SAXO BANK

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Outrageous
predictions

Global squeeze set to continue

Saxo Bank's annual fat-tail forecasts for 2014

Welcome to Saxo Bank's 2014 Outrageous Predictions

We are living through a critical phase of history, not only for humanity but also in the markets. When the chapter on the global financial crisis and its drawn-out aftermath is finally written, it will be deemed far greater in importance than the Great Depression. The world's central banks and government policymakers are running on empty, avoiding any accountability on what has transpired and avoiding real reforms that will allow us to move forward. Instead, they have been reduced to "talking the market higher" or simply going to church to pray for better times ahead.

The world is as lopsided as it has ever been in terms of wealth and income distribution. And the current policy mix means that 20 percent of the economy – listed companies and large banks – benefits from quantitative easing, easy money and is going from strength to strength. The remaining 80 percent – made up of SMEs and average workers – is facing the lowest wage-to-GDP ratio in history, an increase in austerity globally and a lack of access to credit.

2014 could and should be the year in which a mandate for change not only becomes necessary, but is also implemented. However, the change will come only through the failure of what has been tried thus far – and not from some kind of proactive "enlightenment" among policymakers. The big disappointment in 2014 will be that both the US and German economies will fail to reach escape velocity and slow to zero growth. This will force policy changes as the strategy of "talking up the market" will no longer be enough. There is a need and call for the real economy to have more focus, both economically and politically.

A wake-up call is necessary as the alternatives would leave us with a dire outlook indeed. Unemployment will eventually lead to social tension, with the first major test in Europe, where there is a serious risk that the European Union will see a massive vote against it in May.

This isn't meant to be a pessimistic outlook: looking back through history, changes have always come as a result of the thorough failure of the old way of doing things. The lesson we should have learnt from the Great Depression was that allowing things to fail is part of accelerating the path to a better future, even if the cost is a large dose of short-term pain. Instead, we are dangerously close to having an economic model that, in the year of the 25th anniversary of the fall of the Berlin Wall, reminds us more of the failed experiment known as the Soviet Union. Let's stop running in circles, kicking the can and pretending that quantitative easing is anything but an economic addiction and finally move forward.

Best wishes for 2014. TF

Steen Jakobsen
Chief Economist
Saxo Bank

Cover illustration: Chris Burke

By Steen Jakobsen, Chief Economist

EU wealth tax heralds return of Soviet-style economy

In 2014, deflation and a lack of growth will create panic among policymakers, leading the EU Commission to table a working group that will focus on different wealth taxes for anyone with savings in excess of USD or EUR 100,000. The initiative will be in the name of removing inequality and will see the richest 1 percent pay a "fairer" share to ease society's burden. Several research papers have established that a wealth tax of 5 percent to 10 percent is needed to secure enough funds to create a "crisis buffer" to bail-in/out banks, governments and other liabilities created in this financial and debt crisis.

It will be the final move towards a totalitarian European state and the low point for individual and property rights. We have gone full circle back to a Soviet Union model.

The obvious trade is to buy hard assets and sell inflated intangible assets. We would buy the SPDR Gold Shares ETF (GLD:arcx), looking for it to go as high as 180, and sell an equal-weighted basket of Hermes International (HRMS:xpar), LVMH (MC:xpar) and Sotheby's (BID:xnys), expecting the basket to go from index 100 to 50. TF

Illustration: Chris Burke

> "We have gone full circle back to a Soviet Union model"

By Steen Jakobsen, Chief Economist

Anti-EU alliance will become the largest group in parliament

From May 22-25 next year, European Parliamentary elections will be conducted across Europe. Since the advent of the Lisbon Treaty in 2009, the European Parliament has not only become a powerful co-legislator, but must be taken into account when choosing a nominee for the post of president of the European Commission (EC), the executive arm of the European Union.

European Parliamentary elections are contested by national political parties, but once MEPs are elected, most opt to become part of transnational political groups.

