2015: THE YEAR OF GLOBAL DOLLAR DANGER

America's domestic economy can handle a surging dollar and a fresh cycle of rising interest rates. Large parts of the world cannot. That in a nutshell is the story of 2015.

Tightening by the US Federal Reserve will have turbo-charged effects on a global financial system addicted to zero rates and dollar liquidity.

Yields on 2-year US Treasuries have more than doubled from 0.31% to 0.74% since October, and this is the driver of currency markets.

Since the New Year ritual of predictions is a time to throw darts, here we go: the dollar will hit $1.08 against the euro before 2015 is out ($1.21 on 12/31), and 100 on the dollar index (already at 90 at year's end).

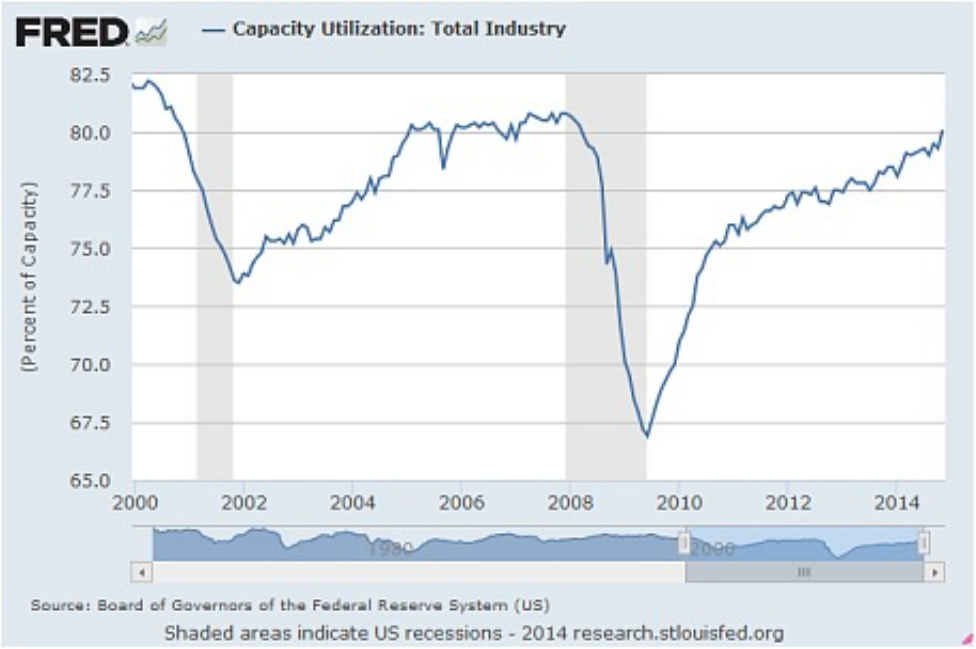
Sterling (the British pound) will buckle to $1.30 ($1.57 on 12/31) as a hung Parliament prompts global funds to ask why they are lending so freely to a country with a current account deficit reaching 6% of GDP.

There will be a mouth-watering chance to invest in the assets of the BRICS and mini-BRICS at bargain prices, but first they must do penance for $5.7 trillion in dollar debt, and then do surgery on obsolete growth models. What are the odds for either?

The MSCI index of emerging market stocks will slide another third to 28 before touching bottom.

The Yellen Fed will be forced to back down in the end, just as the Bernanke Fed had to retreat after planning a return to normal policy at the end of QE1 and QE2.

For now the Fed is on the warpath, digesting figures showing US capacity use soaring to 80.1%, and growth running at an 11-year high of 5% in the third quarter.



The Fed pivot comes as China's Xi Jinping is trying to deflate his own country's $25 trillion credit boom, early in his 10-year term and before it is too late. He does not need or want uber-growth. The Politburo will more or less keep its nerve as long as China continues to meet its target of 10m new jobs a year - easily achieved in 2014 - and job vacancies outstrip applicants.

Uncle Xi will ultimately blink, but traders betting on a quick return to credit stimulus may lose their shirts first. Worse yet, when he blinks, a tool of choice may be to drive down the yuan to fight Japan's devaluation, and to counter beggar-thy-neighbor dynamics across East Asia. This would export yet more Chinese deflation to the rest of the world.

At best we are entering a new financial order where there is no longer an automatic US "Fed Put" or Chinese "Politburo Put" to act as a safety net for asset markets. That may be healthy in many ways, but it may also be a painful discovery for some.

A sated China is as much to "blame" for the crash in oil prices as America's shale industry. Together they have knouted Russia's Vladimir Putin. The bear market will short-circuit at Brent prices of $40, but not just because shale capitulates. Marginal producers in Canada, the North Sea, West Africa and the Arctic will share the punishment. The biggest loser will be Saudi Arabia, reaping the geostrategic whirlwind of its high stakes game, facing Iranian retaliation through the Shia of the Eastern Province where the oil lies, and Russian retaliation through the Houthis in Yemen.

