Market Viewpoints

Manish Singh

December 2014

"Success is getting what you want. Happiness is liking what you get"

- ***H. Jackson Brown, Jr***

The US economy added 321,000 non-farm jobs in November and 2014 is on course to be the best year for hiring since the 1990s. The oilmen of North Dakota and Texas have been hard at work fracking. In a surprise move, the Organization of the Petroleum Exporting Countries (OPEC), the guardian and keeper of oil prices has walked away, leaving the "goal" unmanned and oil bears are scoring goal after goal. I see Brent oil prices bottoming out near $60 per barrel. Last week we learned that the European Central Bank (ECB) now "intends" and no longer "expects" to expand the balance sheet to its 2012 level. We also learned that the ECB could launch a new stimulus package without Council "unanimity." While falling oil prices are a bane for oil producers and sellers, they are a boon for oil consumers and oil importers – principally in Japan and the Emerging Markets (EM). US dollar strength remains a massive obstacle to crude stabilizing, therefore low crude oil prices will continue to be a tailwind for world growth. I see a volatile Q1 2015 for the market, with Greece being the spanner in the ECB works, and a strong US dollar causing EM disquiet. However, low energy prices combined with continued improvement in the world's biggest economy (the US), will see the year end on a very positive tone. 2015 will be another year of growth and higher equity prices.

Crude Awakening

While oil speculators and traders may be crying – "I am a Commodity, Get Me out Of Here," the oil consumer is cheerfully filling up his fuel tank and keeping the change. In a surprise move, the Organization of the Petroleum Exporting Countries (OPEC), the guardian and keeper of oil prices has walked away leaving the "goal" unmanned and oil bears are scoring goal after goal. With market forces – supply and demand - finally in control of oil prices, the price of Brent oil has dropped from $112 per barrel in June, to $65 today. That is more than a 40% drop, and it is still falling, as the world finds itself in an oil glut.

The oilmen of North Dakota and Texas have been hard at work fracking - drilling and injecting a mixture of water, sand and chemicals into the ground at a high pressure - in order to fracture shale rocks to release the natural gas inside. Since 2008, US oil production has risen from about 5 million barrels per day (b/d) to more than 9 million b/d - an increase of 80% and just 1 million b/d shy of Saudi Arabia's oil production.

Can oil prices fall further? Yes they can. The supply and demand for oil is highly price inelastic in the short-run and therefore prices tend to overshoot beyond the equilibrium level. Besides, fracking is a relatively young technology undergoing rapid innovation and efficiency gains, as oilmen learn how to drill wells faster, cheaper and extract even more oil from each well. The current challenge of low oil prices begets even more innovation and efficiency gains. So what will eventually stop the slide for oil prices?

Compared to conventional oil wells, shale-oil wells are short-lived. The output can fall by two-thirds in the first year alone. The shale producers have to keep digging new wells just to maintain the same level of production, let alone add to production. Therefore, any slowdown in new wells will quickly translate into falling production. Respected oil-market research firm IHS concludes that about 80% of the shale oil estimated to be pumped next year will still be profitable at between $50 and $69 per barrel. IHS also estimates the growth in US shale oil production will slow next year to 700,000 b/d, down from one million b/d in 2014. (That estimate is based on a price of $77 per barrel. As oil is now well below this level, that

projection will likely be cut in half to 350,000). Therefore, it's likely that we see Brent oil prices bottoming out near $60 a barrel.

Jobs, Jobs, Jobs

What a stunning US jobs report we had last week! The US economy added 321,000 non-farm jobs in November and the prior two months numbers were revised up by 48,000. It's been 50 months now of month-on-month jobs growth and, in that time, 9.7 million Americans have been added to the payrolls. With just one more jobs report to go, 2014 is on course to be the best year for hiring since the 1990s.

It is hard for anyone to poke holes in this jobs report, but to accept it as a very good report that signals bullish signs for the US economy. Will it make the US Federal Reserve (Fed) jump the gun on a rate rise? I don't think so. While the data is very reassuring, the Fed needs to be unequivocally convinced that the recovery is strong enough to warrant an increase in interest rates. With the US 4Q GDP growth still tracking sub +3% and disinflationary pressures from weak import prices likely to build up; the Fed will continue to wait.

While the timing of the Fed's interest rate rise is important, of even greater importance, is the path that the rate rise will take this time. Will it be similar to the rapid rise seen in 1994 that crashed the markets or will it be a very gradual one, like in 2004, that which arguably sowed the seeds for the housing bubble that followed?

It's safe to say that it will not be anything like the 1994 cycle. Today's policy environment is almost the exact opposite of 1994. Then, the object for the Fed was to control inflation and the 1970s experience of runaway inflation was still fresh on the minds of policy makers. Today, inflation has been low for two decades and core inflation has been below target for six years. Today's challenge is to revive growth and inflation and preserve price stability.

As regards the 2004 Fed rate hike cycle, in a recent policy speech, New York Fed President William Dudley noted that while the Fed hiked the funds rate 17 times, financial conditions "did not tighten", "Treasury yields did not rise much", "credit spreads generally narrowed", "US equity price indices moved higher" and "the availability of mortgage credit eased." He concluded that the Fed should have been more aggressive in either hiking rates or using macro prudential policies to cool the mortgage market. Lessons have been learned, therefore it's safe to say the 2015 rate hike cycle will be more aggressive than 2004, but the Fed will apply the brakes more gently than it did in 1994. I expect the Fed to start rate hiking in H2 2015, with the Fed Funds rate staying below 1% until the year end.

