Trend Macrolytics, LLC
Donald Luskin, Chief Investment Officer
Thomas Demas, Managing Director
Lorcan Roche Kelly, Europe Research Affiliate

MARKET CALLS

2015: Oil Change for the Global Economy, Non-US Edition

Wednesday, December 31, 2014

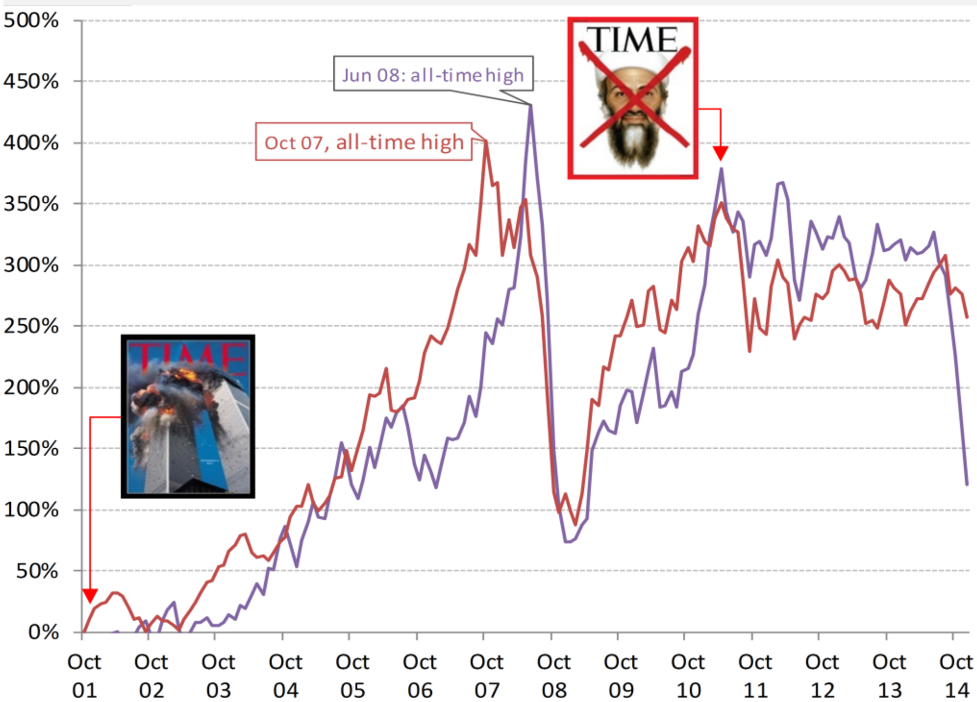
Donald Luskin

Break up the BRICs -- BR losers, IC winners. Abe gets a do-over, and the EA gets QE.

In this review of 2014 and outlook for 2015, we build on the main theme laid out in our companion report for the US -- *the global economy's exit from an era of the highest oil prices in history. Especially in the smaller and less diversified economies outside the US, the game will be to pick the winners and the losers in this fundamental economic and geopolitical regime change -- and to avoid getting blind-sided by instabilities it may trigger.*

EMERGING MARKETS: Emerging markets stocks as a class topped out post-crisis three and a half years ago -- the very day oil did, immediately following the assassination of Osama bin Laden in May 2011 (please see the chart below, and "The bin Laden Commodities Crash" May 6, 2011).

— Global crude oil price — MSCI Emerging Market Index
Change from October, 2011



Source: Bloomberg, TrendMacro calculations

Update to strategic view

EMERGING MARKETS MACRO, EMERGING MARKETS STOCKS: Winners and losers from lower oil prices are most starkly contrasted in emerging markets -- a fragile extraction economy like Russia is an obvious loser, while India and China are winners.
ASIA MACRO, ASIA STOCKS, BOJ: Japan gets another crack at Abenomics lubricated by cheaper oil, but we're not convinced Abe can really fire the "third arrow."
EUROPE MACRO, EUROPE STOCKS, EUROPE FINANCIAL STOCKS, EUROPE BONDS, ECB: Cheaper oil improves Europe's energy security, but Russia's collapse means a poorer importer of Europe's goods, and the low-probability but high-intensity risk of a geopolitical accident. Longer-term, banking deregulation will improve the dynamism of euro area capital markets. Short-term, the announcement of QE by the ECB will restore confidence, lifting equity markets and bond yields.