Mr. Putin will achieve his objective of crippling Ukraine's economy and freezing the conflict in the Donbass, but only by crippling Russia in the process. Controls will not stem capital flight. Mr. Putin will have to choose been a dangerous loss of foreign reserves and a dangerous chain of corporate bankruptcies.

He will continue to pawn Russia's national interest to Beijing in order to save his Siloviki (KGB ruling elite) regime, but wiser heads in Moscow will question how a perpetual dispute with Europe and the revival of a dying NATO can possibly be in Russia's interest. They will check his folly.

The European Central Bank cannot save the day for asset markets as the Fed pulls back: it does not print dollars, and dollars are what now matter. Nor is it constitutionally able to act with panache in any case.

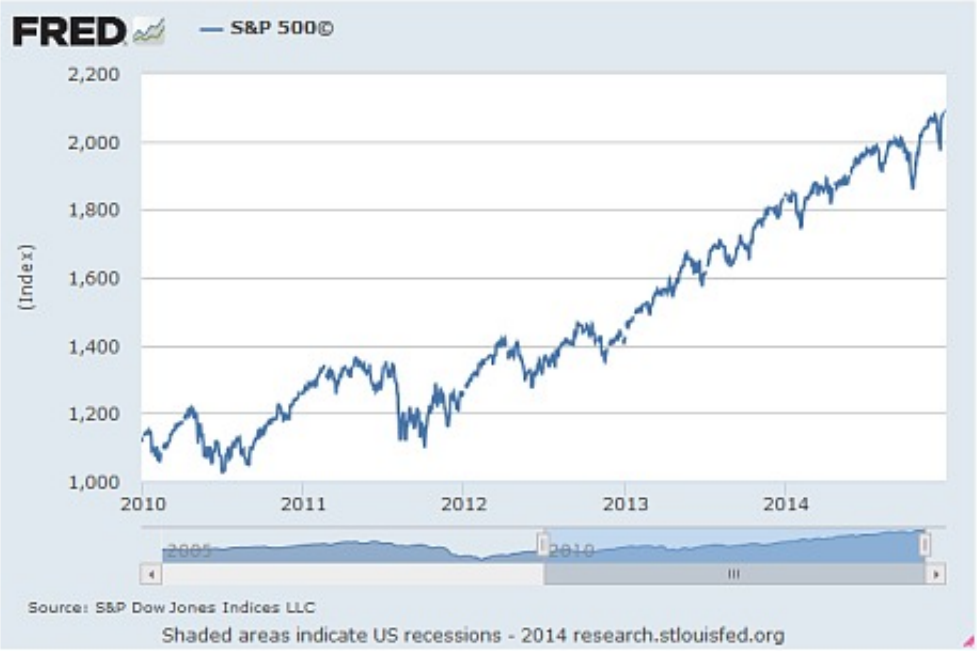
While Mario Draghi and the Latin bloc could theoretically impose full-fledged QE against German resistance, such *frechheit* (impudence) would sap German political consent for the EMU project. Mr. Draghi will accept a bad compromise: low-octane QE that makes no macro-economic difference, but noisy enough to provoke a storm.

The eurozone will be in deflation by February, forlornly trying to ignite its damp wood by rubbing stones. Real interest rates will ratchet higher. The debt load will continue to rise at a faster pace than nominal GDP across Club Med. The region will sink deeper into a compound interest trap.

The political triggers for the next spasm of the EMU crisis are complex, yet trouble must come since the North-South gap is as wide as ever in key respects, and the depression drags on. The detonator may of course be Greece. If Syriza rebels hold their poll lead into the snap-election this month, a cathartic showdown with Brussels will occur in short order.

The EU creditors may agree to debt forgiveness for Greece, but they might equally refuse to talk with a gun held to their heads. There is a 50/50 risk that they would instead switch off life-support and eject Greece, calculating that they now have the back-stop machinery to stop contagion. In this they would be wrong.

Breaking my normal rule of discussing equity prices let me say only that the S&P 500 index of Wall Street stocks will not defy monetary gravity or the feedback loops of global stress for much longer. Half the earnings of US big-cap companies come from overseas, repatriated into a stronger dollar, and therefore worth less in reporting terms.



The index has risen at double-digit rates for three years, further inflated this year by companies buying back their own shares at a pace of $130bn a quarter, often with borrowed money. The profit share of GDP is at a post-war high of 12.5% (much like 1929), an untenable level as US wages start to rise and the balance of power swings back to labor. The S&P index measuring the price-to-sales ratio is higher today than at its pre-Lehman peak.

Expect a S&P shake-out of 20% comparable to the LTCM crisis in 1998 when the wheels came off in Russia and East Asia, though don't be shocked by worse. Emerging markets are a much bigger part of the world economy today, and their combined debt ratio is a record 175% of GDP.

Once these hiccups are behind us, we can look forward to sunlit uplands as always. Happy New Year.

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