

FIVE SERIOUS ECONOMIC DANGERS

for 2015 and Beyond

Roubini's **Edge**



Is the Global Financial System Heading for the Perfect Storm?



In the 21st century, globalization has created a new paradigm for stock markets and investors. Never before have advanced and emerging economies around the world been so intimately connected.

Most investors, though, remain unaware. According to the latest AAI Investor Sentiment Survey, optimism among individual investors remains near all-time highs. 79% of the surveyed believe that the stock market will either rise or stay the same for the next six months.

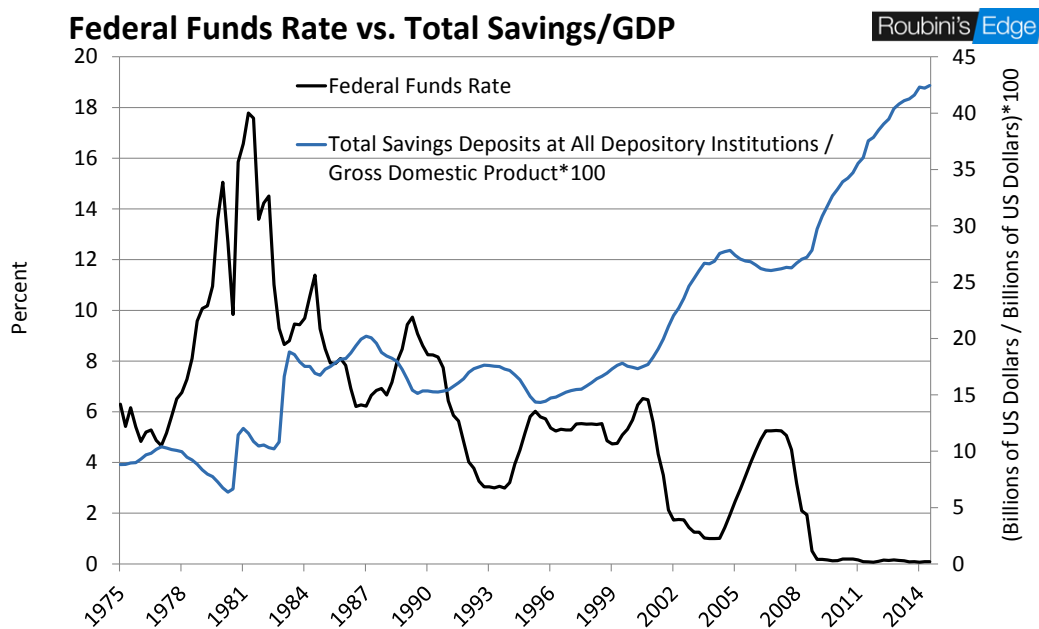
But don't be lulled into a false sense of security by the stock market's performance over the last few years. The simple truth is, there remain several serious risks to the global economic and financial system, and any one of them could impact global growth and stability. When combined, they could trigger another global crisis.

Investors need to be aware of and monitor these risks in real time. Failure to do so will leave unprepared investors ill-equipped to protect their assets—which is why the *Roubini's Edge* team has put together this timely special report. The more aware you are of what's going on in the global economic theater, the better your chances to financially survive if disaster hits.

Today's Macroeconomic Red Flags

Now that the US Federal Reserve is no longer easing as QE is over and China is pressing ahead with credit tightening, the excessive speculative risks that ultra-loose monetary policies led investors to take are starting to unravel. Meanwhile, Japan is taking quantitative easing to new heights and the ECB may follow soon.

While the Fed kept interest rates near zero for many years, the dangers to the global economy are becoming obvious.



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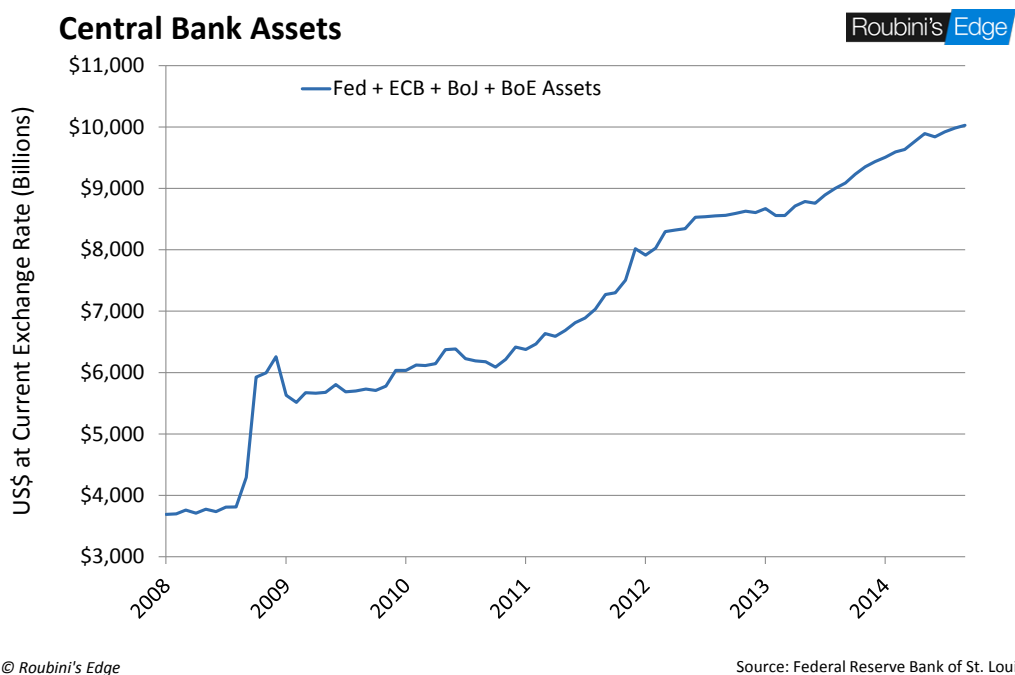
Source: Federal Reserve Bank of St. Louis

Money supply isn't the problem. It doesn't matter how low interest rates go, because banks and investors are saving the liquidity created by the Fed instead of lending it and spending it. As you can see in the chart above, US holdings of liquid savings deposits have gone up dramatically since the 2008 crash.

The liquidity created by the Fed has not gone into credit to the real economy but rather asset reflation and inflation. Surging asset prices and bubbles have made a few people rich, but they're squeezing households from London to Hong Kong as housing is becoming unaffordable, while a wave of goods price deflation is hitting many countries in the West and increasing the real value of the debts of households and governments.

Once again, Europe has become a top concern, with its economy threatening to plunge into a deflationary debt-spiral. The European Central Bank would like to repeat Japan's ongoing experiment with Abenomics, but for now German opposition to full-blown quantitative easing may rule that out.

Ironically, the unconventional monetary policies pursued by central banks around the world in response to the last crisis may have left the financial system more vulnerable than ever. Bubbles are building up in credit, real estate, and some equity markets. It has also allowed politicians to put off the day of reckoning, when they will be forced to tackle the world's \$100 trillion mountain of debt.



And because the excesses of the last bubble were never exorcised, [extreme monetary policies](#)—that were necessary as growth is low, unemployment high and inflation falling—may simply have helped form the next one. Central banks say that the risk of another credit and asset bubble will be controlled by macro-prudential regulation and supervision of the financial system.

But macro-pru is untested and likely to be ineffective. So, as exit from zero rates is slow as the economies are weak, we risk creating the mother of all bubbles.

In this zero-interest-rate world, investors have hunted for yield wherever they could find it. But they may have gone too far: domestic and foreign companies with large debts are now particularly vulnerable to a rise in US interest rates.

Now everyone's talking about a major bull market in the dollar and US assets—a bull market that is argued could last years. The strong dollar has become a shock absorber for the deflationary forces taking hold of the global economy.

But that leaves emerging markets—whose dollar borrowing has surpassed the extremes seen just before the Asian financial crisis in the late 1990s—extremely vulnerable to a currency shock. The strong dollar is also weighing on commodity prices at the very moment China's ability to deflate its [property bubble](#) and avoid a hard landing is being questioned.

Slower growth in China, a Fed exiting easy liquidity, and the end of the commodity super-cycle are threats to many emerging markets. Indeed, emerging-market stocks and high-yield debt tumbled on these fears during the “taper tantrum” of 2013. And they're starting to do so again.

It's Never Been More Important to See the Big Picture

In the following report, we take a look at the greatest macroeconomic dangers today.

- A repeat of the eurozone crisis
- A hard landing in China
- The risk of a failure of Abenomics to reflate Japan
- Mounting geopolitical risks
- Global currency shock caused by the strong dollar

Any one of these risks has the potential to cause worldwide financial havoc and tip the global economy into recession and another financial crisis. Combined, they could form the perfect storm.

