of an *"unusually blank sheet"* – an **exciting but demanding year** laced with a touch of optimism awaited. The actual results show that we got plenty of things right – and some things a tiny bit wrong...

Based on what actually happened in 2014, what insights do we have that can have a bearing on what will happen in 2015? Below we present 18 thoughts and conclusions that can provide guidance for the New Year. *"Reflections"* concludes with an **epilogue for 2015**.

1. Monetary stimulus without a finishing tape in sight

Utterly incredible! Events at the end of 2014, a full six years after the collapse of Lehman Brothers, mean that several countries are still planning for **more monetary easing in 2015** via e.g. negative interest rates and "banknote printing presses". These countries include Sweden, EMU, Japan, Denmark, Switzerland and China. The role of the central banks has been narrowed down to primarily stabilising/raising **inflation expectations** and to ensuring a weak currency. **Contours of continued currency wars in 2015 have been reinforced.** The central banks are being pressured by a growing sense of resignation in the face of political overreliance on what monetary policy can deliver. **The weaknesses of inflation target regimes will become increasing exposed in 2015**, while stagnating wage growth and the low oil price mean that both the euro zone and the USA will flirt with **CPI *deflation* in 2015**.

2. Fed prepares for rate increase with "millimetre precision"

Six years of zero interest rates in America and a fast growing Fed balance sheet (+ 3,500 billion dollars over the same period) until last autumn require **a carefully prepared soft landing before an initial increase** and cautious normalisation steps can be introduced. The preparatory phase can be said to have ended at the end of 2014. The fact that the stock indices rose after the Fed confirmed market expectations of an increase is a sign of this. The Fed is looking to increase the interest rate in six months' time despite continuing low CPI inflation (depressed by energy factors and despite the risk of falling inflation expectations). Many countries are hoping this policy will **strengthen the dollar** while weakening their own currencies at the same time. However, Fed is being forced to proceed with caution, not least to avoid a far too strong dollar, to be able to manage a generally rate sensitive US economy amid to uncertain growth prospects in Europe and Asia and risks of major destabilising global capital flows.

3. Front and backside of the collapse in the oil price

The historic collapse in the price of oil in 2014, 70 percent of which can, according to the IMF, be explained by increased supply and the rest by weaker demand, will at spreadsheet level deliver **a genuine boost to global growth in 2015. However, the price of oil is also highly political.** In late 2014, for the first time in 40 years, the USA took visible steps to become an energy exporting nation. The motives of Saudi Arabia, the world's largest oil producer, are both political (e.g. to undermine Iran and Russia) and economic (to win market shares and convert the country's oil reserves into financial reserves in order to be able to counter a possible "Arab spring"). **Plenty of signs point to the oil price remaining low**. Several oil producers are facing greater political and social challenges as a result, which will further increase an already heightened geopolitical risk premium.

4. Equities & bonds – a somewhat amazing journey

What an utterly incredible equity and bond journey 2014 proved to be. The Stockholm Stock Exchange rose by 12 percent in 2014. At the same time, the 5-year government bond yield fell from 1.8 to 0.13 percent (i.e. bond prices rose). This made it virtually impossible for financial portfolios not to deliver a good yield in 2014. As Japanese rates must continue to be the benchmark for European/Swedish rate levels, there remains certain if limited scope for a further fall. Return hopes therefore rest with the equities market that at the time of writing appears to be fairly reasonably valued, a conclusion that is based on permanently lower interest rates and oil prices plus an admittedly slow but still global recovery. A direct return of 4 percent on the Stockholm Stock Exchange seems to be persuading investors to buy equities due to the lack of other attractive investment alternatives.