[Strategy Dashboard home]

- Overall, EMs have tracked oil closely for over a decade. We're not sure why -- perhaps both are barometers of general global growth (again, please see the chart on the previous page). Yet over the last six months while the global oil price has fallen about 50%, EM's overall have only weakly corresponded, and there has been tremendous diversity among individual markets.
- While the dominant narrative seems to be that in 2014 the US equity market vastly outperformed all others, the reality is that some of the emerging markets have done far better, even when the strong dollar is taken into account (please see the table below). The best performers are the energy "hostage states" -- the nations strongly dependent on others for oil.
- At the same time, the countries most dependent on supplying that oil have done the worst (again, please see the table below).
- There are no doubt many factors at work -- such as with Indonesia, with its peaceful transfer of power to a reformist prime minister. But as a general matter we think this is a clear demonstration of how regime change in the oil price is creating winners and losers.

2014 equity market total return Through December 30

Local currency		USD	
Shanghai	+54.6%	Shanghai	+50.9%
India	+31.5%	India	+28.6%
Turkey	+27.3%	Indonesia	+22.9%
Indonesia	+24.8%	Turkey	+17.5%
S&P 500	*+14.9%*	*S&P 500*	*+14.9%*
South Africa	+9.3%	Hong Kong	+4.8%
Hong Kong	+4.8%	South Africa	-0.6%
Russia	-2.3%	Brazil	-13.4%
Brazil	-2.9%	Russia	-42.1%

Source: Bloomberg, TrendMacro calculations

- *And even for the winners, equity risk premia remain higher than in the US or most of the developed nations. They aren't the smokin' hot value propositions they were in early 2014, but virtually all the EMs are still relatively cheap.*
- Before the oil price cascade began after the June top, the dominant narrative about emerging markets had to do with the Fed's tapering Large-Scale Asset Purchases (LSAPs). The idea was that somehow EMs were dependent on Fed liquidity for growth. We could never quite see the sense in that -- and at the peak of such fears, which corresponded to the 2014 lows for most EMs, we switched our long-standing neutral position to positive (see "I Shall Fear No Taper" January 27, 2014).
- Russia has been a special case. When it invaded and then annexed Crimea (see "Crimea River" March 4, 2014 and "Crimea Doesn't Pay" March 11), we figured it would all blow over, and called the bottom in Russian stocks. After an astonishingly rapid recovery, we called the top (see "Russia Recovers, Emerging Markets Re-Emerge" May 21, 2014). We're glad we never got back in as Russian stocks and the ruble have collapsed along with oil. It

Contact TrendMacro

On the web at
trendmacro.com

Follow us on Twitter at
twitter.com/TweetMacro

Donald Luskin
Chicago IL
312 273 6766
don@trendmacro.com

Thomas Demas
Charlotte NC
704 552 3625
tdemas@trendmacro.com

Lorcan Roche Kelly
Agenda Research
Sixmilebridge Ireland
617 600 6969
lorcan@trendmacro.com

[About us]

hasn't been about Crimea or Ukraine or sanctions, it's been all about oil.

