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THE YEAR AHEAD

WHAT TO EXPECT IN 2015 (AND BEYOND)

Some Opportunities and Several Tail Risks

December 2014

It is once again time to put down in print in one place some pretty specific speculations on what could happen next year. We do this every year with the intent of trying to get investors to think about what could happen and factor that into their decisions on how to adjust their portfolios to take advantage of opportunities while at the same time being aware of the risks. And, maybe, do something about it. One can always speculate about a possible occurrence. What I have tried to do is include those elements where I believe the odds are high enough of an occurrence to take into account in a portfolio. In addition, this may bring to the fore some things that could happen and what to look for to indicate a possible mid-term adjustment. You may want to take a look at the mid-year review we did of the 2014 expectations to get a sense of how we saw the world a year ago. It might give you some perspective on how much weight to put on this year's observations. Let's proceed.

UNITED STATES—GROWTH CONTINUES AND THE US DEFINES ITS OWN ECONOMIC PATH

Let's first discuss the United States. The US remains the market of most focus as much technologically, politically and economically is taking place here and is a primary determinant of what happens in the rest of the world. The US is not fully isolated from what is happening elsewhere, but can, if it so chooses, make its own economic, political and geopolitical decisions. It can only get in its own way. So what is the path for the next year?

Economically, the US experiences real GDP growth that varies by quarter between 2.5% and 4.5% with growth generally surprising to the upside as a result of lower energy prices working their way positively through the economy. The lower energy prices will increase volatility of reported numbers on employment and growth, but the trend is up. Export trade is not as robust as we move through the year and begin experiencing some impact from the strong dollar. On the other hand, the lower cost of imported oil offsets growing demand

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for other imported goods producing less of a negative impact on trade balances and GDP. While lower energy prices produce financial accidents in the oil patch and geopolitically, the ripple effect of lower feedstock, transportation and production costs are, on balance, positive for the US economy. At the same time, in spite of cutbacks in the energy sector, overall employment ultimately continues to grow. A tight labor market continues to get tighter with wages, a lagging indicator, growing faster than they have in some time. Capacity utilization, which is already at levels seen before 2008, moves higher, putting some pressure for price increases and likely increasing capex. The Fed takes notice.

The mix of sectors and companies that benefit from lower energy prices is significantly different from those that generated excess returns in the last several years. The Fed, to some extent ignoring what is happening outside the US, gives stronger signals on timing of a rate increase in 2015. The combination of credit concerns, primarily coming from the energy sector, and the potential for a rate rise also affect performance in the interest rate sector. I anticipate that the halo effect of deserved wider credit spreads in the energy sector produces opportunities to lock in some decent returns in the rest of the high yield and high grade corporate sectors. I believe the real money is made on the negative side of the credit markets. The yield curve gets even flatter.

THE REST OF THE AMERICAS—A MIXED PICTURE OFFERS OPPORTUNITIES

On balance the lower oil prices do have a negative impact on **Canada**. With Canada's housing market looking a bit overextended we start seeing a few leaks in the Canada story on both the credit and equity side.

Mexico also sees some impact from the lower energy prices in terms of revenues and the privatization of its energy sector. It still continues to be one of the good stories of growth, reform and development in the world.

Venezuela likely moves into real or technical default with major political disruptions and uncertain actions from the ruling party. Venezuela's problems ripple through to the Caribbean, in particular, **Cuba**, where subsidized oil flow becomes problematic. The timing of the Chanukah opening of relationships between the US and Cuba likely does stem from a long period of talks, but the oil situation has no doubt increased some sense of urgency for Cuba to find another partner to replace the string of subsidizers since the revolution. This will likely produce another bargaining chip for the new Congress, as the President needs support to go beyond what he can do administratively. Cuba will get more headlines than it deserves, but maybe the Cuban people will start moving toward a better life as a result.

Argentina continues to muddle through toward the ultimate payment in some form at some discount of its outstanding debt obligations. As a result of the Argentine issue with a few holders being able to avoid participating in a restructuring approved by a majority of the debt holders, there is talk, and possibly real action, on new rules for sovereign debt structures to avoid a similar problem in the future. This likely raises the cost of sovereign debt in general and may change the nature and mix of the buyers.

With **Brazil**'s economy under some pressure and oil as a savior looking a bit less like one, Rousseff makes some adjustments to policy becoming more markets friendly. This is not without some domestic turmoil. The uncertainty substantially increases volatility in the markets and the currency.