5. Huge forces in motion – focus on financial stress

Despite the stock exchange and interest rate rejoicing in 2014, the world remains very vulnerable with a large risk of financial stress despite a general belief in rising indices, low rates and supportive central banks. **15 October** and **16 December were alarm bells that gave rise to a degree of anxiety ahead of 2015.** In October, liquidity suddenly vanished, a 10-year US yield fell by 37 basis points! Central banks were forced into verbal calming interventions. In mid-December, the Swedish krona and Norwegian krone suddenly weakened – liquidity was once again drying up albeit only temporarily. **The world is now radiating a kind of nervous optimism** about the current situation and the future. The strong market reactions in 2014 remind us of the enormous forces in the system, whose amplitude is strengthened not only by economic and political uncertainty and monetary policy orientation but also by a low return environment and new rules and requirements on global banking systems that reduce the buffering and risk absorption capacity of the systems.

6. Short-term and indecisive decision-makers

The economic, financial and political **compass needles are spinning** for governments around the world – not just for the central banks. IMF Annual Meetings in Washington in the autumn proved dismal gatherings following the economic and inflation disappointments in 2014 and confirmed the view that historical correlations were fumbling and economic models have to be revised. The ghost of Japan and stagnation lurks in several government offices. An uncertain outlook for 2015 means that **economic policy** therefore has a **bias**: policy-wise, negative surprises are having a far greater impact on shaping economic policy than any surprises in a positive direction.

7. Despite the fall of the Berlin Wall...

2014 was a contradictory year, to say the least. The 25th anniversary celebrations of the fall of the Berlin Wall in the autumn were sadly just a pale glimmer of light in the growing geopolitical **uncertainty gloom** from the east. On the threshold of 2015, following the annexation of Crimea and a presence in east Ukraine, the Kremlin continues to frighten its neighbours and the world. The Russia-Ukraine crisis talks have crashed while Kiev continues to position itself closer to the EU and NATO. The oil price drop came at an inconvenient time for Moscow and has brutally exposed the vulnerability and short-term thinking of the Russian economy. A **deep Russian recession awaits** and the probability of new trade sanctions is high. How the Kremlin deals with the economic, financial and political situation that is arising is anyone's guess; only President Putin can answer that.

8. USA is going like a train...

How strong is the US **immune defence system** against weakness in the EU and Asia? Probably **pretty strong**, which was confirmed by statistics from the autumn and winter. The falling oil price boosts consumer spending power and growth, although some investments in the energy sector may be postponed. US growth will be impressive in 2015 with **GDP increasing by around 3.5 percent**, which is just over one percent above the level considered normal/balanced today.

9. Rumours of the death of the euro crisis are greatly exaggerated

Pressure continued to increase in the euro zone in 2014. The market chose to turn a blind eye, with the help of the ECB's protective balance sheet, to the fact that the euro zone has not achieved its target of political and fiscal policy union. Ever louder calls by the ECB for greater integration are not heard in the euro zone capital cities. **Disintegration winds are blowing hard** at a time when fiscal discipline and austerity policies are making way for fiscal expansion. The thought of debt write off has been kept alive by the enormous debt mountain and constant issues of political staying power and stability in e.g. Greece and Portugal. The focus is on Germany and its willingness to pursue a more expansionary policy to support both Germany itself and the euro zone; at the same time, populist movements are growing in an EU that is facing feeble growth and high unemployment while wrestling with immigration issues. **2015 is expected to be the year when the realisation returns that the euro zone is far from a political and fiscal union**. Is there a risk that ECB President Mario Draghi will tire and seek political challenges in his native Italy instead?

10. Abenomics – trump or turkey?

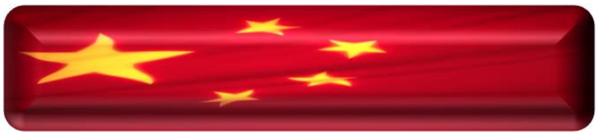
Having secured government power for four more years, Prime Minister Abe **has room to manoeuvre** in the direction of a strong structural policy. **It is needed.** The state of the Japanese economy at the end of 2014 would barely convince Abenomics fans; growth and inflation figures proved a big disappointment for the world's third (!) largest economy with the world's largest public debt (245 percent of GDP). In 2015, both monetary and fiscal policy will be put in **an even higher stimulus gear**. A more **optimistic view on Japan** would require that more women enter the job market to counter clearly negative growth effects of a rapidly ageing population, that salaries rise for far more employees and that inflation expectations increase to levels preferably above the inflation target of 2 percent.

