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WHAT TO LOOK FOR IN 2O15

Summary	Investment Conclusions
The year 2014 was pretty traumatic both in terms of disappointments (Japan, EU), unstable expectations (US) and volatility (oil, UST and forex rates).It is unlikely that 2015 will be significantly better as the Fed has indicated that, it will be patient, but will hike rates as appropriate. We stay with our neck stuck out with our position that the Fed will not hike rates in 2015, or if they do, it will be a single and desultory 25 bps to show that they mean business. In other words the markets will be hung on the zero rates in EU and Japan and their continuing poor macro performance, low inflation combined with threats of higher rates, while Asia does better.	Equities in US are likely to perform better than equities in G2 as macro policies in latter economies have clearly failed to boost GDP growth and inflation and are unlikely to do so in 2015. The global low inflation, primarily but not exclusively thanks to commodity and oil prices, will keep longer UST yields down with the likelihood of further flattening of the curve. Asian equity markets have outperformed G20 markets in 2014 and will likely to continue to do so in 2015 as most of these economies are now decoupled from USD rates. China's bottoming in 2H.15 will boost sentiment.

A sureal world

Consider this: The US is, supposedly, about to tighten, the EU and Japan are clearly faced with the consequences of NOT loosening enough, while in Asia one can pick and choose from central banks loosening (China, Thailand and S.Korea), tightening (Philippines, Malaysia Indonesia) and staying put (India).We leave aside the extraordinary measures in Russia caused by the oil price declines. The "global" economy and global financial markets are in disarray, there is next to zero "coordination" of policies, and indeed why should there be, and most of the major and minor economies have decoupled from the US cycles, or better said, the US has decoupled from the rest. Incidentally, the exceptionally strong 3Q.14 US GDP growth will not necessarily strengthen the case of a hike while inflation in the US remains well below Fed's expectations. (Charts 1 & 2)

China, the supposedly big swing factor in the global economy, has impacted the AUD and commodities, but to claim that it drives global GDP growth rates ignores the fact the US is not exports- driven as are most of the EU economies (except Germany) Also the EU export trade is nearly 75% intra-EU and not with the rest of the world. The signs are that the Chinese economy may flatten out by, latest, H.15 as the looser monetary policies kick in.Meamwhile the SHCOMP is now the best performing index in Asia in USD terms as Chinese equities became favourities despite the absence of any fundametanl changes and the fact that the economy has decelerated.But then equities markets have near zero correlation with basic macro data, as do indeed Chinese equity indices and GDP growth.We are cautiously bullish on a predominatley retail- driven market. As our heading said, a sureal world.

Chart 1: GDP growth, US (red),EU (green),Japan(blue),China (yellow) , yoy 2008-14

Source: Bloomberg

Why "monetarism" never worked

The policies pursued by the BoJ and the ECB are based on the notion that increases in the monetary base will translate to increases in bank deposits via the banks' lending more thus causing bank deposits to rise. Rising bank deposits are the core part of money stock in any economy. Increases in money stock can, somehow, lead to more consumer spending and business investment and may impact directly prices thus causing inflation to accelerate. The key word here is that "increases in money stock **may** cause prices to rise" as demand responds faster than supply. There are, however, two weak links in this argument. Banks may receive a lot of liquidity from central banks, through purchases of their illiquid portfolios, but they may not be willing or able to lend, exactly as EU banks have been responding to repeated liquidity injections. A weak economy and falling prices do no encourage the banks to lend and consumers and business to borrow. Worse, even if somehow money did find its way to consumers and producers, they may sit on it and not spend it. They can decide to accommodate more cash in their portfolios rather than more physical goods or other assets. Hence pumping money can be "pushing on a string". Hyperinflations, especially during and after the WWII, associated with explosive growth of money are not "proofs" of monetarism as they involved economies which, physically, could not produce more, and as demand rose (insecurity, scarcity etc) so did prices.

FACT BOX :The Greeks again

The spectre of Greece defaulting again arose as a result of political instability.Greek 10Y bond yields have doubled since September. Conflicts over the election of the president led to a snap election on January 25th where the left is expected to have a relative majority.Unlike in Spain and Portugal, the "troica", the ECB, IMF and the EU, have deemed that Greece has not made sufficient progress to be allowed to exit fiscal controls.More austerity measures have been demanded, to which the current government, let alone a future left wing administration,are vehemently opposed to.

Chart 2: US, VIX (red),UST 10Y (green),PCE (blue)

Source: Bloomberg

Summing up

As Chart 2 shows volatility in US equities (VIX), although still low in historical terms, has reappeared in more frequent intervals. The Fed's preferred inflation measure, Personal Consumer Expenditures, had been on a longer term falling trend, and then flattened out well below the 2.0% target of the Fed. Falling commodities and oil prices will keep the PCE down while the 10Y UST is falling during a period of repeated threats by the Fed to, eventually hike. What this tells us, is that the Fed claims that it will hike in a period of volatility and falling inflation does not make countercyclical sense but only helps to exacerbate volatility. Our investment suggestions stays that, in relative terms, US equities will likely to perform well given the strong US macros, while Asian equities, decoupled mostly from the US macros will do even better. As for FI assets the case for staying neutral to negative gets stronger every day. The strength of the USD may flatten out as the likelihood of repeated hikes by the Fed recede- let alone if the Fed desists altogether- as we expect it to. The markets and currencies of the EU and Japan will not offer attractive alternatives for most, if not all of 2015, even on the basis of" "buying cheap". There are no policy initiatives on the pipeline to change the course of cyclical, let alone structural trends, which would make G2 shares and FI assets more attractive.

Andrew Freris

(writing completed on 30/12/2014)