Following the May elections, a pan-European, anti-EU alliance, whose members will include the UK Independence Party, euro-currency sceptic Alternative for Germany, the National Front in France and Party for Freedom in the Netherlands, will become the largest group in parliament with a majority of more than 275 seats. Sweeping the traditional political groups out of power, the new European Parliament chooses an anti-EU chairman and the European heads of state and government fail to pick a president of the EC, sending Europe back into political and economic turmoil. One trade would be to long German Bunds versus short Spanish Bonos – looking for a 300-basis-point spread again. TF

> "European Parliament... must be taken into account when choosing a nominee for the post of president of the European Commission, the executive arm of the EU"

Watch Steen Jakobsen´s video

CONNECT WITH STEEN JAKOBSEN:

By Peter Garnry, Head of Equity Strategy

Tech's 'Fat Five' wake up to a nasty hangover in 2014

The US information technology sector is trading about 15 percent below the current S&P 500 valuation, which is in sharp contrast to the historical premium of approximately 160 percent during the dotcom bubble. We like technology stocks in general as they are the main driver of the necessary productivity growth the economy needs to create long-term increases in wealth per capita.

However, a small group of technology stocks trade at a huge premium of about 700 percent above market valuation, almost defying the "Newtonian laws" of financial markets. These stocks are what we call the "Fat Five" of the technology sector – Amazon, Netflix, Twitter, Pandora Media and Yelp. These stocks have very inflated valuations based on a skewed valuation premium on growth that has evolved in the aftermath of the financial crisis. Investors have trouble finding good growth scenarios, so when some suddenly drop by the neighbourhood, they get bid up to levels that present very poor risk/reward ratios. It is like a new bubble within an old bubble.

Facebook's USD 3 billion cash offer for Snapchat, declined by its 23-year-old founder, is the ultimate display of hubris that shows how exuberance has grown to new levels in this part of the technology sector. Snapchat has zero revenue and does not have a business model, so the acquisition value is not determined by incremental cash flow to Facebook, but from the potential destruction value to Facebook based on assumptions about wider adoption of Snapchat.

This creative destruction is exactly the "dark matter" that should make investors cautious about the huge valuation premium that is currently being put on this small group within the information technology sector. To trade this, we would create a synthetic equal-weighted index of the Fat Five, starting at 100 on the last trading day of 2013. Our Outrageous Prediction is that this index will go to 50 during 2014. TF

Illustration: Chris Burke

By Peter Garnry, Head of Equity Strategy

Desperate BoJ to delete government debt after USDJPY goes below 80

In 2014, the global recovery runs out of gas, sending risk assets down and forcing investors back into the yen. USDJPY goes below 80 in a déjà vu of 2011, forcing a desperate Bank of Japan (BoJ) to delete its government debt securities in a final bid to escape the deflation trap the country has been in for the past two decades. As nobody knows the outcome of this accounting manoeuvre inside the government sector, the decision will see a nerve-wracking journey into complete uncertainty and potentially a disaster with unknown side effects. Sounds crazy right? Well, these days, everything is possible in the name of a crisis.

Quantitative easing is essentially an unconventional back-door route for a central bank to allow the government to maintain a large dis-saving without putting upward pressure on interest rates and downward pressure on government expenditure. Central banks are indirectly buying government debt through their prime dealers, increasing the percentage of government debt owned by the government sector. Inflation has supposedly been low because the massive debt purchases have been swapped with the prime dealers flowing into what is called excessive reserves. These reserves, due to very low credit demand from the private sector, have not been multiplied and injected into the economy.

Have central banks invented the Holy Grail? Not quite. In fact, in many developed economies, government debt is on an unsustainable trajectory with growth hobbling along despite massive government stimulus. Most notable is the situation in Japan, where government debt to GDP is about 215 percent and forecast to rise. With strong deflationary pressure still present in Japan due to demographics, the debt burden could soon be highly unsustainable.

> **“These reserves, due to a very low credit demand from the private sector, have not been multiplied and injected into the economy. Have central banks invented the Holy Grail? Not quite”**

However, in the inner circles of central banks, a neat and untested trick in which one simply deletes its holdings of a government's debt is beginning to gain traction.