DANGER #1: The Eurozone Becomes a Destabilizing Force



Source: AP

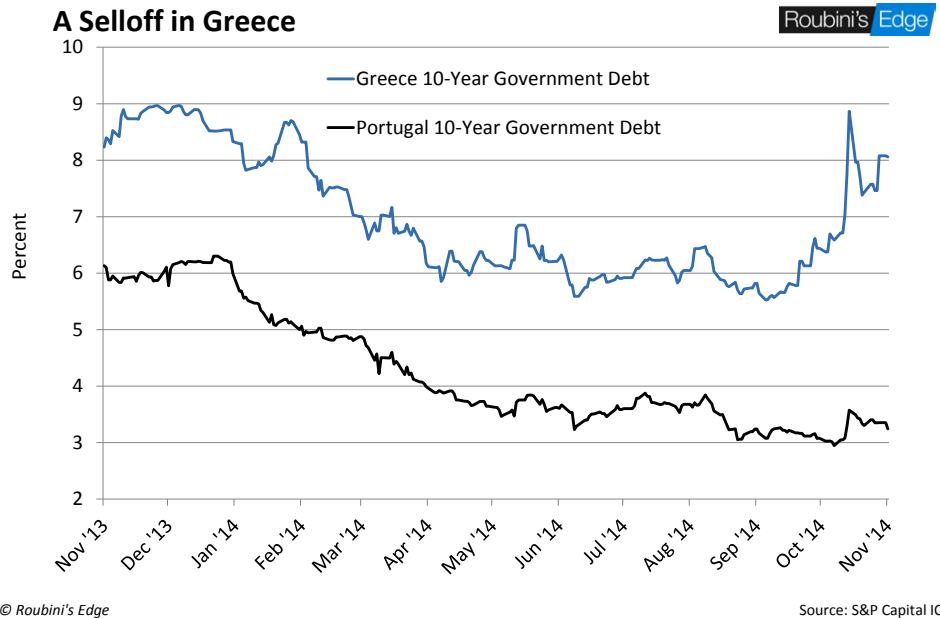
Though we have seen two years of relative calm in Europe, the years of enforced austerity and high unemployment in Greece, Italy, Spain, and Portugal are taking their toll—and providing ammunition to the euro's critics.

Just how long it will take for the euro crisis to resume is anyone's guess, but with Europe facing the prospect of a triple-dip recession and deflation, we expect the next couple of years to be turbulent.

As usual, politics are getting in the way. Unstable governments and alliances now exist in several European countries. And eventually, the real power brokers in Europe could turn out to be the leaders of the anti-euro parties that are gaining ever more fans.

Anti-Euro Forces Are Gathering Steam

In Greece, where nearly half the population lives below the poverty line, a fresh crisis is looming. If Prime Minister Antonis Samaras fails to get his candidate elected in the February 2015 presidential election, this will automatically trigger parliamentary elections next year.



If that happens, there's a very real risk that the leftist anti-austerity SYRIZA Party—which is clearly ahead of all other parties in the polls—and its charismatic leader, Alexis Tsipras, might sweep to power and lead Greece's exit from the euro. This prospect has caused Greek bond yields to spike again (see above chart).

Meanwhile, in Italy, Beppe Grillo's Five Star Movement has just launched a petition drive for withdrawal from the euro to lift the country out of depression and protect Italian democracy. And in Spain, the anti-euro Podemos party is first in the polls, while the neo-fascist Marine Le Pen could poll first in the first round of the French presidential elections.

But what's really making the eurozone a political accident waiting to happen is the transformation of the German political landscape, where the anti-euro party, Alternative für Deutschland (AfD), is threatening the established parties. It's forcing Chancellor Merkel to take a tougher line on the euro and resist monetary and fiscal measures to prevent the eurozone from slipping into Japan-like stagnation and deflation.

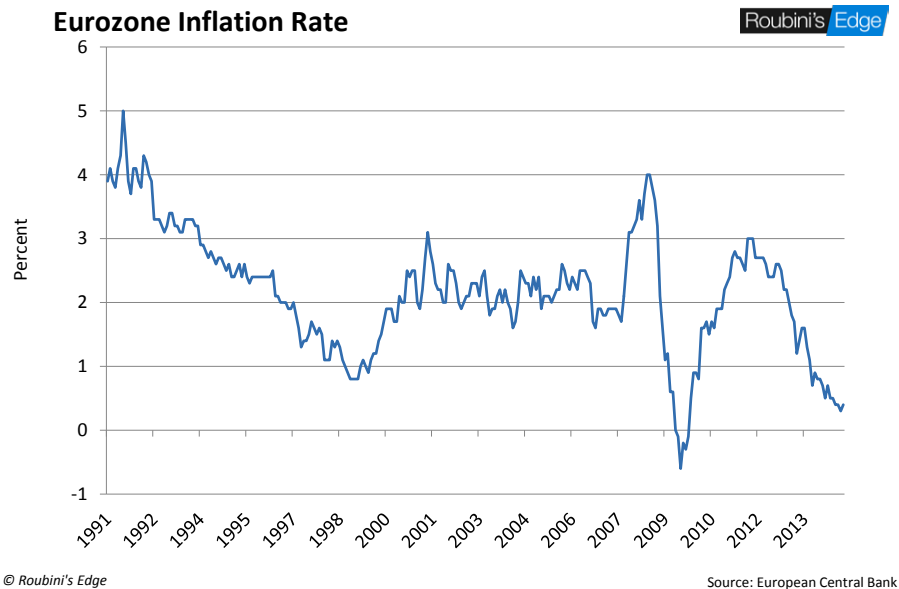
Due to Europe's larger economy and stronger financial links with the rest of the world, this scenario would be much more damaging to the global economy than Japan's Lost Decade in the 1990s.

Germany's "No" to QE and Fiscal Stimulus Could Reignite the Crisis

Europe already teetered on the brink of recession when it was hit by the Russia-Ukraine crisis and its sanctions and countersanctions. High energy costs—in spite of falling oil prices—and a weakening of key export markets like China and Eastern Europe are weighing on Germany, France, and Italy.

Outright deflation is a real possibility, as you can see in the chart below. Rate cuts and other stimulus measures have had no effect on economic confidence as they have been too little, too late, while fiscal austerity remains a drag on growth. Now Europe's policymakers are desperate for the European Central Bank (ECB) to implement full-scale quantitative easing (QE) of the type Japan is experimenting with so that they can devalue the euro and stimulate inflation.

But the German government is, for now, opposed to quantitative easing and fiscal stimulus and unlikely to yield on these issues. It's even possible that Germany's constitutional court could block quantitative easing next year.



It is unlikely that the European Central Bank can launch QE without the approval of the German government and the Bundesbank. If anything, the balance of power on the ECB's governing council may be shifting in Germany's favor, raising doubts about the central bank's ability to gain the consensus it needs.

Bundesbank President Jens Weidmann's primary allegiance is to the Bundesbank's hard-money principles. He and Berlin have also rejected calls by the IMF, the US Treasury, and now even ECB President Draghi for Germany to cut taxes or ramp up public infrastructure spending, despite the mounting signs that Germany's economy is succumbing to the Europe-wide downturn.

Stimulus Spending... or Else

The eurozone's deflationary bias has persisted for so long that without serious fiscal stimulus from the creditor nations like Germany, monetary policy can only hope to slow the slide into deflation. France and Italy's governments in particular aren't happy about the eurozone's austerity regime. They warned that Germany's demands for further belt-tightening could set off a "political backlash" and endanger European stability.

The backlash that French Prime Minister Manuel Valls has in mind is what Marine le Pen, leader of the nationalist Front National Party, threatened to do: leading France out of the euro.

How Much Good Would QE Actually Do?

Europe would clearly like to see a weaker euro, but the currency may not weaken as much as needed, even if the ECB started full-blown QE. After all, Europe's \$400 billion trade surplus is now bigger than China's in the 2000s and may partially prevent euro weakness.

And how effective would any aggressive quantitative easing by the ECB be? Even a €1 trillion increase in the ECB's balance sheet might not be sufficient, because it would only take it back to where it was two years ago. Much more aggressive QE may be needed over time.

A weaker euro could boost exports in countries whose exports are highly sensitive to price competitiveness, like France, Spain, and Italy. But a weaker currency, acting as a tax on households, could partially cancel such benefits, as we've seen in Japan.

So while QE and a weaker euro are on net beneficial for the eurozone they lead to some collateral damage for consumers.

France and Italy are now putting pressure on Germany to abandon budget rigor and agree to a “grand bargain” that would trade slower fiscal tightening for structural reforms and the reform of Europe’s high-tax, high-spend welfare model.

Will the EU Force a Fiscal Stimulus on Germany?

While Merkel appears to be in no mood to agree to stimulus spending—except for some limited infrastructure spending—the incoming president of the European Commission, Jean-Claude Juncker (right), may have other plans.



