



Briefing Update: Friday, 9 January 2015

Global Economic Risk Estimate

At the start of each month we detail key trends that we believe are worth monitoring. These are the economic issues that will likely have both a short and long term impact on businesses and are the kinds of issues that are likely to provoke some kind of strategic response. The nature of that response depends heavily on the sector or industry one is in and it depends on the country or countries that one does business in. Some of these trends will appear month after month as they evolve and change. Others may be far shorter in terms of their influence on business conditions.

Trend One – US Dollar Strength

The US dollar could be the largest business impacting global event to watch in a trend that started in October. US CEO's mentioned in third quarter calls that the impact of the US dollar was going to be impactful for their US exports and it would affect how much they import (shifting some business to importation. They cited the **strengthening US dollar as the number one risk for US manufacturing** at the time. We made the same observation in our National Economic Security Brief. **It continues to be one of the biggest factors that could change everything from sourcing strategy to supply chain management.**

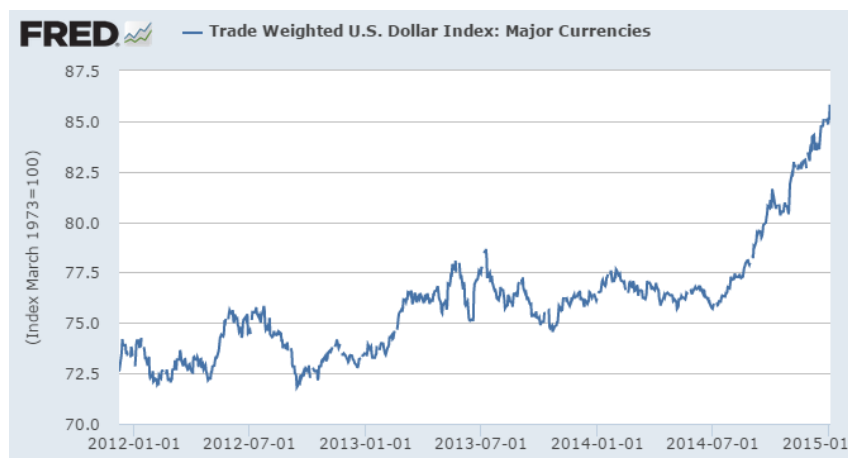
The US dollar continues to gain against a bucket of foreign currencies. The chart at right from the Federal Reserve shows the latest value of the US dollar index, and it doesn't paint a great picture for exports.

As we mentioned last month, the ripple effects could be enormous - because we don't know how long actions by the Central Banks of these nations will continue to prop up the dollar. Incidentally, this is the same complaint that the emerging markets had about the US Federal Reserve doing QE - that it undervalued the dollar and made US exports more competitive.

We are now likely to see the inverse - and it could have a big impact on some of the sectors that have been propping up US recovery - such as manufacturing activity.

What will reverse the US dollar trade is uncertain (from a market fundamentals perspective). **Other economies are going to have to show significant recovery rates from their current conditions.** Countries like Germany and Japan will have to see strong improvement before we start to get improvement in the US dollar.

On the positive side, anyone procuring products abroad (including energy resources that the US imports) will see lower prices. That should help a number of companies move profits higher as a result.



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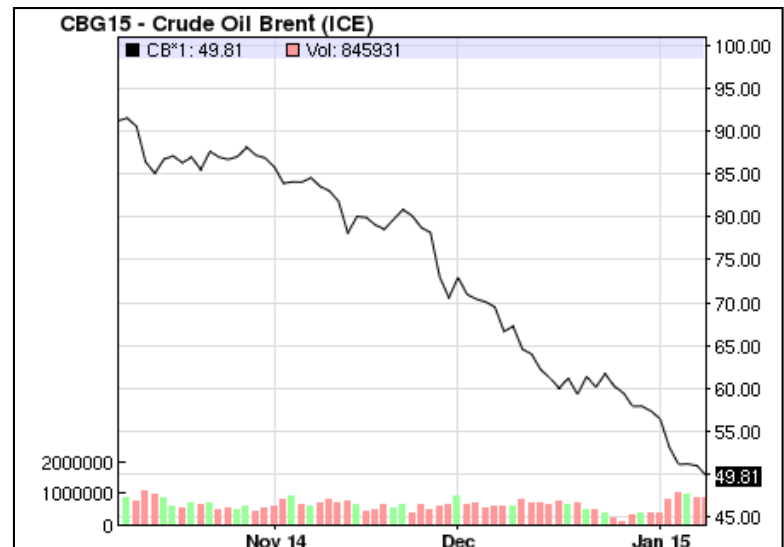


Trend Two – Oil Prices and Geopolitical Stability

This has become a broken record for us, but we have to keep it in our top 10 most watched factors that will alter or change international business. But this month, we have two takes on the situation.

