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Global Outlook

Oil, the dollar and monetary policy: it's all (or at least mostly) good

OVERVIEW

Oil, the dollar and monetary policy: it's all (or at least mostly) good

Larry Kantor

- **The plunge in oil prices is boosting growth and reinforcing the trend of lower inflation and bond yields, as well as easy monetary policy, thus providing further support to financial asset prices.**
- **The surge in the dollar is redistributing growth and inflation from the US, where monetary policy is set to tighten, toward the euro area and Japan, where it is most needed because of deflation risk and excess capacity. It has not been positive for emerging markets, however: China has resisted currency weakness and some EM countries have experienced strong capital outflows.**
- **The euro area and Japan should be clear beneficiaries: both unambiguously stand to gain from lower oil prices, weaker currencies, and extreme monetary support including massive quantitative easing (QE) programs. Stock markets in both areas have been outperforming; a trend that we believe still has some legs.**
- **Fixed income markets in developed economies seem reasonably valued. QE should keep bond yields in Japan and the euro area extraordinarily low, while US bonds should be supported by low inflation, a strong dollar, and yields that are high relative to other developed markets. Fixed income valuations in some emerging markets have become attractive enough to take some risk, especially considering the very high carry that has developed following large capital outflows.**
- **While we expect the Fed to tighten later this year, we do not expect it to be particularly disruptive to markets. In a low inflation, strong dollar environment, Fed tightening is likely to be unusually gradual and aimed at adjusting to a more mature economic recovery, as opposed to slowing the economy significantly to ward off inflation.**

The ECB outperformed already high expectations by embarking on a massive asset buying program

Markets and economies have been rocked by a number of major changes since we published our last *Global Outlook* in November: the drop in oil prices and the rise in the US dollar became much more pronounced, and global monetary policy became significantly more supportive than expected. While the Fed has behaved largely as anticipated by dropping its commitment to be "patient" about raising rates, thus opening the door to rate hikes later this year, it also confirmed that the pace is likely to be extraordinarily gradual. More broadly, a surprisingly large number of central banks around the world have cut interest rates, and the European Central Bank (ECB) outperformed already high expectations by embarking on a massive asset buying program that will last at least 16 months and amount to more than 1 trillion euros.

As far as implications are concerned, these changes are mostly positive for both economies and markets – at least for the developed countries – and in many respects reinforce trends that were already in place. The more than halving of oil prices – along with declines in many other commodity prices – has put further downward pressure on inflation, generating enhanced monetary easing and even lower bond yields, and providing a net boost to global growth and continued support to risk assets (eg, stocks and corporate bonds) in most developed markets. The surge in the dollar, meanwhile, has helped boost growth and stem deflation in some of the countries that need it most – particularly the euro area and Japan. It moderates growth and inflation in the US, where the Fed can now be more cautious about raising rates than it otherwise would have been. The story is more complicated and country-specific in emerging markets, although it remains the case that the EM block as a whole is past its cyclical peak in both economic and market performance.

Lower oil prices and a strong dollar likely to persist

The recent strength in the US dollar reflects the fact that US monetary policy is moving in the opposite direction of most other central banks

We do not expect the dramatic shifts in energy prices, the dollar and monetary policies to be reversed over the next several months. The plunge in oil prices reflects a large supply increase in North America, the unexpected decision by OPEC not to reduce output, and a multi-year slowing in demand that is less about weak global growth than it is about increased energy efficiency and the development of alternative energy sources after years of very high oil prices. None of these developments is likely to change significantly over the next several months, nor probably for the remainder of this year. With respect to the dollar, we are inclined to view the recent strength not so much as a "currency war" but as a long overdue currency realignment that reflects the improved relative performance of the US economy and the associated divergence in relative monetary policies – especially between the Fed on the one hand and the ECB and BoJ on the other – also not likely to change in the foreseeable future.

