Schroders
Economic and Strategy Viewpoint

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2014 review: Geo-political risk and USD dominate (page 2)

- **Political corruption, civil war, annexation, election results good and bad – geo-political risk returned in 2014 having a significant impact on markets. Meanwhile, central banks were busy going in opposite directions, but nonetheless contributed to volatility. Oil prices dominated the end of the year, plunging Russia into crisis, but leaving some upside risks for 2015.**
- **Investors saw good returns from both government bonds and equities. Shrinking flows of government debt instruments may have helped lower yields against a backdrop of growing liquidity. In equities, only the US index outperformed in USD. Japan had a good year in JPY, but was still down in USD, while European bourses struggled with poor earnings.**

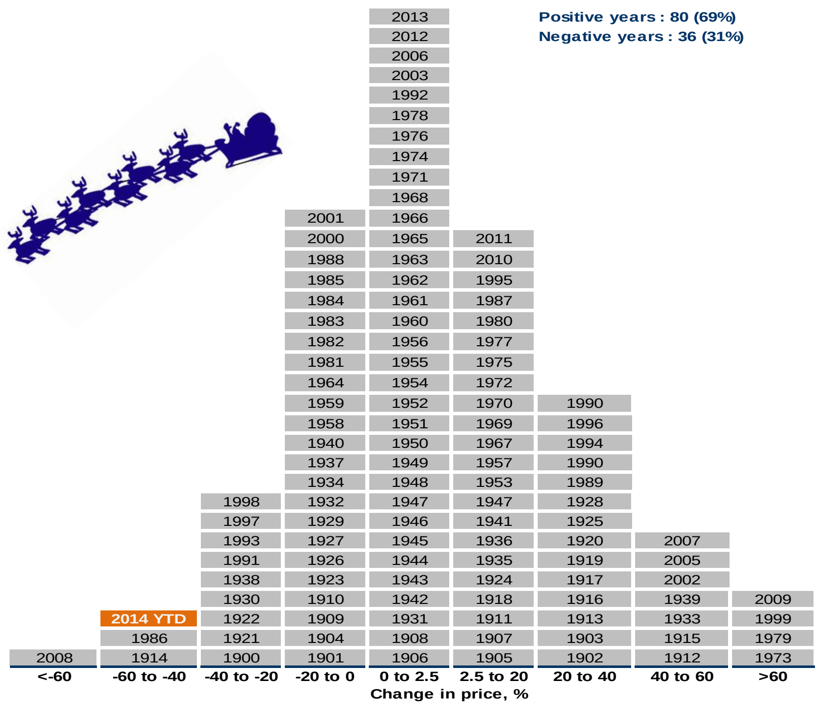
Global themes for 2015 (page 12)

- **The latest fall in oil prices moves the cost of energy well below the assumptions we used just a month ago to form our baseline. The decline will add to pressure on commodity producers and energy firms, but overall the clear implication is that growth will be stronger and inflation lower as a result.**
- **Some might term this a "disinflationary boom" and that is our first theme for 2015. Three other themes: the "desynchronised cycle", where the US continues to lead the world economy; "Japan: winning the currency war", where Japanese firms use the latest move in the JPY to gain market share; "Back to the 1990s" whereby the Federal Reserve is distracted by external events, keeps policy too loose and fuels a domestic bubble.**

Views at a glance (page 18)

- **A short summary of our main macro views and where we see the risks to the world economy.**

Chart: Second largest annual fall in oil prices since 1900



Source: WTI index, Thomson Datastream, Schroders, 22 December 2014.

2014 review: Geo-political risk and USD dominate

At this time of year, we like to take a step back and review the performance of markets, and the lessons we can learn for the coming year. 2014 will probably be remembered for the rise in geo-political risk more than the performance of markets. Investors had ended 2013 on a high, with a strong rise in risk assets, and a sell-off in government bonds.

Geo-political risk returned in 2014 to impact financial markets

2014 started with aftershocks from the taper tantrums of 2013, as investors pared back risky positions as default risk in Argentina escalated, prompting a sharp depreciation in the peso. Meanwhile, a corruption scandal ahead of local elections in Turkey also drew the attention of investors, also leading to yet another sharp depreciation. Sharp sudden falls in emerging markets (EM) currencies were clearly going to be a theme for the year. In Ukraine, protest and unrest quickly developed into a civil-war, as President Viktor Yanukovych was ousted and forced to flee to neighbouring Russia after an arrest warrant was issued. Accusations of Russian involvement and funding of separatist rebels were escalated when Russia annexed the Crimea region in March. Russia's actions (officially denied) were quickly followed by sanctions on Russia by the US and Canada, but only joined by Europe after the tragic downing of Malaysian flight MH17 in Ukraine in July.

Another source of political risk that hit investors' confidence in the summer came in the form of ISIS in Iraq/Syria. The ease in which the group took major cities in Iraq led to concerns that future oil supplies would be at risk. Those fears were eased with the eventual international response, although the fighting continues. However, that relief and initial fall in oil prices started the downward shift, and the momentum which built throughout the year.

The fall in oil prices may go down as the single most important development of 2014. Accommodative supply faced with weaker demand pushed oil prices some 42% lower over the year – the second worst performance since 1900 (see chart on front page). Non-OPEC oil producers had steadily been increasing output while US shale oil (and gas) output had been building at an exponential rate. As OPEC decided not to cut output in November, the market forced prices to collapse in order to clear inventories. As discussed in the next section, the fall in oil prices acts as a tax cut to households and corporates, with the greatest benefits occurring where oil is imported. For exporters like Russia, it is a significant hit to revenues, which of course drove assets related to oil down in value.

Central banks were busy, but with different directions of travel

As for central banks, actions were very mixed. The Federal Reserve (Fed) saw Janet Yellen take over from Ben Bernanke as the new Chair. Yellen was initially criticised over her communication, but has since found her feet and has successfully brought an end to the Fed's QE programme and changed the Fed's communication to signal monetary tightening in 2015, all without significant market volatility. Meanwhile, Mark Carney was less successful at the Bank of England having caused a false start in sterling money markets after warning of a potential rate rise by the end of 2014 (Mansion House Speech in June). He has of course since retreated to a more familiar dovish tone.

The European Central Bank (ECB) was probably the busiest of the central banks as Mario Draghi cut interest rates further, announced new liquidity measures targeted at boosting lending to corporates, and also unveiled private asset purchases, focusing on asset backed securities and covered bonds. European macroeconomic performance has poor over the year, not helped by ongoing austerity, a lack of lending from banks as they faced a review of their balance sheets, and of course the impact of geo-political risk with Ukraine/Russia. Deflation concerns have not gone away either. Given the fall in oil prices, the ECB is ending the year by seriously considering whether to start buying sovereign debt in early 2015.

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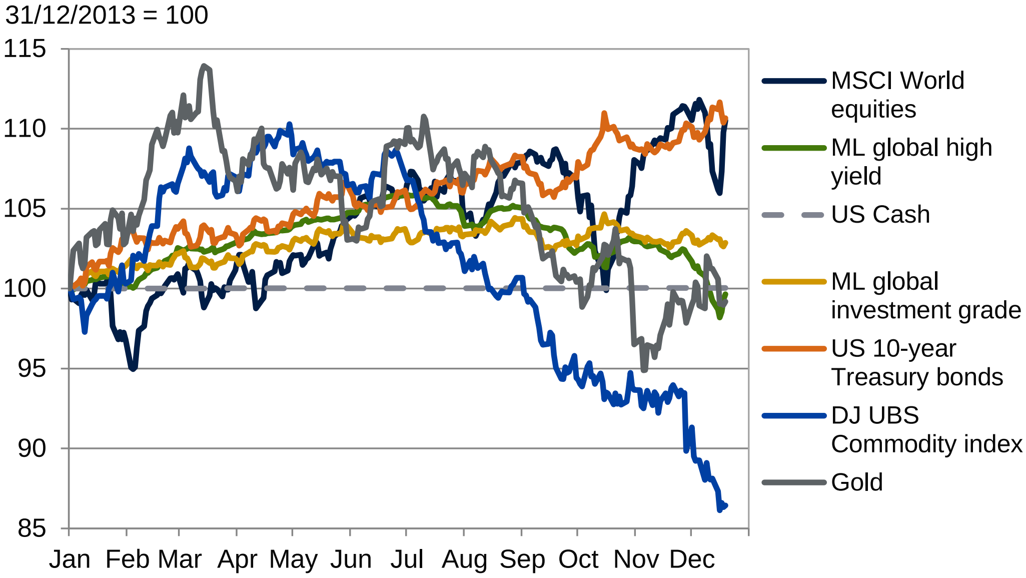
Finally, having sounded confident of its actions for most of the year, the Bank of Japan (BoJ) surprised most economists and investors in October by increasing its target of asset purchases from 60-70 trillion yen to 80 trillion yen per year. The move came as it became obvious that Japan was heading back into recession after the government went ahead with the rise in the sales tax in Spring. The move was significant for JPY and Japanese markets.

