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Global Themes and Forecasts

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Global Themes Overview

- **Global:** Global recovery still on track, but growth projections scaled back over likely Eurozone recession. Monetary policy pivoting towards accommodation in some quarters in light of global risks. Fiscal consolidation coming to deal with debt and deficits– particularly in Europe and Japan. U.S. a conspicuous exception.
- **U.S.:** Eurozone risks aside, recent economic data point to a sustainable though sub-par economic recovery for the U.S., bolstered by ongoing growth in Emerging Markets. Despite all the expressed pessimism, businesses and consumers continue to spend, while manufacturing expands at a modest pace. Against this backdrop, DE has become more confident in its baseline outlook for the recovery.
- **UK:** Although volatile, the economy has actually shown no underlying growth in the last few quarters thanks to a swing in fiscal policy and some pay-back for aberrant strength in 2010. Headwinds from the still fragile banking sector and consumer retrenchment are damaging confidence and their on-going impact is likely to mean continued unevenness and fragility lies ahead.
- **Eurozone:** Growth remains fragile with geographical divergences still very much the order of the day. What little strength there is still looks to be linked to the fading global backdrop, with little sign of any clear domestic momentum and with consumer demand looking more suspect. The shift towards greater fiscal consolidation and the need to support the banks and guard against fresh sovereign debt turmoil lies behind the ECB decision to reverse course and lower rates this month.
- **Japan:** Japan's economy has rebounded from the post-Tsunami crash, but generally not back to pre-disaster levels, and now confronts the global-demand uncertainties faced by all the Asian exporting nations—with difficulties compounded by the strength of the yen.
- **Emerging Markets:** The global growth slowdown has reached emerging market shores and substantially changed the balance of risks that guides policymaking. However, a static snapshot of economic activity across EMs shows these countries are still in an expansion phase.

DE Global Economic Outlook
(Real GDP Growth)

	2010	2011F		2012F	
World*	4.3	2.8	↓**	2.9	↓
U.S.	3.0	1.8	↓	2.9	↑
U.K.	1.9	0.9	↓	1.0	↓
Eurozone	1.7	1.6	↑	0.6	↓
Canada	3.2	2.2	↓	2.5	↓
Mexico	5.4	3.4	↓	2.6	↓
Japan	4.0	-2.1	↔	1.2	↔
EM Asia, NICs	9.3	7.6	↔	6.7	↓
Brazil	7.5	3.9	↓	3.5	↓
Russia	4.0	4.3	↓	4.5	↔
India	8.8	7.6	↔	7.5	↓
China	10.3	9.2	↔	8.0	↔

*Weighted average of country economic growth.
** (↑) indicates a higher forecast from three months ago; (↓) indicates a lower forecast; (↔) indicates an unchanged forecast.
Source: Decision Economics, Inc. (DE).

U.S. ECONOMIC THEMES AND FORECASTS IN DETAIL

Overview: The Eurozone debt crisis continues to drive financial markets, pushing most economic fundamentals – growth, jobs, earnings, and fiscal and monetary policy - to the background. Investors and policy-makers will likely swing between fits of optimism and pessimism in the coming months, depending on which way European winds are blowing. Resolution to the EU crisis is months away and appears less likely given the recent events in Greece especially the on/off referendum. Volatility is here to stay. DE continues to believe that the Eurozone will muddle through this crisis and avoid a disastrous "Lehman moment." In the near-term, however, prospects for U.S. and global equities remain uncertain. The U.S. dollar might appreciate further and Treasury prices rise as investors seek a safe port from the crisis, keeping long-term interest rates close to historic lows. Commodity and oil prices could forfeit recent gains and gold prices could fall as the dollar strengthens.

Eurozone risks aside, recent economic data point to a sustainable though sub-par economic recovery for the U.S., bolstered by ongoing growth in Emerging Markets. Despite all the expressed pessimism, businesses boosted capital spending by +17% in Q3, while consumer spending growth accelerated to +2.4%. Manufacturing continues to expand, albeit at a somewhat depleted clip, thanks to strong overseas demand. Core rates of inflation are higher than in the spring, but continue to moderate as the effects of the energy price shocks wear off. Confidence in the economic recovery should boost commodity prices further, but with productivity growth strong and the labor market weak, core inflation isn't expected to reach unmanageable rates.

