

# Global Economic Outlook and Strategy

## Prospects for Economies and Financial Markets in 2015 and Beyond



- In this “*Prospects*” edition, Citi’s research team presents updated forecasts for economies, interest rates, FX rates, commodity prices and sovereign ratings around the world for 2015 and beyond. We also present Overview essays on the drift into secular stagnation, whether globalization is stalling, political issues for 2015, emerging market strains, advanced economy “low-flation” and long-run projections for the size of major economies.
- We are cutting 0.1 percent off our global growth forecast for 2015 and 0.2 percent off for 2016, and expect only a slight pickup in global growth, to about 3.1% YoY in 2015 from about 2.7% in 2014 (at current FX rates). The improvement from 2015 is likely to be led more by advanced economies rather than emerging markets. Growth in the US and UK is likely to stay around 3% in 2015-16, and we forecast modestly higher growth for the euro area and Japan. EM growth will probably again outpace AE growth in 2015, but the EM-AE growth gap is likely to be the lowest since 2000. Indeed, we expect China’s official data to show real GDP growth slowing slightly below 7% in 2015, the lowest since 1999 — and the economy’s underlying momentum may well be even softer. By contrast, we highlight India, Mexico, Spain and Ireland as likely reform-driven outperformers.
- Economic divergences are likely to prompt sizeable divergences in monetary policies in 2015-16. We have pushed back our forecasts for the start of Fed and BoE tightening, but still expect that shrinking slack will prompt both central banks to hike rates in late-2015. Conversely, the prospect of persistent low-flation is likely to prompt the ECB to follow the BoJ and launch a major QE program soon. We also expect widespread nearterm monetary easing across emerging markets. In turn, we expect further major USD appreciation, breaching €1.10/\$ and ¥125/\$ in 2015, with levels of €1.00/\$ and ¥135/\$ likely over the next 2-3 years.
- Key downside risks center on China’s domestic economy (especially if monetary easing is delayed or ineffective); continued underperformance in the euro area and Japan; and the weakening political support for global economic integration. Key upside risks center on the boost for consumers from falling commodity prices alongside loose monetary policies, especially in advanced economies.

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With thanks to Jan Maguire

Next issue 21 January 2015

**Figure 1. Currency and Interest Rate Forecasts, as of 1 December 2014**

	Current	1Q 15F	2Q 15F	3Q 15F	4Q 15F	1Q 16F	2Q 16F
United States: Federal Funds	0.25	0.25	0.25	0.25	0.50	0.50	0.75
10-Yr. Treasuries (Period Ave.)	2.21	2.70	2.85	2.90	2.95	3.00	3.05
Euro Area: US\$/€	1.24	1.16	1.12	1.09	1.07	1.05	1.02
Euro Repo Rate	0.05	0.05	0.05	0.05	0.05	0.05	0.05
10-Yr. Bunds (Period Ave.)	0.70	0.65	0.85	1.00	1.15	1.25	1.25
Japan: ¥/US\$	118	121	124	126	128	130	132
Call Money	0.10	0.10	0.10	0.10	0.10	0.10	0.10
10-Yr. JGB (Period Ave.)	0.44	0.45	0.45	0.55	0.55	0.60	0.60

F: Forecast. Note: All forecasts are for end of period, unless specified. Source: Citi Research

**See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.**

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## 2015 — Drifting Into Secular Stagnation?

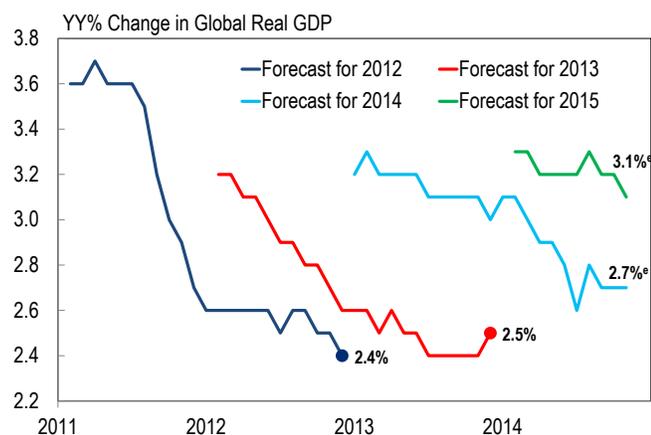
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The past few years have probably established a record of disappointments for economic forecasters of global GDP growth. Every year, since at least 2011, forecasts have been systematically proven optimistic forcing a downward revision. Rather surprisingly, these backward-looking downward revisions were invariably accompanied by a forecast of a meaningful pick-up in growth (from the downward revised current levels) for the following period (see Figure 4). The logic of forecasting models, one imagines, is that business cycles and growth mean-reversion are powerful forces. However, these effects seem to have lost some of their strength.