Cross-asset comparison

Looking across the major asset classes, the best performing asset class was government bonds, but was closely followed by global equities. Our proxy, US 10-year Treasury bonds, generated a total return of 10.7%, while global equities as measured by the MSCI World index provided a total return of 10.5% (chart 1).

Government bonds were the best performers, but equities were close behind

Chart 1: Multi-asset performance (in USD)



Source: Thomson Datastream, Schroders. 22 December 2014.

The worst performing broad asset class was commodities. The Dow Jones/UBS commodity index returned -13.6%, largely driven by falls in energy prices, but in particular oil, which as measured by Brent Crude has fallen by 44% since the start of the year. This is unusual as the fall has not coincided with a global recession unlike 2008 for example. Meanwhile, gold ended the year down 0.8%, despite being up 14% by mid-March.

Thanks to the strong performance in government bond markets, investment grade credit also had a reasonable year, generating 2.8% of returns. High yield credit bonds had performed roughly in-line with investment grade bonds for most of the year, until the sharp fall in oil prices caused investors to worry about default risk of high yield corporates in the energy sector. US high yield returned -0.4% during the year.

Explaining lower bond yields

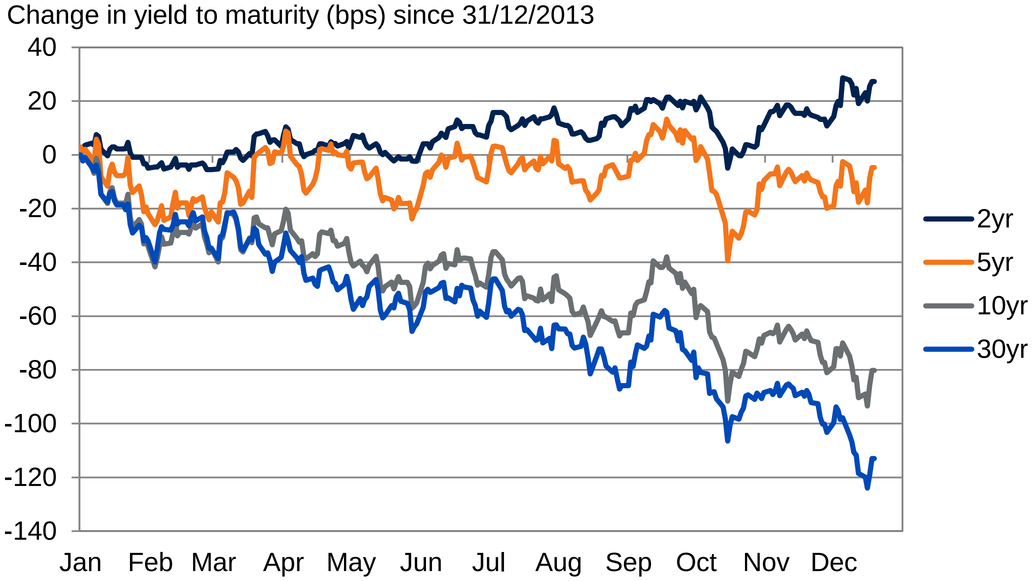
Bonds have beaten expectations of poor returns in 2014

Perhaps the above title is a little ambitious, but we feel it is important to think about why government bonds have performed so well, against expectations of poor returns, especially on US Treasuries as the Fed prepares to tighten monetary policy. Indeed, some investors may have seen the outperformance of government bonds as a signal that the economy was in trouble.

In focusing on US Treasury bonds, it is interesting to note that the positive performance has not been across all maturities (chart 2). While the 30-year and 10-year bonds have seen a substantial fall in bond yields (and therefore rise in price), the 5-year bond has been largely unchanged, while the 2-year has sold off. This is important as the rise in 2-year bond yields suggests that markets did not substantially push out their expectations on the rise in the Fed funds interest rate. The fall in yields in the longer-end of the curve suggests that a contraction in the term premium has been the driver of the performance in Treasuries overall.

Lower yields are not a signal of dovish expectations for the Fed

Chart 2: 2014 change in US Treasury yields



Source: Thomson Datastream, Schroders. 22 December 2014.

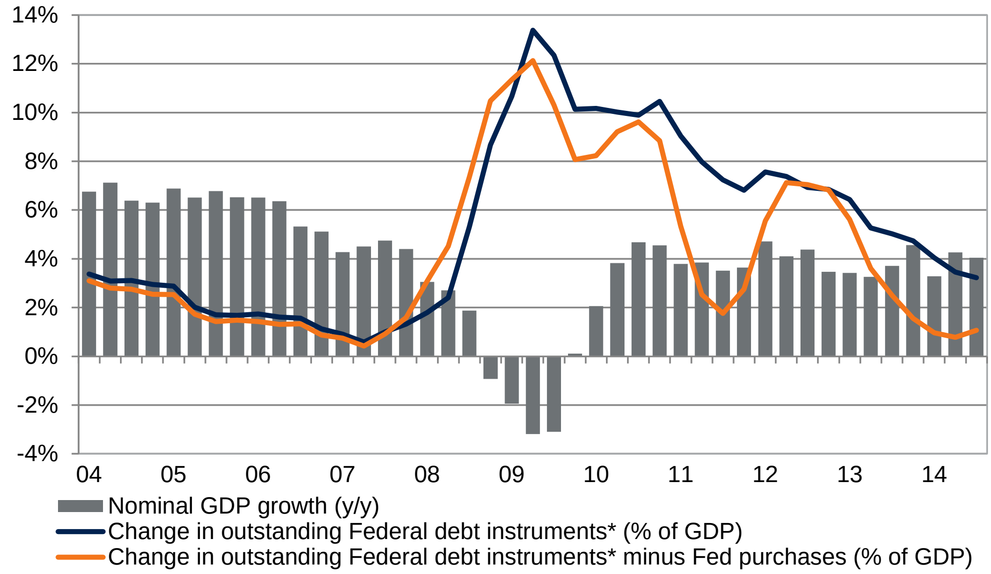
One factor that helps explain the lower term premium is a re-assessment of trend GDP growth estimates, and therefore a re-assessment of equilibrium interest rates. Lower productivity growth coupled with an aging population suggests potential growth in the US may be lower going forward. As a result, investors may expect the Fed to end its rate hiking cycle at a lower level than in the past. This is consistent with the rapid fall in the unemployment rate, without the boom-like growth seen in previous cyclical upswings. While this is likely to be an important factor, it is difficult to measure as regular surveys of trend growth estimates do not exist. Strangely, we would have expected this to bring down yields of the 5-year bond, but it has had little impact.

Demand and supply dynamics are a key factor…

Another factor worth considering is the change in demand and supply dynamics in the market. Starting with supply, as growth has accelerated over recent years, the US Treasury has benefited from rising tax revenues. At the same time, tight spending plans helped sharply reduce the nation's budget deficit. This has reduced the supply of new issuance to the market. Moreover, this has happened while the Fed has continued to buy Treasuries, albeit as purchases were tapered and eventually halted. Chart 3 below shows the fall in the annual change in outstanding Federal debt instruments (the equivalent of new flows excluding re-financing), and the same measure minus the amount of bonds the Fed has purchased. The supply of new Federal debt instruments fell by 44% in the first three quarters of 2014 compared to the same period in 2013; however, once Fed purchases are taken into account, net new supply fell by 57%.

…especially with supply limited by Fed purchases.

Chart 3: Lower supply of Federal debt instruments

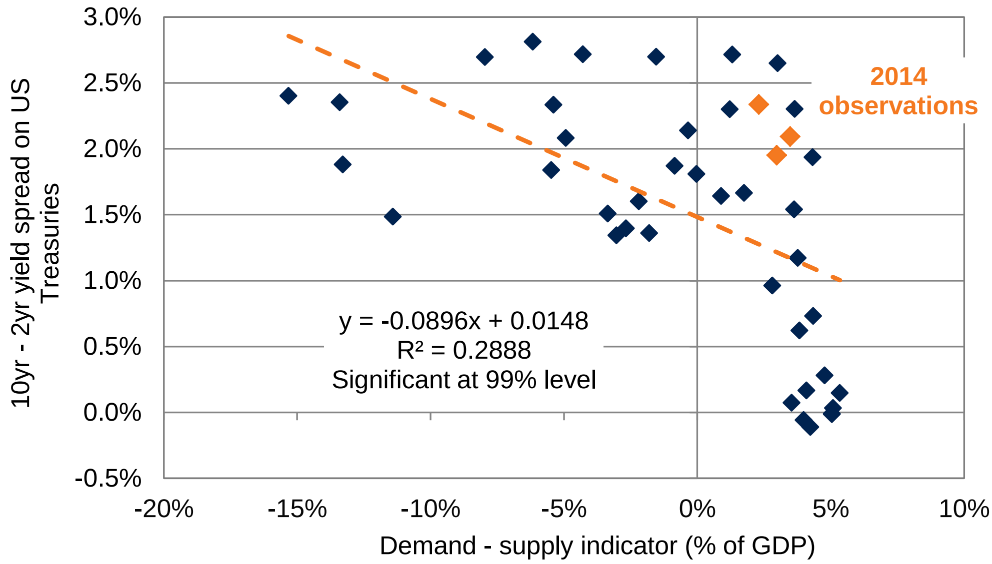


*Federal debt instruments include Treasury bills, notes, bonds and inflation-linked bonds. Source: Thomson Datastream, Schroders. 22 December 2014.