The chart at right shows the current price of Brent North Sea Crude. As we can see, **it has now broken through a fundamental level of \$50 a barrel.** Further, the gap between Brent and West Texas Intermediate is now about a dollar.

On the positive side of the drop in prices, we know a couple of things. **The global drop in prices should add approximately .5% to global GDP** as we mentioned in yesterday's brief. Japan has already adjusted their annual GDP forecast positively because of the drop in oil prices. Just in the United States alone, it has put about \$14 billion back in the pockets of consumers just in 2014. **Estimates suggest that it will give back approximately \$50 billion in 2015 if prices stay at these levels.**



Businesses will also benefit through lower transportation and supply chain costs - we also saw this reflected in November's Producer Price Index which came in lower than expected. That should yield improved profits for companies as a result.

On the downside, and as you know, there are countries around the world that are starting to see some fairly significant drops in economic activity. Those countries that count on oil for a significant portion of their GDP are now starting to see budget pressures. Many of them also subsidize a lot of their citizens' raw materials that they purchase (cooking oil, energy, food, etc.). If these governments are forced to start rationing their aid to their citizenry, many of those countries will begin to see internal geopolitical issues. It could also start to lead to regional conflicts - especially among producer nations.

Trend Three – Is it Deflation in the Eurozone?

There is a tremendous amount of debate on whether the Eurozone is officially in a deflationary condition. Remember that the risk of deflation is multi-fold and many people call it the "death spiral" (it was what finally pushed the world into depression in the 1930's). First, **the condition normally starts as a drop in prices such that it kills corporate profitability.** Products that companies had purchased and put into inventory months ago cost more than they will bring when sold today. That drop in selling value will reduce corporate profits. As corporate profits ease, companies adjust their cost structures to reduce their operating costs. As they lay off workers, the broader consumer market loses purchasing power and sales suffer. **Since cash flow slows when sales slow, companies reduce the selling price of products to try and increase their cash flow, and the result is further deflation which starts the cycle all over again.** It's the death spiral for economic conditions.

There are many things that can cut the cycle off, and we haven't seen too many modern versions of the death spiral because of those factors that can head it off. But, the fear that it can create could also be worse than the actual deflation impact itself.



Today, **unemployment across the Eurozone is 11.5%, near a record. Inflation slipped across the Eurozone by an annual rate of -.2% in December.** If that trend continues, it would signal deflation across the zone and Central Banks would have to take a series of steps to try and increase inflation. For now, the ECB is saying that it will review conditions till March, primarily waiting to see what energy prices do between now and then.

Remember that if you do international business trading, deflationary prices in the Eurozone means that consumers are likely weaker and have less purchasing power, and products in those markets are cheaper and expected at a deeper discount than prices in other markets. It could make the trade environment tougher unless you are sourcing products from that region. Then, lower transportation costs, a stronger dollar, and cheaper products in those markets will make sourcing products there cheaper. But **eventually, it could slow US manufacturing.**

Trend Four – Will Plentiful Global Commodities Kill US Producers?

This is a grotesque over exaggeration, but you will get our drift. **The world has been on a commodity producing binge for the last five years and we may begin to pay for it.** For instance, Chinese producers have put together the resources and technology to produce fertilizer for crops. As a result, the Midwest Farm Report suggested that the Chinese market alone will produce 131 MMT of fertilizer this year for a global market with demand of about 74 MMT. That will drop the price of fertilizer which could be good for producers, but the reasons why prices are lower probably isn't a great story.