Against this backdrop, DE is more confident in its baseline outlook for the recovery. The likelihood of a double-dip recession – which had been elevated at around 10% - is now fully discounted. Nevertheless, downside tail risks to the outlook remain. Offshore risks from a Eurozone recession – a near certainty – and a hard growth landing in China threaten U.S. trade, which has so far been an important source of growth. Domestically, Washington's inability to solve our own debt and deficit problems could ultimately result in a crisis, and severely erode consumer and business confidence to the point that spending contracts. These risks will require ongoing monitoring and analyzing.

Meanwhile, the fundamentals around U.S. equities remain quite positive. Interest rates will remain low into 2013 as the Fed maintains an accommodative stance. Corporate earnings growth continues to weather the growth slowdown, and should outstrip the pace of global nominal GDP growth. Business capex and strong EM demand will continue to offset a weak U.S. consumer, with help from a weakening U.S dollar. Against this backdrop, the cyclical equity bull market should endure. Likewise, fundamentals around fixed income securities and the U.S. dollar remain strategically negative despite the current safe-haven bid. Once some resolution to Europe's debt crisis is reached, markets will likely turn back to the U.S.'s own debt problems, depreciating the dollar and raising long-term interest rates.

Monetary Policy and Interest Rates: The gradual improvement to the economic outlook means that the Fed will not have to adopt another round of balance sheet expansion or QE3. However, the Fed may decide to support the housing industry a bit more by purchasing mortgages from the proceeds of selling existing Treasuries. Hence the composition not the size of the Fed's balance sheet may change. DE looks for no meaningful change in policy rates until 2013, in keeping with the FOMC's forward guidance. At the moment, Treasuries are trading on Eurozone fears, but expectations for growth, inflation, and deficits suggest higher long-term interest rates to come. Projections based on fundamentals support a 10-year Treasury rate of 2.5% by the end of this year, and 3.75% by the end of 2012.

Fiscal Policy: There are a considerable number of moving parts in the fiscal policy outlook. First, DE assumes that Congress will adopt by year-end much of the Obama stimulus proposals of September in an effort to offset significant coming fiscal drag. Second, we do not think that the Congressional deficit reduction super-committee will be able to produce a "grand" $4 trillion plan to stabilize the debt to GDP ratio by 2020 or even the requested $1.5 trillion compromise plan, as the Republicans will not vote for a plan with taxes in it and the Democrats will not vote for one that does not. This means an automatic sequester will kick-in in fiscal 2013 in order to provide $1.2 trillion in 10-year budgetary savings, in addition to the $0.9 trillion already agreed upon as part of the August debt ceiling compromise. This sequester may be overturned after the 2012 election but that assumes Republican control of both house of Congress and the presidency. Otherwise ongoing gridlock will support the automatic sequester. All this risks another credit downgrade in 2012H1. Finally, the bulk of the Bush era tax cuts will be extended past 2012. The only question is whether the tax cuts to the wealthy (one-fourth of the total cost of extending the Bush era cuts) will be extended.

Earnings and Equities: Earnings fundamentals remain positive for most sectors and the latest Q3 results show companies weathering the growth slowdown and higher commodity costs. The major themes underlying corporate earnings performance remain in tact: Overseas sales are compensating for a weak U.S. consumer; U.S. capital investment growth lifts sales in the Info Tech, Industrials, and Materials sectors; Financials earnings are propped up by

accounting gains and improved credit quality, while revenues are held back by stagnant lending and underwriting and volatile trading. In light of the latest set of earnings results as well as a qualitative and quantitative upgrade to the U.S. outlook, DE has raised its S&P500 operating EPS forecasts to $98.34 (+13.4%) in 2011, $107.64 (+9.5%) in 2012, and $116.15 (+7.9%) in 2013. These forecasts incorporate assumptions of positive though sub-par growth in the U.S., a mild Eurozone recession, and a soft-landing in China. Assuming some gradual improvement in price-multiples, these earnings projections imply fair value targets on the S&P500 of 1,300 by the end of this year and 1,400 by the end of 2012.

Consumption and Employment: Despite deep-seated pessimism, expressed through major sentiment indices, consumers continue to spend, albeit at a sub-par pace. There are, however, several headwinds facing the U.S. consumer that will crimp spending growth going forward. First, a jobless recovery is keeping unemployment high and income growth weak. DE doesn't envision the unemployment rate falling below 8% until the end of 2012. A return to 5-6% unemployment is even further out in the horizon. Second, households are de-leveraging, returning debt-to-income ratios to more sustainable levels in a process that could unfold well into 2015 if current rates of income growth and debt reduction persist. Finally, persistently high energy prices and rising food prices are eating into households' discretionary spending. As confidence in the recovery builds, commodity prices will move even higher. All told, the Q3 rebound in consumer spending growth to +2.4% is probably as good as can be expected going forward. DE is currently projecting 2.25%-2.5% spending growth through 2013. At 70% of the economy, sub-par consumption growth translates into sub-par GDP and jobs growth.