Net of Fed purchases, new issuance over the past four quarters is worth about 1.1% of nominal GDP. When compared to nominal GDP growth of 4% over the same period, it suggests that supply has been short of potential demand. Nominal GDP growth is usually used as a proxy for where long-term interest rates should be in accordance with the trend-growth argument above. However, we are looking at nominal GDP as an indicator of the growth in wealth in the economy. This is because excluding cyclical fluctuations; we would expect a certain proportion of wealth to be invested in government debt instruments, largely irrespective of their valuations. These investors will include banks, insurance companies, pension funds, and long-term investors. Therefore, if demand or an economy's wealth continues to grow faster than supply of debt instruments, like any other asset class, it should put upward pressure on the price, and downward pressure on yields of such assets. This might help explain previous years of term premium contraction.

To test this hypothesis, we ran a simple regression using the US term premium as defined by the spread in yields between the 10-year and 2-year bonds, along with our demand/supply indicator, defined as the gap between nominal GDP growth and new debt issuance. The results are encouraging. As the gap between demand and supply widens, the term premium tends to fall. Indeed the regression line on chart 4 (next page) suggests that the term premium in 2014 (orange observations) is still higher than the equilibrium suggests - possibly due to abnormally low policy interest rates (keeping the curve steep).

Chart 4: Term premium vs. demand - supply indicator



Quarterly data used since 2004. Demand/supply indicator, defined as the gap between nominal GDP growth and new debt issuance net of Fed purchases. Source: Thomson Datastream, Schroders. 22 December 2014.

Global liquidity easing is also likely to be depressing yields

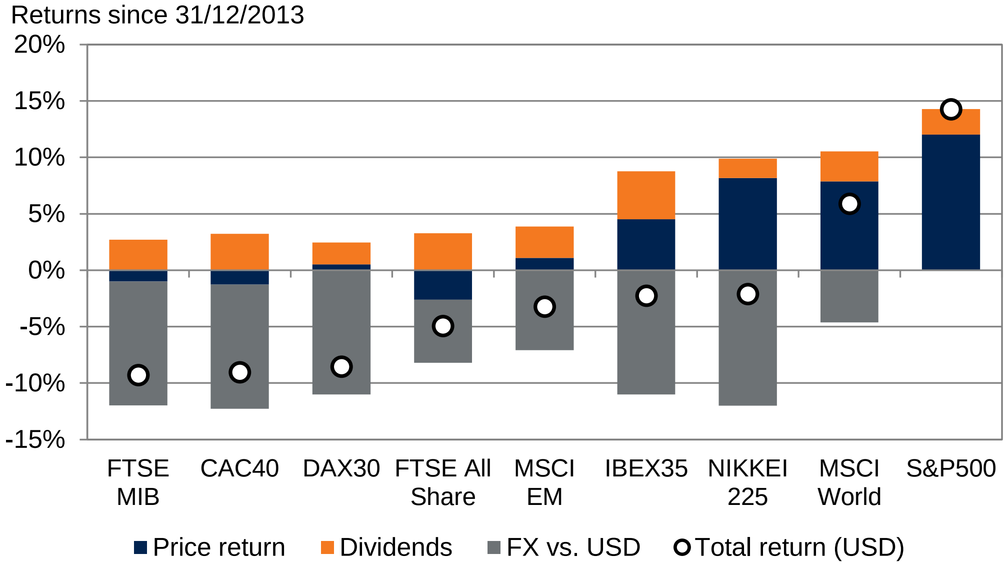
A final factor worth considering is the cross-market impact from the actions of other central banks. As the ECB edges closer to sovereign QE, and as the BoJ continues with its QQE, both have successfully lowered their own sovereign bond yields, which have made US Treasuries relatively more attractive. Their actions are likely to have encouraged overseas investors to buy US Treasuries, in order to make up for the low yields available in Europe and Japan. Indeed the Fed, BoJ and People's Bank of China (PBoC) have added a huge $1.3 trillion of liquidity to the global economy so far this year through the expansion of their balance sheets. Much of that liquidity has probably found its way to the global government bond market.

Comparing equity market performances

Despite the gains in the broad global MSCI World index, the only major market worth investing in this year was the S&P500, with a total return of 14.3% (chart 5). The Japanese NIKKEI 225 was the second best performer in our sample returning 9.9%; however, due to the sharp depreciation in JPY, the performance in USD was actually -2.1%.

US dominates equity returns as Europe struggles

Chart 5: Equity markets performance (in USD)



Source: Thomson Datastream, Eurostat, Schroders. 22 December 2014.

The UK's FTSE All Share understandably struggled with its large exposure to commodities, but the worst performers were the European bourses, as the Italian FTSE MIB (-9.3% in USD) led the decline. Political uncertainty during the unseating of Prime Minister Pier Luigi Bersani, was eased by his pro-reform replacement Matteo Renzi; however, Italy's dismal macroeconomic performance left investors preferring its Iberian partner. The Spanish IBEX35 enjoyed a relatively stable year, and withstood the occasional banking scare. The index was the best performer of the major four European markets, although still declined in USD terms.

Politics was the big driver of EM equities

In EM equity markets, politics has been a key driver this year. For one, events in Ukraine have weighed on EM Europe more than the rest of the complex - the MSCI EM Europe index is down 31% (in USD), compared to a 1% rise in Asia and 15% fall in Latin America. Other examples can be found in those countries which held elections this year (chart 6), each of which prompted hopes of reforms, some of which were dashed.

The earliest of the three was India which held its parliamentary election in April/May. Market optimism was already building months in advance of the result as anticipation grew of a win for opposition candidate Narendra Modi, widely seen as a pro-business reformer. His victory prompted further strong gains and this positive sentiment has continued almost unabated since. Helped by some progress on reform, the market is up almost 27%.

Indonesia's own election in July also promised to deliver a reformer, Joko Widodo ("Jokowi"), and the market duly swelled in anticipation. However, polls tightened going into the election and the end result was a far less convincing mandate for Jokowi than for Modi. Equities consequently have stayed flat since the election - though Jokowi's position is improving - and the market ended the year up 16%.

Last, and least (in equity performance, anyway) is Brazil, where October's election disappointed markets by returning incumbent populist Dilma Rousseff to power. The market had hoped, as suggested by polls, that the pro-reform candidate Aecio Neves would win, and before him the surprise candidate Marina Silva. These expectations led to a surge in equities which dissipated quickly following news of Dilma's victory. The announcement of a more market friendly cabinet since has done little to stem the equity slide; the market has gone from a high of +20% in September to -10.8% for the year.

Chart 6: Elections produced varying results for EM equities

Elections were a big factor in India, Indonesia and Brazil

Source: Bloomberg, Schroders. 22 December 2014.

One final equity market which has posted remarkable returns this year, is China's A share market. Largely closed to foreign investors, a partial liberalisation allowing investors on the Hong Kong exchange to buy shares in dual listed companies on the Shanghai A-share index (the so-called "Hong Kong - Shanghai connect") has led to large initial inflows into the Shanghai exchange and a flurry of speculative activity among domestic investors. Performance has since been propped up further by expectations of further policy easing by the central bank. We are sceptical of the sustainability of this rally, but for now the market is up over 43% since the start of the year.

Market liberalisation sparked speculation in China

Chart 7: Stock market opening has delivered impressive returns in China

Chinese index performance (Shanghai composite) ytd, %

Source: Bloomberg, Schroders. 22 December 2014

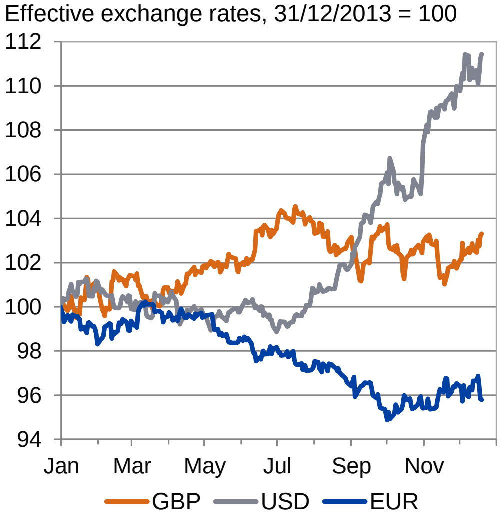
Investor expectations of policy easing reflect the stance taken by the central government and also increasingly by the PBoC of providing support to growth. Some commentators had expected another strong year for China in January, but the consensus view now is of a managed decline, or soft landing. So far the authorities have managed this reasonably well, though they have been unable to hit the 7.5% growth target - 2014 looks likely to be the first time since the Asian Financial Crisis the target will have been missed. Policymakers retain a firm grip, but they are not omnipotent - even in China.