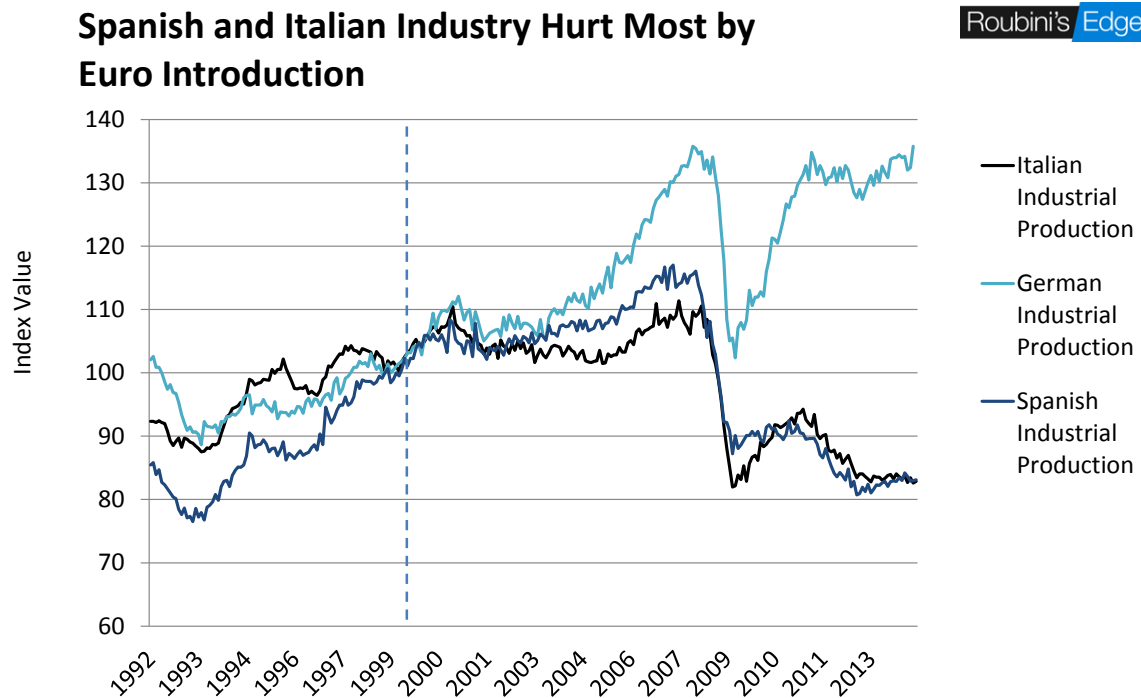
A €300 billion investment program over three years proposed by Juncker, using cash sourced from existing budgets and the European Investment Bank, could form the basis of a fiscal union, according to László Andor, the EU’s commissioner for Employment, Social Affairs, and Inclusion.

But it’s clear that a stimulus program that small would not be enough to counter deflation without action from the ECB and significant fiscal easing in Germany.

Southern Europe on the Brink

It is unlikely that France, and Italy will successfully gang up on Germany and form some kind of “anti-austerity pact.” In the meantime, knowing that the EU can’t offer more fiscal flexibility since that would be a betrayal of the Greeks, Portuguese, and Irish, who have played by the rules and suffered harsh austerity, the French government simply abandoned its budget targets for the next two years and effectively imposed its will on the EU Commission.

However, Southern Europe doesn’t have that option. Its debt loads are more onerous than ever, with Italy, Portugal and Greece’s public debt having swelled to 135%, 130% and 175% of GDP respectively. The chart below shows the precipitous drop in Italian and Spanish industrial production, a depression rather than a recession.



Public-debt-to-GDP ratios in the eurozone could spiral out of control, and outright deflation would make it virtually impossible for the “PIGS” (Portugal, Italy, Greece, and Spain) to grow their way out of debt. And if they’re forced to default on their debts, it would almost certainly spell the end for the euro.

In July 2012, current ECB President Mario Draghi calmed the financial markets by promising to “do whatever it takes to preserve the euro.” Over two years later, rhetoric is still a lot of what he has, as QE is long overdue and fiscal policy is going in the wrong direction. But the markets and voters may eventually lose patience if growth and job creation do not rapidly resume.

The crisis could smolder on for years. Or a definitive German QE and fiscal stimulus veto could trigger a day of reckoning if investors suddenly unwind the carry trades that have driven the yields on European sovereign bonds to such risk-defying lows.

What you as an investor should consider: There’s more systemic risk in the eurozone today than there was at the beginning of the crisis. Italian and Spanish long bond yields as low as US long bond yields don’t make sense for countries with much higher and rising public debts.

DANGER #2: The Risk of an Implosion of Abenomics



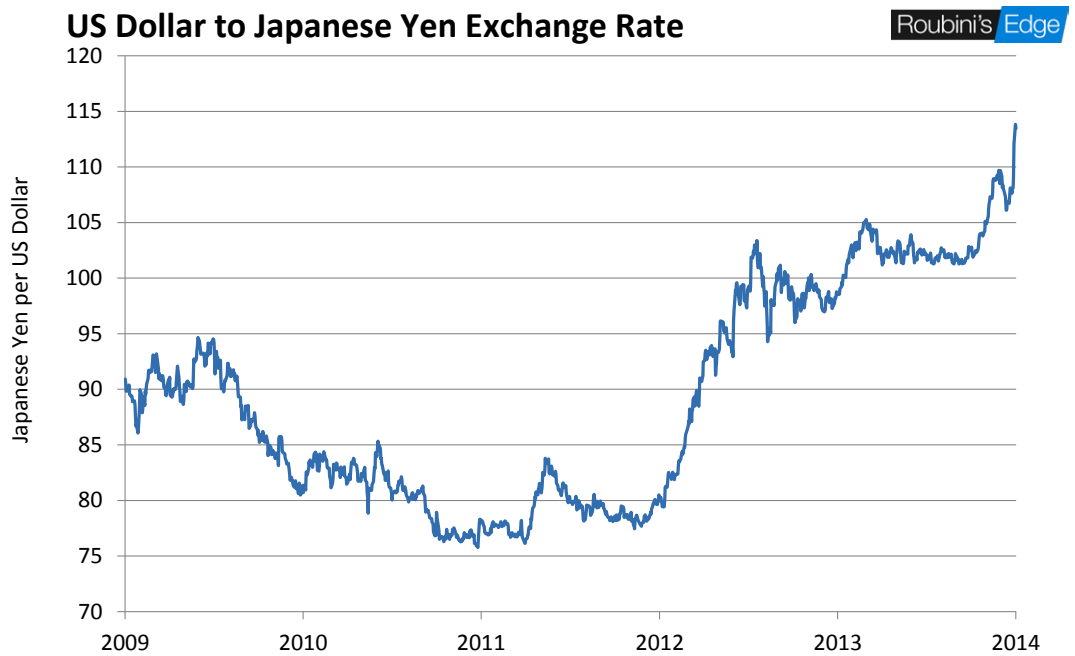
Abenomics is Japanese Prime Minister Shinzō Abe's plan to fight deflation and jolt Japan's economy out of the suspended animation it's been in since the collapse of its 1980s real estate and stock bubbles. Described as "QE on steroids," it's a bold attempt to stabilize public debt that has swelled to over twice the size of the economy.

The goal was to revitalize industry, fuel an export boom, and put the proceeds into hiring and capital investment. It would also curtail imports by making them more expensive in Japan. The trade surplus was going to soar.

But instead of reviving the economy by pushing up inflation to 2% and fueling an export boom, Abe's master plan squeezes consumers and increases economic hardship.

That's because pushing the yen lower relative to the dollar—a drop of 30% since late 2012— and the rise in the consumption tax this year (to be followed by another tax hike in 2015) are undermining the earning power of the Japanese consumer.

With little pickup in demand, corporations haven't increased their domestic investment and job hiring; they are instead investing abroad.



© Roubini's Edge

Source: S&P Capital IQ

In fact, because the weaker yen has led to soaring raw-material costs, corporate bankruptcies have increased by 140% since the start of Abenomics, especially among small and medium-sized businesses that face a domestic market.

Despite falling inflation and the Japanese economy's risk of sliding into another recession—its fourth one since 2008—Bank of Japan Governor Haruhiko Kuroda still insists Abenomics is working, while PM Abe will proceed with the second consumption tax hike in 2015. In October, Kuroda announced that he would use another round of additional QE to drive the yen even lower, which will raise the target for expanding the monetary base by 14% to \$720 billion.

But this will increase the distorting effect the yen has on global markets. By exporting deflation to Europe, the US, China, and emerging Asia, it could trigger another round of currency wars and a global recession.

