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REMEMBERING THE FUTURE

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2015 Market Outlook

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Introduction

"Economists can predict anything, except the future."

At this time last year we were looking forward to a prolonged period of time where we could enjoy a calm stage in the global economy where growth was slowly building in some parts of the world (e.g. the U.S.) while the bleeding in other regions (e.g. Europe) would slow and allow for a prosperous 2014. We expected that period of time to last through 2015 and had our eyes cast to 2016 at which vigilance, though always present, would need to be enhanced.

As things stand now heading into 2015 we are trimming that time horizon and bringing forward our period of alertness into this new year. The decoupling in fundamentals between the U.S. and the rest of the world that has revealed itself over the past few months has made us more pessimistic than when we turned in our 2014 outlook. Monetary policy is diverging between the U.S. and the rest of the world (including the Bank of England which not long ago was thought to be the first to normalize policy). Liquidity has become much more difficult to come by over the past few months (even in the U.S.), credit markets have tightened intermittently, volatility has reared its head far too frequently for us to be comfortable while Europe (debt, shaky banks, high unemployment, high taxes, over-regulations, bureaucracy, etc.), Japan (QE addiction) and China (shadow banking, slower growth, bubbles, political cleansing, low demand, etc.) have all descended into their own respective spirals of danger.

Given the decoupling between the U.S. and the rest of the globe we expect global demand to remain weaker than our original forecasts while tighter monetary policy in the second half of the year and constrained credit markets will revive the illiquidity and volatility the markets have witnessed over the past three months. Geopolitical risks (while always present and providing reasons to sit on the sidelines) has also become more acute recently, increasing the risk that the global financial system's plumbing will not be as clear as we originally imagined.

For additional details into the specific machinations that have us more wary please see our two recent commentaries (Existential Disruptors, parts I and II). The remainder of this newsletter will be using the above backdrop to set the stage of some of the world's key regions, where things stand currently, and the positives and negatives that have the respective economies at a crossroads. This newsletter wraps up with a preview of some of the sector and allocation preferences we have going into 2015 (as we do see some opportunities in front of us) and the reasons why.

The Global Macroeconomy

The United States

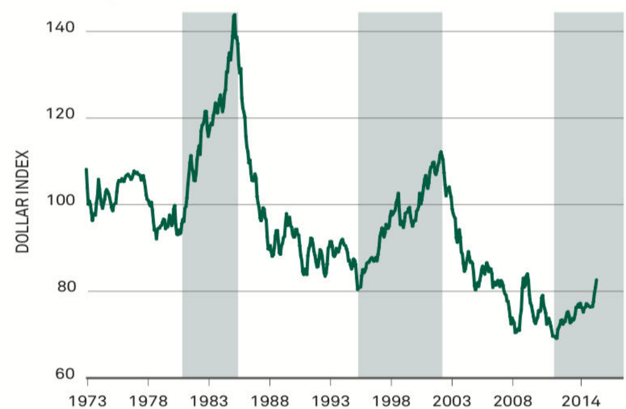
The burden of carrying global economic growth in 2015 will continue to fall to the United States. While the U.S. is far from having addressed all of its weaknesses or guarded against its risk, it has progressed far more than any other developed economy since the global financial crisis.

The official unemployment rate has steadily fallen, close to the Fed's target of 5%, enough improvement for the central bank to end quantitative easing this past October. The banking system is far better capitalized than its counterparts across the Atlantic while credit continues to expand. The U.S. has also deleveraged at a better rate than other economies across the globe thanks to low interest rates and the general recovery while the public sector has scaled back its spending cuts at the federal and state levels; both have the effect of propping up demand in the economy. The third quarter print of 5% GDP growth shows the economy is gathering steam and consolidating. In a nutshell, we expect US growth to be around 3% in 2015.

Monetary policy still points to being highly accommodative in 2015, even if quantitative easing is behind us. As we have stated a few times in our commentaries, we believe that the Fed's reverse repos are much more effective in advancing credit growth than QE was. The first expected rate hike by the Federal Reserve is expected to take place in mid 2015- the Federal Futures market is betting on the increase coming in the third or fourth quarter- but the Fed has consistently extended its dovish attitude. A 25 bps move (if the Fed raises it by so much) still leaves real rates in negative territory, conducive to stimulus, while affirming the fundamentals of an improving economy and also boosting the dollar, which has plenty of room to run (Figure 1).