11. China's economic muscle is increasingly being questioned

The world is gradually **becoming accustomed to the thought of China's growth gearing down at a controlled rate.** However, the worry remains that we do not know whether Beijing will succeed in achieving balanced economic growth. Growth is expected to reach around 7 percent in 2015, however the risks are on the downside. Clearly the focus will be on credit market as the growth-stimulating factor and additional monetary policy easing can be expected. Since the autumn, China has also let its currency weaken against the dollar, which reflects fears of a far too strong negative effect on exports if Japan is able to successfully weaken its currency even more at a time when the dollar is expected to strengthen. It is worth noting that global indebtedness is growing in relation to GDP and especially in emerging economies such as China. A belief in greater debt as an engine of growth can lead to problems further down the line.

12. The world’s centre of power is shifting eastwards

On **29 September 2014, China overtook the USA as the world’s largest economy** (in terms of purchasing power), according to the World Bank. This is a political fact rather than an economic event. The USA will continue to play the natural main role in the world economy for some time to come, but **Chine is methodically positioning** itself for further economic growth and to eventually have a global political say. The BRICS summit (Brazil, Russia, India, China and South Africa) last summer was a further sign of the ongoing power shift via the development by the BRICS countries of a structure shadowing the established, west-dominated IMF and World Bank. Russia's problems are now being alleviated by BRICS, e.g. China is supporting Russia by providing liquidity and increasing energy imports. **Russia’s chairmanship of the BRICS group in 2015** will be up against the **German** chairmanship of the politically important **G8** and the **Turkish** ditto of the heavyweight **G20**. Cooperation or conflict – that is the question.



13. Good morning, Sweden – political uncertainty here too

The autumn political deadlock and new election manoeuvrings confirm the emergence of a **new parliamentary and government landscape**. With the “December agreement” in place at the last moment, certain structural issues have been resolved, but **it remains to be seen whether this works in practice** as it offers scope for different interpretations and for stretching boundaries (e.g. what should be included in a budget bill). Both the Social Democrats and the Moderates appear to remain in an as yet unresolved ideological search phase. Ultimately, Swedish politics are expected to be a matter of tactics and positioning ahead of the 2018 election and how much scope the individual alliance parties will have before then to present their own proposals. Political defeats will be an everyday occurrence and major issues will be kicked into the long grass. **Welcome to semi skimmed politics!**

14. The Nordic model – a new perspective

The Nordic countries' (excluding Iceland) **economic model** and their **crisis management** of the major global recession have been praised as a success story in recent years. In 2014 doubts were increasingly raised about growth, structural problems and political stability in these countries. The following questions will feature heavily in 2015 too: *how will **Norway** manage a lower oil price in both the short and long term, and what will be the outcome in **Finland** of structural sector problems and Russia's economic and potential political problems (this naturally also applies to the three **Baltic countries**)?*

15. The British general election and the EU

British attitudes towards the EU hardened in the autumn of 2014. In the run-up to and following the **general election** in early May, the focus is (expected) to be on both the strength of the anti-EU UK Independence Party (UKIP) and, if Cameron is re-elected, the preparation for a referendum on EU membership in 2017. The somewhat power weary Conservatives face a weakly led Labour party. Many signs point towards a new political landscape with another coalition government (2010 was the first since 1945). Political commentators are therefore keeping the door open to a coalition between Tories and Labour on account of the more extreme views of the smaller parties and because minority governments increase the risk of a new election. **Britain's relationship with the EU** and how much of the current contributions the British want to renegotiate and how other EU member states will view this – are set to colour the EU political agenda in 2015.