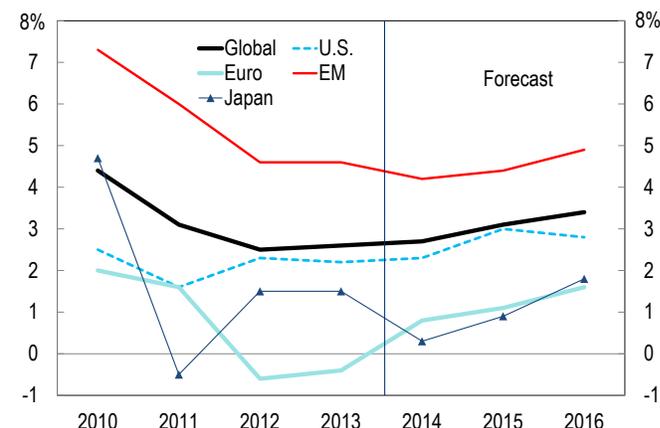
We find that an increasingly appealing interpretation of the frustrating economic performance in advanced economies (AE) is “Secular Stagnation.” The version of that hypothesis that we favor holds that the economic recovery is extraordinarily weak because there is an endemic excess of savings over investments that only a spontaneous eruption of animal spirits boosting domestic consumption and/or capital formation, a major boost from external demand or aggressive expansionary policies can resolve. In a world with such limited growth and ample resource underutilization, low inflation is likely to emerge. Low-inflation, in turn, contributes to prolonging the period of low growth when nominal policy rates are near the zero lower bound, limiting the effectiveness of traditional policies. Low global activity leads to low commodity prices. Note, however, that the recent weakness in oil prices is not just driven by a reduction in oil demand caused by a lower global GDP growth and by policies that promote a less commodity-intensive, energy intensive and carbon-intensive composition of production and demand, but is to a large extent the reflection of a technological disruption that led to a large (distributional) global shock. These three themes marked the second semester of 2014 and, we think, will continue to shape economic and political outcomes in 2015.

Figure 4. Consensus expectations of growth have proven to be consistently optimistic leading to systematic downward revisions



Note: Dots = data for 2012 and 2013, last available forecast for 2014-15. Sources: Consensus Forecasts and Citi Research based on a graph by Gavyn Davis: <http://blogs.ft.com/gavyndavies/2014/10/12/its-the-new-mediocre-not-a-global-recession/>

Figure 5. Global growth has been mediocre and, although we are forecasting a small rebound, it is set to continue at a moderate pace, at best



