CFA Society Los Angeles

Central Banks Face Multiple Challenges in Trying to Stimulate Economic Growth Even With Lower Oil Prices, Analysts Tell CFALA 2015 Forecast Dinner Attendees

LOS ANGELES – The diverging monetary policies of major central banks and the performance of the U.S. economy will be the key determinants of what happens to the global economy in 2015, top analysts said at CFA Society Los Angeles' 13th Annual Economic and Investments Forecast Dinner.

David Malpass, President of Encima Global, an economic research and consulting firm serving institutional investors and corporate clients, outlined the challenges to U.S and global GDP growth in 2015.

"We expect many of 2014's economic and market drivers to carry into 2015," he said in prepared remarks. "The U.S. may slow back into the new norm as weakness in Europe, Japan, Brazil and Mexico persist. We expect Japan and Europe to pursue QE rather than structural or regulatory reforms, leaving their economies weak. The European Union will come under increasing pressure from recession, unemployment, UK politics, immigration problems and major disappointments on fiscal deficits and tax receipts.

"World dollar GDP is likely to be lower in 2015 than in 2014, even though the consensus is for substantial growth in 2015. Global growth is dependent on a strong U.S. acceleration above the third quarter's 2.7% real growth year-over-year. That's possible, but we think a return to the 2.5% new norm or below is more likely given weak foreign growth, current U.S. policies and recent data showing weakness in business investment, housing and bank lending.

"Current global monetary/regulatory policy is driving a powerful disinflationary wave that is likely to spread beyond the commodity sector. Under this 'post-monetarism', there's no linkage from excess reserves and the central banks' M0 monetary base into the private sector – no ability for central banks to drop money from helicopters to soften the deflation. Instead, commercial bank lending and the M2 money supply are controlled through regulations on bank leverage, liquidity and capital adequacy – post-monetarism. We expect disinflation to weigh on asset prices, debt ratings and corporate earnings prospects. Unlike 1998, the Fed has no ability to cut rates or inject liquidity as the disinflation deepens, and we're skeptical that the European Central Bank's asset purchase plans will actually be helpful.

"Equities were in a strong up-channel in 2013 and 2014, fueled by positive policy developments on U.S. stabilization and the euro. We think growth-oriented policies by political leaders will be the critical variable in extending those gains."

Krishna Guha, Vice Chairman of Evercore ISI, the broker-dealer arm of the investment bank Evercore, argued that the "Great Divergence" in monetary policy will continue to pressure exchange rates in 2015 but said the global growth outlook is better than the market's current mood suggests.

"The bond market today is too pessimistic, in our view. We believe monetary easing in the Eurozone, Japan and emerging markets, including China, along with a strong boost from lower oil prices, will help stabilize the nominal growth outlook outside the U.S.," he said in comments prepared for the Thursday event at the Omni Hotel in Los Angeles.

"The U.S. economy will continue to perform despite the drag from weaker foreign growth and a strong dollar, and the Fed will be able to raise rates, though perhaps not as fast as policymakers currently anticipate."

Guha predicted that ECB QE will be de facto open-ended, with the ECB ending up buying assets worth about two trillion euros. He said ECB QE could be reasonably effective and, along with oil price declines, a lower euro and stronger banks, could deliver a mild upside growth surprise. However, without deeper structural reform and institutional integration, he said the Eurozone would remain in a chronic low growth/low inflation equilibrium and exposed to political stress.

The Bank of Japan will continue very large scale QE but with a high bar for further increases due to concern about a weakening yen, he said, adding that further asset price gains in Japan need to come from growth and multiples rather than currency effects, with structural reform essential to Japan's longer-term growth prospects.

Guha said the U.S. expansion is increasingly self-sustaining and would withstand global weakness. He warned against assuming the Fed would postpone rate increases.

"The Fed is approaching its dual mandate objectives and the zero bound on interest rates is no longer obviously binding," he said. "The committee is looking through the near-term effect of oil on inflation and a forward-looking approach to policy implies rate increases this summer."

Sharp movements in oil and the dollar will pressure many emerging markets, Guha said, but pessimism about the asset class is overdone.

Guha said the main risks to Evercore ISI's outlook involve Russia, EM corporate exposure to dollar funding and the possibility of an abrupt spike in yields.

Addressing the outlook for oil prices was Roger Diwan, Vice President of IHS Financial Services and a veteran advisor to energy companies and financial institutions on oil markets, geopolitics of oil, and strategic shifts in the global oil and gas industry.

"People are not used to seeing sharp prices moves in any asset class, but for oil prices the decline we have seen was in many ways foretold," he said. "Going into 2014, we had global oil supplies growing at twice the rate of demand and this obviously was not sustainable. I believe prices still have downside from the $50 level they are at right now, and they are likely to stay low through the second quarter before they start to react to lower supply. Moreover, the inventories build that is likely to occur will also delay a potential quick recovery in prices."

Lower energy prices will boost U.S. GDP by about a half percent, Diwan said, while negatively impacting states that have experienced economic growth linked to oil exploration and production.

"The drop in energy prices is, in effect, a massive tax cut," he said. "We're seeing lower energy prices across the board, which frees up money for consumers to spend elsewhere. As far as disruptions in the energy sector, it's quite small relative to the U.S. economy, although we will see a number of restructurings in the oil industry."

On the global front, "Lower oil prices clearly impact some oil producing nations more than others," Diwan said. "The more negative impacts will fall on Venezuela, Nigeria, Angola and others that have not built up a lot of currency reserves. Gulf producers are in a different situation because they have put a lot of money by and can withstand lower prices. For Russia, lower prices will impact the state more than Russian oil companies."

Diwan stressed that nothing is permanent in energy prices.

"Oil really should be thought of in terms of cycles," he said. "We are in a deflationary cycle for oil prices and oil activity, but these things don't last forever."

CFALA's annual forecast dinner benefits the California Council on Economic Education (CCEE), which provides economic and financial literacy education to K–12 teachers and students to help them make better personal and financial decisions, improving students' ability to succeed and compete in the global economy. CCEE's Teacher of the Year, Larry Shoham of Hamilton High School, was honored at the dinner.

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