Japanese Corporations Have Given Up on Their Domestic Market

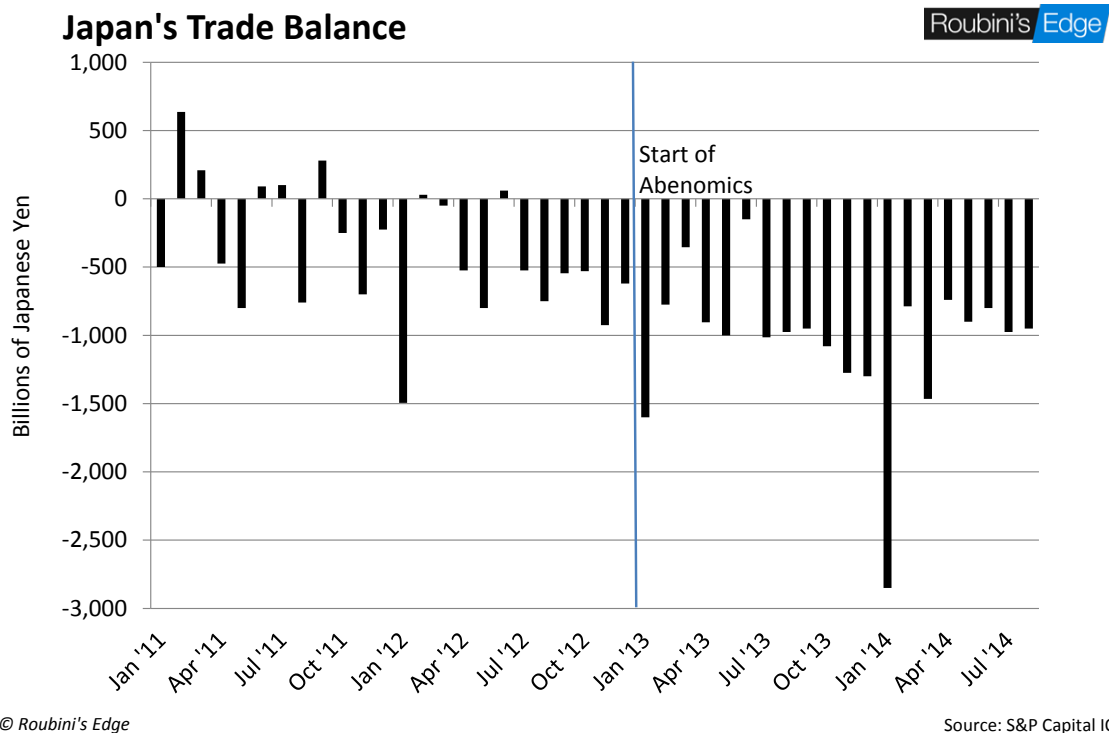
The Japanese stock market has nearly doubled since Abenomics began—in part because foreign currency profits are now worth more when converted into yen, and in part because the Bank of Japan, and now the government pension investment fund (GPIF), are aggressively buying stocks directly and via exchange-traded funds.

There's only one problem.

Instead of using their newly competitive currency to boost export volumes by cutting the foreign-currency prices of their exports, Japanese companies have simply padded profits through higher margins.

The weaker yen may have given Japanese companies even more incentive to outsource their manufacturing than before, precisely because it boosts their financial results. After all, a rapidly aging island experiencing stagnation and a near depression is hardly an attractive market.

In practice, Abenomics hasn't even given Japan's exporters an advantage. Not only have exports failed to rise, but Japan's trade and current-account surpluses have decreased markedly, posting negative numbers for the first time in decades.



Japan's trade balance has been negative every month since July 2014 (see chart above).

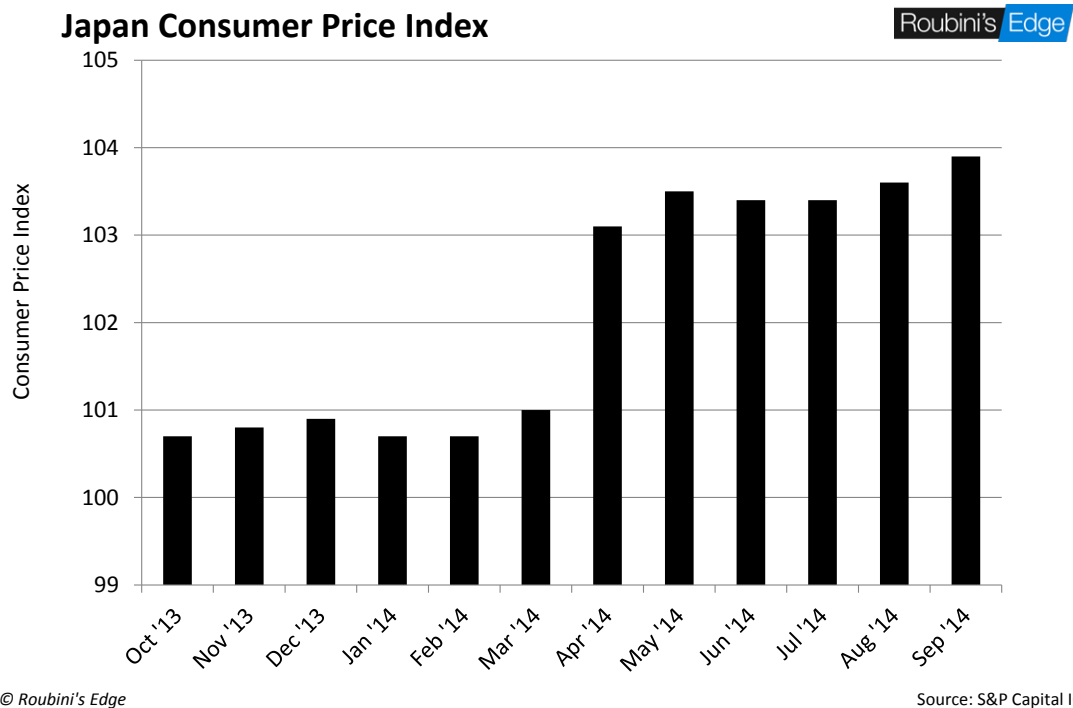
Japan's long-lasting malaise may have turned into something more structural and long term than a debt deflationary hangover from the bursting of a property bubble in 1992. Because of its untenable national public debt, Abenomics could turn out to be the wrong solution to the wrong problem.

Japan's Deepening Social Depression

We always doubted that Japan's aging population would go on a spending spree just because the Nikkei Index was booming. The only healthy way to grow an economy is to increase the disposable income of the people most likely to spend it.

But the wealth effect that was supposed to result from a higher stock market has been canceled out by higher prices, higher taxes, and declining real incomes—much like quantitative easing has done in the US and Britain. Retail and automobile sales have recently slumped.

Like all devaluations, Abenomics secured a temporary advantage for export-oriented companies. But a weaker yen increased the cost of imports, including food, oil, and other natural resources that Japan depends on. Even after taking into account the broad-based hike in consumer taxes from 5% to 8%, which came into effect in April, consumer prices have temporarily soared.



For Abe's reflationary experiment to work, wages in Japan would have to rise at a faster pace than inflation. But two decades of stagnation—and labor laws that make it tough to fire older workers—have relegated vast numbers of young Japanese to low-paying,

temporary contract jobs. So even though unemployment is only 3.7%, this casual and insecure work force is keeping a lid on wage growth.

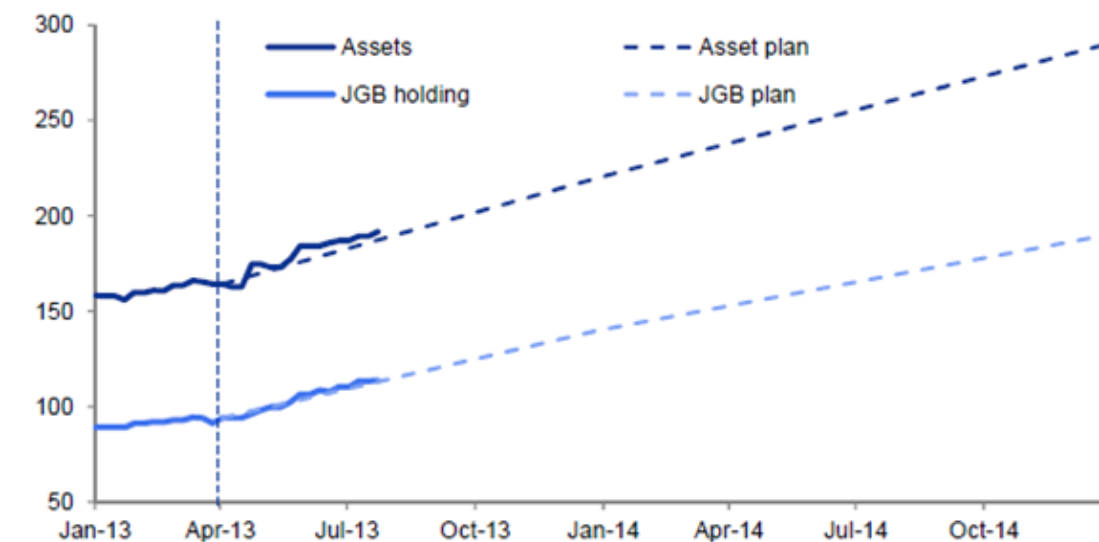
Japan's lost decades have turned a once-egalitarian nation into one of haves and have-nots, in which prosperity is limited to the financial and political elite.