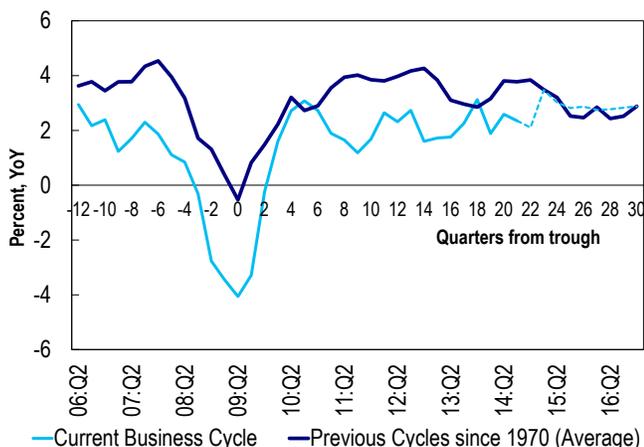
Source: Citi Research

### Secular stagnation gains traction

The world economy grows at a modest pace. For 2015, our forecasts still exhibit some tendency to mean-revert, but the forecast level is quite mediocre (see Figure 5). Even positive stories like the US, are only the result of an early pick up in Q1 to above 3%, with growth likely to then revert back to the high 2s. Japan and Europe are expected to deliver close to 1% growth and China is forecast to decelerate to below 7% (6.9% is our actual forecast for officially reported GDP). In all these cases, except for the US, even these modest growth rates are based on the assumption that there will be further expansionary policy support. And the repeated disappointment of recent years suggests that risks probably lie mainly to the downside of our forecasts for 2015-16.

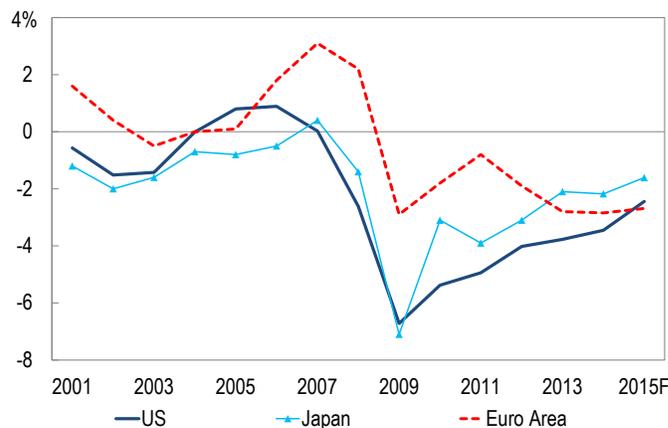
Growth is insufficient and output gaps remain wide open despite some gains in labor market conditions. The global financial crisis (GFC) is gradually fading in memory, yet the pace of economic recovery leaves much to be desired. Take for instance the case of the US, where growth has run since 2010 at an average annualized pace of 2.16% (see Figure 6). At that pace and given most estimates of potential growth (CBO estimates 2% on average for 2010-2014) the output gap has closed only marginally in those years and remains quite significant. Our forecasts for US growth in 2015 imply some further closing of the output gap, but it remains large even after a year of 3.0% growth. Using IMF estimates of potential growth, Figure 7 illustrates that the problems in Europe are more acute given the shabby recovery (an average growth rate of 0.68%) which remains roughly similar to the 0.7% potential growth that the IMF estimates (a number we deem too pessimistic, even without reforms in Italy, France and Germany). In Japan, the relatively speedy growth of actual output immediately following the crisis and the very modest rate of potential output growth (the IMF estimates 0.4% while Citi pencils down 0.5%), resulted in a narrower output gap, yet the poor growth performance in 2014 has kept the gap from closing further. Notice too that despite our forecasts for policy actions, output gaps in all three regions are expected to remain large towards the end of 2015. Is prolonged cyclical stagnation about to become secular?

Figure 6. US Global Financial Crisis cycle and previous cycles. Even if potential growth were 2%, the recovery fails to close the output gap



Sources: IMF and Citi Research

Figure 7. Output gaps in Advanced Economies are still wide open. IMF estimates, adjusted with the latest Citi growth forecasts



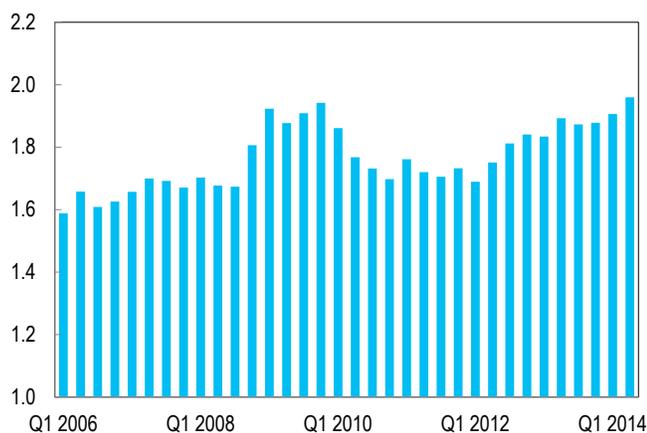
Sources: IMF and Citi Research

In some cases, it may be natural to blame fiscal consolidation and private deleveraging, for the lack of final demand. However, except in Japan, 2014 was hardly a year of additional fiscal tightening and, furthermore, private sector