- India, on the other hand, is an example of how falling oil prices have imparted multiple dimensions of benefits to importing countries. It's not just a "tax cut" like the one being enjoyed world-wide now -- but at the same time, it has been an opportunity for new Prime Minister Narendra Modi to decontrol oil prices -- subsidies on price and caps of consumption -- thus fundamentally liberalizing the economy and fulfilling one his key reformist campaign pledges (see "Don't Let a Good Oil Crisis Go to Waste" October 21, 2014).
- *Going forward, "The Yellen Rule" -- the Fed's new pledge to keep the funds rate below normal virtually forever* (see "The Yellen Rule is Taylor Minus Two" May 19, 2014) *-- is much better for capital flows supporting emerging markets than LSAPs ever were.*
- *And more important for emerging markets, the new regime of lower prices means more of the key input to growth in the hands of those economies for whom it has the highest marginal utility. We expect oil-dependent EMs -- still relatively cheap compared to developed markets -- to continue to strongly outperform in 2015.*
- *Russia is a special situation beyond being an obvious oil victim. On the one hand, it is a heightened source of potential geopolitical instability, as President Vladimir Putin has become a cornered rat whose game theory matrix is a "loss frame." On the other hand, under most circumstances Putin's desperation means more energy source stability for Europe, and pick-off opportunities for neutral states like Turkey and China now signing significant oil deals with Russia at fire-sale prices.*

JAPAN: We've been neutral on Japan throughout 2014 -- having gotten into its great Abenomics bull market at the beginning (see "On Kuroda and Iwata at the BOJ" February 25, 2013) and out once it became obvious that Abenomics was going to be a wet firecracker (see "Japan Breaks Out -- Does It Matter?" November 19, 2013). Prime Minister Shinzō Abe's decision to raise the national sales tax in March was a cave-in to the institutional interests obsessed with chimerical "fiscal imbalances," and a betrayal of the supply-side promise of Abenomics. (see "The Abe Restoration" May 10, 2013).

- But the sharp decline in the oil price makes Japan worth another look.
- Just as India was able to use the lower oil price to painlessly implement a deregulatory agenda, Japan has used them to double down on the Bank of Japan's LSAPs (see "On the October BOJ Policy Meeting" October 31, 2014).
- The BOJ denies it, but surely one of its missions here is to weaken the yen to help Japan's highly efficient export sector. The problem is that weakening the yen punishes everyone else in Japan by raising oil prices -- especially with Japan's nuclear electricity-generation capability still entirely offline. The falling oil price solved that conflict of interests -- so the BOJ was able to act.
- We are not especially impressed that Abe's Liberal Democratic

Party just won a landslide re-election. The barrier to Abe's actual implantation on the big promises of Abenomics -- the so-called "third arrow" -- was never the opposition parties he faced, but rather the vested interests within the LDP itself. So nothing has really changed, except perhaps that Abe has something more of a mandate for charging ahead, as he campaigned explicitly promising the same economic reforms he failed to deliver when he was first elected.

- *We remain basically neutral on Japan for 2015, until we see actual evidence that Abe can get it right this time -- except that we recognize it will be a beneficiary of lower oil prices, and its stock market is relatively cheap.*

EUROPE: It's complicated. Our long-standing bullish call on peripheral euro area sovereign bonds certainly paid off handsomely in 2014. Early in the year we called them a "high yield play" (see "When PIIGS Fly" February 10, 2014) and now Spanish and Italian yields are lower than those in the US, despite renewed political risk in Greece (see "Yes, It's Another Greece Crisis" December 10, 2014). Peripheral euro area stocks started 2014 as the best-performing equity markets in the world (again, see "When PIIGS Fly"). But by year-end euro area equity markets were pretty much back to little better than unchanged in local terms, and lower in USD terms.

What happened? First, there was the exogenous shock of Russia.

- When Russia first annexed Crimea and menaced eastern Ukraine, Europe was able to look the other way in order not to disturb a key trade and energy relationship (again, see "Crimea Doesn't Pay"). But when Russia accidentally shot down a passenger airliner (see "On MH17" July 18, 2014), the resulting moral outrage forced the euro area to impose sanctions it never wished for -- putting Russian-sourced natural gas supplies at risk, and imperiling an export relationship that accounts for 1.4% of European Union output.
- The actual economic impact of the sanctions has probably been trivial so far. But now Russia's extreme distress in the face of a lower oil price and a sharply devalued ruble makes it an even poorer buyer for Europe's exports. And the risk of a geopolitical accident as Putin attempts to save face with various quasi-military actions and gestures is a further chilling factor.

And then there were the self-inflicted wounds.