Distorting Japan's Stock Market—The Final Straw for Abenomics?

The Bank of Japan (BoJ)—and soon enough the GPIF—has been buying up stocks whenever they show any weakness, making the BoJ the biggest holder of Japanese stocks with a portfolio of 7 trillion yen, or roughly 1.5% of the market.

Naturally, manipulating a stock market in this way distorts its price discovery mechanism—which is why central banks don't usually buy stocks.

BOJ's asset and JGB purchases, ¥tn



Note: As of July 26, 2013.

Source: BOJ.

The risk is that this house of cards could one day implode. Indeed, the key missing element of Abenomics is its third arrow of structural reforms needed to boost productivity growth and the supply of labor; these reforms are occurring too slowly and too timidly.

Apparently, Abe is starting to realize that his grand plan may not work. Now that his popularity is crumbling and he is facing scandals, he's even expressing concerns about

a weakening of the yen and is planning fiscal measures to compensate the losers from a weaker currency. Some of his advisors are urging him to face down powerful interests in the Finance Ministry and the BoJ and delay a planned hike in the sales tax.

What you as an investor should consider: While the risk of a public debt crisis is for now very limited as the BoJ is effectively monetizing a larger fraction of the public debt, Abenomics may fail over the next three to five years.

This would happen if the third arrow of structural reforms is not accelerated, if the second arrow of fiscal austerity becomes an excessive drag on growth and prevents a stabilization of the public debt ratio, and if eventually the BoJ becomes less willing to continue open ended QE-infinity while inflation fails to recover in a stagnating economy. Then, one cannot rule out an eventual debt crisis unless the BoJ goes to full scale monetization of the public debt.

DANGER #3: China's Tricky Balancing Act



As if the slump in Europe and the risk of a failure of Abenomics weren't scary enough, China's housing bubble may have finally burst. Because the country is inextricably linked to the global economy, the fear of a hard landing in China is starting to send shockwaves through financial markets.

Like the US Fed, China unleashed a giant wave of credit in 2009 to act as a counterweight to the global financial crisis. Private domestic debt exploded from \$9 trillion then to \$24 trillion today, feeding a real investment boom as fixed investment in new capital is now almost 50% of GDP. But as Japan learned the hard way in the 1980s, the longer a boom runs, the greater the danger of excessive and

bad real investments in real estate, infrastructure, and industrial capacity, bad debts, bad assets and a major crash.

In China's case, the construction boom—in which it consumed more cement between 2011 and 2013 than the US did *during the entire 20th century*—made the economy overly reliant on housing.

With property prices now falling faster than they did during the 2012 wobble and economic growth slowing rapidly, China's financial system is exhibiting signs of significant stress.



Also, overinvestment in infrastructure and industrial capacity has massively added to the glut of productive supply and bad debts.

However, injecting even more crediy into the economy will eventually make mass defaults more likely.

The country has to purge the excesses from its financial system and rebalance the economy from investment to consumption. People's Bank of China (PBoC) Governor Zhou warned markets not to expect the kind of easy money seen in the US and Japan.

China must focus on stabilizing its banking system rather than investing in infrastructure and real estate, which is why commodity markets have sold off so strongly. Bad debt is soaring at every major Chinese bank, including the biggest bank in the world, Industrial & Commercial Bank of China.

This is a big deal because these banks have large operations abroad. There could be knock-on effects in asset markets around the world if these banks are eventually forced to sell assets to shore up their balance sheets.

China May Have No Choice But to Devalue the Yuan

China needs to buy time to make the transition from a centralized, debt-fueled and investment-led economy to an open and labor-intensive one in which consumers and markets drive growth.

The only way to avoid a major slowdown in growth may be to again export its way out of trouble by devaluing its currency, the yuan—especially now that another round of QE in Japan is bringing even more deflation to China, just like the yen devaluation did during the Asian crisis in 1997.

No matter what, the economic adjustment will be tough. But cutting prices for Chinese goods would remove the massive levels of excess capacity that an investment rate of 48% of GDP has left in the economy, and would give China a fighting chance to rebalance its economy.

In early 2014, the yuan fell when its trading bands around the dollar were widened, and now its trade balance has widened again. But going back to export-led growth is not feasible, for two reasons: First, China is now the second-largest economy in the world; thus, beggar-thy-neighbor currency policy will lead to trade wars and protectionism in the US and around the world against Chinese goods. Second, going back to export-led growth prevents the rebalancing of growth towards consumption, as a weak currency makes domestic and imported consumption goods more expensive.

A big question is also: will China remove its exchange controls on capital movement? A freely floating currency and phase-out of capital controls would all but guarantee a weaker currency by triggering an even bigger outflow of Chinese private money into overseas assets, such as US stocks and Treasuries—and global property markets—than we've already seen.

A Credit Crunch in the Making

China has committed to making the exchange rate more flexible. It's gradually made offshore yuan liquidity more easily available and signed up markets such as London and Frankfurt to trade the yuan.

Floating the yuan would likely weaken it and make Chinese exports more competitive. However, a major yuan devaluation could unleash a devastating credit crunch on a corporate sector that's already facing rising borrowing costs now that its debt is trading at near-default levels.

That's because cross-border loans to Chinese corporations have rocketed to \$1.1 trillion in just five years. In fact, unprecedented borrowing in dollars across East Asia has made the entire region highly vulnerable to a rise in US interest rates. Debt ratios have surpassed the extremes seen just before the Asian financial crisis in the late 1990s.

The rise in unregulated shadow banks creates another source of financial instability. Shadow banks have been the sources of more credit growth as the PBOC has started to slow down lending by regulated banks.

Have Mass Protests in Hong Kong Hurt Prospects for Reform?

A failure to reform its economy could produce an even bigger financial crash in the future, so China is under a lot of pressure to put itself on a more sustainable path. In fact, the situation is so urgent that the World Bank is calling for China to put reform ahead of growth, even if it shocks the global economy.

But the protests in Hong Kong couldn't have come at a worse time. Indirectly, they could become a major obstacle to an export- and reform-led recovery in China.

Fearing social unrest on the mainland, the Communist Party leadership has rallied, bringing anti-reformists to the fore. And Xi's administration may no longer consider itself powerful enough to challenge the party and impose reforms on an older generation of leaders.



Suddenly, Xi may need the very same old guard that he recently targeted in his anti-corruption campaign. To head off dissent in his own ranks and help deflect any blame for whatever happens in Hong Kong, they may have patched things up.

Therefore, it may no longer be politically expedient to implement structural reforms and relax capital controls. Outward capital flows would drain cash from the banks' deposit base and expose the true nature of the loans made by the present generation of bankers.

That leaves the Xi administration between the proverbial rock and hard place. It wants to promote the yuan as a global currency but it needs to ensure the survival of the Communist Party and its sole authority to manage the economy.

The demonstrations in Hong Kong have exposed a harsh truth: China can't simply open up its financial system and make the yuan a competitor to the dollar—unless it also liberalizes its economy and reforms its political system. It's clear that the political fight between the reformists and conservatives has only just begun. For now, President Xi is busy dealing with foreign policy, territorial disputes with Japan and other neighbors, the fight with internal enemies, the crackdown against corruption, and his attempt to concentrate his power even over the military.

So, the structural reforms to rebalance growth from investment to consumption have taken a back seat. But the longer China kicks the can down the road and postpones reforms, the more likely a hard landing becomes.

Commodities and Trade-Driven Economies Take a Hit

A significant slowdown in the Chinese economy will affect other emerging markets as well. Latin America, which like many other emerging markets has become dependent on commodity exports to China, could be entering a slow-growth era.

