The Clash of Three Global Market Views

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The late global political scientist, Samuel Huntington, famously began writing of "The Clash of Civilizations" in 1992. Instead of perpetuating of the post-Cold War bliss that commenced with the fall of the Berlin Wall on November 9, 1989, Huntington presciently predicted the resurrection of tensions along old civilization fault lines.

With some limitations, a similar framework of sharply contrasting perspectives can be applied to world capital market analyses almost exactly halfway through this second decade of the 21st century. Three distinct world views color the preponderance of current capital market perspectives.

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World View No. 1, by far the most dominant, is also the most traditional. The future path of global financial market parameters will be mainly determined by systemic economic and idiosyncratic issuer trends. The adherents of this view will devote their primary attention to sifting through the regular releases of "data tea leaves" for possible deviations from existing convictions. For further confirmation of their beliefs, World View No. 1's will look to the statements of supranational organizations like the IMF and local central banks. This U.S.-centric group tends to favor short forecast horizons and has a high trading propensity. Thus fortified by a robust September U.S. employment report that probably attests to gathering economic momentum for the world's largest economy, members of this World View category sent equities more than 1% higher on October 3 and October 17, while many yield curves rotated slightly higher. But fearful of European economic malaise and borderline deflation, equities markets dropped sharply on October 9th, 10th, and 15th as yield curves descended.

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Perhaps because of their shorter-horizon focus, this school of market thought acknowledges but does not readily trade on geopolitical and long-term structural concerns.

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The disciples of World View No. 2 tend to be more commonly located in Europe and look at the world through a longer-term lens. Perhaps rooted in the quarter-century secular stagnation of Japan and the chronically disappointing economic performance of portions of Europe, especially its labor markets since the mid-1990s, capital market operators of this mien tend to be less celebratory about strategic economic and market prospects. Perhaps not surprisingly, the anemic economic velocity of ex-U.K. Europe in 2014, accompanied by an overly deliberate European Central Bank, inspires a more subdued outlook. While not heavily beholden to geopolitical developments, the members of this club cannot but notice the escalation of tensions between Western European nations and their neighbor, Russia, as evidenced by a demonstrable slowdown in Eurozone industrial activity during the third quarter.

World View No. 3 seers are more sensitive to wildcard risks, especially emanating from the geopolitical realm and conspicuously including major new health risks. This cadre has had no shortage of “wildcard risk ammunition” in 2014. The long-heralded transition to a post-hegemonic, multipolar world has not gone smoothly. Russia may be considering the reassembly of the old Soviet Union. ISIS/ISIL romps through portions of Syria and Iraq as century-old nation state boundaries in the Middle East effectively succumb to recidivist ideological, theological, and ethnic divides. Democracy-minded demonstrators in Hong Kong challenge China’s reform-promising senior leadership. The stability of the North Korean leadership again has been called into question. Iran flirts with Western acquiescence to potential nuclear weapon threshold status. And more a biological event than a geopolitical development, an awful Ebola epidemic scours portions of West Africa and has now escaped to Europe and the Americas. While hoping for the best, the proponents of this world view harbor the greatest anxiety and hold the greatest discomfort for the near-and medium-term course of financial markets.

Our pragmatic reconciliation finds utility in portions of all three world views.

Like World View No. 1, we agree that the central tendency will be for slightly swifter global economic growth in 2015. Even beleaguered southern Europe will participate, thanks to additional stimulative help from the ECB. With their sovereign’s persuasive exits from economic intensive care wards and should wildcard risks subside, we believe first the Bank of England and then the Federal Reserve will commence interest-rate normalization operations during the first half of 2015. This would shave potential bond returns and probably induce higher equity valuations, albeit at a more modest clip (mid-single digits) than 2009-2014.

Like World View No. 2, the speed of Western economic growth in 2015 will be insufficient to reach escape velocity from the secular stagnation thesis. Even with a currency possibly on its way to dollar parity by 2016 according to our FX strategy team, the Eurozone would do well to reach 1% growth in 2015. This World View indeed reinforces expectations of further dollar strength and instills some caution for those EM segments with significant dollar-based liabilities. Should this world view prevail, the equity asset class likely will not meet optimistic expectations, while bonds produce a coupon-clip return.

Like World View No. 3, we cannot shake our concerns about the potential market disruptive forces of geopolitical events and an expansion of the Ebola-afflicted. The main geopolitical risk events, especially in the Middle East, will not be resolved during the fourth quarter of 2014, possibly not over the course of the remaining five years of this decade, and unfortunately, perhaps not for decades. Accordingly, over the next three to six months, Ebola progression probably represents the greatest short-term wildcard threat to capital markets. In all likelihood, this pernicious virus will be quickly contained by the more technologically enabled medical facilities and quarantine procedures in Western nations. But the saturation coverage in the media and the unfortunately high likelihood of further infections in the West may well author additional days of doubt over the fourth quarter of 2014. This viral scourge hopefully will then retreat to the background in the manner of its SARS and avian flu predecessors.

This dissonance among competing market World Views will lift volatility across all asset classes from their summer of 2014 quarter-century troughs. While World View No. 1 has the highest probability of realization, the greatest tail risks emanate from World View No. 3.

Accordingly, our main near-term focus will continue to be World View No. 3, especially on the containment of Ebola. We all would welcome a world with less “wildcard risk baggage” on January 1, 2015. Our surest near-term prediction: the next six months will not be boring for markets.

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