Figure 1: The Dollar Has Room To Go

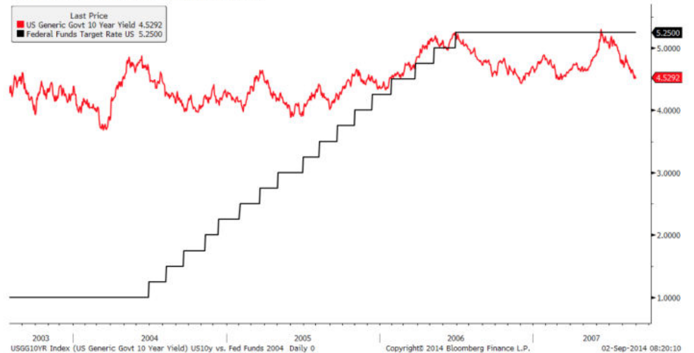
Trade-weighted U.S. Dollar Index, 1973–2014



Sources: BlackRock Investment Institute and U.S. Federal Reserve, November 2014. Note: The shaded areas show the periods of a rising U.S. dollar.

Market commentators have treated the impending hike with unworthy hysteria, acting as if the tight money of the late 1970s has returned. More likely, increases in the Federal Funds rate will reproduce Greenspan's conundrum of the mid-2000s, as Jeffrey Gundlach of DoubleLine predicts (Figure 2).

Figure 2: A Higher Fed Funds Rate (Black) Does Not Equate to Higher Long-Term Rates (Red) Source: DoubleLine



The strong dollar will attract capital, especially as the rest of the world is mired in poor growth. As BlackRock has pointed out, the 10-year yield has

posted a strong correlation to German bunds; thus until Europe gets its act together and capital is deployed for growth instead of safety on the Continent, investors will opt for U.S. debt, despite its low return, given even lower rates in the EU's core. So long as rates stay low, the cost of capital should not be an impediment to the economy.

While the prospects for the U.S. remain favorable it is not isolated from risks; the market declines in mid-October (wiping out the entire gains from the year) and in early December demonstrate this thoroughly. Liquidity in the credit markets, specifically the lack thereof, remains a concern (Figure 3). There is growing evidence that the lack of liquidity is becoming structural and most endangers the corporate bond market.
The illiquidity in the markets could make the episodes witnessed in October and early December more frequent, though hopefully not as dramatic. It will also put a lid on the yield of benchmark Treasury bonds and introduce caution into the minds and spirits of investors.

Finally, the markets are only two months removed from the end of QE and the NY Fed is still in the midst of experimenting with its reverse repo program. For onlookers to claim they know how credit markets will respond in the future to a shift in the most experimental of monetary policies is pure hubris.

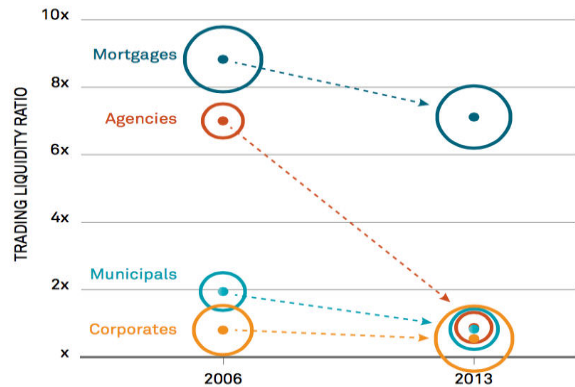
China

The Chinese economy stands at an interesting precipice. The mainstream analysis assumed a tradeoff between reforming the economy to being consumption driven and more market-driven with higher growth rates. The days of double-digit growth are in the rearview mirror, and private sector estimates put GDP growth at roughly 5%, rather than the published 7%. Monetary policy has indeed tightened (Figure 4) after the credit spigots were opened to prop up the economy during the financial crisis while reforms to deposit and lending rates were also announced.