Other commodity prices are also falling as we have shown you in the past. Although a group of them have stabilized (gold, silver, platinum, palladium). But others are starting to suffer from oversupply and lack of demand worldwide. Copper, aluminum, and other production metals have softened in recent months. The chart at right from Kitco of the spot 1 year aluminum prices is just one example of the drop in commodity prices.

Pressures in the producer segment including farming could start to show up in economic data as early as Q1. Farmers in the US are already starting to change their planting forecasts as a result of current oversupplies of certain commodities. And, if the current weather patterns in the US hold, we should get a better harvest this year than we had last year. That, coupled with improved production in other markets in South America, Asia, and even Europe will add to the global supply of commodities - and reduce the price for those commodities. **This is just one of the factors to watch in the global marketplace as we start 2015.**



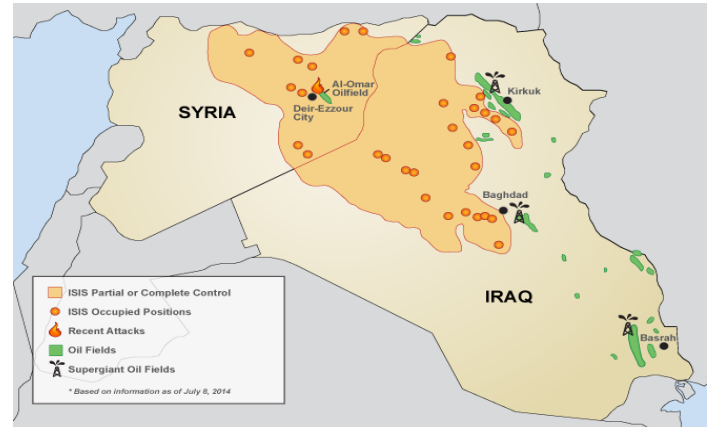
Trend Five – ISIS and Syria

In most respects the next few months will be much like the last year. There is unlikely to be a major breakthrough in the fight against ISIS but there have been some changes in the battlefield position of the fighters and this is leading analysts to conclude that an extended stalemate is more likely than ever. The various factions in the region have been retreating to areas that constitute strongholds and are essentially protected against anything other than a major offensive involving foreign troops and significant engagement. That is not going to happen as there is no appetite for this kind of engagement on the part of the US or any nation in Europe. The ISIS forces are locked into traditional Sunni territory and the Kurds have taken defensive positions in their region while the Shiite are reinforcing their regions. The Syrian military has taken the same approach and is protecting the home areas that



belonged to the al-Assad clan. The next few months will see fighting along the borders of these regions but major changes are not likely.

What does this mean for the business community? By this time there is precious little interest in this part of the world unless it has to do with some remaining oil activity. **The bad news for ISIS is that the collapse of oil prices has robbed them of their most lucrative income sources – an estimated reduction of some 90% of their former revenue.** The settling of territorial control has left most of the oil infrastructure in Iraq in the hands of the Kurds or the Iraqi government and the ISIS forces control only the small fields in Syria and some of the more remote parts of Iraq. There is not likely to be a major oil shortage developing as a result of the fighting in the region so this will not be the part of the oil world that provokes higher prices in the near future.



Trend Six – Populism in Europe

As of this writing the terrorists that attacked the French satirical magazine Charlie Hebdo have been killed and the additional hostage situation that erupted in the same day as the manhunt was resolved with the death of the terrorist as well as some of the hostages. Europe has been rocked by these events and France in particular. The reactions thus far have been anger, grief and shock but the political forces are already at work. The leader of the National Front in France – Marine Le Pen – has been in the media almost constantly as she expresses the position of the angry French. Throughout Europe there has been a dramatic increase in right and left wing populism and they share some common traits if not common solutions. They represent the fed-up population, those who have been pushed too hard by austerity and budget cuts. They are pensioners who are threatened with the loss of their income, workers that are being laid off and can't find new jobs, minority groups that are feeling shut out and so on. Almost ten years of recession has taken its toll and most of the mainstream political parties have been watching their support numbers dwindle fast.

The Syriza coalition is poised to take control of the Greek government and they plan to undo as much of the system imposed on Greece as they can. They have targeted the "oligarchs" and the wealthy of Greece and this is a position that has been embraced by the majority of the left leaning groups. The right is targeting immigrants and those they see as undermining the cultural norms of the country and there are many of these parties operating now – gaining power with every passing day. Most would now come in second in elections if they were held today.