ECB's QE train has left the platform

Last week, the European Central Bank (ECB) cut its growth forecast for 2014 to +0.8%, rising slightly to +1% in 2015 and +1.5% in 2016. That's down from previous forecasts given three months ago. The oil-price slump is a double-edged sword. On the one hand, it will boost Eurozone growth, but on the other hand it will reduce inflation further. The boost to the economy is of course welcome; but a danger is that the headline inflation rate (currently just +0.3%) gets dragged into negative territory. This will have unwelcome second-round effects, by pulling down inflation expectations, entrenching a "low-inflation" regime and pushing up real interest rates. This all amounts to an unwarranted tightening in monetary policy and is a quite troublesome outcome for the debt-laden economies in the Eurozone.

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The most significant part of the ECB press conference last week was the official statement that the ECB Governing Council would reassess the asset purchase situation early in 2015. That the ECB now "intended" and no longer "expected" the current measures to reach the size of the balance sheet from 2012, speaks of the ECB's determination to purchase assets. Mario Draghi, ECB President, also insisted that the ECB could launch a new stimulus package without Council unanimity, if need be. He said – "It's an important monetary policy measure, it can be designed, I believe, to have consensus. But we have to remember that we have a mandate, and as I said before, we don't tolerate prolonged deviations from our mandate." It is safe to say that the ECB's QE train has left the platform (and barring a miracle of Eurozone inflation improving drastically over the coming months, or the German authorities ambushing the train); Eurozone QE is set to arrive before the end of Q1 next year.

Outlook for 2015 and my predictions:

Come January 1, Lithuania will become the nineteenth nation to join the Euro. Come September 10, if still reigning, Queen Elizabeth II will surpass her great-great-grandmother Queen Victoria as Britain's longest-serving monarch. 2015 also marks the 800th anniversary of the Magna Carta (Great Charter). On 15 June 1215, at Runnymede (close to Windsor) the charter written on a piece of parchment was signed and sealed under oath by King John and witnessed by barons, noblemen and bishops. The signing of the Magna Carta transformed Norman England from a dictatorship to a limited monarchy. The charter was a vital development in the process that eventually led to Britain becoming a democratic nation. It signaled a new era of freedom for the common man. The Magna Carta has shaped the constitutions of many a nation (including the US) with some of the clauses still remaining part of British law to this day. Next year, also sees release of the new James Bond movie. All one needs to know about the new movie – it has the new Aston Martin DB10, Monica Bellucci, Ralph Fiennes, Christoph Waltz and of course there is Mr. Bond too.

While falling oil prices are a bane for oil producers and sellers, they are a boon for oil consumers and oil importers – principally in Japan and the Emerging Markets. The US dollar strength remains a massive obstacle to crude stabilizing therefore low crude oil prices will continue to be a tailwind for world growth. I see a volatile Q1 for the market, with Greece being the spanner in the ECB works, and a strong US dollar causing EM disquiet. However, low energy prices combined with continued improvement in world's biggest economy (the US), will see the year end on a very positive tone. The rate curve may flatten but it's unlikely to invert for another eighteen months and curves invert at least a quarter before we see a cyclical recession set in. Therefore, 2015 will be another year of growth and higher equity prices.

It's worth bearing in mind that since 1876, following a slump of more than -30% in the price of oil, the S&P 500 Index has risen (on average) by +11% in following 12 months. This increases to +18% for oil price slumps since 1980.

On to my predictions for 2015:

• The S&P 500 hits a new high of 2250 next year, with a full year upside of +8-10%
• China sees further slowdown in growth (but no hard landing) with growth rate adjusted down to the +6.5% level
• The ECB announces sovereign QE (in Q1 2015) as Eurozone inflation continue to fall. The unloved Eurozone equities find favor and perform well
• Japanese PM Shinzo Abe and the Bank of Japan (BOJ) double down on money printing and USDJPY heads over 135 by year-end. The Nikkei rallies to 20,700 by year-end i.e. +15% upside.

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• India's stock Index NIFTY sees a -10% slide in Q1 but regains lost ground in the following quarters and scales the 10,000 level by year end i.e. +15-20% upside for the full year
• Investors fall in love with Apple (AAPL) stock again, as it starts shipping the iWatch. As competition between Google (GOOG) and Apple hots up, Apple may launch its own search engine
• Electric cars to get much more traction, with their number on the road hitting one million. Tesla (TSLA) stock heads back to its all-time high of $291, (current price $215)
• Netflix (NFLX) gets acquired by a larger rival as the content war intensifies
• In the UK, PM David Cameron fails to win a second term. The Labour party, with the support of Scottish Nationalist Party (SNP) and others form the next government. The prospect of a hung parliament, and a fiscal deficit which is still over 5% of GDP, could see the GBPUSD trade in the 1.35-1.40 range, come May next year
• For cricket fans, India successfully defends its World Championship title in Australia next spring

Best wishes,

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