Humble Pie

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A fistful of potential surprises in 2015

It was a good year for the economy and investors in 2014, but less so for forecasters bent, but unbroken as we look ahead to 2015. Stocks posted a third straight year of double-digit gains. Long-term bonds defied near unanimous expectations of higher yields and accompanying losses in posting even more spectacular returns—one of two glaring "bloopers" that included an unexpected collapse of oil prices. Following a key forecasting maxim of never looking back, however, we'll offer up a few thoughts on a crowded field of uncertainties and potential "shocks" as the new year gets underway. Any list of surprises will, in retrospect, be incomplete. In fact, true surprises, profoundly affecting economic financial and investment performance in a given year, tend to be just that—unanticipated, or low probability events, often with unintended consequences and with a pervasive effect on asset returns and volatility.

Any real value in the points listed below comes from identifying potential risks helping shape tactical changes in asset allocation. Outlook risks are screened first for their potential impact on economic and investment performance "levers"—economic growth, interest rates, the dollar, and oil prices—and then by identifying "crowded" trades skewed heavily in a given direction and most vulnerable to a surprise.

Based on those criteria, here's what we've been able to put together:

1) A long-awaited burst of economic growth, in what has been a disappointing, stop-go recovery, is triggered by an energy related boost to consumer spending serving, in turn, as a catalyst for the release of long-deferred investment spending.

2) Below (2%) target inflation persists through most of 2015, trumping slower economic growth in keeping a more "dovish" Fed on the sidelines until 2016. Unusually prolonged "disinflation" and aggressive Fed stimulus allow interest rates to defy strong, consensus expectations of an interest-rate increase for a second straight year.

3) The dollar's rally is aborted by the delayed rise in U.S. interest rates, trumping supportive "flight" and yield-driven capital from abroad.

4) Oil prices stage a stronger-than-expected rebound from an oversold position in 2014, to the $80-$90 per barrel range, triggered, in part, by OPEC production cuts and/or supply disruptions in politically vulnerable Iraq or Libya plus added support from a delayed U.S. interest-rate "up cycle" and aborted dollar rally.

5) Strong financial market reaction to the Fed's interest-rate increases triggers "liquidity" pressures and an unexpectedly large rise in bond yields, as leveraging, lax underwriting standards, and other excesses built up by years of aggressive monetary stimulus are unwound.
   - "Liquidity risk" is a wild card in any future unwinding of financial market distortions, aggravated, in part, by exchange-traded funds (ETFs) and by new regulations discouraging the buildup of banks' corporate and other securities investments once bolstering their intermediary role in these markets.

6) Emerging market economies are squeezed by the effects of a strengthening dollar on commodity prices and on sizable dollar-debt servicing burdens of corporate and, in some cases, government borrowers. Worsening trade deficits of commodity producers and growing defaults on dollar-denominated debt trigger a vicious circle of foreign capital outflows and growth debilitating increases in local interest rates to stem that flight.

7) Eurozone financial strains resurface, as gains by Greece's anti-austerity Syriza party in upcoming elections triggers confrontations with creditors there, in other hard-pressed peripheral economies in the monetary union and, perhaps, in the "core" Italian economy. Financial turbulence accentuates the "safe haven" flight to U.S. and German Treasury securities plus gold and other high-quality assets.

8) China suffers a "balance sheet" growth recession, as housing, equity, and other financial asset prices weaken, forcing over-leveraged households and certain businesses to pull back on spending and borrowing to realign debt with slower revenue growth. Aggravating the slowdown are credit-quality strains on state and private financial institutions, triggering a lending pullback to households and to smaller firms.

Market Comment

9) An aggressive currency war is sparked by "quantitative easing" in Europe and in Japan, along with more traditional central bank stimulus in other developed and emerging market countries. Foreign exchange turbulence roils the international financial market, pressuring authorities to implement capital controls of varying intensity in lieu of increases in domestic interest rates.

10) Russia embraces increased capital controls, more inward-looking economic policies, and new "adventurism" abroad in response to worsening economic fallout from 2014's oil price declines, Western sanctions, and a resulting "spike" in domestic interest rates. Fallout is serious enough to rekindle enduring "risk-off" trades into U.S. and German Treasury assets, gold, and other higher quality assets.

11) The release of "Abenomics'" "third arrow" of thoroughgoing structural reforms by an LDP government emboldened after its sweeping mandate in the recent elections, touches off a "boom" in Japanese stocks, a rebound in the Japanese yen, and a bond market sell-off as "deflation" concerns dissipate.