- Euro area inflation has been quite low, and got lower throughout 2014. European Central Bank President Mario Draghi chose to whip that into a state of emergency (see "'Whatever It Takes' Comes to Jackson Hole" August 25, 2014) in order the coerce his colleagues on the Governing Council to approve his pet asset-backed securities purchase scheme (see "The ECB's Real Agenda" October 22, 2014). Now ECB spokespeople are using the drop in oil prices -- and entirely salutary development -- to amplify this scare-story.

- Costly side effects from that stratagem include raising exaggerated fears in an already unsettled market about harmlessly low inflation levels, and driving embarrassing public infighting over policy (see "On the ECB November Policy Decision" November 6, 2014).
- To add insult to injury, once Draghi's ABS program was finally implemented, its debut was a conspicuous flop (see "Failure to Launch at the ECB" December 3, 2014).
- When Draghi ended the euro crisis in 2012 with his "whatever it takes" speech (see "On Draghi in London" July 26, 2012), both the institution and the man acquired immense prestige -- and investor confidence has to an important extent hinged on that prestige. Now that prestige is at risk, chipping away at confidence that the euro area can pull out of recession once and for all -- and not slide back into crisis.
- Now it seems the only way the ECB can restore its prestige -- and put "foam on the runway" ahead of Greek general elections in late January -- is to bow to market pressures for QE with sovereign bond purchases (see "Here Come Greek Elections -- and QE from the ECB" December 30, 2014).
- We don't really see how the ECB's purchase of already extraordinarily rich euro area sovereign bonds will objectively achieve anything at all. But markets and economies thrive on confidence, and if they've decided arbitrarily that confidence can be improved by having the ECB buy sovereigns, then so be it.
- We don't think the euro area's situation is objectively as bad as the consensus seems to believe. As a major net importer of energy, it stands to gain considerably from both lower oil prices and Russia's urgent need to export as much natural gas to Europe as it can. This is both an offset to the geopolitical risks in Europe's relationship with Russia -- and the same "tax cut" that the rest of the world is getting from a lower oil price.
- While Greece is at risk of becoming a failed state, the rest of the so-called PIIGS have made various degrees of progress toward real labor and product market reforms, and are poised to perform quite well from very low bases. Already Spain, our favorite euro area economy -- and 2014's best-performing equity market among the larger euro area nations -- has notched five consecutive quarters of positive GDP growth, and is poised for a sixth in Q4 -- even while Germany has faltered.
- Finally, with the ECB's new role as the Single Supervisory Mechanism for banking, euro area banks will be able starting in 2015 to operate seamlessly across borders for the first time. Over time, this will set off a wave of highly constructive competition, rationalization and consolidation (see "Stop Stressing, Start Lending" October 24, 2014).
- *For 2015, we expect the euro area to make up for its poor equity market performance in 2014 -- at least if we rule out a low-probability but high-intensity geopolitical accident emanating from Russia. Lower oil prices will be an immediate win, and cross-border banking liberalization will be an intermediate-term win. The*

announcement of sovereign bond purchases by the ECB will, perhaps non-rationally, restore confidence and cause investors to take another look at euro area stocks.

- *Euro area bonds are already priced for perfection. ECB QE will likely not lower their yields, and may indeed raise them, especially if it succeeds in improving growth and inflation expectations -- remember, yields in the US have risen all three times the Fed has undertaken LSAPs* (see "US Fixed Income Strategy: The Fed Irrelevancy Hypothesis" July 2, 2013).

Bottom line

Winners and losers from lower oil prices are most starkly contrasted in emerging markets -- a fragile extraction economy like Russia is an obvious loser, while India and China are winners. Japan gets another crack at Abenomics lubricated by cheaper oil, but we're not convinced Abe can really fire the "third arrow." Cheaper oil improves Europe's energy security, but Russia's collapse means a poorer importer of Europe's goods, and the low-probability but high-intensity risk of a geopolitical accident. Longer-term, banking deregulation will improve the dynamism of euro area capital markets. Short-term, the announcement of QE by the ECB will restore confidence, lifting equity markets and bond yields.