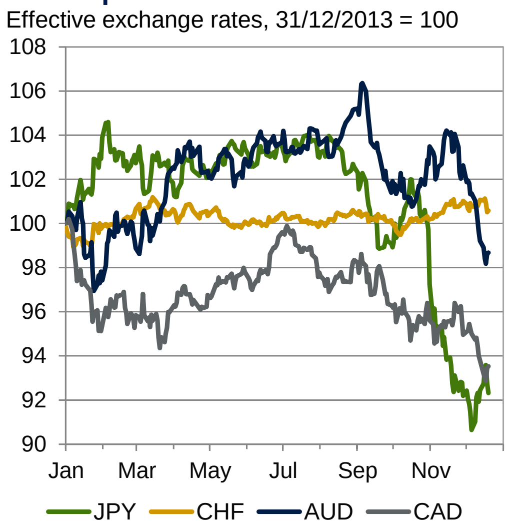
Comparing currency market performances

Relative monetary policy stances drove currency divergence

The outperformance of the US economy and end of QE helped drive the USD up against its main trading partners (+11.4%). With few economies keeping up with the US, the dollar was a favourite long for many investors against various short positions elsewhere. GBP saw a small appreciation as it too outperformed growth expectations; however, a dovish central bank, concerns over potential Scottish independence and the UK's proximity to Europe limited the gains in trade weighted GBP (+3.3%). The EUR effective exchange rate depreciated over 2014; however, more aggressive monetary stimulus in other countries meant that the depreciation was relatively small (-4.2%). One of those more aggressive countries was Japan, which saw the BoJ's increased QQE programme helping trade weighted JPY fall 7.7% over the year.

Charts 8 & 9: Currency performance in developed markets





Source: Bank of England, Schroders. 22 December 2014.

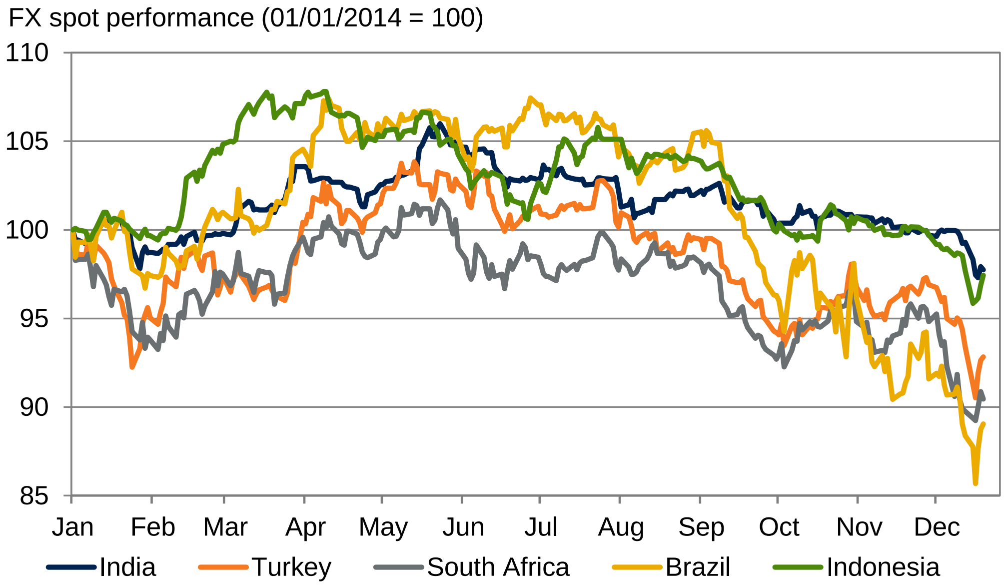
Elsewhere, the CAD and AUD had mixed performances over the year, but both began to slide since the start of the third quarter as commodity prices began to tumble.

Limited reforms in EM leaves currencies exposed

In EM, after a difficult year in 2013, the "Fragile Five" currencies of India, Turkey, South Africa, Brazil and Indonesia might have been expected to recover in 2014 as their politicians moved to address the vulnerabilities exposed and attacked by the market. For the first half of the year, currency behaviour might even have indicated this was the case (chart 10), with all five strengthening against the dollar for a time. However, much of this was due to dollar weakness and a more dovish stance from the Fed (chart 8 above), leading to improved sentiment about the broader EM complex.

Unfortunately, too few took the opportunity to address structural weaknesses and so as dollar strength has built, these gains have unwound, though more so in some economies - Brazil, Turkey, South Africa - than others. India especially has proved resilient, though even there the rupee is weaker now than at the start of the year. Still, the relative outperformance reflects the improvements India has made to its current account deficit (from 5.4% of GDP in 2013 to 1.3% this year) and the robust hawkishness of its central bank. No other EM economy has made such large improvements to its external balance sheet.

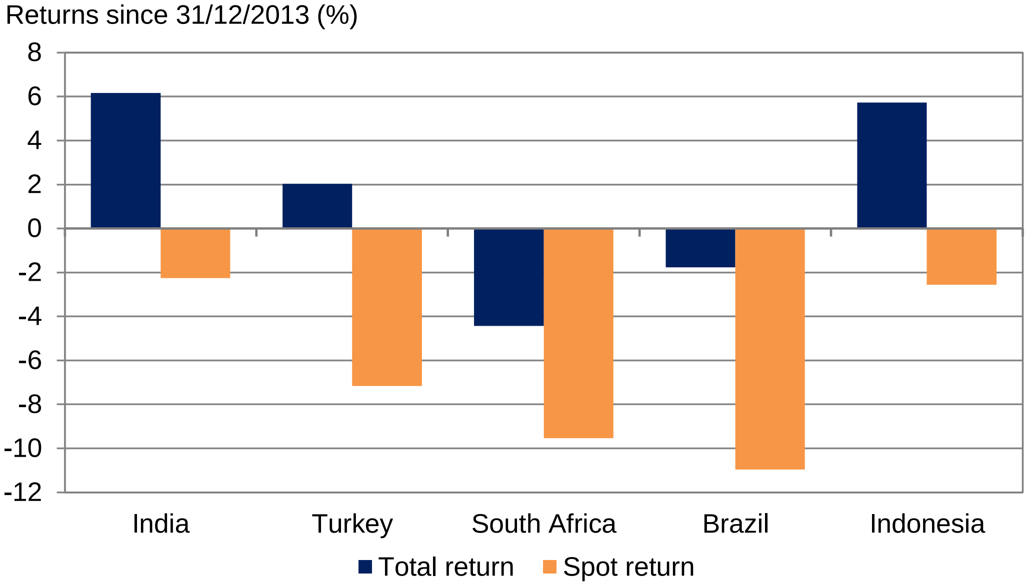
Chart 10: Dollar strength or idiosyncratic weaknesses?



Source: Bloomberg, Schroders. 22 December 2014

Of course, this is not the full story for currency returns, which also incorporate carry. The Fragile Five were all obliged to hike interest rates either in defence of their weakening currencies, or to combat the inflation engendered by depreciation; Brazil's policy rate today stands at 11.75%, and held the crown for highest policy rate until Russia's recent emergency hikes. Rates in its fragile peers are less stratospheric, but still high, particularly in a world where the G3 currencies offer near-zero interest. Consequently, the return including carry has been stronger than the FX performance alone, though even in this respect, Brazil and South Africa have witnessed depreciation in the second half of the year sufficient to negate even this high level of carry (chart 11).

Chart 11: Recent weakness largely negates even high carry



Source: Bloomberg, Schroders. 22 December 2014

Russia's currency crisis not readily resolvable

The problems of the Fragile Five, however, pale by comparison with the recent travails of the Russian rouble (chart 12). The currency had been steadily depreciating along with other EM currencies, with additional pressure due to sanctions relating to the situation in Ukraine. The currency's crisis was really initiated following the decision by OPEC not to cut oil production. Oil prices, and the rouble, plunged. After an initial 100 basis points rate hike, and several rounds of intervention, proved ineffective, the central bank hiked rates an additional 650 basis points - only to see the currency hit new lows against the dollar.

One interpretation of the market reaction to the hike is that the central bank's defence simply is not credible – Russian corporates are already squeezed on overseas financing and now face a much higher burden at home too. Rates can not be held at this level for long without inflicting further damage on an economy already reeling from the fall in oil prices. By a similar token, spending reserves will not do much if the market is convinced resolve is weakening. Given that reserves have been used to help repay corporate borrowing in foreign currency, and that political willingness to see reserve capital disappearing into the pockets of foreigners will wane over time, many speculators are doubtless betting intervention will end before reserves are depleted completely. We may need to see further hikes coupled with capital controls to finally bring the crisis to an end, unless oil and the Ukraine situation both improve.

