



**From the desk of Komal S. Sri-Kumar, Ph.D.**

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## ***10 Economic Indicators to Watch in 2015***

Here are some key developments that may shape the path for the global economy in 2015. Some of them, such as Federal Reserve decisions on interest rates and Europe’s measures to end recession, have been long awaited and would have widespread implications.

Here, in no specific order, are my picks for the 10 major developments to watch:

### **1. Will the Federal Reserve Raise Interest Rates?**

The United States and the rest of the world have got used to Fed-determined interest rates being near-zero since the financial crisis of the autumn of 2008. Even though Fed officials voted in October to end quantitative easing after quintupling the balance sheet from about \$800 billion at the time of the financial crisis to \$4.5 trillion at the end of 2014, the federal funds rate will continue at its current level into 2015.

When the funds rate will undergo its first post-crisis increase, and at what pace future hikes will occur, are factors that will weigh on market sentiment. While the 5% increase in US real GDP in the third quarter heightened expectations of a rate increase by mid-2015, other factors argue against any rate hike at all during the year.

First, inflation has been way below the Fed’s target of 2%, with the CPI falling by 0.3% - - the most since December 2008 - - in November. Second, while job creation has picked up with nonfarm payroll up 321,000 in November (the most since January 2012), the labor force participation rate has continued to decline to 1978 levels despite the recovery. Third, the global economy is projected to slow in 2015, with parts of the Eurozone in

recession, and China and India posting slower growth.

On balance, my vote is for no change in the Federal Funds rate during the year.

### **2. Will US Economic Growth Become Self-Sustaining?**

The 5% expansion of the US economy in the last quarter followed the 4.6% growth posted in the second quarter. This boosted equity prices amidst growing expectations that the US had attained a sustainable growth path. There have been growth spurts before that proved unsustainable. For instance, GDP rose by 4.5% and 3.5% in the third and fourth quarters of 2013, respectively, only to *decline* by 2.1% in the first quarter of 2014 - - a result attributed by the consensus to extremely cold weather or a “fluke.”



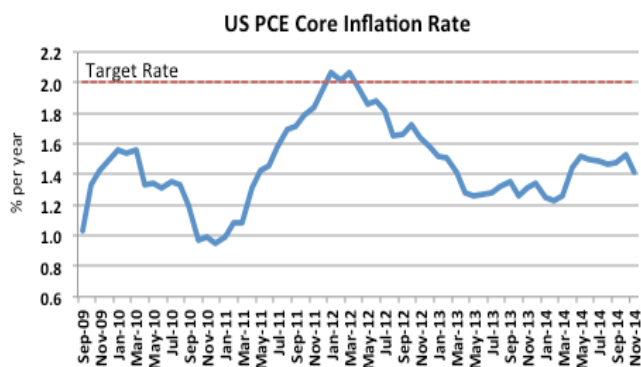
The fact is, the healthy increase in corporate earnings and continued economic growth were made possible by abnormally low interest rates.

With the dollar likely to appreciate further, and US exports likely to be hurt by global economic weakness, will growth persist at a rapid pace, or experience a renewed slowdown as has been the case in recent years?

With the headwinds the US will face, 2015 will *not* be the year growth takes off.

### 3. Will Fed Succeed in Raising Inflation?

US personal consumption expenditure core inflation rate is running at 1.4%, repeatedly defying Fed efforts to raise it to 2% through QE and zero interest rates. Headline CPI fell by 0.3% in November, the most since 2008, due to falling energy prices.

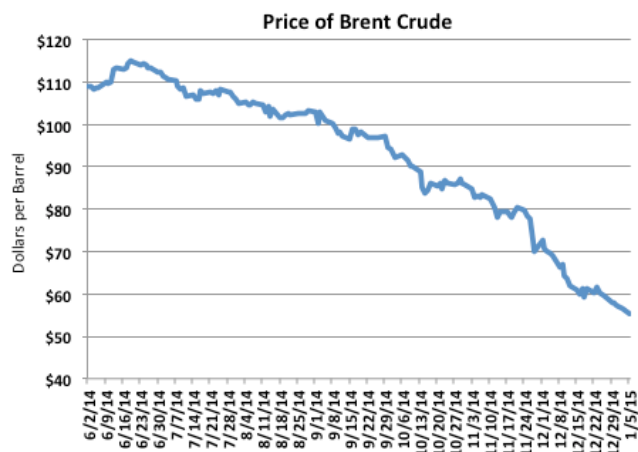


With oil prices likely to go down further, and the jobs situation not strong enough to encourage consumers to spend much more, I do not see inflation moving up sharply during coming months. And historically low participation rates suggest that there is a significant amount of slack still left in the labor market.