deleveraging has slowed almost everywhere. Monetary policy accommodation remains extensive across the board (less so in the euro area, EA), and real policy rates are negative in AEs, except in parts of the EA periphery where actual deflation has taken hold. Nevertheless, once policy rates are near the lower bound, the transmission mechanism relies more on wealth and liquidity effects which seem to have lost some of their punch. In the US, for instance, household wealth increased in value by nearly \$15 trillion since the launch of QE3 (roughly 8% per annum) yet consumer spending has only grown a modest 2.5%, in contrast with the pre-crisis high propensity to spend out of wealth. There are two obvious explanations for the apparent fall in the US marginal propensity to spend out of wealth. The first is that the increase in wealth since the GFC is likely to have been more unequally distributed than in the past. If the marginal propensity to spend out of wealth falls with the level of wealth, this would account for a weaker wealth effect on consumption. The second is that since the GFC, household wealth increases, especially those associated with higher home prices, have not been leveraged to the same degree as prior to the crisis as mortgage equity withdrawal has been more limited.

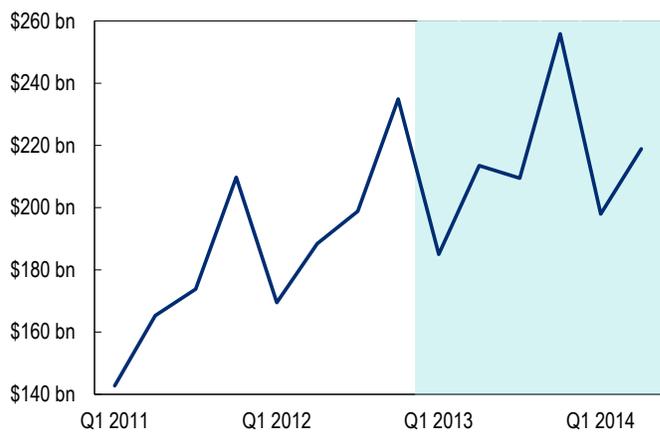
Investment in the AEs has been disappointing, despite the low level of real interest rates. The same way that consumers sport a lower marginal propensity to spend out of wealth, corporates with still fairly healthy balance sheets are reluctant to engage in capital expenditure. Remarkably, at least in the US, corporate balance sheets started to deteriorate at the time of QE3 with some corporate re-leveraging (see Figure 8). However, the higher leverage has been mostly used for other purposes, including equity buy-backs, extraordinary dividends, mergers and acquisitions, etc. rather than to support increased capex (see Figure 9). Perhaps the simplest, and most convincing explanation of the low capex is the weakness of the recovery and the persistence of large negative output gaps (which inhibits the ‘accelerator’). With output constrained by effective demand, the weakness of the recovery is itself in no small part due to the weakness of capex.

**Figure 8. US Corporate leverage on the rise. Median leverage ratio (total) for industrial corporates.**



Note: Median of total debt over LTM EBITDA at issuer level  
Sources: Steve Antczak at Citi Research and Bloomberg

**Figure 9. Little of that leverage is going to investment. Total capex for IG industrial corporates.**



Sources: Steve Antczak at Citi Research and Bloomberg

A prolonged period of low growth may lead to lower potential growth. With nominal policy rates close to the zero lower bound (ZLB), a contractionary demand shock (an ex-ante glut of saving over investment) drives the short-term real risk-free

interest rate consistent with full employment (the short-term neutral risk-free real rate) into negative territory. This negative 'neutral' risk-free rate of interest cannot be achieved because the nominal interest rate is at the ZLB and inflation (and expected inflation) is lowered by the negative demand shock. Without either an external boost to demand or an exogenous boost to domestic demand, full employment cannot be restored. The resulting negative output gap and underutilization of labor reduce investment and lower the effective supply of labor: short-term unemployed turn into long-term unemployed and ultimately drop out of the labor force altogether. So the path of potential output may be lowered by a persistent negative output gap. Cyclical stagnation becomes secular stagnation.