Figure 3: Liquidity Is Tough To Come By
Source: BlackRock

MORE BONDS, LESS LIQUIDITY

U.S. Fixed Income Liquidity and Market Size, 2006 vs. 2013

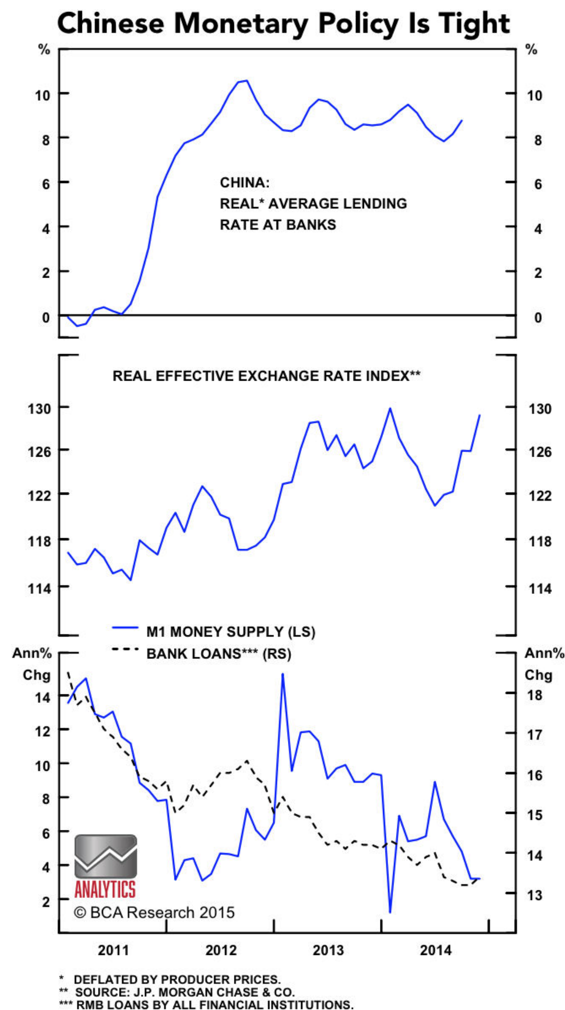


	Outstanding ($ Trillion)		Trading Ratio	
	2006	2013	2006	2013
U.S. Treasuries	4.3	11.9	31.6x	12.4x
Corporates	5.5	9.8	0.8x	0.5x
Mortgages	8.4	8.7	8.9x	6.5x
Municipals	3.2	3.7	1.9x	0.8x
Agencies	2.6	2	7.1x	0.8x

Sources: BlackRock Investment Institute and SIFMA, April 2014.
Notes: The trading ratio is the annual $ trading volume divided by the total debt outstanding. Bubble sizes reflect the amount of total debt outstanding.

The Chinese authorities have demonstrated a willingness to support key institutions with liquidity injections as ruptures from the excess credit seep through. According to the work of Lombard Street Research, the buildup in China's debt bubble has concentrated in the corporate sector. With the yuan's appreciation in 2014, rising labor costs and tight credit it would not be surprising to see China depreciate the yuan in 2015. Given the Bank of Japan's doubling down on QE and the consequential fall of the yen, while the Euro trends further downward, China will need to do all that it can to capture a piece of meager global demand and repair the balance sheets of businesses.

Figure 4: Tight Chinese Monetary Policy
Source: BCA Research



Whether or not a devaluation in the currency propagates the current structural weaknesses is certainly possible but not mutually exclusive. Urbanization of rural communities and reforms to the hukou system could provide additional domestic demand while a deepening reform of banking and interest rates could help capitalize overleveraged firms.

Japan

The situation in Japan offers a more straightforward proposition. Until the third arrow of Abenomics, meaningful domestic reform, is unleashed the dances from fiscal and monetary authorities will not have an impact. Whatever inflation the BOJ has instigated has come more from the yen's fall than it has from bringing demand forward. Corporations continue to stockpile cash and boost their margins all while Mr. Abe pleads for wage increases from the nation's business community.

Japan has been targeted as an investment opportunity by a number of commentators and publications going into 2015 despite the weak fundamentals. Their markets are undervalued based upon P/E ratios and the falling yen and lower energy prices should help corporate bottom lines and overall competitiveness. A weak economy and rising risk assets are not inconsistent, especially in an era of ZIRP and central bank asset purchases (in the case of Japan, the central bank is even buying ETFs).