### 4. How Low will Oil Prices Go?

It seemed outlandish when I publicly forecast a \$100 oil price for year-end in mid-2008 when the price was already at \$145, and a major US investment house expected it to rise to \$200. It turned out I was not pessimistic enough!

Both supply and demand factors contributed to the 46% plunge in oil prices last year, compared with mainly demand factors that operated in 2008 – 2009. While it is always difficult to guess the absolute bottom, I am working with an assumption of another \$3 drop in the price of Brent crude to around \$50.

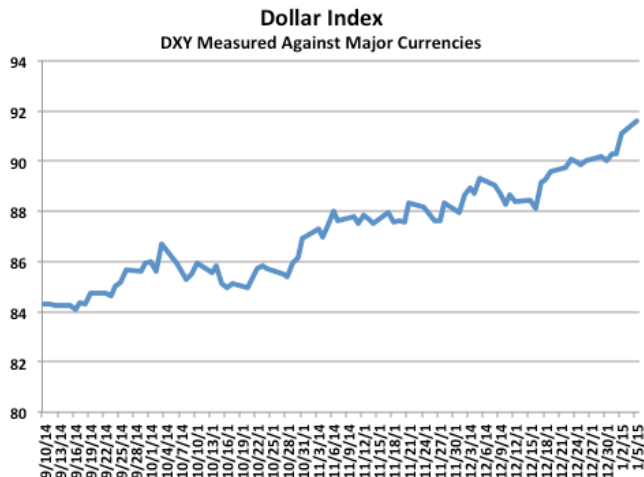


Risk to the forecast? With the Saudi oil minister publicly indicating that OPEC will not reduce oil production even if the price hits \$20, a lower bottom than even \$50.

With energy accounting for about 15% of the US high-yield market before the oil price drop last year, watch for the impact on bond issuers.

### 5. Will Dollar Keep Appreciating?

In my opinion, three factors were responsible for the significant appreciation of the dollar last year. First, US economic performance was significantly better than the rest of the world, especially compared with the Eurozone and Japan. Second, senior Fed officials have stated repeatedly that the US would end its policy of zero rates, probably mid-year. Third, the Bank of Japan has massively increased asset purchases, and the ECB may initiate purchases of sovereign bonds later this month.



These forces are likely to continue having an impact this year. By how much will the dollar appreciate? I look for a 4¢ appreciation against the euro to \$1.15, and a 11 yen appreciation to 140 yen before forces limit to work a further strengthening. Slowing exports and GDP growth in the first half of 2015 will discourage the Fed from hiking rates anytime in the year, in my thinking. It could even consider resuming QE as James Bullard, President of the St. Louis Fed, suggested in October.

The big impediment to further massive appreciation of the dollar would be potential concerns at the Fed, and possible political reaction in Washington to an overly strong currency.

### **6. How Large a QE Will ECB Initiate?**

The euro initiated the new year by plunging to a 4 ½ year-low of \$1.20 as Mario Draghi indicated that the Eurozone could go into outright deflation. Mr. Draghi feels that this is due to the sharp fall in oil prices, and sees this as a negative to be countered through a sizable expansion in the central bank's QE program. Jens Weidmann and the Bundesbank heads see lower oil prices as a major stimulus for the economy, *lessening* the need for QE.

On balance, the Draghi faction looks set to run policy, with outright purchases of sovereign paper following the ECB meet on January 22. Ten-year German bund yields crashed to less than 50 bp on January 2, and two-year German paper yields *negative* 10 bp. Ten-year French, Italian and Spanish sovereigns yield substantially less than their US counterpart.