When there is no boost to aggregate demand from external sources - a spontaneous recovery of animal spirits or an effective fiscal and/or monetary stimulus - the inevitable conclusion is that real interest rates ought to remain low. Both ex-ante and ex-post real policy rates are negative throughout the AEs<sup>1</sup>, though the decline in inflation expectations results in an effective reduction in the level of stimulus afforded by nominal rates at or close the lower bound. Another avenue through which non-conventional policies have worked is via super-low longer term real rates. Indeed, 10y real rates in Germany and Japan are negative, as were US real rates before the taper tantrum of mid-2013. However, the magnitude of the output gaps and the slow response of consumption and investment to the non-conventional policy stimulus suggest that real rates will have to stay low for quite some time, capping potential policy normalization actions by central banks.

### Low-flation

Global inflation is running at extraordinarily low levels. Michael Saunders shows in his essay, *Will Advanced Economy Low-flation Persist?*, that inflation in OECD countries is running lower than at any time in the last fifty years while core inflation has been at or below 2% (YoY) since 2009. The forces behind this phenomenon are linked to large output gaps, slack in labor markets, international linkages and weaker commodity prices. Importantly, expectations of inflation are catching up and now reflect inflation in the long term significantly below the central banks' stated targets: 10y inflation breakevens, which include significant risk premia, are at 1.83% in the US, 1.21% in Japan, 1.06% in Italy and 1.02% in Germany. Such a low level of inflation and expectations can be quite costly and will surely drive central bank policy decisions.

The same logic applies at the global level. Global growth during 2014 is likely to be 2.7% (at market exchange rates). That is below our guesstimate of global potential output growth of just over 3 percent. This means that the global output gap is widening and, thus, global disinflationary pressures have grown. Exchange rate movements merely redistribute this global disinflation from the countries whose currencies are depreciating to the countries whose currencies are appreciating.

Short-term nominal interest rates have been at zero for some time while measured inflation is positive, suggesting real rates are negative. However, Robert Gordon shows that, because of upward biases in measured price inflation, true price stability is consistent with PCE deflator increases of 1.2 or 1.3%.<sup>2</sup> If a similar bias were present in Europe and Japan, both regions would be facing meaningful deflations and the US would be near true price stability today, despite a measured rate of core PCE inflation of 1.48%. In other words, the deflation threshold, once

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<sup>1</sup> The negativity of the real policy rates holds for all large economies if we treat the euro area as a single economic entity or nation.

<sup>2</sup> Robert J. Gordon: *The Boskin Commission Report: A Retrospective One Decade Later*. NBER Working Paper No. 12311. June 2006.

measurement issues are accounted for, would put (core) PCE inflation above 1%, not zero! Therefore, if real rates need to be negative to equilibrate saving and investment at full employment, measured inflation needs to be significantly higher.

Furthermore, there are crucial distributional and economic dislocation consequences that low-flations can have. If an economy has debtors and creditors, and if the levels of pre-existing (nominal, fixed-rate) leverage are significant, the consequences of low inflation can be quite important. There are two main sources of economic costs. (1) Debtors tend to have a higher marginal propensity to spend than creditors (which is how they got to be debtors) and unanticipated low-flations typically implies a transfer from debtors to creditors, reducing the bang-for-the-buck potential of some aggregate demand policies; (2) unanticipated debt deflation increases financial distress and bankruptcy, imposing large deadweight costs.<sup>3</sup>

Solvency is a challenge in several public and private corners in Europe, high public leverage is a concern in Japan and high private leverage is a concern in EM countries such as Korea and China. Take China, for instance, where the ratio of non-financial private sector debt to GDP reached 200% at the end of 2013 and where the regulated minimum (non-binding) lending rate is now 5.6%. China's inflation objective is 3.5%, yet the latest inflation print is 1.6% YoY. At a time of slow growth, with several sectors mired in excess capacity and low profitability, the resulting increase in real interest rates can be a serious obstacle to growth (and financial stability). Similar difficulties can emerge in Korea where non-financial private sector debt is 234% of GDP and inflation runs at 1.2% YoY. Notice that in both countries large fractions of those debts are internal. Therefore, the contractionary impact of low-flations at the ZLB is most likely to come from the redistribution between borrowers and lenders, with a likely decline in the aggregate marginal propensity to spend, and through the possible insolvencies and bankruptcies associated with this wealth redistribution.

