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ECONOMISTS' OUTLOOK

2013: Eight Themes

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1. **Global growth stays moderate**, dominated by structural re-balancing changes, but led by Emerging Markets (EM). We project global growth to remain in the 3-3.4% range, with EM representing half of the global economy and contributing 3/4ppt of total growth. Advanced economies continue to de-lever, but encouraging signs are emerging. Private sector de-leveraging has made significant strides in the US, while public sector de-leveraging is only starting. Public sector de-leveraging continues to dominate the Euro area, but the impact will be less severe this year than in 2012.
2. **Central bank bond purchases lessen the tail risk**. Quantitative easing remains the principal monetary policy framework for advanced economies, while EM economies navigate the course between limiting currency appreciation and the need for maintaining a stable inflation outlook.
3. **Commodity prices are set on moderate trend**. Global growth is one of the key factors determining commodity prices and moderate global growth suggests an easing of prices to a more sustainable trend than what had been the case in the recent past.
4. **The US and the fiscal headwind – not the cliff.** Congress passed the American Taxpayer Relief Act of 2012 on 1 January 2013. The main provisions of the bill are well known, notably the permanent extension of the "Bush tax cuts" for incomes below USD 400/450K. The relief for The Alternative Minimum Tax is also permanent. For businesses, we note the one-year extension of the bonus depreciation, a plus for investment spending. Decisions on automatic spending cuts and the debt ceiling increase were postponed for two months.

   The focus of policy is on near-term growth rather than aggressive deficit reduction measures. The fiscal drag represents a manageable 1% of GDP this year, largely concentrated in the first half. We welcome this dynamic for two reasons: a) a more aggressive fiscal consolidation would have given the economy a major negative blow at the crucial time when the deleveraging of the household sector has improved significantly and the housing sector is recovering; and b) the bill is not inconsistent with the enactment of a gradual and longer-run deficit reduction package. Fiscal policy will still shave off about 1ppt of GDP this year.

   The postponement of spending cuts for only two months does not eliminate uncertainty regarding the conduct of fiscal policy or enhance the chances of a quick compromise. As such, market volatility will return and the outlook remains uncertain for business investment spending and we still anticipate the recovery in investment spending to be skewed toward the second half of the year. This dynamic will keep employment growth gradual.

   The rating agencies may run out of patience with the uncertain fiscal outlook, with the US remaining vulnerable to a potential downgrade.

   The still uncertain longer-run fiscal path ensures the continuation of a pro-active Fed and very low interest rates.
5. **The US and the private sector improvement**. The US economy will increasingly benefit from less aggressive de-leveraging of the private sector (households and banks), still elevated profit margins, the recovery in housing, an efficient manufacturing sector, and a buoyant energy sector.

   Household debt has declined from a peak of 98% of GDP in 2009 to 81% in Q3:12, while the debt service ratio (as measured by household debt service payments and financial obligations as a percentage of disposable personal income) has declined from a multi-decade high of 14% in 2007 to 10.6% last year. The financial sector debt ratio has declined from 123% of GDP in 2009 to 87% last year.

   Corporate balance sheets remain very strong and we anticipate another year of elevated profit margins, as unit labour and non-labour costs (interest costs) remain low. Only when wages start to rise and the labour market has fully recovered will margins decline. Furthermore, our expectation of investment spending recovering in the second half of the year when more clarity regarding fiscal policy sets in should not dampen margin significantly.

   A related dynamic is the efficiency of the manufacturing sector. The prime example is the recovery in the auto industry with production having contributed on average 0.4ppt to quarterly GDP growth

since the through of the recession. That role will now be passed on to the housing sector.

The expected recovery in housing will have positive direct impact on growth, with stronger housing starts adding to construction activity and residential investment; the recovery will have a positive indirect impact, in the form of jobs growth and positive wealth effect. The Conference Board estimate that every new single-family home built generates 3 full-time jobs and every USD 1 change in wealth yields a 6-8 cent consumption change.

Jobs growth continues on a moderate trend, as shown in the latest December employment report. The three-month average payroll trends now stand at +151K and +181K for total and private jobs, respectively. The firming of the payroll income to a yearly growth rate of 4.1% from 3.7% in November is welcome ahead of the rise in the payroll tax on January 1.

6. **Fed Policy, still assisting**. Fed bond purchases keep yields low, while rising inflation expectations put upward pressure on yields. The Fed announced additional USD 45 billion-a-month bond purchases, which brings the total purchases to USD 1.02 trillion a year. It is a powerful technical that trumps fundamentals and sends the clear message that the monetary safety net remains well anchored.

   Inflation expectations have risen moderately, pushing up nominal yields.

   Markets have recently interpreted somewhat negatively the Fed's discussion on how long the additional asset purchases should last, in light of some Fed officials being in favour of ending them prior to year end.

   We see markets as trying for a new "yield equilibrium", expressing the tension between the powerful technical of Fed bond purchases and the upward pressure on inflation expectations as economic data show a better tone. This will define this year's term structure and will keep ten-year yields in the 1.75-2.10% range (which would allow for potential overshoot to 2.25%).

   An exit from the low interest rate environment would be premature in 2013 and in 2014. The adverse debt dynamics, particularly at the government level, force central bank policy to remain prudent

7. **Euro area: a gradual recovery**. Sovereign debt costs will continue to be anchored by ECB bond purchases (OMT) program. ECB policy will result in improving credit conditions in the euro area. Relatively more aggressive monetary policy by the Fed, BoE, and BoJ likely to result the EUR maintaining its relative strength vs. USD, GBP, and JPY.

   Slowing fiscal drag and improving financial conditions are set to support a gradual recovery in H2:13, while the fiscal tightening will slow in all euro area countries with the exception of France.

   Full year real GDP will contract marginally, even with the anticipated recovery in H2. Growth is most likely to surprise on the upside in Germany and Italy, while France and Spain face downside risks to growth.

   The political cost of internal adjustment will slow European integration in 2013. We believe that European integration has reached the limit of what is possible under the current treaty and constitutions in some countries (e.g. Germany). As a result, further significant integration (i.e. fiscal union, common bank deposit scheme) will require treaty changes and in some cases constitutional amendments. It is unlikely that European leaders will seek referenda on further integration, while unemployment is still rising and the trust in European institutions and National governments is deteriorating.

8. **EM: domestic demand is a driver of growth**. China's growth stabilizes and supports our soft-landing view. This bodes well for commodity exporters, many of which will see their growth stabilizing as well in 2013.

   We believe conditions are favourable for domestic demand rather than external demand to contribute to EM growth. We see generally favourable prospects for domestic demand in countries such as Brazil, Mexico, Qatar, and non-Japan Asia. We are mindful that countries growing at or above potential are set to tighten policy in order to stave off inflation pressures.

Conclusion

Global growth stays moderate and re-balancing is taking place. In the US, the quality of growth has improved significantly. The balance sheet repair of the US private sector has come a long way, and the recovery in the automobile industry is set to pass the growth baton to the housing sector. Growth could surprise on the upside, depending on the tightness of fiscal policy that will set up the government de-leveraging. In the Euro area, fiscal policy will ease in the coming year and the ECB will aim at keeping credit conditions easy, thereby setting the stage for a second half recovery, albeit modest. In the EM arena, growth remains relatively strong but the adjustment from an export-led to domestic oriented growth models in the larger economies limit the upside momentum.

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International Corporate Rescue

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