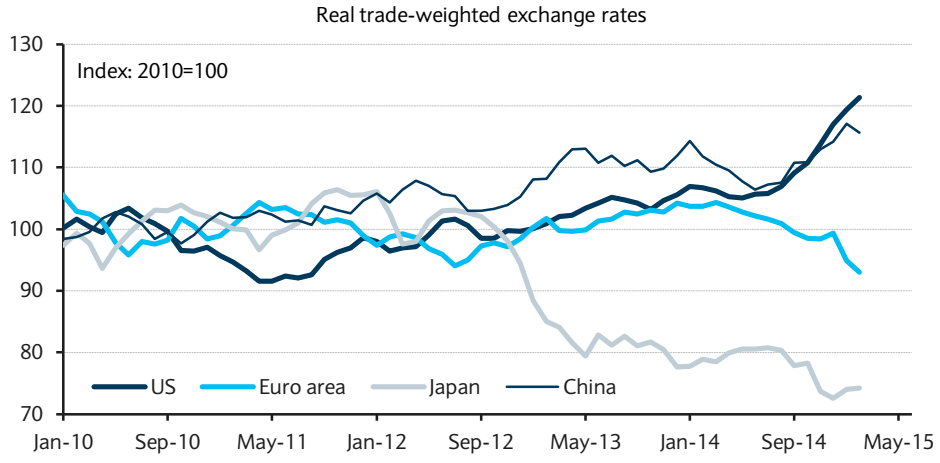
Winners and losers

Countries that depend most on oil revenues – such as Russia and Venezuela – are the biggest losers, whereas the euro area and Japan are clear beneficiaries

These large moves in markets and policies produce winners and losers among various countries and regions. The biggest losers are the countries that depend most on oil revenue, especially those with political issues such as Russia and Venezuela. The big Middle Eastern producers are also taking a hit, although those with large reserves such as Saudi Arabia, the UAE and Kuwait are better able to cushion the blow. The surge in the dollar and the prospect of Fed rate hikes have also exacerbated problems in other EM countries that are already in the down phase of the business cycle and have large current account imbalances, such as Brazil, Turkey and South Africa. The euro area and Japan are clear beneficiaries: both are major net oil importers, have experienced huge currency depreciation (Figure 1), and have central banks that are committed to maintaining zero policy rates and pursuing massive QE programs for at least the remainder of this year. The moves in oil, the dollar and policy are not as unambiguously positive for the US. It is true that as the biggest oil consumer in the world, the plunge in prices has given US consumers a major lift (real spending in Q4 rose sharply). But the bulk of this boost has probably passed, and the US has also become one of the biggest producers of energy: it is already taking a toll on oil drilling and investment spending. Moreover, the sharp rise in the dollar is reducing the value of foreign profits earned by US multinationals and rendering US products less price competitive on international markets. And while the moves in oil and the dollar are keeping the Fed at bay for now, US monetary policy is no longer in easing mode and policy rates are likely to rise before year-end.

FIGURE 1

US dollar and Chinese yuan up, euro and yen down



Source: Haver Analytics, Barclays Research

Fed hikes likely to be relatively benign

We expect a very gradual rise in US rates that should not generate major market risk

As expected, the Fed decided at its March meeting no longer to make any promises about how long policy rates would remain at zero. At the same time, it suggested that it was in no particular hurry to raise rates and foresaw a gradual pace, which provided relief to many investors, judging by the rise in stocks and the drops in bond yields and the dollar that followed. Given the surge in the dollar and the plunge in oil prices and headline inflation since last summer, this should have come as no surprise (in fact, the market was pricing a very gradual pace for some time). True, the labor market has improved enough to make the Fed comfortable with getting off the zero bound, but the risks of inflation are so low that the aim of rate hikes would not be to kill the economy or markets, but rather merely to adjust policy to stronger growth (and provide room for rate cuts when the need for them eventually arrives). We still believe that the Fed will make its first rate hike this year (our call is September), but expect a very gradual rise that should not generate major market risks (at least in the initial stages).