Assuming that the ECB wants to increase its balance sheet by €1 trillion as Mr. Draghi has suggested in past press conferences, the resulting bond purchases of say, €40 billion monthly over two years, could cause bond yields to drop further in member nations. However, since the European banks' hesitation to increase lending is due to concern about asset quality, I don't believe that an expanded QE will do much to revive Eurozone economic growth.

### **7. Will Greece Leave the Eurozone?**

The Greek tragedy continues to play even after the troika's €240 billion program since 2010. In effect, while the credits enabled lenders to protect what

were essentially impaired loans, Greece's debt /GDP ratio surged from about 120% at the initiation of the programs to around 175% today. That is "debt relief," European style! And, of course, unemployment remains at around 25%, and youth unemployment exceeds 50%.

This is what explains the forced general elections later this month, and the likelihood that the anti-austerity Syriza party may become the largest single party in the new Greek parliament. The solution is not more lectures from German politicians that Greece should follow the troika program. Greece faces a solvency problem, not a short-term liquidity issue, and needs a significant reduction in the level of debts - - "haircuts" in debt parlance - - accompanied by credible privatization and debt-equity conversion programs.

Watch Greece. The policy followed by European leaders may force it to leave the Eurozone. But both Greece and Europe will be better off in the long-term if Greece adopts a "new drachma" and follows pro-growth economic policies.

### **8. Japan: Will Abenomics Help End "Two Lost Decades"?**

Prime Minister Shinzo Abe won the early elections he called to get a democratic mandate to validate, and expand, Abenomics. He was responding to the 1.9% decline in GDP in the third quarter, worse than previously estimated, following the negative impact on consumption of a rise in sales tax in April. The Bank of Japan announced plans to expand QE by 15% of GDP per year even though the balance sheet as a percentage of GDP is already twice the size in the United States.

Again - - you guessed it! - - JGB yields plunged and the yen trades at 119 to the dollar compared with 101 last July. However, the latest measures are unlikely to stimulate economic growth. Japan's problems are structural - - rapidly aging population, insufficient female participation in the work force, and sectors closed to competition - - that cannot be resolved through monetary or fiscal stimulus.

### **9. How Big a Global Threat are Chinese Bad Loans?**

The Chinese response to the global financial crisis was a massive stimulus program initiated in 2009, involving among other measures a surge in credit

creation. A large part of the new loans were outside the purview of organized banking. The unofficial lending, a large part of which was directed toward the property sector, was termed "shadow banking." From a very small amount in 2008, the shadow banking sector is currently estimated at the equivalent of almost \$2 trillion.

With property prices falling, the risk is rising that some of the loans could go into default, hurting the Chinese financial system as a whole, with the impact extending to global financial markets. While I expect more corporate defaults to occur, a portion of the almost \$4 trillion in international reserves held by the People's Bank of China will be used to bail out "systemically important" companies or banks.

Slower Chinese growth and a higher frequency of Chinese corporate defaults will add to volatility in markets, but China does not appear as a global financial risk.

## **10. Is Russia a Threat?**

The Russian economy was hit by a double whammy in recent months. While its officials were learning to cope with the impact of sanctions, the sharp fall in oil prices guaranteed that the economy would go into a deep recession this year. Even official forecasts suggest a 4% fall. Energy accounts for some 16% of Russian GDP, and over 50% of the government's budget revenues. Russia should still continue to service its debt obligations through 2015 - - its \$370 billion in international reserves, though lower by about \$150 billion over the course of 2014, are still one of the largest in the world.

On the other hand, the West does not get a free pass imposing severe sanctions against Russia in stages during 2014. Russia is the 8<sup>th</sup> or 9<sup>th</sup> largest economy in the world based on IMF and World Bank calculations, with especially important trade and investment relations with Germany, Europe's largest economy.

The Eurozone, already facing economic stagnation, is likely to see its prospects worsen as the boomerang effect of sanctions comes through.

In conclusion, above are some of the major factors I will watch during the course of the year. This is not to say that a "black swan" event cannot recur. After all, few foresaw the full global impact of the subprime crisis - - then Fed chairman Bernanke said in his Congressional testimony in March 2007 that the crisis had been contained, and that its impact on the overall economy would be small. Still, any major risk to the global economy may well emanate from one of the factors discussed above.

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