Still, markets are usually cheap for a reason. There is growing stress within the policy board of the Bank of Japan. Multiple reports point to growing tension between Governor Kuroda and other monetary officials, as well as the country's Treasury department, a long-time voice for fiscal balance. With global demand weak and beggar-thy-neighbor policies coming from emerging markets, Europe and possibly even China, the yen could fall further. Currency protection on any investments into Japan will become all the more vital. Overall Japan, with its huge deficit, long-term unsustainable debt, demographic challenges, and negative savings rate, is fast approaching the point where a miracle would be needed for it to return towards a growth trajectory.

Europe

Europe will not make markets wait long before providing some drama. The parliamentary votes in Greece in December offered us an appetizer for a series of dishes being served in January. The EU Advocate General will decide on January 14th on whether purchases of sovereign bonds are legal. If approved, Barclays estimates Mario Draghi will launch QE on January 21st. Finally, Greece will go to the polls in snap elections on the 25th and signs point to Syriza, the leftist party, as gaining the highest share.

The election of Syriza provides a new dynamic to Europe's problems, reviving concerns about Greece's bailouts. Syriza's leader, Alexis Tsipras, has vowed to renegotiate the agreement while staying within the Eurozone. His rhetoric has given European markets new jitters but the Financial Times points out that the party leader has been using backchannels to assure leaders in Brussels and Berlin that his intentions are not antagonistic. Some may recall Papandreou's promises and what has happened to Greek productivity (the key ingredient for growth) in the last forty years.

Moving to the Continent as a whole, no region suffers more from insufficient demand than the Eurozone, thanks in part to sclerotic regulations that suffocate investment. QE won't change the debt burdens hanging over the periphery. The largest banks face a myriad of non-performing loans and are in dire need of cash, thanks to poor local conditions and exposure to Russia. They will welcome ECB's effort but as far as a meaningful impact for Europe we continue to contend that such efforts may be useless in the long run.

Several money managers and market professionals are touting Europe's low valuations as an opportunity for investment. In addition, the start of QE could boost asset prices as it has in Japan and the US while a depreciating currency could give the region the competitive edge it has long lacked. While these factors support reasons to be enticed by European markets we urge caution. The debt burden throughout the Eurozone, overleveraged banks, sclerotic bureaucracies and growing political segmentation are all immediate risks that will make Europe a roller coaster at the start of 2015. Unless investors are willing to stomach the turbulence we think it's better to wait for some plausible vision of growth for the Continent centered around labor reforms, privatizations, trade liberalization (particularly with the US) and other changes before a devaluation offers confidence in the direction of asset prices. Cheapening the currency is not necessarily a prescription for prosperity.

Emerging Markets

The buildup in external debt in foreign markets has us concerned and cautious. The Bank for International Settlements recently sparked a growing amount of attention to the amount of debt denominated in dollars being issued by foreign corporations at a conference at Brookings last month. The trend highlights a risk not just to these markets but also to the entire global economy. Excessive global imbalances were central in excessive credit creation, as capital was recycled from exporters to the U.S. and Wall Street's financial engineers. A stronger dollar will help with competitiveness but a lack of demand from Europe may counteract the benefit.

The taper tantrum of 2013 has shown the sensitivity many of these countries have to tighter U.S. monetary policy. Some countries, like India, used that experience to improve their current account but others, such as Turkey, have not. As Benn Steil illustrates in an article for Foreign Affairs (Taper Trouble, July/August 2014 issue), wild swings in capital flows can have political consequences.

China's weakness and slower rates of growth hampers a key pillar of emerging market growth as well. Countries like Brazil are dependent upon the

Middle Kingdom's commodity demand. Russia's weaknesses may make some investors pull out of emerging markets indiscriminately too. Thus, while the long-term trajectory for several emerging market countries may seem favorable we prefer to enter when global growth is more stable and more clarity on monetary policy is available.