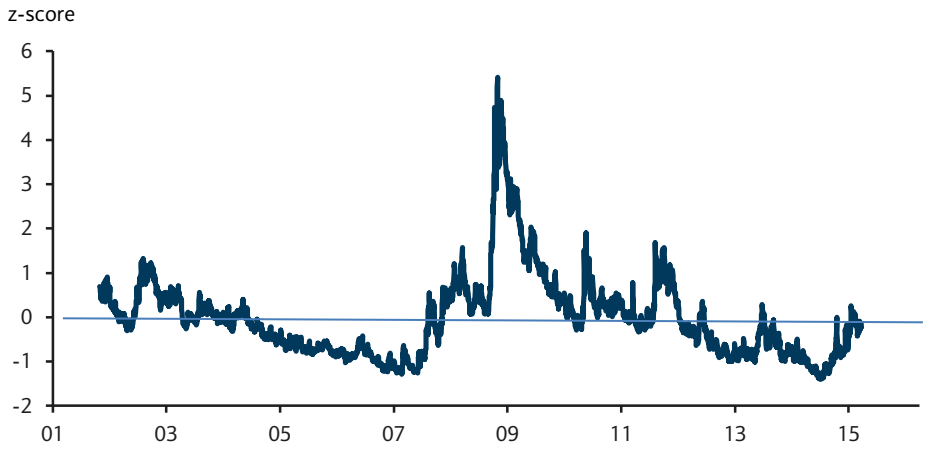
Lack of forward guidance should mean higher volatility

The decision to forgo forward guidance is another withdrawal of policy stimulus aimed at preventing excessive risk-taking

Meanwhile, the decision to forgo forward guidance was in some respects another withdrawal of policy stimulus, not just a way to provide the Fed with the flexibility to hike rates whenever it saw fit. Providing assurances that it would not raise rates for a long period was part of an effort – along with QE – to push bond yields down further and to provide investors with incentives to take risk and buy stocks, corporate bonds and other spread product. Given the improvement in the economy and the strong performance of risk assets, this assurance was no longer felt to be necessary. A byproduct of this decision is higher market volatility, since it implies heightened uncertainty about when the Fed will hike rates. While this can be disconcerting to investors, it is in many ways a healthy development and a sign that the US economy no longer needs life support. Extending this kind of assurance can produce investor complacency and the kind of excessive risk-taking that produces asset bubbles (which were responsible for the last two US recessions). Note that while forward guidance was firmly in place, volatility was unusually low, and it has merely risen to a more normal level (Figure 2).

FIGURE 2

Volatility has moved up from unusually low levels, but is not particularly high: z-score average for equities (VIX), FX (CVIX) and rates (MOVE) volatility



Source: Bloomberg, Barclays Research

We still recommend a neutral balance between stocks and bonds

Low inflation and continued large asset purchases by central banks argue against a large sell-off in bonds, and we still see value in many stock markets

Given the persistent combination of low inflation, modest economic growth and extraordinary monetary support, we continue to favor a relatively balanced portfolio as far as the allocation of stocks versus bonds is concerned. We still find value in the stock markets of many areas of the world. And while it is true that bond yields have fallen to historically low levels in nearly all developed markets, we would not recommend underweighting fixed income. Inflation is low everywhere, and in the euro area and Japan central banks are buying bonds well in excess of net issuance. Even in the US, where the Fed has ended its QE program, low inflation and the strong dollar argue against a major bond sell-off, particularly when US yields are so much higher than elsewhere in the developed world. And while buying sovereign bonds with such low yields will almost surely not prove profitable over the long term as a single investment strategy, they serve as an effective hedge against holdings of stocks and corporate bonds in a portfolio, especially given the impressive gains in stocks in recent years and the lack of any significant correction.

The euro area's chance to shine

The euro area finally seems set for a period of genuine recovery

Regional economic performance continues to evolve, as the moves in energy prices, currencies and central bank policies have different effects on various countries, and because many regions are in different phases of the business cycle. The most striking development is that the euro area finally seems set for a period of genuine recovery, as it is among the biggest beneficiaries of the recent moves in markets and policies: (i) the most obvious is the aggressive (albeit nascent) ECB QE program that has already pushed bond yields there to historic lows; (ii) the drag on growth from fiscal tightening has eased significantly; (iii) credit conditions have finally begun to improve; (iv) the euro has declined significantly, which should boost trade; (v) euro area stock prices have risen sharply (up more than 15% just this year); and (vi) lower energy prices have boosted consumer spending with minimal negative supply-side effects because of the dearth of energy production in the euro area. Consumer spending already began to pick up noticeably in Q4, and we expect further acceleration in overall economic activity in the coming quarters.