It is too early to estimate the reaction to the atrocities in France but most expect there to be revenge attacks directed at Islamic residents throughout Europe and that tends to provoke further responses. It is inaccurate to assert that this is civil war in the making but is expected there will be more and more of these incidents in the year to come.

Trend Seven – Drug Wars in Mexico

The good news is that drug wars today are not quite as widespread in Mexico as they were just a few years ago but the bad news is that they are becoming more common again and more violent. Between 2006 and 2012 there have been 60,000 people killed in the various drug wars that have pitted the major cartels against the Mexican military and against one another. The strategy has been to find and eliminate the heads of these cartels and this approach has been very successful as every one of the leaders that were in place in 2006 are now dead or in prison. The problem is that none of these attacks have resulted in the destruction of the cartel itself. Instead there

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have been vicious battles over who would take control and rival gangs worked to try to grab the territory of a weakened gang. The latest atrocity was the kidnapping and killing of some 43 students with the tacit support of the local government in Guerrero. This incident has severely weakened the national reputation of Enrique Pena Nieto and that has placed all of his reform efforts in jeopardy. The much vaunted arrival of Mexico as a major oil state is now in serious danger from the dropping price for oil and the fact that he is now fighting for his political life.

There are some who assert that the drug war was never thought out. There is a school of thought that holds that stability within the ranks of the cartel should be the goal. The longer that someone is the head of these organizations the more conservative and defensive they become. They are not fighting to get power but to protect it and over time they seek more legitimate levers of influence. This is what ultimately worries the existing political leaders as they are soon competing with elements of that drug cartel.



Trend Eight – China and Japan

The territorial conflict between China and Japan will not likely reach the point of becoming a hot war anytime soon but the relationship between the two states has deteriorated to the point that it has become a flashpoint and anything could spark a more intense reaction. The two countries have been at odds over who can lay claim to the small chain of barely inhabited islands that the Japanese call the Senkaku and China calls the Diaoyu. There have been some who assert that this is over resources but the oil potential here is limited and both nations have far more lucrative options for development. This is territorial assertion – pure and simple. On the one hand that limits the lengths that either nation is willing to go but on the other hand it makes the situation volatile as this is all about national pride and both nations are experiencing the kind of economic challenge that brings this kind of nationalism to the forefront.

Both nations are trying to plant flags and both have warships patrolling and there have been near misses already. The big issue is that both populations are becoming enraged over the gestures of the other. The Chinese expect to be at war with Japan in the next five years according to some polls and Japanese think they will have to be in direct confrontation with China according to their polls.

For now the conflict is at a dull roar but this is a very unknown situation and it is hard to predict what will set the issue on fire.



Trend Nine – Indo- Pakistani Tensions

In the days that followed the victory of Narendra Modi in the Indian election there was a great deal of speculation as to what kind of leader he would be. Throughout most of his political career he has positioned himself as an ardent Hindu nationalist and the most controversial aspect of his resume was when he seemed to tolerate – if not encourage – attacks on Muslims in the Gujarat state he led from 2001 to 2014. He has also built a reputation as a



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reformer interested in seeing advances in the economy of India and campaigned on that platform. In the first weeks of his tenure it was this reform agenda that gathered the most attention and it seemed that he was going to try to shed some of that nationalism. There were overtures to the Pakistani Prime Minister, Nawaz Sharif, and some even started to talk about real rapprochement. Today that seems a distant possibility as the conflict over the Kashmir region is flaring again.

Last October there was an outbreak of violence that left 17 people dead and scores more injured. Both Pakistan and India blamed the other for the outbreak and there have been skirmishes in the region ever since. The latest took place just this week and there have been exchanges of gunfire between the militaries of both nations. The cynicism and skepticism in this region runs very deep and every incident is part of a conspiracy. The Pakistani assertion is that all of these incidents are being stirred up by India because Modi will soon be hosting a visit from Obama. The Pakistani relationship with the US has been frayed over the last few years as the US has been irritated by the lack of support in its campaign against the Taliban in Afghanistan. The US has been well aware that insurgents have been hiding in Pakistan for years and that there is considerable support for the radicals in official Pakistani circles. **The US has long tried to create a balance between the two nations but that has been very awkward as the leaders of the two countries interpret every action taken by the US through their own prism and that means that any gesture towards one is seen as an insult to the other.** Obama suggested the visit when Modi was trying to create a different image of himself and the BJP and many warned that arranging a visit to India right away as premature. It would have been better to give Modi some time and determine what his real policies would be. The US Presidential visit is not going to take place at the same time that tensions are flaring in the Kashmir and the leaders of India and Pakistan may be at each other's throat.