Chart 12: Russia rumbled

Source: Bloomberg, Schroders. 22 December 2014

Lessons from 2014

Having reviewed events and the performance of markets over the year, we have found a few lessons worth considering for 2015:

The importance of politics and policy impressed upon investors

- **Geo-political risk is alive and well.** Not only can geo-politics act as a major downside risk to individual markets, but it can quickly spread to hurt global sentiment towards risk assets. The year also reminded us that positives from geo-political risk also exist, after the gains seen in India after the election.
- **Government bonds are not immune to the laws of demand and supply.** While government bond yields often reflect general risk appetite, 2014 showed that like any other asset, when supply is restricted and demand is plentiful, the price will rise (and yields fall). Global liquidity has been an important factor, and may continue to be so next year.
- **Europe still has plenty to do.** Having started the year with lofty earnings expectations, a lack of growth and fears over deflation led to a significant underperformance of European equities. European equities still appear on the expensive side, so have markets learned their lesson?
- **The Fragile 5 are still fragile.** A lack of reforms left those reliant on overseas capital exposed in 2014. As the Fed tightens monetary policy next year, beware of this group. Once again, the majority of policymakers have shown they are not afraid to waste a good crisis. India was the exception in 2014 rather than the rule.
- **Oil prices can fall without a crisis.** Unlike 2008, the fall in oil prices has not been caused by fears of a global recession. Relatively small falls in demand and increases in supply have led to the dramatic fall in prices.
- **Gravity has caught up with China.** Investors have learnt that not only is slower growth possible in China, but the government may be powerless to do more than cushion the fall. A soft landing looks the most likely outcome.

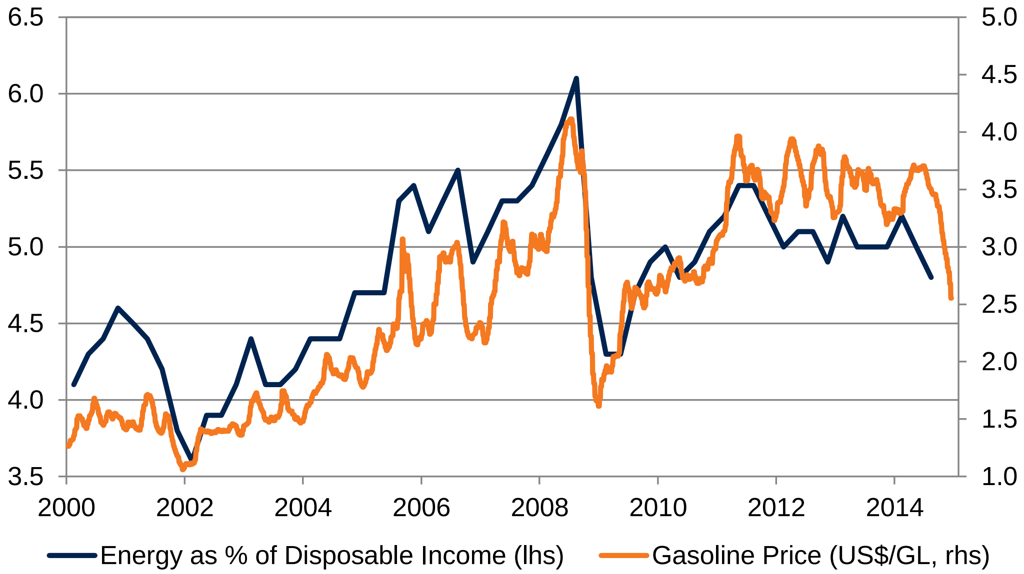
Global themes for 2015

Lower oil prices, good or bad for the world economy?

Oil price falls significantly further, boosting energy dividend to consumers and the prospects for growth

Before outlining our themes for 2015, a word on the oil price. Since we put together our baseline forecast, the oil price has fallen considerably such that Brent crude is now some $20/barrel below its original starting point in mid November. The gap narrows to $17/b two years out, but is still considerable and based on our models would imply a further boost to global growth of around 0.5% and a reduction in inflation in 2015 of about 1%. Lower oil and energy costs act like a tax cut to consumers who are likely to accelerate spending (chart 13). Recent retail sales figures in the US and UK suggest that some of the energy dividend is already coming through.

Chart 13: The energy tax cut in the US



Source: Thomson Datastream, Schroders. 19 December 2014

Financial markets seem more sceptical

Financial market reaction, however, suggests that the outcome will not be so favourable with equity markets and bond yields both declining, a clear warning that the world is headed in a more deflationary direction. The recent rebound in equity markets tempers this somewhat, but government bond yields continue to fall.

One market concern is that lower oil prices reflect lower demand in 2015. For example, the IEA has repeatedly downgraded global demand this year and its Oil Market Report for December[1] cut the outlook for 2015 global oil demand growth by 230,000 barrels per day to 0.9 million barrels per day (mb/d). This reflects lower expectations for demand from the former Soviet Union and other oil-exporting countries. Not surprisingly, the oil producers are cutting back, and whilst oil consumers will not make up this shortfall by consuming more oil (which is very price inelastic in the short run) they will increase consumption of other goods and services thus boosting overall global activity.

Another area of debate is whether the benefit to consumers will be outweighed as the energy industry slashes capital expenditure. There have been a number of high profile announcements from the majors, but as a share of total investment in the US for example, energy only accounts for 6.5% of total capex, around 1% of GDP (chart 14 on next page). Slower energy capex will hamper investment growth, but needs to be balanced against stronger capex in other sectors benefitting from lower energy costs and rising capacity utilisation rates.

[1] The IEA *Oil Market Report* (*OMR*) for December 2014.

Chart 14: US energy investment as % total capex

Source: Thomson Datastream, Schroders. 19 December 2014.

Energy though is a bigger proportion of the equity and credit markets: the energy sector accounts for 25% of S&P500 capex and R&D and the impact of lower oil prices is being felt through lower earnings forecasts and an increased risk of default in credit markets. Some banks with significant energy exposures have also been affected.

Cuts in energy capex and increased volatility will offset some of the gains from lower oil prices

In addition to corporate concern there is increased country risk as oil states such as Russia, Nigeria and Venezuela will find they have to cut expenditure and, of course, we have seen the RUB collapse in recent days. Default is not our central case for Russia, although the increased fragility of the oil producers will add to market volatility and they will no longer have the same level of surplus to recycle into financial markets. For example, it is estimated that at $70/b, OPEC revenues are reduced by $316 billion, a figure that will be reflected in lower growth in assets held in reserve and sovereign wealth funds such as US Treasuries.

In conclusion, there are some offsets to the boost to growth brought by lower oil prices and these may be felt in the near term via lower capex and increased volatility in oil-related currencies and credit. Nonetheless, the benefits to consumer spending and business through lower energy costs are set to outweigh these further out with the result that global growth will be stronger and inflation lower.

Themes for 2015

We outline four themes for 2015 and consider the market implications.

1. Disinflationary boom

World economy likely to enjoy a combination of stronger growth and lower inflation

The first theme follows on from the above. At this stage we are not revising up our growth forecasts, but are giving a clear indication of the direction of travel: higher growth and lower inflation. Lower inflation will increase fears of deflation and such risks remain strong in the world economy, but we have resisted making deflation a theme for 2015. Instead, on the basis that oil prices stabilise, the effect on inflation will be temporary. Given the prospect of our forecasts for growth having to be revised up and inflation down in coming months, the world economy would look like it is enjoying a disinflationary boom. It is possible that global growth hits 3.3% in 2015, the best since 2011.

Markets do not seem to be priced for this level of cyclical strength which would tend to support commodity prices further out. Although low inflation might give central banks pause on policy rates, longer yields may rise, particularly if unemployment falls more rapidly as growth strengthens. Equities should benefit from stronger earnings, but look for a rotation in markets away from the bond proxy companies, who focus on pay-outs, toward cyclicals.

2. Desynchronised cycle

US leading the growth and interest rate cycle over Europe and Japan

This theme will be familiar as it has been running for much of 2014 with the US leading the global upswing and the Fed poised to be the first of the major central banks to raise interest rates. The latest FOMC meeting held on December 17th did not change this conclusion. In contrast, the ECB and BoJ are set to keep policy loose, or even looser, with the former expected to start sovereign quantitative easing in March next year.

The macro question is whether one economy can break away when the rest of the world is still treading water? At this stage the answer is still yes in our view. The US, may be one of the biggest trading nations in the world (second only to China), but the external sector is relatively small as a share of US GDP. Exports are around 13% of GDP, imports 15.5% and on our calculations net exports have been neutral for GDP growth since the start of 2012. The US recovery has been led by stronger domestic demand, particularly consumer spending.

On balance we believe that domestic strength will outweigh foreign worries and keep the Fed on a tightening path. The concern however, would be that cyclical divergence pushes the USD to such a level that we see a reaction from the Fed similar to 1998. At that time fears of deflation were rife and the rise in the USD was acting to push down import prices and wider CPI inflation.