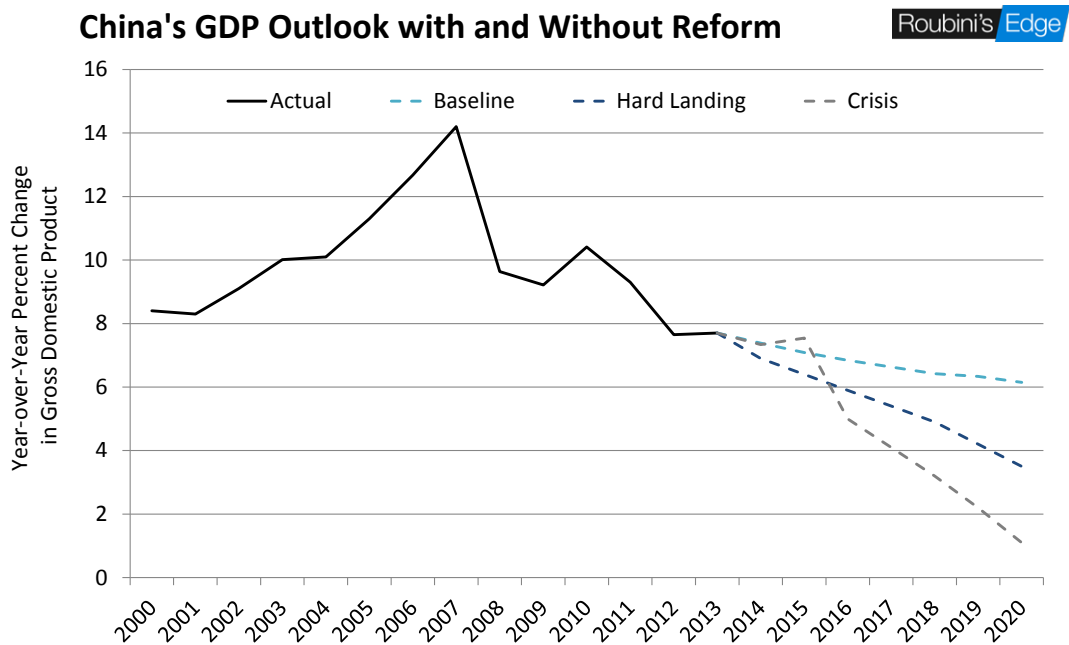
There are exceptions, like Mexico. Its economy is closely tied to the US, which makes it less vulnerable than countries like Brazil, whose success is based on commodity exports.

Slowing Chinese growth will also weigh on the Australian dollar and the Australian stock market. The Aussie dollar is likely to fall 20%, to below US\$0.75, on a combination of the lower interest-rate differential and slumping GDP growth, with commodity price effects outweighing volumes.

Trade-driven economies like Japan, Taiwan, Singapore, South Korea, and Malaysia would also take a big hit if China suffers a hard landing and lets its currency weaken.

Germany already ails from ebbing Chinese demand for high-end engineering equipment. In August 2014, exports suffered the biggest monthly decline in more than five years; factory orders from outside the eurozone fell 9.9%.

Property prices in major cities like Hong Kong, London, and San Francisco, which have benefited from wealthy Chinese buyers, are already starting to exhibit signs of weakness.

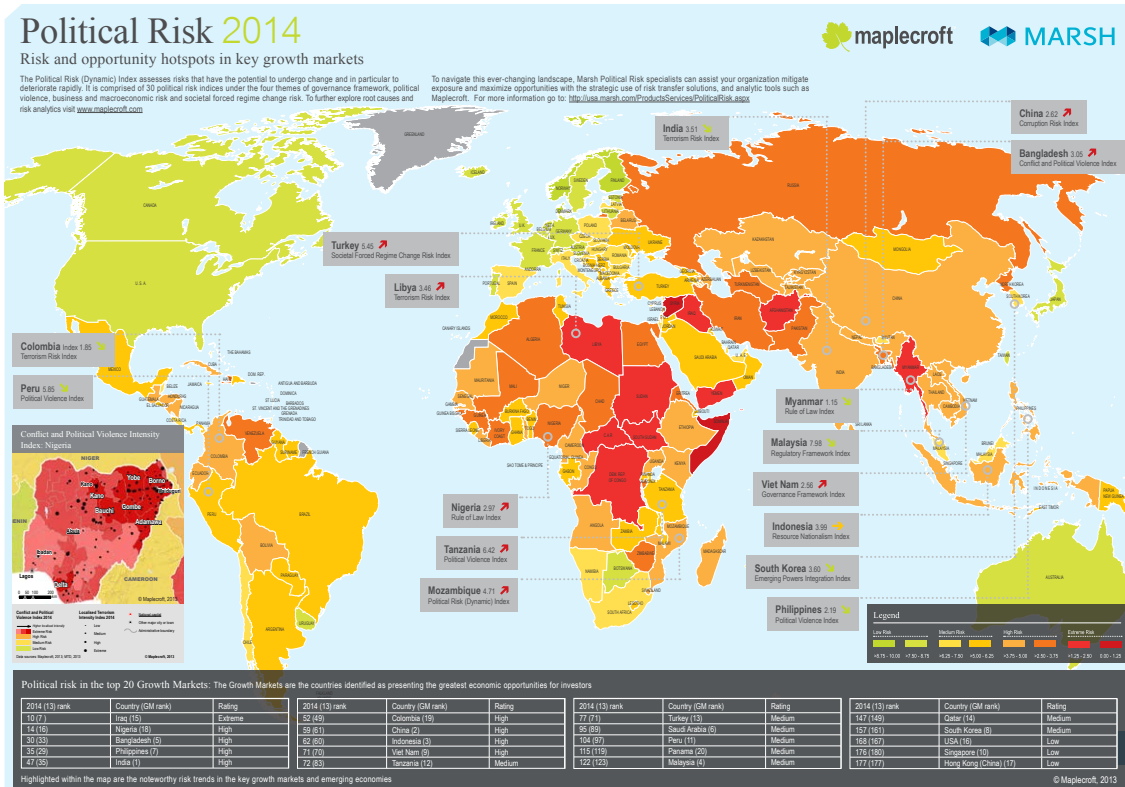


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Source: Chinese National Bureau of Statistics

What you as an investor should consider: A substantial decline in economic growth in China will affect many global markets—from stocks to currencies, to commodities, to exports, to real estate. If Chinese growth slows, we may not see any more rapid expansion in many emerging markets for quite some time. Commodity and equity markets in Asia are not pricing in the risk that Chinese growth may slow down to 5% by 2015, a bumpy and rough landing, if not an outright and more damaging hard landing.

DANGER #4: Geopolitical Risks Are Building



Source: Maps on the Web

Perplexingly, markets have remained in a rather bullish mood until recently, despite the multiplying number of geopolitical risks. But how long can their luck hold out?

One would have thought that the Russia-Ukraine conflict, the rise of the Islamic State, growing turmoil across the Middle East, and the possibility of a crackdown on mass protests in Hong Kong would have had a bigger impact. Instead, accommodative monetary policies have kept long-term interest rates low, have suppressed volatility, and have generally continued to support equities and other risky-asset prices around the world.

Nonetheless, it would be naïve to assume that everything is under control. Historically, geopolitical and political tensions are more likely to trigger global contagion if they coincide with systemic financial risks. And those risks are mounting.

The mini-perfect storm that roiled emerging markets in 2013 and again in early 2014—even spilling over for a while into advanced economies—was a harbinger of things to come. Concern about a China hard landing and the taper tantrum following Fed signals that QE tapering would soon start were the matches that ignited a tinderbox of regional and local uncertainty.

And given its systemic importance and the role Hong Kong plays in the financial system, China could do so again if its growth continues to disappoint. Another bout of volatility started in the late summer of 2014 when a global growth scare and the rise of new and old geo-political and geo-economic risks—ISIS, Russia-Ukraine, Hong Kong, Ebola—led to another rise in volatility and global equity market correction that partially reversed only when the Fed, BoJ and ECB again signaled renewed policy dovishness.

Markets have always been poor at correctly pricing low-probability, high-impact tail risks. A century ago, the markets blissfully ignored the hazards that led to World War I until the summer of 1914. Today they may be ignoring the very real possibility that the big macro and geopolitical risks highlighted in this report come together to form a perfect storm.

7 Ways in Which Our Luck Could Run Out

The Jihadi Terrorist Threat

If one or more surprise terrorist attacks were to occur in Europe or the US, markets would certainly be unnerved. A “blind spot” of markets is that they tend to disregard the risks of events whose probability is hard to assess but that have a major impact on confidence when they do occur. Another attack is a relatively plausible development, though, given that several hundred Islamic State jihadists are reported to have European or US passports.

The Ukraine Crisis

Markets have taken the view that the Russia-Ukraine conflict will remain contained, but the situation in Ukraine is fragile and the recent cease-fire is on the verge of falling apart. Also, sanctions and countersanctions between the West and Russia are hampering economic



growth in Europe at the worst possible moment and making business even more risk averse, thus delaying important investment decisions.

With its industry already facing the bleakest backdrop since 2009, Germany doesn't look like it's in any state to lead a European recovery while the eurozone is at risk of deflation and another recession.