For Japan, it would mean that about 15 percent of government debt would just disappear. It's a simple accounting trick that effectively equates to “now you see it, now you don't”. TF

Watch Peter Garnry´s video

top 20 competition forecasts

chosen by our analysts

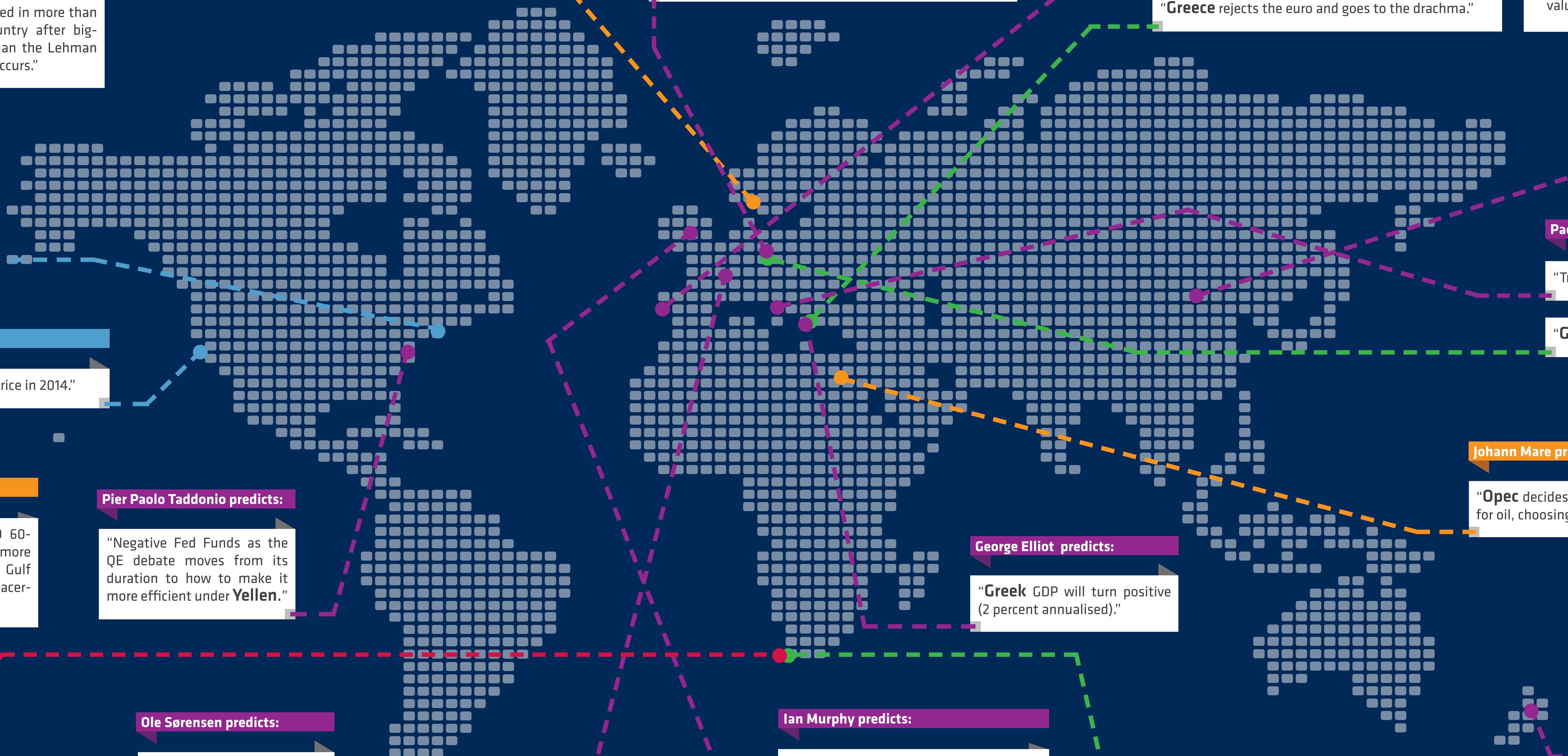
- Macro
- Equities
- Forex
- Commodities

Winning prediction: Johann Mare

"**South Africa** will experience huge political upheaval, splitting the ruling party, leading to extreme levels of violence and resulting in high levels of industrial action that, combined with a gold price of 1,100 USD/oz, results in the closure of up to 50 percent of gold mines.