China and Korea, and much of the EM world are also facing deflation in producer prices which may result in imported deflation in the rest of the world, unless countered by EM FX appreciation. Over the last three years, China's PPI has averaged -1.8% YoY and Korea's -1.0%. Singapore, Malaysia and Thailand's PPI deflation is a more recent phenomenon, but still poses a future threat to import prices in the rest of the world. If declining producer prices are compounded with some currency weakness in EM manufacture-exporting countries, the deflationary impact on the rest of the world increases.

When in low-flations, traditional policies lose effectiveness. While it is technically possible to have more negative nominal policy rates in AEs than those observed today, operational constraints make it difficult for central banks to implement them. When facing such constraints, AE central banks aiming to increase inflation are likely to undertake expansionary quantitative and qualitative easing policies. The Bank of Japan recently announced a first expansion of its aggressive QE program, expanding the menu and scope of asset purchases. It is now the turn for the ECB to pursue its own 1trn euros large scale asset purchases, probably in early 2015. Even in those advanced economies where the output gap is closing more materially (the US and the UK, mainly) we now imagine the Fed initiating the zeroexit of the Fed Funds target rate beginning in December 2015, proceeding at a very moderate pace to reach a new normal rate only after 2018. Meanwhile, the Bank of England is

<sup>3</sup> Low-flations can impose costs even if anticipated. Refinancing old debts and recontracting takes time and is costly. Therefore, even if debtors were offered more advantageous borrowing terms, the process will involve a transitional period and a significant amount of renegotiation costs. Furthermore, once an economic agent is highly levered, it is likely that he will not be an attractive credit candidate and, therefore, not eligible for recontracting.

expected to start raising Bank Rate slightly before the Fed's zeroexit, unless uncertainty preceding or following the general elections of May 2015 severely damage domestic demand. Should QE prove incapable of closing the EA output gap, the obvious (and much more effective) alternative — monetized fiscal stimulus in the periphery — would face strong political resistance from Germany.

The divergence among the monetary policy paths of, on the one hand, the US and UK, and the Eurozone and Japan on the other, activates an important transmission mechanism for QE policies: the exchange rate. Divergent policies will impact long-term interest rates, generating spillover effects across countries. Similarly equity and property prices, and lower credit risk premia in the countries implementing the expansionary monetary policies (EA and Japan) are likely to spill over to the rest of the world. However, if the lower marginal propensity to spend out of wealth observed in the US is also present in Europe and Japan, the best hope for a lift in inflation is likely to be through the exchange rate. In consequence, we anticipate further weakness in the Yen, Euro and in EM currencies vis a vis the US dollar. Sterling ought to move like the dollar were it not for the uncertainty generated by the forthcoming general election in May 2015 and the risk of UK exit from the EU.

Emerging markets are far from implementing QE policies, but global disinflation forces and slow growth will likely result in softer interest rate policies. China recently announced a reduction in deposit and lending rates and we anticipate more to come. Korea, Israel, Colombia and India are also likely to cut rates. Others are likely to pursue a less aggressive path than they would have otherwise followed. As a result, EM exchange rates are expected to depreciate against the dollar by 5% or 6% during 2015, including some (moderate) depreciation in China's heavily-managed currency.

### **Commodity prices**

Low global growth and, in particular, disappointing activity in China are taking a toll on the demand for commodities. However, the overwhelming force impacting the oil and gas markets is, in our view, a large technological disruption that is changing the way the market is organized and works. The shale revolution and the resulting reduction in US demand for oil and gas imports are leading to a change in the behavior of other market participants attempting to preserve market share.