One risk that continues to hover over the euro area is the potential for Greece to exit the euro zone. It is difficult to assess the implications, given the lack of any precedence, but it is worth noting that the euro area is much better prepared to limit contagion from such an event because of the various firewalls put in place over the past several years (European Stability Mechanism, banking union, Outright Monetary Transactions, Public Sector Purchase Programme and ECB QE). Moreover, an exit would be very damaging for both Greece and the euro area as a whole, and so far it has paid off for investors to assume that euro area officials will find a solution before the breaking point.

US economy coming off the boil

US growth is slowing from the accelerated pace of last year

The US recovery finally achieved lift-off last year, as GDP growth averaged more than 3% for the five quarters through Q3 and the labor market showed impressive strength. Growth has slowed over the past two quarters, however, back down to around a 2% pace. While bad weather depressed activity in Q1 and GDP should bounce in Q2, we believe the slowdown from the brisk pace of last year also has fundamental underpinnings, as some of the drivers of above-trend growth have weakened or disappeared. The dollar has appreciated sharply, and this is already depressing US exports and foreign profits at multinationals; the Fed ended QE last October and is expected to hike rates later this year; stock and house prices are rising more slowly, implying a smaller wealth effect on consumer spending; and the shift in fiscal policy from significantly restrictive in 2011-13 to roughly neutral has mostly played out in terms of removing a major drag on GDP. We expect US growth to settle at around 2.5%, better than the pace of the recovery through 2013, but somewhat more moderate than what was achieved last year.

Japan likely to perform better, albeit from a low base

Prospects for Japan look considerably better for the immediate future, although the bar is low: the economy is recovering from two significantly negative quarters following last April's consumption tax hike, as well as a disappointingly modest Q4 rebound. That said, Japan should also be a major beneficiary of the plunge in energy prices and the strong dollar, as the yen has fallen sharply in trade-weighted terms and Japan is a major net importer of energy, even more so since it reduced domestic production of nuclear energy in the wake of the Fukushima disaster. Encouragingly, exports have recently rebounded, and the "Shunto" spring wage negotiations revealed higher wage increases from large companies, suggesting that more profits are being passed on to consumers. If sustained, this could well revive confidence in "Abenomics".

We have marked down EM growth forecasts

Financial conditions in China have actually tightened

The growth outlook for emerging market countries is a mixed bag, but the general tone has been negative; the majority of our EM country economic forecast revisions have been downward. Growth in China continues to slow somewhat more than expected, and we project this will continue through the first half of this year – we are forecasting annualized growth of 5.7% and 6.6% for Q1 and Q2, respectively. Despite recent interest rate and reserve requirement cuts, financial conditions in China have actually tightened. The yuan has depreciated much less than most other currencies against the dollar, and thus has appreciated on a real trade-weighted basis (the bulk of China's trade is outside the US). In addition, the drop in interest rates has lagged the reduction in inflation, so real rates have increased. And while lower oil prices are a net benefit, the boost is moderated by the relatively small response of retail energy prices to the drop in crude because of government subsidization. Beyond near-term cyclical factors, the bigger story remains that policymakers' efforts to restructure and reform the economy to make growth more sustainable are producing a drag on growth in the near term. This process involves letting the air out of the property bubble, reducing the amount of credit that flows through the shadow banking system, withdrawing support for big state-run enterprises and lowering the economy's dependence on investment and exports. That said, the authorities retain significant policy tools at their disposal and are willing to use them in case growth slows appreciably more than expected. Indeed, the pronounced slowdown we expect in H1 should elicit additional rate and reserve requirement cuts and increased infrastructure spending to produce a modest rebound in H2.