Allocation Preferences

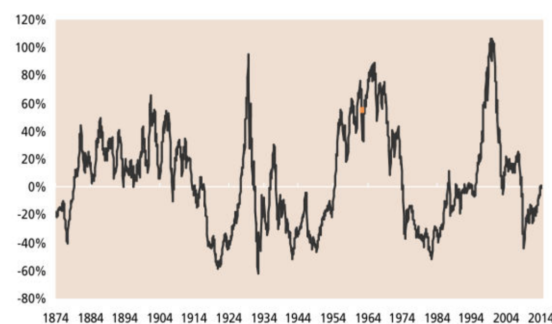
On the whole, we are not as enthusiastic about the markets and their potential going into 2015 as we were at this point one year ago. The economy on a global scale is weaker and geoeconomic risks (from China, to Europe, to ISIS, to Russia and others) have accelerated. The fault lines in the credit markets and liquidity concerns are real and prevent us from jumping in with full force. Thus are approach is to protect profits, be active hedgers and possibly even find opportunities to go short.

Valuations in the market place have been the subject of considerable debate. Some voices and metrics scream of excessive prices and other perceptions offer some value.

Using the Cyclical Adjusted Price to Earnings ratio the market currently stands at a multiple of 27, above its historical average. However based upon estimated earnings for 2015 the PE ratio sits at 17, slightly above historical averages but far below levels of past corrections when the value was pushing 30. In addition, it is natural for valuations to be stretched with interest rates at rock bottom; indeed, it could be surprising such metrics are not higher given monetary policy these past few years. Finally, it took 12 years for the S&P 500 to match its 2001 high of 1,527, hitting that level in Spring 2013. Yet during that same period the underlying economy grew by 20%. One has to ask then, how much of the markets' gain since 2009 is simply an attempt to catch up?

Our general philosophy therefore going into 2015 is that the markets are close to being fully valued (Figure 5) but there are pockets of opportunities, some of which are detailed further below:

Figure 5: Markets Are Close to Being Fairly Valued as Opposed to Either Extreme
Source: Lombard Street Research



Financials

Banks stand to benefit from the continued credit growth in the United States and the consolidating domestic demand. An interest rate increase in the latter half of 2015 will boost margins while strong interests in Merger and Acquisitions activity and IPOs (see our September 2014 newsletter) mean additional fees for investment banks. If legal disputes are truly behind and the next round of stress tests go well (we believe they will) financials should do well. Moreover financials boast some of the best valuations going into the New Year.

Consumer Staples and Cyclicals

Lower energy costs offer a dramatic boost to the wallets of consumers. Whether they're saving at the pump or on their home energy bills consumers enter 2015 with the opportunity to boost spending without reaching the dangerous levels prior to the 2008 crash. In addition, as the general climate solidifies and consolidates greater confidence in economic security will support spending; the December Consumer Confidence reading hit a new high.

The two sectors have the highest valuations in the market at the moment but if the economy continues to improve it could be justified. Cyclicals will be poised to gain the most the longer energy prices stay low and the faster the economy grows while any substantial sluggishness should draw appeal to staples and their dividend offerings.

Technology

We like the technology sector for two main reasons. First, new innovations and technological advances are increasingly needed by businesses to increase productivity and maintain costs. With some wage pressures marginally increasing the need to use technology to maintain margins will continue. Second, the sector provides good opportunities from a valuation standpoint.

Healthcare

Demographics and the ageing of the economy are things that cannot be stopped. In addition, with greater economic security and a better employment environment workers who had been putting off medical treatments can get the care they need. As a result, we like the healthcare sector in 2015.

Concluding Comments

We have a favorable disposition to other industries and sectors as well. Mainstream retailers (avoiding upscale/luxury names) should benefit from additional consumer income in the form of lower energy prices and any increases in wages. The same consumer-driven effect should reach the hospitality and transportation sector.

We also have our eyes on the real estate sector. Housing's slow recovery after the financial crisis has stymied homebuilders but related fields such as home improvement stores have benefitted as homeowners have been upgrading their current homes instead of buying new ones. That trend could continue in 2015 but get an added boost with rental prices at high points in several regions, pushing families to revisit housing in general.

Finally, the value currently offered up in the mining sector, particularly in the precious metals area, bears close attention. We could see ourselves recommending a position in the sector for its deep value but also as a hedge against any turmoil unraveling in 2015.

In all prospective investments we will continue to serve as stewards of our clients capital in a manner consistent with strong fundamentals and the principles of our investment philosophy.

From all of us at Blacksummit Financial Group, we wish you a healthy, joyful and happy 2015.