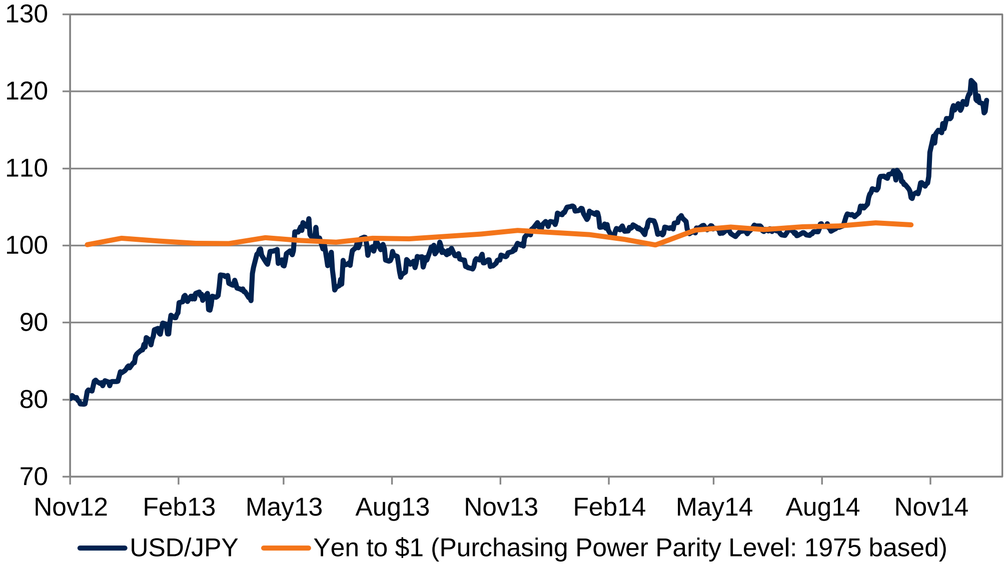
Markets have priced in a degree of synchronisation and this theme suggests a continuation of a stronger USD, weaker commodity prices and weaker emerging market equities. The implications for bonds are harder to gauge with many chastened by the experience of 2014, when Fed tapering was expected to push US Treasury yields higher. Certainly the short end of the US yield curve does not seem priced for the Fed tightening profile we expect. However, as discussed above, Treasury supply has slowed and the search for yield remains strong outside the US. Institutions in the Europe and those such as the Government Pension Investment Fund (GPIF) in Japan will seek yield in international markets as they switch from Bunds and JGBs. This suggests a flatter yield curve in 2015, with yields on short dated bonds rising by more than long dated bonds.

3. Japan: winning the currency war

And the winner is…Japan! If Abenomics has achieved anything it is a weaker yen. We can think of the devaluation of the JPY in two phases. Phase one from 80 to

100 took the JPY from an overvalued position to a more neutral level and was widely seen as an appropriate adjustment by the international community, endorsed by the G7 for example. However, phase two from 100 to close to 120 may be less welcome as it takes the JPY to a more competitive level. Purchasing power parity (PPP) for the JPY is put at around 103, for example (chart 15).

Chart 15: Latest move makes JPY cheap



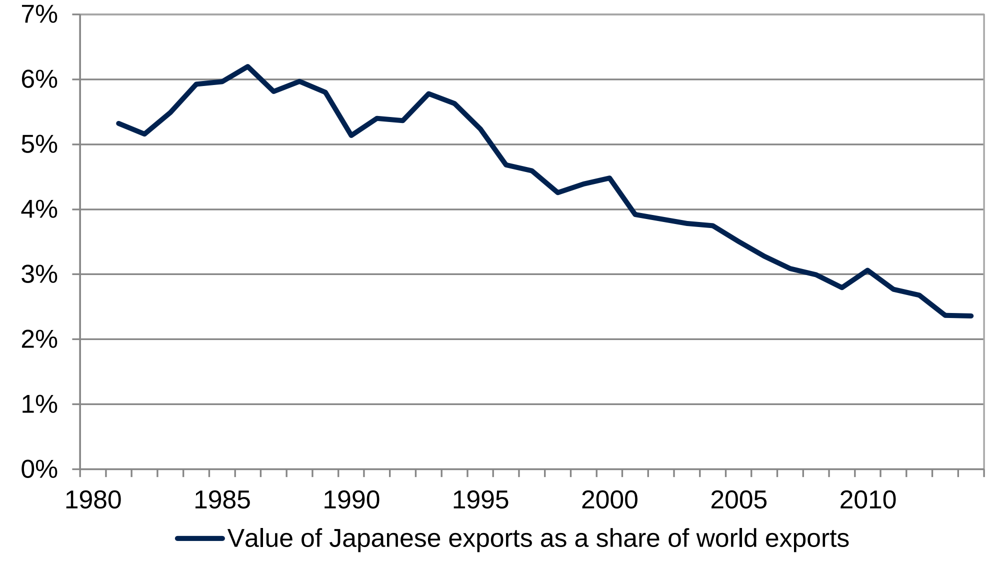
Source: Thomson Reuters Datastream, 19 December 2014

The latest fall in JPY makes Japan Inc. very competitive

Thus far, Japanese exporters have used the fall in the JPY to increase their profit margins and have kept their foreign prices stable. Margins have risen and higher profits have boosted the Japanese equity market. In turn this has helped boost consumer incomes through increased bonuses. The downside has been that export volumes have not responded and hence have not supported GDP growth.

This should now change: with the JPY at competitive levels, Japanese exporters may well decide to become more aggressive by cutting their prices to gain market share. This would help boost exports, thus reinforcing the recovery in the economy. It may be that we have to wait for new products to be introduced in different sectors before we see this effect, but it is likely to come and should see Japan reversing the long term decline in its share of global trade (chart 16).

Chart 16: Japan's declining share of global trade



Source: Thomson Reuters Datastream, 19 December 2014

The downside to this theme would be felt by competitors of Japanese companies who would lose market share and, given the slow growth in markets, this would probably mean seeing sales decline.

For example we would see a greater impact on Asia particularly Korea and China. However, further afield, countries like Germany which compete directly with Japan in a number of areas could also feel the squeeze from a resurgent Japan. From the perspective of these economies, Abenomics is very deflationary. We are already seeing a reaction in Asia with China and Korea easing monetary policy to head off this effect; however, this could go considerably further.

Although Abenomics has been with us for a couple of years and looks like enjoying another four after the recent general election, this scenario does not seem to be fully priced in. There is still considerable scepticism about the ability of Abenomics to work on Japan. However, if the latest fall in the JPY has the effect we believe it might then it would surprise markets with stronger than expected growth. Such a move would suggest outperformance by Japanese equities particularly at the expense of the rest of manufacturing Asia and also Germany. By prompting greater monetary easing across the region it would be positive for Asian bond markets.

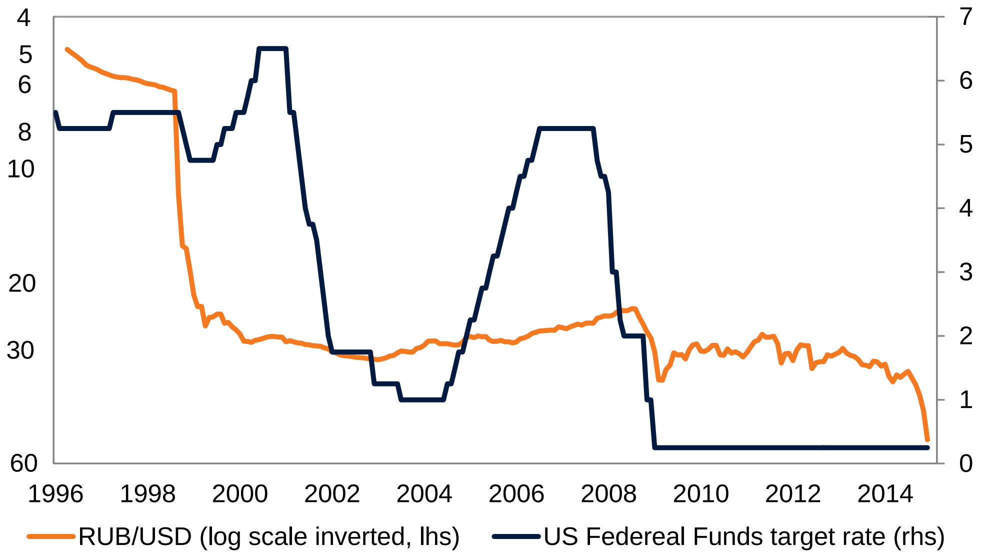
4. Back to the 1990's

Finally, a theme which we have been discussing with clients since the summer. We have described the attraction of the USD above in our desynchronised cycle theme. An important element of this is the divergence of monetary policy. However, alongside this the US is also an attractive destination for real investment in terms of foreign direct investment (FDI) and equity portfolios. In the late 1990's we saw the USD strengthening alongside equity markets as international investors poured money into US tech stocks. The result, of course, was the tech bubble. One factor which fuelled this was the loose monetary policy of Alan Greenspan's Federal Reserve.

