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Our Top 10 "Black Swans" for 2015

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In the upcoming year, it seems that there are many things that could flare up and surprise investors. So, the State Street Global Advisors Investment Solutions Group (ISG) gave itself a stiff challenge: predicting the unpredictable things most likely to throw markets for a curve. In order.

When the Swiss National Bank (SNB) suddenly released the Swiss franc from its fetters on January 15, 2015,[1] the stolid, century-old central bank stunned foreign currency markets and investors alike.

Following the bank's surprise move to scrap its cap on the franc's value against the euro, the Swiss currency soared, gaining as much as 30% against the euro during the day to close about 20% higher. Meanwhile, the Swiss Market Index dove in the opposite direction, plunging nearly 9%[2] as investors worried about the impact of the higher-valued franc on Swiss exports, tourism and the country's entire economic outlook.

By almost any reckoning, the bank's dramatic move was a Black Swan event of the sort Nicholas Taleb describes in his prescient 2007 book *The Black Swan: The Impact of the Highly Improbable*. It had the three qualities Taleb identifies in such events—rarity, extreme impact, and retrospective (though not prospective) predictability. In the case of the franc: it's ***rare*** that the Swiss National Bank (SNB) ever surprises; the impact was certainly ***extreme***, given the massive trading losses on some currency trading desks; and in ***retrospect***, the move was actually predictable, given the euro's precipitous decline in recent months and the prospect of the European Central Bank (ECB) implementing massive Quantitative Easing (QE). Indeed, the ECB launched a $60 billion per month QE program a week after the SNB's move.[3]

Gluttons for punishment that we are, we on the State Street Global Advisors ISG Politics & Policy team recently set out to canvas the economic and geopolitical landscape to generate the list of our Top 10 Black Swans for 2015. This is, of course, a nearly impossible exercise (see the part above about such events being visible only in retrospect), but we felt the effort was worthwhile, particularly this year.

Coming into 2015, there is an especially large number of trip-wire situations lurking on the global stage, and the market seems to know it. The rise in SSGA's Market Regime Indicator (MRI)[4] to the current "crisis" level shows just how much markets are on edge. The MRI started moving higher in September 2014, when the Scottish referendum on Scotland's independence from the United Kingdom rocked currency markets in Europe, and global monetary policy divergence had already impacted rate markets in the US, Europe, Japan and elsewhere. Oil price declines and general global growth concerns continue to rattle investors, leaving many waiting for the next shoe to drop.

Below, we rank—in order (why make it any easier on ourselves, right?)—the most likely out-of-the-blue flare-ups for the global markets in 2015. Just to clarify, *none* of these are our base-case scenarios (by definition, black swans never are). And, inevitably, the events that *most* rock markets won't be *exactly* these. But we'd be willing to bet that we're at least getting warm.

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1. A Russian Debt Default—Entering 2015, Russia faces a collapse in the value of its primary revenue source (oil) and a rapidly falling currency. The country is also waging a proxy war on its doorstep that has made it an international pariah state in the view of Western democracies. In addition, on January 26, Standard & Poor's downgraded Russia's sovereign debt to junk status due to inflexible monetary policy and a deteriorating economy.[5] This only exacerbates the country's troubles by narrowing the investor base for Russian sovereign debt.

Russia owes about US$700 billion in foreign debt, with roughly US$130 billion due before the end of 2015.[6] Because of Western sanctions, foreign markets are not currently open to Russian corporations to roll over their debt. So as corporate debt to foreign entities comes due, Russian companies actually have to pay it off in dollars, an increasingly costly proposition given the huge decline in the ruble's value. The Bank of Russia has already stepped in to bail out one bank whose fortunes were closely tied to the oil industry, but the question remains: how long can the public sector keep backstopping failing private entities before Russia's sovereign debt could be imperiled? Moreover, the sheer size of Russian debt markets means that its full contagion potential on other sovereign entities (particularly in other emerging markets) is hard to calculate.