"Inflation will skyrocket to double digits (about 15 percent); USDZAR will get to 22.

"Welcome to 'South Zimbabwe'."



James Benjamin predicts:

"Martial law declared in more than one **western** country after bigger credit event than the Lehman Brothers collapse occurs."

Christian Mørk Lauridsen predicts:

"**Norway** goes into recession on an oil price plunge"

Michiel Smits predicts:

"Recession in **Germany**, revolution in **Greece** and **Spain**, while **French** President François Hollande is forced to resign."

Joao Carlos predicts:

"Capital controls in **Portugal**."

"**Greece** rejects the euro and goes to the drachma."

"**Bitcoin** plunges to single-digit value."

fxtime predicts:

"US defaults on bonds, causing **China** to re-allocate its treasury holdings by a token 1 percent with widespread ramifications."

Søren Møller predicts:

"The **S&P 500** will go down to 800 and **Nasdaq** 100 to 2,250 by February 1."

Humphrey McCarthy predicts:

"**Twitter** to hit 50 percent of its IPO price in 2014."

Paolo predicts:

"Troika arrives in **Italy** (new political elections in Italy)."

"**Germany** decides to exit from euro."

Scott Schuberg predicts:

"**US** crude to fall to a USD 60-70 range on Opec output, more US oil shale production and Gulf states/US hostility that exacerbates the rush to pump."

Pier Paolo Taddonio predicts:

"Negative Fed Funds as the QE debate moves from its duration to how to make it more efficient under **Yellen**."

Johann Mare predicts:

"**Opec** decides to drop the USD as the pricing mechanism for oil, choosing a basket based on euro/yen/yuan."

George Elliot predicts:

"**Greek** GDP will turn positive (2 percent annualised)."

Konstantinos Tzavras predicts:

Mark Carney leaves the **Bank of England** to become a farmer in **New Zealand** as no one believes his guidance any more."

Ole Sørensen predicts:

"**OECD** decides to introduce a global tax by 2015 and the markets subsequently plunge 20 percent."

Ian Murphy predicts:

"The **EU** leaves the **UK** after it creates a re-accession treaty premised on euro membership to counter secessionism. Scotland's vote for independence forces Brussels to show London the exit door."

Vanessa Sabbatini predicts:

"**South Africa**'s rand back at R7 to the USD, decides to adopt the EUR."

By Mads Koefoed, Head of Macro Strategy

US deflation: coming to a town near you

Indicators may suggest that the US economy is stronger, but the Federal Open Market Committee (FOMC) remains hesitant and with good reason. The fragility of the housing market has been underlined by the modest increase in yields in mid-2013.

This sent sales of new homes to a year low in July, while sales remain depressed compared with the first half of the year. Wage growth remains non-existent despite higher employment due to abundant capacity in all industries. With Congress scheduled to perform Act II of its "how to disrupt the US economy" charade in January, investment, employment and consumer confidence will once again suffer.

This will push inflation down, not up, next year and deflation will again top the FOMC agenda. The trade for this would be to go long on 10-year US government bonds, which we see at 1.5 percent in 2014. TF

> "Congress is scheduled to perform Act II of its 'how to disrupt the US economy' in January"

Illustration: Chris Burke

By Mads Koefoed, Head of Macro Strategy

Quantitative easing goes all-in on mortgages

A quick glance and you would think that the US economy is about to pick up speed, but this is merely an illusion fuelled by the Federal Open Market Committee's (FOMC) third round of quantitative easing, which amounts to USD 85 billion per month.

These purchases have pushed interest expenses down and sent risky assets to the moon, hence creating an artificial sense of improvement in the economy. Grave challenges remain, however, with private sector deleveraging ongoing, a housing market that struggles whenever rates rise, continuous declines in public sector spending and weak private sector employment; all of which the FOMC is keenly aware.

Housing, in particular, is on life support and the FOMC will therefore go all-in on mortgages in 2014. This will transform QE3 to a 100 percent mortgage bond purchase programme and increase – forget talk of tapering – the scope of the programme to more than USD 100bn per month.