Emerging alternative sources of oil may prove disruptive for a gradually less-powerful price setting cartel like OPEC. Non-OPEC oil production is reducing the market share of OPEC members. According to EIA estimates, OPEC's share of global petroleum and other liquids production is expected to fall from 41.2% in 2012 to 38.7% in 2015. As a result, facing softer demand growth, OPEC needs to cut its own production more to achieve a given impact on prices. Furthermore, the economic weakness of a growing number of cartel members puts them in a very fragile position to withstand a reduction in production. Therefore, the likelihood of a sustainable and credible reduction in OPEC supply is limited, unless the burden of the production cuts shifts towards the financially stronger members of the group.

Lower oil prices have large distributional effects. These effects are significant across nations and within countries. If oil prices decline from an average of \$105 as observed in Jan-July 2014 to our forecast average of \$80 a barrel in 2015, in a global market with nearly 93mn barrels a day of production, the total income redistribution from oil producers to consumers could be equivalent to nearly \$850bn or almost 1.1% of global GDP! If, as is likely to be the case, there is a significant difference in the marginal propensity to consume between consumers and producers of oil, the impact on the level of global aggregate demand could be

meaningful. For the US alone, the decline in gasoline prices could amount to a boost of \$100bn a year in disposable income for consumers. Our forecasts for US growth already factor some of this effect for Q4 14 and Q1 15. Notice, however, that these are level effects and are unlikely to maintain a sustained boost to consumption growth later in the year. Should oil prices fall significantly further, the negative effect on investment in shale gas and tight oil production would reinforce the reduction in consumption demand by the oil producers. Investment in oil and gas-using industries could, however, be boosted.

Lower oil prices are likely to result in significant financial and economic distress in a number of countries. Russia, Venezuela, Iraq, Iran, Nigeria, Ecuador, Kazakhstan, Azerbaijan and others are likely to face significant economic hardship. All these countries are dependent on oil for export revenues and some of these countries are large debtors. In those cases, a 25% drop in oil prices may well result in domestic economic and international financial distress. Take the case of Venezuela, for instance, where the drop in oil revenues could amount to nearly \$20bn in lost revenue for 2015, twice the amount of maturing principal and coupons on external debt obligations and about half of the non-oil import bill. If the oil price remains at that level, the likelihood of a credit event grows exponentially. In the case of Russia, a credit event is less likely, even if the \$420bn reported reserves were to fall rapidly in support of private sector firms. Under normal circumstances, we estimate that a \$25 dollar drop in oil prices could result in nearly a 2% drop in Russia's GDP growth within four quarters. In addition, economic and financial sanctions triggered by the Ukraine conflict have isolated Russia's economy and are likely to compound the effect on investment and activity. Russian corporates, many of them oil-related, have \$107bn in external debt coming due in 2015 and, because of the sanctions, are unlikely to be able to rollover all of them. The impact can generate distress in the FX market (some of this has already played out) and on investment in those companies. Finally, the decline in oil prices may result in a more complex geopolitical landscape. As a token illustration, the financing to both Iraq and ISIS could dwindle, changing their relative strengths. Or, both Russia and Iran, countries subject to economic and financial sanctions, may find their bargaining power reduced by the weakening of their financial strength.

Summarizing, the combination of the three forces (monetary policy constrained by the ZLB, the reality or imminent threat of secular stagnation in the AEs and a sharp decline in oil prices) discussed above is likely to shape policies and economic/social outcomes. However, despite the significant policy/political developments that may be triggered, we judge that this soggy economic environment is unlikely to result in radical monetary, fiscal, regulatory or structural policy actions. Instead we imagine a muddling-through scenario on a global scale. We do not have a relapse into outright recession as our central scenario; although it is a material risk. We expect that the policy-puts (especially in the euro area and in China) are likely to ensure that is not the case. Neither do we foresee a large-scale crisis in countries with systemic importance, or even a market shattering economic accident. The major fiscal-financial unsustainabilities (in the euro area periphery) and the most threatening credit and asset bubbles (China) are unlikely to reach the point of no return in 2015. Rather, the year is likely to shape up as another mediocre year, much like 2014.