EUROPE—ECONOMICALLY BETTER, BUT POLITICALLY WORSE

Also aided by lower energy prices, the European economies show some new signs of life while the politics get more dismal. A modest form of QE combined with some even more modest elements of financial reform garner interest from investors in some segments of their markets. Without real reform, though, or a major decline in the Euro ultimately approaching parity with the dollar, it is hard to see the Eurozone maintaining a single currency. Not an issue for 2015 although the noises will be there increasing volatility in the markets.

JAPAN—ABENOMICS CONTINUE WITH THE YEN WEAKENING FURTHER

Lower energy prices combined with a freer hand for Abe with cooperation from Kuroda push the Japanese market up and the Yen down with continued volatility. No one is quite clear how this experiment will end, but it will likely continue at least until the upper house elections in 2016. The lower Yen does have a positive impact on Japan's export picture particularly relative to Europe (Germany).

CHINA—GROWTH DISAPPOINTS, CURRENCY STAYS STRONG, AND THE ECONOMIC TRANSITION ACCELERATES

Estimates of growth for 2015 prove to be too high with the real number approaching 5%. Lower energy prices help China's trade balances and the general economy, giving the leaders some room to continue the transition from a labor-cost-driven export economy to an internal economy taking advantage of a huge home market while the country comes up the technology curve. China's leaders are somewhat accepting of the lower growth rate as they push toward reform and expand the infrastructure spending, particular on transportation systems, roads, rails, ports, and airports. Two years ago, China filed more patents in each of the categories—invention, utility, trademark and design—than the perennial leaders, the US and Japan. 2015 may be the year when patents issued exceed the leaders. In addition, China takes advantage of the geopolitical and global economic turmoil to expand its influence in the Asian sphere and beyond, including moving further toward making the Yuan a reserve currency. Odds are the currency holds its own with the dollar in contrast to almost every other currency.

INDIA—BREATHING ROOM FOR REFORM AND INDIA JOINS THE CURRENCY WARS

Lower energy prices provide some breathing room for Narendra Modi to continue down a reform path without as much interference from other parties. The impact of energy on overall inflation, combined with weak economic results, provide room for lower rates and, to some extent, India's participation in the currency wars. With the simple prospect of lower rates India's markets continue to do well. A less belligerent China makes nice with India. India's relationships with Pakistan as well as difficulties with the internal Hindu/Muslim relationships represent the few risks facing the Modi administration. Worth watching how this aspect develops.

RUSSIA—THE FINANCIAL SITUATION PRODUCES A DIFFERENT PATH LEADING TOWARD REGIME CHANGE

Lower oil prices continue to have a major financial impact on Russia, likely leading to a financial accident when it becomes apparent Russia's reserves are not adequate to meet all its needs. Putin continues to take a belligerent stance toward the west and supports, overtly and covertly, continued action in the Ukraine. While Putin has consolidated power, one could make the argument that his support could erode with the general populace as shortages continue and a falling Ruble affects prices. Putin could take some unusual steps geopolitically to try and influence oil prices. At some point the financial elite and others who do not believe the country (and themselves) benefit from an anti-west view attempt to exert some influence over the current path. Ultimately, this path could lead to regime change—or a change in path. I would expect the former. Watch for indications of internal strife or a change in direction from Putin. First steps would likely be purges of those not fully on Putin's team. Russia has an educated population and the ingredients for being an important economic player on the world stage. The current path will not get them there and will add to geopolitical volatility as long as it continues. Trading in Russian securities and the currency remains a professional's game, but volatility makes that difficult as well.

IRAN—A SETTLEMENT SOONER THAN THE DEADLINE. OIL PRICES MAKE A DIFFERENCE

Sanctions and lower oil prices may work to the benefit of a settlement of the Nuclear issue with Iran before the 7-month deadline is reached. The settlement could include other elements, which benefit Iran and reduce conflict in the Middle East. Israel protests.

OIL—PRICES STAY LOW WITH GENERALLY POSITIVE, BUT VOLATILE EFFECTS

We have discussed oil in every one of the paragraphs above. My belief is that oil prices will stay lower longer than many expect. In the near term, it would take a major geopolitical disruption involving the Middle East to push prices up significantly. OPEC (really Saudi Arabia and to some extent Kuwait) may be thinking strategically about the benefits of lower oil prices. It does reduce new exploration and hydro-fracturing until technology pushes down the cost curves. On the margin it can negatively affect the pace of alternative energy development. With exceptions of some of the oil producing nations it provides an overall economic lift to growth, which could put a floor under prices as demand increases sooner than otherwise might occur. For more background on this, see "OPEC and the Logic of Low Oil Prices."