Renewed weakness in the housing market will send the Vanguard REIT ETF down substantially, touching USD 30, the lowest level since 2009. TF

> **"Housing, in particular, is on life support and the FOMC will therefore go all-in on mortgages in 2014. This will transform QE3 to a 100 percent mortgage bond purchase programme..."**

Watch Mads Koefoed's video

CONNECT WITH MADS KOEFOED:

By Ole Hansen, Head of Commodity Strategy

Brent crude drops to USD 80/barrel as producers fail to respond

Global oil markets are going through a period of transition, in which rising production from non-conventional methods (especially in the US and Canada) and an increase in Saudi Arabian production have helped to ensure stable prices despite numerous disruptions. Brent crude oil has therefore averaged about USD 110/barrel over the past three years with the consensus forecast for 2014 pointing towards an average price of USD 105/barrel.

With non-Opec supply expected to rise by more than 1.5 million barrels per day and the potential for another two million arising as disruptions in Libya and sanctions against Iran ease, the global market will become awash with oil. Producers will have to make a concerted effort to cut output. Hedge funds will react to the altered dynamics by building a major short position in the market for the first time in years. This will help to drive Brent crude oil down to USD 80/barrel, especially as almost all producers, which are in desperate need of high oil prices, will only react slowly. Russia and most Opec producers will delay to balance their budgets, while the US will drag its feet because of the need for high prices to ensure the economic viability of shale oil.

Once producers finally get around to reducing production, oil will respond with a strong bounce and the industry will conclude that high prices are not a foregone conclusion. TF

