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ASSET MANAGEMENT

Looking back at 2014

Dag Lindskog, 29 December 2014

The lowest interest rates ever recorded

When someone in a distant future looks back at the economic development during 2014, the most striking feature will surely be how remarkably far interest rate fell. Leading central banks adopted zero interest rate policies. Several governments could borrow over the next ten years for less than 1%. Surely, the low interest rates were one of the most important explanations why many equity markets performed quite well.

From pessimism to optimism

2014 turned out to be another strong year in most financial markets. However, pessimism and high volatility dominated the opening month. The American Fed started tapering off its support bond buying program, and the American economy contracted under the strains of an unusually hard winter. Political turmoil, particularly the conflict between Russia and Ukraine, contributed as well to falling equity prices and bond yields.

Gradually, optimism took over. Monetary policy was the important contributor. The American Fed managed to follow its pre-announced tapering plan and ended quantitative easing (QE) in October without upsetting the financial markets. The other leading central banks followed the opposite route. The Eurozone's ECB cut rates a number of times down to essentially zero and more or less promised to start QE in the beginning of 2015. Bank of Japan enlarged its already exceptionally large-scale QE. Several other central banks including the Swedish Riksbank also cut rates down to a zero policy rate or even negative as in the case of Switzerland. Important equity markets including New York and Stockholm made double-digit gains (in local currencies) although some included the group of emerging markets ended slightly down.

This monetary policy stance along with everywhere subdued inflation had two important consequences. Firstly, throughout the year long interest rates gradually fell in many places to the lowest levels ever recorded. Secondly, the dollar surged against all other currencies. The appreciation was for example around 10% versus the euro and 20% versus the Swedish krona.

Strong America, volatile Japan and weak Eurozone

The American expansion picked up strength after the weak start of the year. The labor market distinctly improved. Employment increased and unemployment decreased. Japan had the opposite profile with a strong start ahead of tax increases, which in their turn contributed to weaker performance over the rest of the year. The Eurozone eked out a weak expansion. Despite no decisive steps to turn the Eurozone away from its lackluster performance after the global financial crisis, rate spreads between the core and peripheral countries shrank. Hence, investors attached a rising probability to the survival of the currency area though worries remain particularly regarding Greece's ability to muddle through its required tuff adjustments.

Inflation was everywhere subdued on the back of the modest global business cycle. Typically, capacity utilizations rates remained low and wage increases were limited in most countries. This was especially relevant for the Eurozone heightening the risk of outright deflation. The drastically lower oil price started to impact headline inflation rates towards the end of the year.

The Riksbank finally cut rates

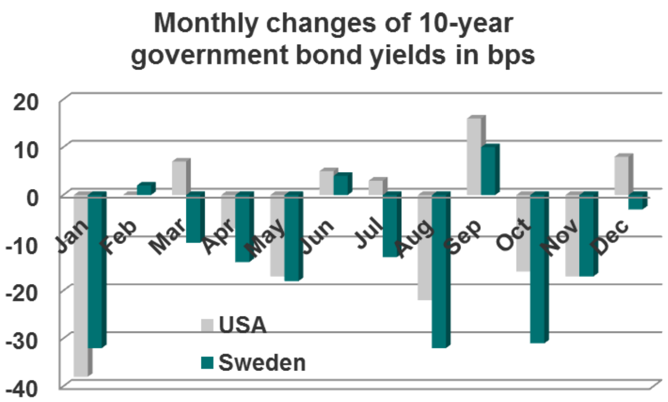
Sweden's expansion held a middle position between strong America and weak Eurozone. Domestic demand was the engine of growth. Private consumption was supported by significant household real disposable income gains from rising real wage increases primarily due to essentially zero inflation, and rising employment. Exports struggled due to weak growth of major export markets.

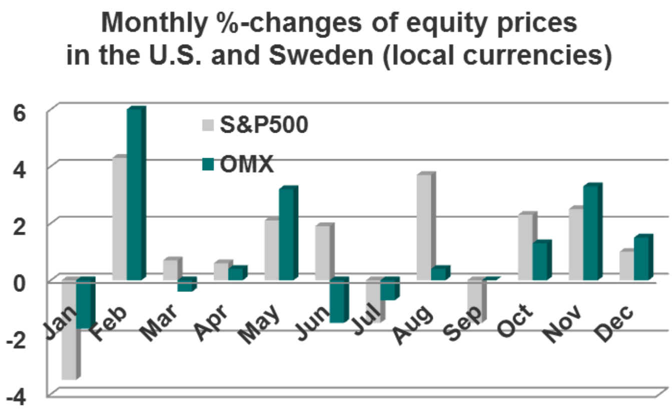
The Riksbank long hesitated to cut rates despite missing the inflation target with a wide margin referring to the risk of high and rising home prices and household debt. Eventually, the central bank cut twice and ended in October at a zero policy rate. The Swedish krona weakened a lot during the year. Monetary policy is one explanation and the political development another. The new Swedish center-left minority government failed to win support for its new budget in the Parliament, but a compromise between the major political blocs makes it possible for minority governments' to govern. However, for the time being, the government has to follow the opposition's budget.

Winners and losers from cheap oil

There were both winners and losers among emerging markets. The difference was partly due to the sharp drop of the oil price, which started during the summer. All consumers and oil importing countries are winners, whereas the limited number of oil companies and oil exporting countries are losers. Among the latter is foremost Russia. The central bank tried in vain to halt the sharp slide of the ruble. Among the former are China and India as well as almost all industrial countries with Norway as one notable exception.

Both the Chinese real growth and inflation rates gradually slowed during the course of the year partly due to a weakening housing market. People's Bank of China took some steps to ease its monetary policy. India got a new government that promised market-friendly reforms. This together with, just like in China, high expectations of an easier monetary policy next year explains the strong performance of the Chinese and Indian equity markets.





Note, the last observations are from December 26 for the U.S. and from December 23 for Sweden.