As long as there's no clear plan for achieving a peaceful resolution of a Ukraine conflict that is worsening by the day, the threat of further sanctions will continue to cast a shadow over the eurozone.

Further likely escalation of sanctions could generate significant negative spillovers, both regionally and globally, as the International Monetary Fund (IMF) has warned. And with the Ukrainian economy in freefall and facing insolvency, the costs to the West of bailing out Ukraine are growing by the day. In the meantime, Russia is facing a recession and a financial crisis as its currency and equity markets are in free fall, worsening every time Putin's saber-rattling increases.

Syria's Civil War Could Spread

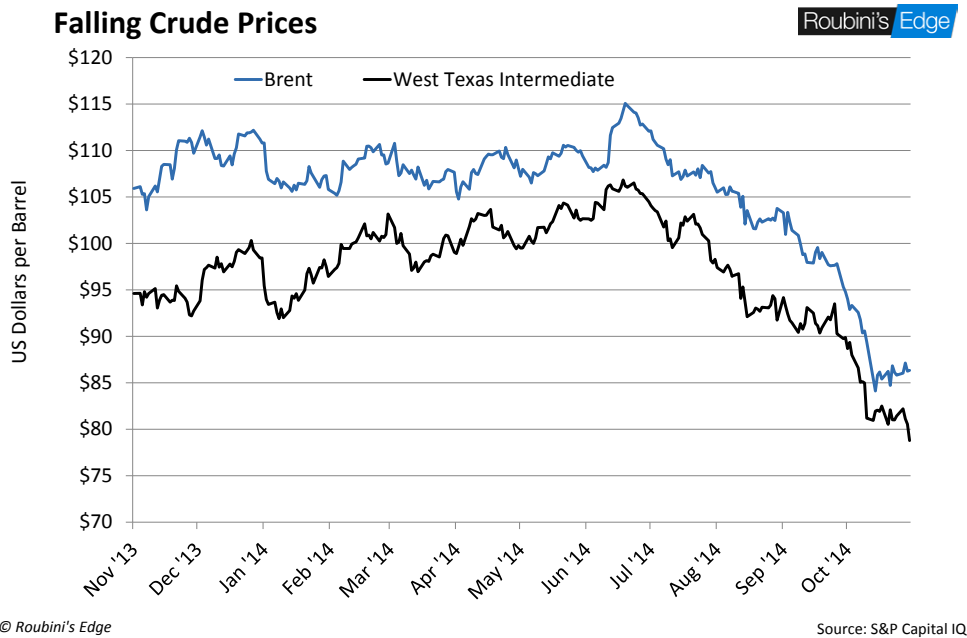
The Islamic State has now become the number-one geopolitical threat. Jordan, Lebanon, and Turkey are all being destabilized by Syria's ongoing meltdown and the threat to Iraq.

Besides the potential collapse of Iraq, the West now also has to face the prospect of an Islamist alliance between Turkey and a post-Assad Syria. The power vacuum left by America's unwillingness to take strong foreign policy and military action has only made the situation worse.

Without any clear strategy, it's unclear what Obama's coalition against ISIS can achieve. Ultimately, a realistic view may dictate that the only way to defeat ISIS is to join forces with Assad—and to strike some sort of bargain with Russia; but Saudi Arabia and the Sunni autocracies dread this outcome as well as a possible détente between the US and Iran.

Oil Glut Could Spark Civil Unrest in Oil-Producing Countries

Because of the vital role energy plays in the modern world, the price of oil has been a major source of economic dislocation. The current oil-price slump is threatening oil producers the world over and is adding to the threat of deflation.



Excess capacity in global oil markets, a strengthening dollar, and the weakest demand for oil since 2005 (as Europe, Japan, China, and emerging-market economies are slowing down) were already driving oil prices lower before the Saudis accepted a price of \$80 per barrel or even lower.

However, there is no fear premium in oil prices as the political unrest in the Middle East has not affected the supply of oil—unlike the 1973 Yom Kippur War, or the 1979 Iranian revolution, or the 1990 Iraqi invasion of Kuwait, which all led to oil embargos and/or oil supply shocks.

It's also rumored that the US has struck a deal with the Saudis to pump more oil and lower oil prices in return for US support for the removal of Assad. American consumers end up with more money in their pockets, and Saudi Arabia—where civil unrest has been bubbling under the surface for some time—is kept safe from the Islamists who have designs on the country.

Other conspiracy theories suggest that Saudi Arabia is happy with low oil prices to hurt its enemies: Russia, Iran, ISIS, the US shale gas and oil producers. In reality, more than any conspiracy, the ability of OPEC to reduce supply and control the price of oil is now limited, as OPEC represents a smaller share of oil production and its ability to enforce production quotas among its free-riding and quarreling members is harder than in the past.

Further reductions in oil prices could cause political incidents in Iran, Russia, Nigeria, Libya, and Venezuela, which all depend on tax revenues from oil to keep their citizens pacified. They may eventually destabilize even the rich Gulf oil producers.

Hong Kong Protests

The pro-Democracy protestors on Hong Kong's streets are really venting their anger about Hong Kong's wealth gap, the government's failure to respond to pressing social issues and the less-than-democratic process imposed by China in choosing candidates for the next election of Hong Kong's leader.

Homes in Hong Kong have become the least affordable in the world, which ordinary Hong Kong citizens blame on rich mainland Chinese who have snapped up property there.

The irony is that the demonstrations are, indirectly, a product of the rampant speculation unleashed by China's credit bubble and unconventional US monetary policy—both have driven fantastical gains in the real estate market and the Hang Seng stock market index.

If the political troubles in Hong Kong were to escalate into a violent conflict, the economic and financial repercussions could be severe. Already, the economic-reform process in China is stalled in part because the Chinese leaders are distracted by the events in Hong Kong. But reform delay in China only increases the risk of an eventual harder landing in China.

Global Financial Havoc

Any of the risks we've highlighted in this report could cause global economic and financial havoc. The Federal Reserve could spark a financial chain reaction by raising rates faster than markets currently expect. Or the eurozone could relapse into recession and crisis, cause new rounds of debt crises and sovereign near-defaults (like

those that hit Greece in the last four years), and trigger an eventual breakup of the monetary union.

But they could prove dangerously combustible if they interact with local sources of geopolitical tension, like Ukraine or the South China Sea.

One potential danger to global finance is the possibility of a virulent financial epidemic originating in China and spreading across the global banking system through Hong Kong, Singapore, and Macao if liquidity dries up in bond markets.

The quest for yield, which drove huge investment flows into emerging markets, has left UK-based banks up to their necks in trouble: they hold a quarter of all cross-border bank exposure to China. In turn, the City of London would spread the contamination further, through powerful feedback loops.

The unregulated shadow banking system in China, the US, and Europe is larger and even more opaque today than it was at the onset of the global financial crisis, as lending services have migrated from more regulated banks to unregulated shadow banks.

Another bout of investor risk aversion could lead to a re-pricing of credit risk in a world where credit spreads are too low relative to their fundamentals. Systemic liquidity risk as assets are concentrated in large and illiquid ETFs and credit funds—while traditional brokers don't provide market-making services as they face higher capital charges—could spark fire sales in fixed-income and credit markets in advanced economies and emerging markets alike.

The West African Ebola Epidemic

Not a financial, but an actual viral infection could cause serious global problems if it were allowed to spread in advanced economies like the US or Europe. A large-scale epidemic turning into a pandemic could have devastating consequences for not just the countries' populations, but also for their markets and financial systems.



Currently Ebola remains a “tail risk,” as the epidemic appears to be contained. But in the past, other epidemics—SARS, bird flu, swine flu, etc.—have led to persistent economic and financial damage.

What you as an investor should consider: Any of these tail risks could trigger a lethal chain reaction at any time. Few geopolitical events are truly unforeseeable, and there presently exist several obvious but serious geopolitical risks. Therefore, diversifying your assets and holding a reasonable fraction of liquid and less risky assets to minimize investment risk makes a lot of sense.