Back in 1998 the Fed cut rates following the Russia default (chart 17). Although the domestic economy was robust at the time the Greenspan Fed allowed itself to be distracted by external events. The same could happen again today with Russia looking increasingly precarious as oil prices weaken and capital flees the economy. We are not looking for a repeat of the Asia crisis of the late-1990s, but sluggish growth in China and the Eurozone could weigh on global inflation and Fed deliberations. Janet Yellen may see such events as reason to hold off on rate tightening, keeping rates at close to zero and helping to fuel a liquidity bubble.

Uncanny similarities suggest a 1990s re-run

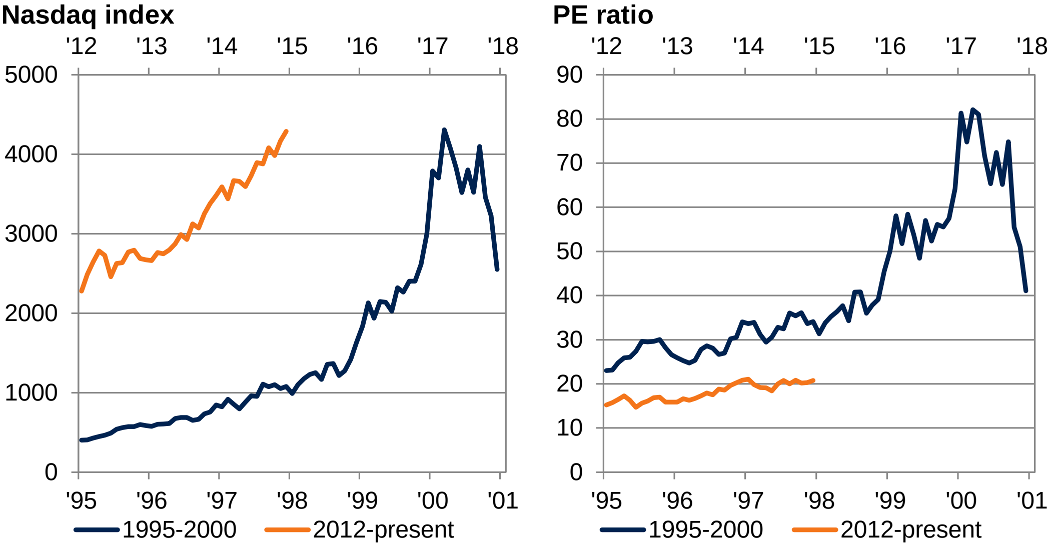
Chart 17: Fed funds rate and the Russian rouble



Source: Thomson Reuters Datastream, 19 December 2014

Is it in the price? Comparisons are never exact, but we have already seen evidence of excess liquidity across a range of asset classes from house prices to fine art. Recently, to continue the comparison, there has been increasing focus on the performance of the NASDAQ. Today the index is higher, but so are earnings with the result that the price-earnings ratio is still some way below the levels seen during the bubble (charts 17 and 18).

Charts 17 & 18: NASDAQ then and now



Source: Thomson Reuters Datastream, 19 December 2014

Schroder Economics Group: Views at a glance

Macro summary – December 2014

Key points

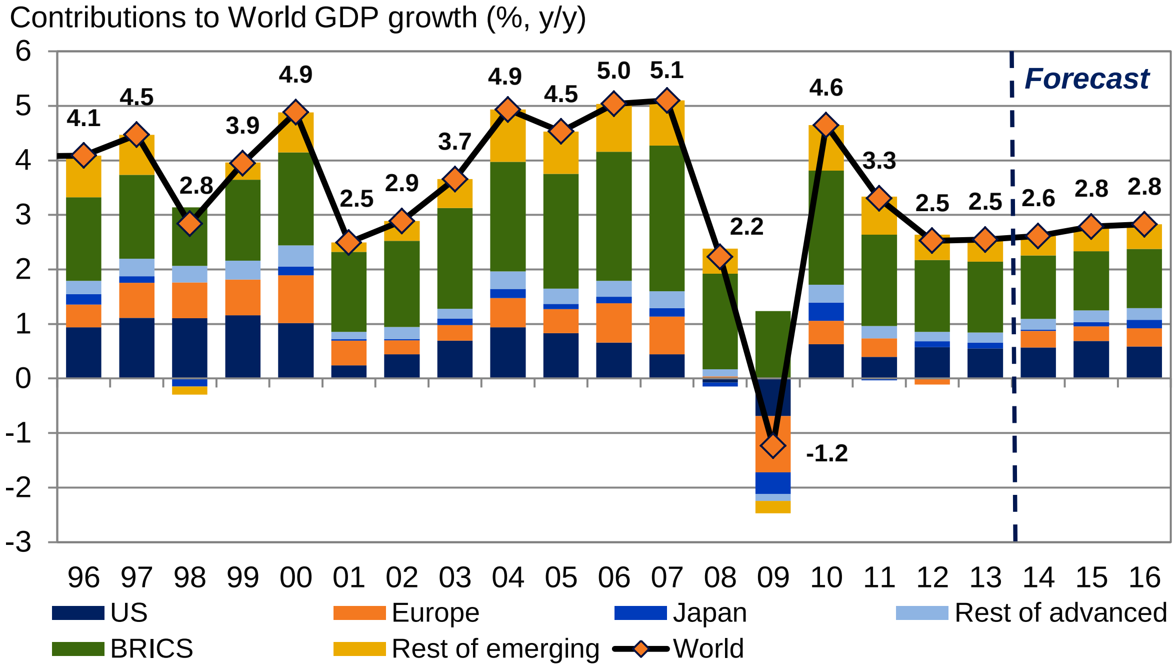
Baseline

- Global recovery to continue at sub par pace as the US upswing is offset by sluggish growth in the Eurozone and emerging markets. Lower energy prices are weighing on inflation, but will also boost growth in 2015.
- US recovery continues and unemployment is set to fall below the NAIRU in 2015 prompting Fed tightening. First rate rise expected in June 2015 with rates rising to 1.25% by year end. Policy rates to peak at 2.5% in 2016.
- UK recovery likely to moderate next year with general election and resumption of austerity. Interest rate normalisation to begin in 2015 with first rate rise in November.
- Eurozone recovery becomes more established as fiscal austerity and credit conditions ease whilst lower energy prices help consumption. ECB to monitor effects of recent easing, but we now expect sovereign QE in 2015 in response to deflation fears.
- In Japan, the consumption tax pushed the economy into recession prompting further easing by the BoJ and a snap general election. Weaker JPY to support the recovery, but Abenomics faces considerable challenge to balance recovery with fiscal consolidation.
- US leading Japan and Europe. De-synchronised cycle implies divergence in monetary policy with the Fed tightening ahead of ECB and BoJ, resulting in a firmer USD.
- Tighter US monetary policy and weaker JPY weigh on emerging economies. EM exporters to benefit from US cyclical upswing, but China growth downshifting as the housing market cools and the authorities seek to reign in the shadow banking sector. Generally, deflationary for world economy, especially commodity producers.

Risks

- Risks are still skewed towards deflation, but are more balanced than in the past. Principal downside risks are Eurozone deflation and China hard landing. Some danger of inflation if capacity proves tighter than expected, whilst upside growth risk is a return of animal spirits and a G7 boom. Increased prospect of stronger growth/ lower inflation if oil prices continue to fall.

Chart: World GDP forecast



Source: Thomson Datastream, Schroders 25 November 2014 forecast. Previous forecast from August 2014. Please note the forecast warning at the back of the document.

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Schroders Baseline Forecast

Real GDP

y/y%	Wt (%)	2013	2014		Prev.	Consensus	2015		Prev.	Consensus	2016
World	100	2.5	2.6	↑	(2.5)	2.6	2.8	↓	(2.9)	3.0	2.8
Advanced*	63.0	1.3	1.7	↑	(1.6)	1.7	2.0		(2.0)	2.2	2.1
US	24.8	2.2	2.3	↑	(2.0)	2.2	2.8	↑	(2.6)	3.0	2.4
Eurozone	18.8	-0.4	1.0	↑	(0.8)	0.8	0.9	↓	(1.2)	1.1	1.4
Germany	5.4	0.2	1.5	↓	(1.6)	1.4	1.2	↓	(2.0)	1.4	1.8
UK	3.7	1.7	3.1	↑	(3.0)	3.0	2.5		(2.5)	2.6	1.8
Japan	7.2	1.5	0.3	↓	(0.8)	1.0	1.1	↑	(0.9)	1.3	2.2
Total Emerging**	37.0	4.7	4.1		(4.1)	4.1	4.1	↓	(4.3)	4.4	4.1
BRICs	22.8	5.7	5.1		(5.1)	5.1	4.8	↓	(4.9)	5.1	4.7
China	13.6	7.7	7.3		(7.3)	7.4	6.8		(6.8)	7.1	6.5

