GLOBAL INVESTMENT STRATEGY OUTLOOK: PAX AMERICANA, iBUBBLE & FX WARS

"For the past five years we have been in a strongly bullish environment for investments, with a backdrop of falling rates and rising earnings. We expect that to end in 2015; earnings should continue to rise, but so should rates. That will be a more challenging environment for investments, but we still forecast global real GDP growth of 3.6% in 2015, up from 3.2% in 2014."

– Michael Hartnett, Chief Investment Strategist

Our view

Shifting winds transform the investment backdrop: The global investment backdrop is shifting from one of the falling rates/rising earnings scenario of 2009-2014 to one of rising rates/rising earnings in 2015. That means the optimum backdrop for asset prices is largely behind us, as is the era of excess returns and excessively low volatility.

Back to the future: Global growth and U.S. yields are likely to rise modestly in 2015, with policy easing in Japan, China and the eurozone successfully averting deflation and stabilizing growth expectations. The secular bull market in stocks and credit is likely to continue with inflation well behaved, interest rates rising very slowly and – crucially – growth and corporate earnings expanding. We see the 1950s as the best historical analogy for today's world.

Where do we go from here? Three scenarios:

- **Pax Americana (*Base case, high probability*)**: The most likely scenario we see entails stronger global economic growth and rising corporate earnings, led by the U.S., where escape velocity is visible in higher house prices, higher bank lending and higher small business activity. U.S. outperformance is already visible: In 2014, U.S. stocks are beating European equities by their widest margin since 1976. Other features of "Pax Americana" include a peak in the global liquidity boom, an avoidance of deflation and a continuation of the lower, narrower and more volatile returns that have characterized the markets in 2014.

- **FX Wars (*Bear case, mid-probability*)**: In the bear case, cash outperforms as stock and credit returns decline. Its catalysts include a U.S. dollar surge that negatively affects U.S. earnings, a Euro crash stemming from a failure to avoid deflation and excessive yen depreciation driven by the Bank of Japan that deepens an FX war with China.

- **iBubble (*Bull case, low probability*)**: In the bull case, stocks and credit markets keep pace with the gains of recent years, with stocks rising 20% and corporate bonds generating 10% returns. Among the possible drivers of this scenario are a continued drop in oil prices, reforms in Japan, Europe and China boosting productivity and earnings expectations in those regions and an "iBubble," with excess liquidity generating a narrow speculative fervor in U.S. technology.

Key calls

In order of conviction, Bank of America Merrill Lynch's 2015 asset allocation recommendations are:

- **Bullish U.S. dollar**: The U.S. dollar should be the biggest beneficiary of the U.S. achieving "escape velocity" and the Bank of Japan and European Central Bank adopting quantitative easing in 2015. The U.S. dollar is cheap and its bull market is still young, in our view. Best positioning: Stay structurally long, until the dollar starts to negatively affect U.S. corporate earnings; buy dips aggressively.

- **Bullish volatility and bearish carry trades**: 2015 should see the end of zero-interest rate policy in the U.S. and the peak of global liquidity expectations. The end of excess liquidity would also mark the end of abnormally low volatility and the end of the zero-interest rate policy leadership from carry trades such as high-yield bonds and small cap stocks. Best positioning: Continue reducing exposure to both high-yield bonds and small cap stocks; prefer investment-grade and collateralized debt.

- **Bullish real estate**: Price gains may be less dramatic, but we believe the asset class has upside as a play on the basis of a U.S. Main Street recovery, Bank of Japan quantitative easing and speculative demand from distressed debt investors in Europe.

- **Bullish stocks and bearish rates**: Equity returns should be positive as earnings are forecast to rise in 2015 (with optimism highest in the U.S. and Japan). However, equity returns should be constrained by low corporate bond returns. In the absence of negative corporate earnings, expected fixed income returns are too low to be competitive.

- **Opportunistic in commodities and emerging markets**: The forecast of higher U.S. growth/yield/dollar is not conducive to emerging market and commodity outperformance. However, China is reforming/reflating and we believe both emerging markets and commodities offer abundant opportunities for value investors. We see China, India and industrial metals as the most attractive.