In the near term, it has a marginal impact on supply. If a well has been drilled or is partially drilled, the marginal cost of production likely leads to continued pumping. I think OPEC may be underestimating the pace of technological developments in the oil patch. If anything, companies may seek to increase their R&D to push down the cost curves. The noise from the oil companies is partly real and partly strategic as well. There is a strong belief, broadly shared, that energy independence for the US is an important objective. The noise about loss of jobs, the lack of further E&P

development, the importance of energy industry capex to growth (now about 10% of total capex in the US, up from 3% in the '90's), and some financial accidents will increase support for the industry and talk of why the oil price needs to be higher. In a strange way it may increase support for alternative energy development as well. If prices stay low there will be a temptation to raise gasoline taxes with some low-income credit offset under the guise of supporting the Highway Trust Fund and other transportation-related infrastructure investments.

We have discussed the changing beneficiaries of this energy-cost paradigm in some recent pieces on the Altegris Blog. I would add to that the auto industry, as, on the margin, miles per gallon becomes less of a factor in purchase decisions. It doesn't take much of a shift to higher margin vehicles to have a major impact on autos' bottom line.

Oil prices staying low through 2015 is a major view, which affects many of the other expectations in this *Perspective*. Probably the biggest one is the boost to growth in the US and elsewhere, and the changing mix of winners and losers at home and around the world.

US POLITICS—A WILD CARD THAT INCREASES VOLATILITY AND UNCERTAINTY IN THE MARKETS

This may seem like a strange topic for an expectation. However, early signs from what will be a changing Congressional makeup at the beginning of the year, is not encouraging. If debt ceilings and budgets become hostage to an agenda around the Affordable Care Act, immigration, education, tax reform and oil, it will add significantly to volatility in the markets and consumer and business confidence. A tail risk.

CYBER ATTACKS—THEY CONTINUE. AN INVESTMENT OPPORTUNITY, BUT ADDED GEOPOLITICAL RISK.

On the back of the Sony episode there is another major cyber attack, which substantially increases investment in IT security. Those companies involved in cyber security become their own market bubble. Many more companies than we could imagine brand an element of what they are doing as being related to cyber security. The threat is real. Some of the claims are not. In addition, cyber warfare takes on major geopolitical characteristics adding to the complexities in relationships among major and some minor players.

CONSUMPTION—CHANGING EATING HABITS AFFECT STOCK PRICES

Here's something else one can blame on Obama—Michelle, not the President: On the margin the American diet begins to change as regular supermarkets expand into the Whole Foods milieu and the cost spread between healthy food and drinks vs the opposite is reduced. The standard fast food and soft drink purveyors, while attempting to adjust to this healthier trend, suffer from changing consumer interests. This is in part fueled by greater awareness of the health hazards from obesity and unhealthy eating in general. At the same time, medical advances hold out the prospect of a longer life if one takes some responsibility in the earlier years to benefit from the changes yet to come. This expectation may be a bit more hope than analytical, but watch consumption patterns on the margin. Mine have changed.

OTHER TAIL RISKS—NEED TO BE CONSIDERED IN PORTFOLIO CONSTRUCTION

Below are some lower odds expectations, but sufficient enough to require some thought about their impact on the markets and to consider some form of tail-risk protection.

1) A Putin-led Russia maintaining and acting on an anti-west stance

2) A terrorist attack in the west

3) An unexpected financial accident beyond those indicated above

4) Something unusual in the Middle East involving Israel in what would be viewed as an independent offensive action

5) OPEC or some other factor (see above) pushes oil prices up

6) A runaway US equity market on the upside with multiple expansion against a backdrop of low interest rates and "the best game in town" syndrome. It has happened before.

The combination of the end of QE, lower oil prices, different patterns of growth including a rise in the wage outlook leads to a different and much more diverse set of winners and losers in the markets. We may be entering a more absolute return world where the traditional equity and fixed income investments, overall, experience low rates of return. This truly may be the time when active managers do well, certainly on a risk-adjusted basis. There are major tail risks from primarily geopolitical actions. We believe it is prudent to spend a few basis points in most portfolios as insurance against tail risk, both positive and negative. We also believe that a fresh look at one's portfolio, moving away from what may have worked over the period of QE, is important. Recent past performance may truly not be indicative of this coming year's results. We expect that allocations related to risk mitigation will become more important, and at the same time provide decent returns.

Each of these paragraphs could be its own *Perspective*. We will be updating these, and, of course, commenting on the true surprises that occur, which none of us are thinking about today. We do need to Pay Attention to this new normality and the characteristics of investments that will work. Getting more specific on risk and portfolio construction is important.

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