In 1998, a similar plunge in oil prices did in fact push Russia to default on its debt and spark a (albeit brief) global financial crisis. More than a decade and a half of boom energy years have left Russia with far healthier reserves than it had then, but its relations with the West are far, far worse, complicating the potential for heroic interventions. With less to lose in terms of ties with Western companies and governments, Russia may be less predictable in both the political and economic arenas, and more willing to undertake further aggression against Ukraine or in other geopolitical hot spots.

While a complete breakup of the eurozone must still be viewed as a doomsday scenario, the exit of a country—or two—can no longer be deemed completely out of the question and would be sufficiently disruptive for the shocks to be felt well beyond the eurozone.

2. A Eurocrisis Redux—As recent political developments have demonstrated, portions of the eurozone electorate are looking for a change from the austerity and readjustment regime that has been the current roadmap for indebted and uncompetitive countries in the region: In late January, the leftist Syriza party won control of Greece's government and formed an anti-austerity coalition government; in Spain, the anti-euro Podemos party currently leads in the polls ahead of a general election in November 2015; in France, the anti-euro National Front has a significant following that could put it in a position of power in future elections.[7] If the ECB's QE program does not prove to be an immediate tonic, the impact of rapidly falling inflation and possible deflation could lead to a further build-up of such pressures that could eventually cause the façade of unity to crack. While a complete breakup of the eurozone must still be viewed as a doomsday scenario, the exit of a country—or two—can no longer be deemed completely out of the question and would be sufficiently disruptive for the shocks to be felt well beyond the eurozone.

3. A US Monetary Policy Mistake—The Federal Reserve faces a difficult conundrum. Following seven years of near-zero interest rates, it will need to carefully thread a communication needle to ease markets into a potential rate hike in 2015. While SSGA economists expect the Fed to begin a tightening cycle in response to a strengthening economy this year, there is also a risk that it will tighten into a *still fragile* economy. This could cause an abrupt economic slowdown and even a recession in the US, with no new monetary policy tools for the Fed to work with, aside from a new round of QE. On the opposite end of the spectrum, downward pressure on inflation from falling oil prices and a soft global growth backdrop may prompt the Fed to stay accommodative for an extended period. This could lead to further asset price inflation and other pressures the Fed will need to react to, in haste and with fewer policy options.

4. Social Unrest in Oil-Exporting Countries—Aside from Russia, there are other standout losers from the current collapse in oil prices, including Venezuela and Nigeria. From an economic standpoint, these countries are small but the oil decline could create unexpected instability throughout Latin America and Africa. For example, Nigeria is the most populous country with the largest economy in Africa.[8] Nigeria contends with a range of sectarian and terrorist threats that will only be exacerbated by further economic weakness. In Nigeria, a failure of the state to maintain order could result in spillover to neighboring countries and result in a reluctance by investors to further develop the region.

5. The Birth of Additional Failed States—The order imposed by the victors of the First World War on the Middle East has come under severe pressure since the Arab Spring of 2011. Currently, Syria is the most acute example of a failed state, though large portions of Iraq are essentially partitioned along sectarian lines, civil war and militia rule grips Libya, and Yemen is mired in instability and faces a potential coup following the resignation of its president.[9] These unstable states serve as battle grounds where regional powers conduct proxy wars and act as breeding grounds for anti-Western terrorists. With the West uninterested in committing to troops

on the ground, the shifting of the old order in the Middle East looks like it will continue. It’s hard to tell how *many* failed states in the Middle East it would take to have a significant effect on global capital markets, but it may not take many more to undermine financial centers in the region or to start to drag on overall global trade and economic growth.