Inflation CPI

y/y%	Wt (%)	2013	2014		Prev.	Consensus	2015		Prev.	Consensus	2016
World	100	2.7	3.0	↓	(3.1)	3.0	2.9	↓	(3.3)	3.0	3.2
Advanced*	63.0	1.3	1.4	↓	(1.5)	1.4	1.3	↓	(1.7)	1.4	1.8
US	24.8	1.5	1.6	↓	(1.7)	1.7	1.5	↓	(2.2)	1.6	2.4
Eurozone	18.8	1.3	0.5	↓	(0.7)	0.5	0.8	↓	(1.1)	0.9	1.1
Germany	5.4	1.6	1.0	↓	(1.1)	1.0	1.4	↓	(1.8)	1.5	1.7
UK	3.7	2.6	1.5	↓	(1.6)	1.6	1.3	↓	(2.2)	1.6	2.0
Japan	7.2	0.4	2.8	↑	(2.7)	2.8	1.3	↓	(1.5)	1.9	1.4
Total Emerging**	37.0	4.9	5.7	↓	(5.8)	5.7	5.6	↓	(5.8)	5.6	5.6
BRICs	22.8	4.6	4.1	↓	(4.4)	4.2	4.0	↓	(4.4)	4.0	4.0
China	13.6	2.6	2.2	↓	(2.3)	2.1	2.2	↓	(3.0)	2.4	2.7

Interest rates

% (Month of Dec)	Current	2013	2014		Prev.	Market	2015		Prev.	Market	2016	Market
US	0.25	0.25	0.25		(0.25)	0.24	1.25	↓	(1.50)	0.82	2.50	1.80
UK	0.50	0.50	0.50		(0.50)	0.57	0.75	↓	(1.50)	0.99	1.50	1.62
Eurozone	0.05	0.25	0.05	↓	(0.15)	0.09	0.05	↓	(0.15)	0.09	0.05	0.18
Japan	0.10	0.10	0.10		(0.10)	0.05	0.10		(0.10)	0.05	0.10	0.06
China	6.00	6.00	5.60	↓	(6.00)	-	5.20	↓	(6.00)	-	5.00	-

Other monetary policy

(Over year or by Dec)	Current	2013	2014		Prev.		2015		Prev.		2016
US QE ($Bn)	4459	4033	4486	↑	(4443)		4594	↑	(4443)		4557
UK QE (£Bn)	365	375	375		(375)		375		(375)		375
JP QE (¥Tn)	276.2	224	295		(295)		383		(383)		383
China RRR (%)	20.00	20.00	20.00		20.00		19.00	↓	20.00		18.00

Key variables

FX	Current	2013	2014		Prev.	Y/Y(%)	2015		Prev.	Y/Y(%)	2016	Y/Y(%)
USD/GBP	1.56	1.61	1.56	↓	(1.68)	-3.1	1.50	↓	(1.63)	-3.8	1.48	-1.3
USD/EUR	1.25	1.34	1.23	↓	(1.32)	-8.2	1.18	↓	(1.27)	-4.1	1.14	-3.4
JPY/USD	116.5	100.0	117.0	↑	(105.0)	17.0	125.0	↑	(110.0)	6.8	130.0	4.0
GBP/EUR	0.80	0.83	0.79	↑	(0.79)	-5.3	0.79	↑	(0.78)	-0.2	0.77	-2.1
RMB/USD	6.13	6.10	6.12		(6.12)	0.3	6.20	↑	(6.05)	1.3	6.35	2.4
Commodities												
Brent Crude	77.5	109	100.4	↓	(101)	-7.9	82.1	↓	(89)	-18.3	85.5	4.2

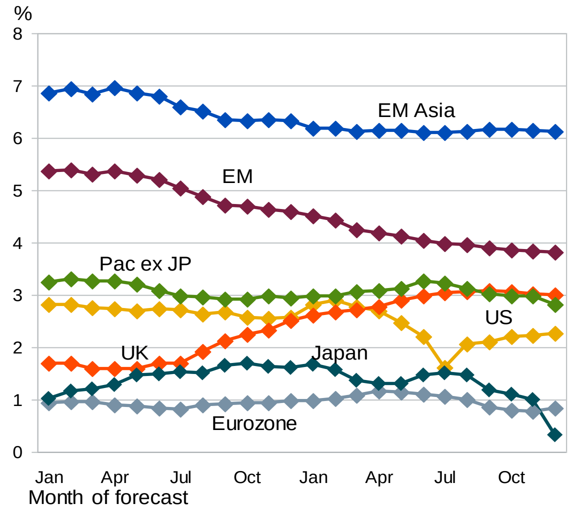
Source: Schroders, Thomson Datastream, Consensus Economics, November 2014
Consensus inflation numbers for Emerging Markets is for end of period, and is not directly comparable.
Market data as at 17/11/2014
Previous forecast refers to August 2014
* **Advanced markets:** Australia, Canada, Denmark, Euro area, Israel, Japan, New Zealand, Singapore, Sweden, Switzerland, Sweden, Switzerland, United Kingdom, United States.
** **Emerging markets**: Argentina, Brazil, Chile, Colombia, Mexico, Peru, Venezuela, China, India, Indonesia, Malaysia, Philippines, South Korea, Taiwan, Thailand, South Africa, Russia, Czech Rep., Hungary, Poland, Romania, Turkey, Ukraine, Bulgaria, Croatia, Latvia, Lithuania.

Updated forecast charts - Consensus Economics

For the EM, EM Asia and Pacific ex Japan, growth and inflation forecasts are GDP weighted and calculated using Consensus Economics forecasts of individual countries.

Chart A: GDP consensus forecasts

2014	2015



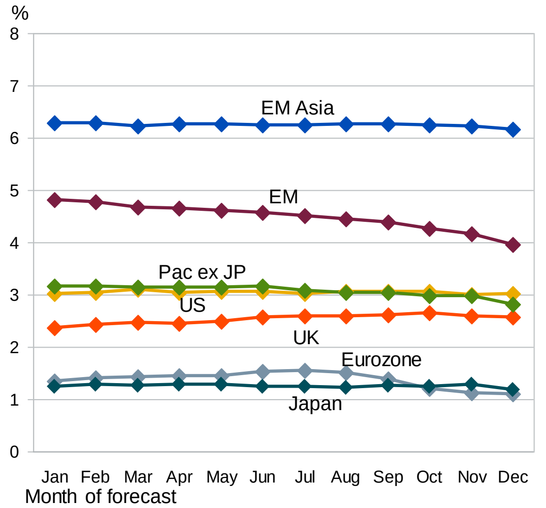
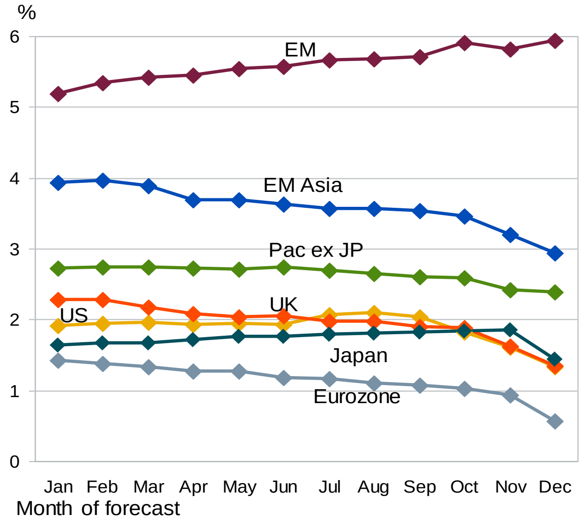
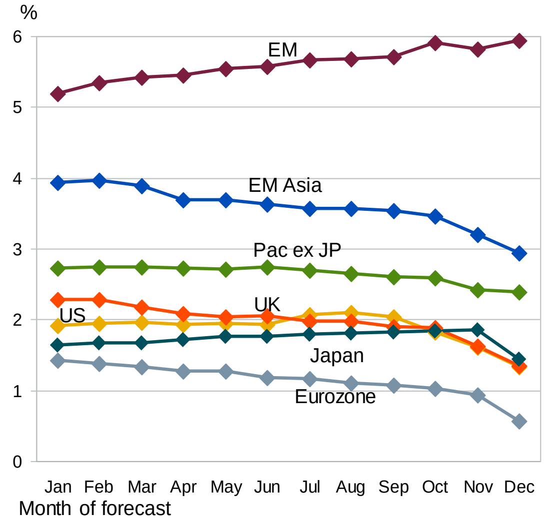


Chart B: Inflation consensus forecasts

2014	2015





Source: Consensus Economics (December 2014), Schroders
Pacific ex. Japan: Australia, Hong Kong, New Zealand, Singapore
Emerging Asia: China, India, Indonesia, Malaysia, Philippines, South Korea, Taiwan, Thailand
Emerging markets: China, India, Indonesia, Malaysia, Philippines, South Korea, Taiwan, Thailand, Argentina, Brazil, Colombia, Chile, Mexico, Peru, Venezuela, South Africa, Czech Republic, Hungary, Poland, Romania, Russia, Turkey, Ukraine, Bulgaria, Croatia, Estonia, Latvia, Lithuania

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