DANGER #5:

The Strong Dollar—A Shock to the (Global) System



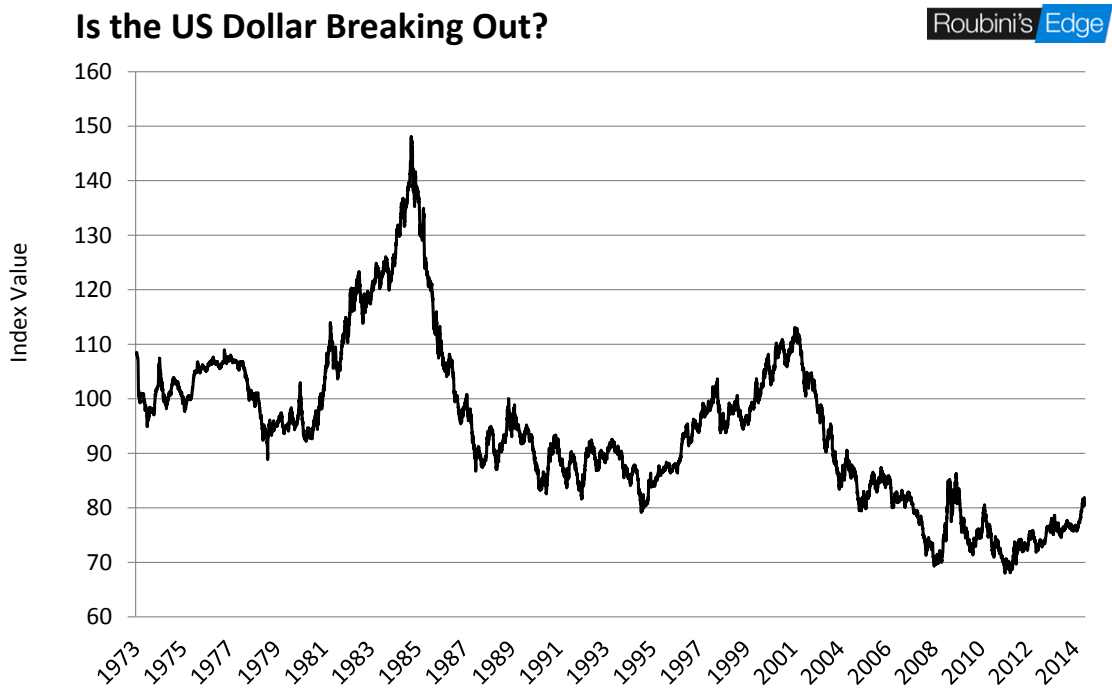
Nearly every major US and European investment bank is now talking of a major bull market in the dollar and US assets that could last years. That's because the strong dollar has become a shock absorber for the deflationary forces taking hold of the global economy.

For Europe, Japan, and China, getting rid of their excess savings through exports is the only way to increase their growth rate without increasing debt.

In other words, since Asian and European countries depend on exports for a return to growth and the US is the only major economy that grows reasonably fast, their monetary easing that leads to weaker currencies will drive the dollar up to a level at which the US again develops large overseas trade deficits, despite having become less dependent on energy imports.

The situation is similar to late 1998 during the Asian financial crisis, when the US economy was relatively stronger than everyone else's. Except that, unlike then, the greenback is still cheap today, having succumbed for a while to QE's downward pressure. The situation could also become similar to the period before the global financial crisis when the US was the consumer of first and last resort, running large and growing trade deficits that eventually became unsustainable.

That means the dollar could have plenty of upside, with Japan, Europe, and China trying to get their economies back on track by devaluing their currencies at the same time that the Fed thinks about tightening.



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Source: St. Louis Federal Reserve

The Dollar's Upside Could Be Limited

The two factors limiting the dollar's upside are the effect it's already having on emerging-market economies with high dollar debts, rising inflation and slowing growth, and its suppression of commodity prices—which could even put a brake on US rate increases.

Emerging markets are falling victim to the strong dollar and the weak yen, in a fashion partly similar to what happened 20 years ago during the Mexican peso crisis. The downward pressure in emerging-market stocks is being amplified by the beggar-thy-neighbour policies of Japan, with the yen's fall to a six-year low.

Investors are shifting their focus to Japanese companies with earnings in dollars. If the yen and euro weaken further, it could drive the Chinese economy over the edge as the Chinese currency is appreciating relative to the yen and the euro—in a replay of the 1997 Asian crisis.

Even a gentle Fed hike could put severe pressure on emerging-market bonds, both sovereign and corporate, as re-leveraging has been rampant in such markets in the last decade. Bond-market liquidity, which is already poor, could dry up because banks no longer have the capacity to hold bonds due to regulatory changes, while crossover investors may desert emerging markets, as they did during the taperantrum in 2013.

A strong dollar is always bearish for commodities, so stock indices with strong connections to commodities, like Brazil's Bovespa, or the MSCI Emerging Market Index, have downside risk. Lower commodity prices benefit economies that are commodity importers, including some emerging markets such as India, Korea, and Turkey; but they are damaging growth in most emerging markets that tend to be commodity exporters. Rising US rates will also hurt those emerging-market economies running twin fiscal and current account deficits, as their borrowing costs will rise.

That's why central banks like Brazil's and India's are asking the Fed to be sensitive to the impact raising interest rates will have on the developing world.

In response to criticism about the timing of Fed rate hikes, Fed Vice Chairman Stanley Fischer has said the Fed will take the global repercussions of its actions into account, but only insofar as they affect US growth and inflation—as well as the role the Fed's quantitative easing played in inflating global asset prices in the first place.

Weaker-than-anticipated foreign growth leading to a stronger and stronger dollar would eventually affect US growth and inflation; so the Fed might try to indirectly accommodate international concerns by taking only gradual action in hiking rates later and more slowly.

Will US and European Interests Take Precedence?

US Treasury Secretary Jack Lew says he's in favor of a strong dollar—for now. But it is also against competitive devaluations by the US trading partners. A stronger dollar could boost real incomes in America as it did in the 2000s, when China exported the kind of benign deflation that left more money in the pockets of both corporations and households. Since the US is a fairly closed economy, a strong dollar shouldn't have too much of an immediate impact on import prices and export activity. But if the dollar appreciates too fast and too much, lower growth and lower inflation will become risks for the US.

A strong dollar could also help Europe avoid a new euro crisis—if low import prices and cheaper energy prices allow the Fed to delay raising interest rates. A lower euro will boost eurozone competitiveness and reduce the risks of deflation.

As we mentioned before, the European Central Bank believes a sustained depreciation of the euro could be its last chance to fight deflation by raising import prices and boosting exports.

While a strong dollar and low inflation should be supportive for stocks—except for big American exporters, which have to compete against European multinationals—a strong dollar could have a negative impact on long-term US growth. The last time capital flows drove the dollar to great heights, US corporate profits started falling just as stock prices peaked. That's when the dot-com bubble burst.

Eventually, a persistently rising value of the dollar will lead to a resumption of the global current account imbalances and accumulation of private and public debts in borrowing countries that were one of the causes of the global financial crisis. It would be dangerous if the US were to go back to being again the consumer of first and last resort as most of the world follows beggar-thy-neighbor currency policies.

With the current amounts of private and public debt, the US cannot afford to again become the overspending residual consumer for the global economy. So, eventually, a stronger dollar destabilizes the global economy.

Final Thoughts

As has been a running theme since the end of the financial crisis, the United States has once again asserted itself as the sole beacon of global economic stability. Foreign currency from around the globe continues to pour into the US dollar and dollar-denominated assets, as they are viewed as a relative safe haven.

However, the real issue at hand is what happens to the global economy if one or more of the many catalysts detailed above—namely ones that directly affect the US—come to the forefront. Even if domestic demand in the US remains robust, the combination of a persistently strong dollar and weakness in other major economies will make it more difficult for the US to insulate itself from contagion. No country is an island, not even the US.

Unsustainable private and public debts in the eurozone and Japan continue to rise, which will more than likely lead to recession if left uncorrected. Such an event would have a notable impact on the US economy, especially as the high debt loads and the inequality that comes from those burdens create unrest around the globe. When that happens, a secular stagnation may soon follow, making necessary structural reforms politically toxic.

Asset reflation and its positive effects on some people's wealth can only mask the underlying issues facing the global economy for so long. Although the deleveraging process has helped keep the global financial system afloat, any combination of the many catalysts discussed has the potential to destabilize the recovery.

Asset reflation has also been a cause of the rise in income and wealth inequality as wealth is highly concentrated in the US and other economies. Inequality has been exacerbated by trade and globalization (as low- and middle-skills blue- and white-collar jobs are outsourced to emerging markets), and by technological innovation that is capital intensive, skill-biased, and labor-saving.

Leaving aside the unfairness of rising inequality, it is also damaging to growth in two ways. First, it leads to social and political instability that eventually hurts growth, and leads to massive taxation of capital. Second, it redistributes income and wealth from those who have a high marginal propensity to spend (low and middle-income households) to those who have a lower propensity to spend and a higher propensity to save, (rich households and corporations).

Thus, by depressing labor income it induces slow consumption growth that leads to low capital spending by cash- and profit-rich corporate firms. So, it undermines growth, especially as lower income households are also still debt burdened and asset poor.

In conclusion, the US could continue to lead the world's economy to long-term prosperity, but the risks to the global recovery remain serious. The global economy is flying on the single engine of the US while the other three engines—Europe, Japan, and China—are to different degrees stalling or slowing rapidly. Thus, economic, financial, and geopolitical tail risks remain serious and may lead to a global hard landing for economies and financial markets.

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