16. Decision-makers must think again and think afresh

The **global debt mountain** continues to grow to new record levels, partly financed directly/indirectly by central bank **asset purchases** and expanding balance sheets. This policy has led to **increased risk taking** and raised asset prices but we are still seeing **few signs of an increase in productive investments**, partly due to geopolitical uncertainty, high return demands and global overcapacity on the production side. Further fiscal expansion is being supported, fiscal discipline rejected, at a time with deflation and stagnation risks in Europe in particular. The long-term unsustainability of this economic policy increases the risk of financial stress.

17. Global cooperation –vital but difficult

Australia had high but not unrealistic expectations of what the G20 could achieve in 2014. Once again, plenty of words were spoken and there was belief that global growth could be increased by an additional 2 percent over the coming five years if individual countries did their homework and pulled their fingers out. The crisis in Ukraine came to overshadow the work of the G20. **The priorities Turkey unveiled for its chairmanship of G20 2015 were not especially innovative** but good results can be achieved if Ankara chooses to pursue Australia's ambitious agenda.

18. Political deadlock

The winds of populism are blowing and new political landscapes are emerging, especially perhaps in Europe. Finland is also experiencing political deadlock that stands in the way of problem-solving policies. In April **parliamentary elections will be held in Finland** but there are few signs that the country will gain a stronger government. In addition to Britain, important elections will also be held in **Denmark**, **Spain**, **Turkey**, **Poland** and **Argentina**. US President **Obama**, who now faces a Republican Congress (a majority in both chambers from 2015), will probably **fall completely into the political shadows when Hillary Clinton makes her expected announcement** that she will run for president, at some point in the spring of 2015. The domestic policy focus in several countries will therefore absorb much of the energy that would otherwise be needed for global cooperation to gain a more stable global recovery and higher economic growth.

EPILOGUE: The world will continue to be a very complex place in 2015

The sense of nervous optimism is a recurring thought concerning the outlook for 2015. There are good reasons to respect the tremendous forces and capital sums that can easily be set in motion. Ongoing **oil and currency wars** – that naturally contain a (geo)political element – indicate a certain desperation in individual countries to get their own domestic growth moving, in some cases at the cost of other countries. This hardly favours global cooperation in a world that is out of **economic synch** and helmed by **short-term/indecisive decision-makers** and where the economic– and therefore also political – **epicentre is gliding eastwards towards Asia**.

The main role of the central banks is important to achieve a better economic and financial outlook but their actions – very vigorous with expanding balance sheets – entail that fundamental problems **are overshadowed**, that the risk of making **wrong decisions** increases and that their policies become a kind of **replacement for comprehensive political changes**. Not least the ECB and the euro zone are grappling with these challenges. Central banks have their own problems to deal with, especially those banks where monetary policy is based on inflation targets: we are probably on the verge of an **inflation target crisis in 2015**. The forces for low inflation are linked to spare capacity and continued weak demand and a low oil price and stagnating wage growth. It remains to be seen how the central banks will deal with this – there is currently no credible new framework that could replace inflation targets.

Looking in the rear view mirror, few people foresaw Russia's conduct in Ukraine or the advance of ISIS in the Middle East. We seem to be moving ever closer to global conflict, partly due to different economic conditions and, in certain cases, growing problems on the domestic front.

It is easy to be pessimistic about 2015. Even so, **growth is expected to be a bit stronger than in 2014**. Big hopes are pinned on the US economy and the growth-stimulating effects on both consumption and investment of the lower oil price. The record-low interest rates are also a positive driving force. But perhaps we have to accustom ourselves to the thought that the growth environment we had prior to the global financial crisis in 2008 is not the most likely scenario for the next few years.

On a concluding note, a few thought-provoking words from the French author and filmmaker Marcel Pagnol:

"The reason people find it so hard to be happy is that they always see
the past *better than it was,*
the present *worse than it is, and*
the future *less complex than it will be."*

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