Lower commodity prices improve prospects for Asia, but hurt the LatAm block

The prospects for emerging Asia outside of China look somewhat better, as lower energy prices, central bank policy rate cuts, weaker currencies and still-strong global tech demand are all positives. India continues to stand out, as the combination of structural reform, lower inflation and monetary policy easing has improved growth prospects over both the near and medium term. While we expect Russia to remain in recession this year due to international sanctions and the plunge in energy prices, some of the countries in Eastern Europe such as Poland and Hungary should benefit indirectly from the ECB QE program, as well as the nascent rebound in euro area growth. Meanwhile, the Latin American block has weakened further due to its exposure to lower commodity prices, as well as individual political problems in many countries. This includes Brazil, where early indications of encouraging policy adjustments have been eclipsed by a host of domestic challenges. Indeed, some LatAm countries have experienced a combination of large capital outflows, sharp drops in currency values and high inflation and interest rates that are reminiscent of emerging markets episodes in previous Fed rate hiking cycles.

Inflation keeps falling, but sustained deflation is unlikely

One notable feature that is pervasive across the global landscape is low and declining inflation. In fact, headline inflation has turned negative in many parts of the world – including the US and the euro area – due mostly to the plunge in global energy prices. Given that the trend in inflation has been generally downward for the past 30 years, it is reasonable to ask whether

we are heading into a period of outright deflation. Our view is that this is unlikely to happen. Even in places where headline inflation has turned negative, core inflation has not, and by our analysis is unlikely to. The surge in the dollar has been fortuitous in this respect, since the US is much less vulnerable to deflation than many other areas of the developed world, given that its economy is operating closer to full capacity and also the preponderance of services in its price indices, which are less susceptible to international deflationary pressures. Regions that are more vulnerable to deflation – the euro area and Japan, for example – have seen their currencies fall sharply and this, along with prospects for better growth, should be enough to stave off deflation. Currency values have also fallen sharply in many parts of the EM world, with the notable exception of China, which has seen a sharp fall in inflation.

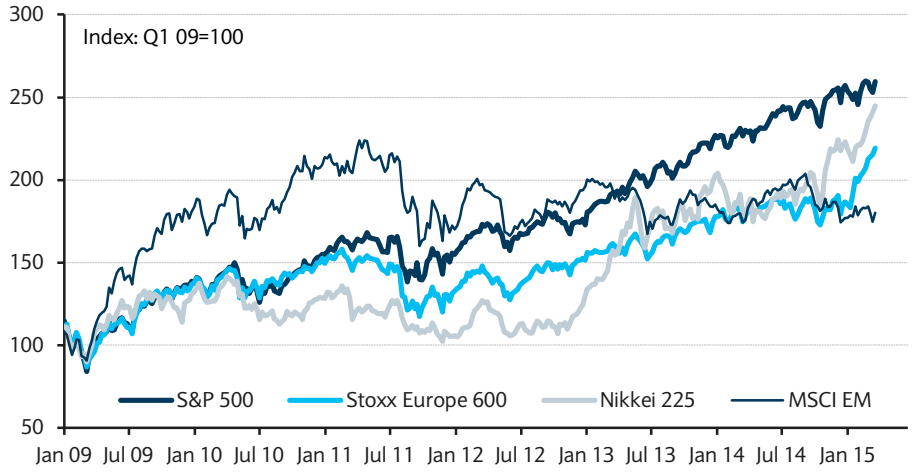
Further room to run for euro area and Japanese stocks

While stocks are vulnerable to correction, we believe the trend remains upward

Euro area and Japanese stocks have significantly outperformed US stocks this year (Figure 3), and we are maintaining our recommendation to overweight them relative to the US, as we see more scope for improvement in economic activity (especially with the bar much lower). We would continue, however, to hedge the currency risk, as we see room for further dollar strength. For the euro area, we are counting on improved economic performance to translate into earnings, which really haven't picked up yet. While P/E ratios are now in line with those in the US following the outperformance recently, more fundamental valuation measures such as price-to-book and cyclically adjusted P/E still make the euro area look cheap, suggesting that better-than-expected earnings would produce further price appreciation. We also expect Japanese stocks to continue to outperform, as companies are now focusing more on profitability than on sales, and seem more disciplined on capital expenditure. Japanese companies have historically delivered very low investor payout ratios, and we are looking for those to increase over time. While we see more attractive opportunities in the euro area and Japan, we are not negative on US stocks. Economic growth is solid, inflation is low and valuations are full but not overly excessive. The surge in the dollar and plunge in oil prices seem to be fully reflected in the shares of exporters and energy producers, which have fallen sharply. In a very low rate environment, we favor a combination of dividend and growth stocks. We recommend a neutral allocation for EM stocks (which peaked earlier in the cycle, much as EM economies did), as relative valuations seem largely consistent with the attendant risks in a weak commodity, dollar strengthening environment.