To make matters even more complicated the US is getting far more cooperation from Pakistan against the Taliban than has been the case in years. The vicious attack on schoolchildren a few weeks ago galvanized the military and they have been aggressive in their response. The US has seen far more progress in terms of keeping insurgents from crossing into Afghanistan and now there is some sense that Pakistan is going to work with the new Afghan President. That whole sense of cooperation could vanish if the Pakistani government thinks that the US is now tilting towards India.

The Modi position is complicated as well. His BJP party lacks the total voting power it needs in the parliament and needs to have a coalition partner. None of the parties that once supported the Congress party are interested in switching to Modi and that narrows his options. One party that was leaning towards that coalition was the People's Democratic Party but this is a party that draws the majority of its support from Islamic voters in the Kashmir region. The leaders of the PDP thought that Modi might be able to make progress in the Kashmir but this is not likely now and they have drifted away from any kind of alliance. That puts pressure on Modi as it now looks like Congress is getting some of its lost support back. The visit from Obama is important but it will have to go just right to benefit Modi and that is looking less and less likely.



Trend Ten - Global Food Prices Falling - Could Help with Spending

This is also a continuation of the trends that we saw in early December - and it hasn't fallen off of our trending data for any reason. We also provided this update in yesterday's brief. The FAO World Food Price Index is important for us all to keep tabs on because it shows us 1) the environment in which US farmers will be working (a good or bad

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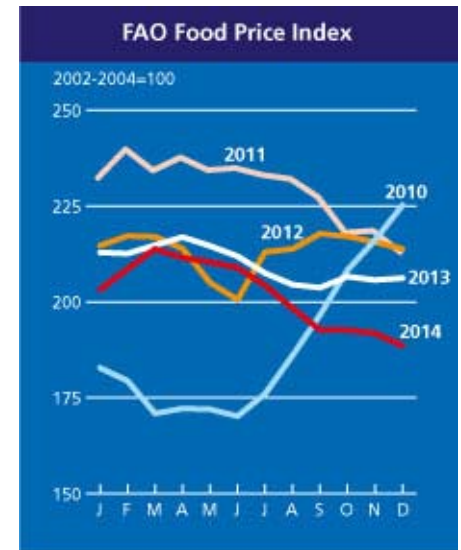


crop export price environment) and 2) whether we should expect starvation and unrest problems in nations because of food shortage problems.

Based on the latest FAO price index, that doesn't appear to be a problem. As you can see from the chart at right, **the FPI is at 5 year lows**. From the FAO:

"The FAO Food Price Index averaged 188.6 points in December 2014, down 3.2 points (1.7 percent) from November. The Index, which had been in a downward trend between March and September, remained fairly stable in October and November, before falling again in December.

Over the full year, the Index averaged 202 points, down 3.7 percent from 2013, with the sharpest year-on-year falls registered by cereals (12.5 percent), followed by dairy products (7.7 percent), oils (6.2 percent) and sugar (3.8 percent). Only the FAO Meat Price Index recorded an increase, advancing by 8.1 percent compared to 2013."



We would expect that this will help to improve global consumerism slightly. Consider one fact, the average US household probably spends less on food costs than most other nations. **In some countries, food costs can be more than 40% of total household spending. So, a drop in food and fuel prices is welcome - and will give them money to spend on other products.** And, since many governments help to subsidize food costs, it should also give many of them some budget easing - which could also show up in additional spending on other products and alternative forms of investments.

The bottom line is that this and the drop in fuel prices should ultimately be a positive boost to worldwide GDP and will help some of those countries teetering on recession to hang on and show some moderate levels of growth as a result.