6. A Further Economic Slowdown in China—China slowed to a 7.4% growth rate for 2014, the lowest rate since the global financial crisis.[10] Clearly, ongoing reform initiatives and years of central planning mismanagement have resulted in a much more serious slowdown than many market participants anticipated. As the world’s largest oil importer,[11] China’s decreasing growth may already be a large component of the demand-side contribution to the decline in global oil prices. Further slowdown in China will spill over to providers of raw materials such as Brazil, a country that counts China as its largest trading partner.[12] A more protracted China slowdown would be a drag on economic activity for the Asia-Pacific region, weakening equity markets and slowing global trade flows.

7. An Overall Decline in Global Growth—In addition to worrying signs in China and Europe, emerging markets growth could also disappoint in the coming year, Slow growth could then ripple out and place stress on the Japanese economy and eventually the US. With most monetary policy tools all but exhausted by the world’s largest economies, and with the ECB just completing the launch of its broad QE program, few salvos against slowing growth remain available to policymakers.

8. A Further Contraction in Commodity Pricing—While great for commodity consumers, further commodity price declines could disrupt markets via defaults on corporate debt in the energy and materials sectors, with general contagion to global credit markets. We have already seen a taste of commodity-related stress in the US high-yield market. High-yield bonds were volatile during the second half of 2014 mainly due to the relatively high concentration of oil producers in this asset class.

9. Cyber-Attacks on Financial/Government Infrastructure—Cyber-attacks to date—such as the recent data leaks from Sony Pictures Entertainment—have primarily focused on disruption to single companies or individuals. However, a more concerted effort by hackers could cause major economic damage if banking networks or other payment systems are compromised. As a reminder of what some far-reaching radical groups are capable of, the US central command Twitter account was hacked by ISIS in the middle of January 2015.[13] Markets could see crippling trade interruptions and unprecedented spikes in volatility if such attacks escalate in frequency and severity.

10. A Significant Terrorism Surprise—As the January attacks in Paris attest, terrorism can strike suddenly and unexpectedly. Given the flow of Western fighters returning from the Middle East with terrorist training, the West could experience more such attacks this year. A series of coordinated attacks in European capitals, for example, could significantly hinder economic activity as individuals avoid city centers and other potential terrorist targets.

What to Do

So what should investors do, given the bevy of black swans (sic) gliding along on the horizon?

At the very least, investors should expect the unexpected and consider holding a diversified portfolio of uncorrelated assets that can persevere in a variety of environments. We also are big believers in explicit downside protection. This can take the form of strategies with built-in rebalancing triggers tied to volatility, or managed volatility strategies that use either rules-based or alpha-seeking active management to systematically tilt the portfolio toward lower-beta holdings, among other approaches. (For a quick primer, see our “Two-Minute Guide to Tail Risk Strategies.”)

Understand, too, that our overall outlook for 2015 remains generally positive. Of course there will be unforeseeable events in 2015 that impact financial markets. Investors should remain vigilant of the investment risks around them, in part so they can take necessary precautions, and in part so they can be ready to take advantage of opportunities that often arise from market turmoil.

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[1] Source: Bloomberg, as of January 15, 2015
[2] Source: Bloomberg, as of January 30, 2015
[3] Source: Bloomberg, as of January 22, 2015
[4] The Market Regime Indicator (MRI) is a proprietary macro indicator developed by the SSGA Investment Solutions Group. The MRI is based on forward-looking market information and is designed to identify the level of risk aversion/appetite in the market. The MRI Market Regimes, from lowest to highest risk, are Euphoria, Low Risk Aversion, Normal, High Risk Aversion, and Crisis.
[5] Source: Standard & Poors, as of January 26, 2015
[6] Source, The Economist, November 22, 2014
[7] Source: Reuters, various dates, January 2015
[8] Source: The World Bank, as of January 30, 2015
[9] Source: Reuters, Various dates, January 2015
[10] Source: Bloomberg, as of January 20, 2015
[11] Source: U.S. Energy Information Administration, as of March 24, 2014
[12] Source: World Trade Organization, as of September 2014
[13] Source: Bloomberg, as of January 12, 2015

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