FIGURE 3

Japanese and euro area stocks have been outperforming lately



Source: Bloomberg, Barclays Research

Valuations in EM fixed income have become attractive

US yields may look low relative to US economic fundamentals but they are high relative to other developed markets

Fixed income markets seem reasonably priced in most developed markets, and we are relatively balanced between US, euro area and Japanese sovereign bonds, as we no longer see much scope for a further widening of the yield spread in favor of the US. Indeed, just a few weeks into the ECB QE program, yields are already extraordinarily low across the euro area. Roughly one-third of all outstanding euro area government bonds now have a negative yield and the entire Portuguese yield curve is below that of US Treasuries. US yields may look somewhat low relative to US economic fundamentals without a Fed QE program to support the market (nominal GDP has been running around 4% in recent quarters), but they look high relative to other developed markets, and we would expect continued strong capital inflows into the US bond market. We recommend some allocation to EM bonds, as yield spreads in a number of countries have become wide enough to more than compensate for the risk, in our opinion, especially when considering the large currency carry (which reflects capital outflows in many EM countries associated with fears of Fed tightening) and the fact that the Fed is likely to tighten only very gradually.

US dollar still has some upside, but pace likely to be slower and choppier

Funding has shifted from dollars to euros, and capital flows into US fixed income should continue to come from Europe and Japan

The dollar has moved up sharply since last summer, and the pace quickened in the first few months of this year. To a large extent, this was due to a divergence in monetary policy that was more pronounced than expected, with the ECB embarking on a larger QE program, more central banks around the world cutting rates, and the Fed ending QE in October and managing expectations for rate hikes this year on the back of stronger-than-expected US labor market activity. Now that the Fed has reduced its policy rate forecasts close to what the markets had been expecting, and with most of the surprises in central bank policy likely behind us, the pace of dollar appreciation should slow down considerably. However, with the ECB QE program still in its infancy, and yields there having already plummeted to historically low levels, there are still likely to be some adjustments by market participants that will drive the dollar somewhat higher. For example, we expect to see multinational corporations increasingly funding in euros instead of dollars. And with interest rate differentials favoring the US by such a wide margin and a slow-moving Fed, we expect to see continued capital inflows into US fixed income. With the Fed having removed forward guidance, we also anticipate greater FX volatility.

Oil prices likely to stay low for a while

Lower prices will cause supply growth to slow, but this will take time

The plunge in oil prices has already caused US drilling rig counts to fall by roughly half, but measured oil supply has not fallen. That is because the rigs that are being closed are the least productive, whereas output is increasing in the most productive fields because it lowers the average cost of production (with the bulk of costs being fixed, such as land and equipment). It is also worth noting that US inventories have kept rising, and that there are many wells that have been drilled but where the extraction process – which is expensive – is being delayed until prices rise. This implies an upside cap on how high prices can go in the short term. Meanwhile, OPEC continues to resist cutting production, and will likely continue to do so. This is not so much a conspiracy to squeeze out high cost producers as it is an acknowledgement of economic reality. For many years, global demand was growing faster than non-OPEC supply, providing OPEC with increased pricing power. For the past five years, the opposite has been true: the surge in North American oil production and reduced demand coming from slower growth in some EM countries such as China, energy conservation efforts such as a more efficient power grid in China and more fuel efficient cars everywhere, and the development of oil alternatives such as ethanol have meant that non-OPEC supply has been growing faster than global demand, thus reducing the pricing power of OPEC. It is also worth noting that despite continued geopolitical risks in the Middle East, supply has actually grown in countries such as Iraq, Iran and Libya. The bottom line is that lower prices will eventually diminish supply, as some investments that would have been made with $100 oil will not be made now, but this is a gradual process and it will be a very long time before we see $100 oil again.

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