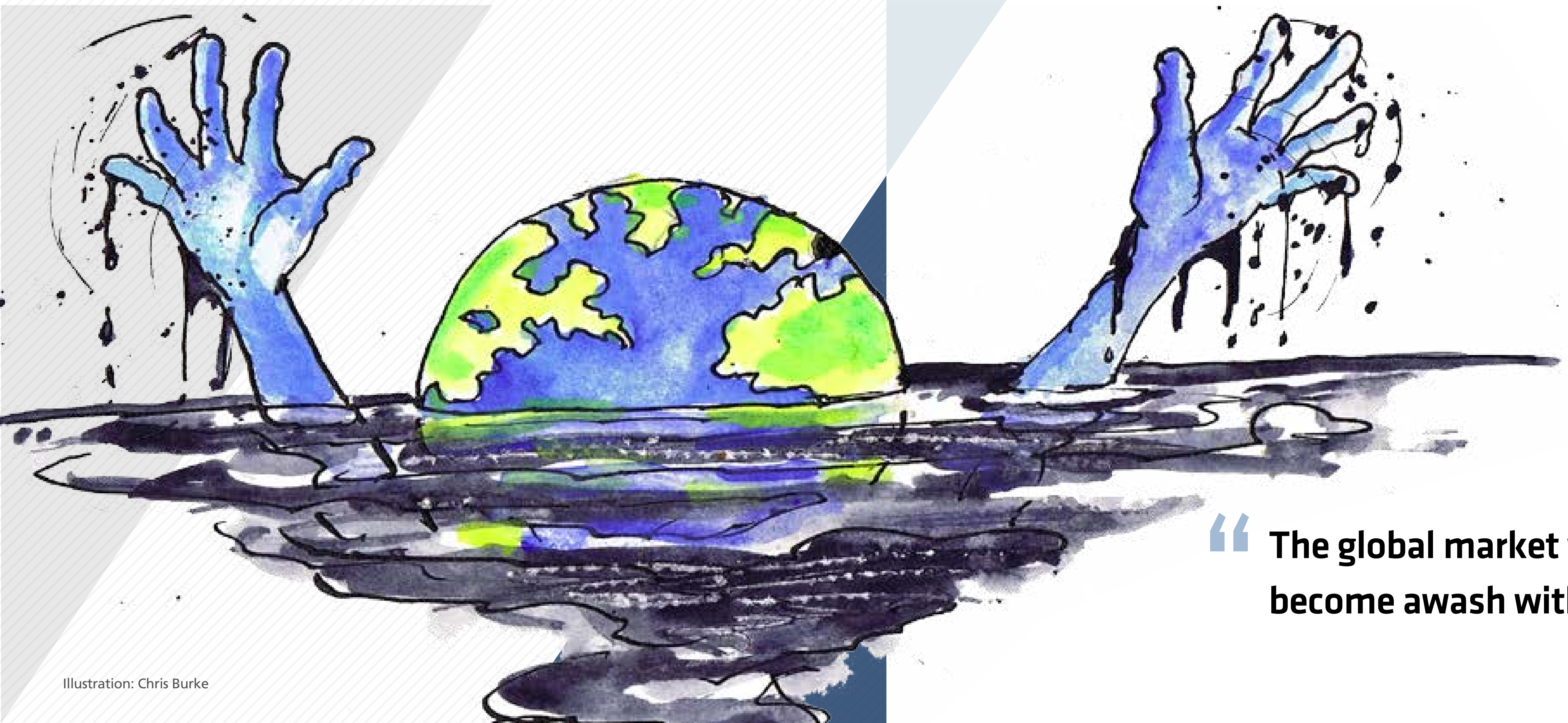


Illustration: Chris Burke

> "The global market will become awash with oil"

By Ole Hansen, Head of Commodity Strategy

Germany in recession

The German economy has outperformed the rest of the euro area in the four years following the global recession, but this outperformance will end in 2014 and consensus, which expects growth of 1.7 percent, will be deeply disappointed. Years of excess thrift in Germany have seen even the US turn on the euro area's largest economy and a coordinated plan by other key economies to reduce the excessive trade surplus cannot be ruled out. Add to this falling energy prices in the US, which induces German companies to move production to the West, lower competitiveness due to rising real wages, potential demands from the SPD, the new coalition partner, to improve the well-being of the lower and middle classes in Germany, and an emerging China that will focus more on domestic consumption following its recent Third Plenum. The fusion of these issues will mean a case for a surprise drop in economic activity. The economy will therefore see output decline, not rise, next year against all expectations, while the German 10-year government bond yield will decline to 1 percent. TF

> "Years of excess thrift in Germany have seen even the US turn on the euro area's largest economy..."

Watch Ole S. Hansen's video

CONNECT WITH OLE S. HANSEN:

By John J. Hardy, Head of Forex Strategy

CAC 40 drops 40% on French malaise

The quantitative easing-driven equity bubble spills into 2014, but then equities hit a wall and tumble sharply on the realisation that the only driver for the market is the greater fool theory. Meanwhile, the malaise in France only deepens under the mismanagement of the François Hollande government as the president and his team fail to come up with answers for the country's lack of competitiveness or to provide any spark for growth.

Housing prices, which never really corrected after the crisis, finally make like their Dutch counterparts did in 2012 and execute a swan dive, pummelling consumption and confidence. The CAC 40 Index falls by more than 40 percent from its 2013 highs by the end of the year as investors head for the exits.

“Meanwhile, the malaise in France only deepens under the mismanagement of the François Hollande government”

Illustration: Chris Burke

By John J. Hardy, Head of Forex Strategy

'Fragile Five' to fall 25% against the USD

The normalisation of global rates, which is expected to be started by tapering of quantitative easing in the US, will lead to higher marginal costs of capital from rising interest rates. This will leave countries with expanding current account deficits exposed to a deteriorating risk appetite on the part of global investors, which could ultimately force a move lower in their currencies, especially against the US dollar. We have put five countries into this category – Brazil, India, South Africa, Indonesia and Turkey.

The "Fragile Five" have seen dramatic growth over the past decade, which has attracted billions of dollars in foreign direct investment (FDI). But as the flow of cheap and easy money begins to dry out, these countries will find themselves exposed as their current account deficits climb. The positive FDI flows removed their focus from creating quality growth through long-term spending plans with positive returns. But with expenditure rising because of increasing labour costs and a general rise in labour-related entitlements, the five countries will face downward pressure on their currencies.

Elections in India in May and in Indonesia in mid-July may delay the introduction of reforms to halt the deterioration, leaving these countries even more exposed to risk. Time has run out for them and they are left with just one policy tool – a weaker currency. Sell an equal-weighted basket of the Fragile Five and look for a plus 10 percent return. TF

"Time has run out for them and they are left with just one policy tool – a weaker currency"

Watch John J. Hardy´s video

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