Inflation: Deflation concerns that abounded a year ago have largely disappeared. Inflation rates have moved higher, thanks to QE2 and energy price shocks, but DE still maintains a benign inflation outlook. Despite a massive expansion of the Fed's balance sheet and acceleration in money supply growth, the economy remains dependent on productivity gains for growth. As labor hours and compensation languish, unit labor costs fall, keeping a tight reign on many final goods prices. Meanwhile, a key ingredient for sharp acceleration in inflation historically – consumer expectations – appear firmly under control. The risk, of course, is that these conditions could change rapidly, for instance if the Fed's inflation-fighting credibility is diminished. But we would have to see a pick up in demand and a decline in unemployment as well. Nevertheless, policy missteps by the Fed remain the central risk to inflation. Risks aside though, DE expects core PCE inflation of around 2.25% in 2012 and 2013. This is above the Fed's desired rate of inflation, however, and will be monitored closely. Confidence in the recovery should boost commodity prices that will flow through (to some degree) to certain final goods prices, particularly food, energy, and apparel. Little upside is expected to housing prices.

The Dollar: As long as the Eurozone crisis persists, the dollar will be viewed as the safest haven around. As the crisis moves towards resolution, however, the market's focus will pivot back to the U.S.'s own debt/deficit problems. At that time, the long-run negative fundamentals surrounding the dollar will reassert themselves. The dollar will return to a gradual process of devaluation as investors and central banks chose to store wealth in a diversified basket of currencies and commodities. DE projects a further 5-10% decline in the trade-weighted dollar by late-2012.

GLOBAL ECONOMIC THEMES AND FORECASTS IN DETAIL

United Kingdom: Although volatile, the economy has actually shown no underlying growth in the last few quarters. This is probably a result of a swing in fiscal policy as well as some pay-back for aberrant strength earlier in 2010. In addition, headwinds coming from the still very fragile banking sector and consumer retrenchment may have been more evident, underscoring the very subdued nature of domestic demand. All these factors are damaging confidence, particularly and increasingly, for the beleaguered consumer. Their on-going impact is likely to mean continued unevenness and fragility lies ahead, preventing GDP this year or next growing even by the 1.3% pace seen in 2010. As for inflation, it has been higher than expected of late but may now have reached a (belated) peak. Even so, while causing some consternation at the BoE, this resilience is hardly indicative of underlying domestic pressures returning, especially given the still soft monetary dynamics in the UK. As a result, the BoE has recently provided fresh stimulus by reviving the gilt purchase plan: further such action may lie ahead.

Eurozone: Growth remains fragile with geographical divergences still the order of the day. What little strength there is looks to be linked to the fading global backdrop, with little sign of any clear domestic momentum and with consumer demand looking more suspect. Moreover, and as softening business survey numbers highlight, the risk is that whatever

upbeat signs may be seen in what could be a solid Q3 GDP performance are now being tempered, if not reversed, by softer global growth and particularly by the hurdles still facing the domestic economy, not least the on-going fiscal consolidation and the inter-related fragility of the banking system. The latter are manifest in on-going, if not deeper, sovereign debt worries which policy makers seem unable to address convincingly. As a result, GDP growth, after a likely pace of just over 1½% in 2011 is likely to slow sharply into 2012, with business surveys even highlighting the risk of fresh contraction in the current quarter and perhaps into 2012. This still weak backdrop, together with weak monetary dynamics, implies that that fresh price softness surely beckons. The shift towards greater fiscal consolidation and the need to support the banks and guard against fresh sovereign debt turmoil meant that the conventional tightening which the ECB put in place earlier this year was reversed in November, a bit sooner than anticipated.

Canada: Signs point to a modest rebound in activity in 2011H2 after brief contraction in Q2, but near-term performance faces both external and domestic headwinds. 2011 and 2012 are now tracking nearer to 2% than 3% for GDP growth, and that scenario assumes a reasonably-contained – not "resolved" – euro area situation. Downside risks to that outlook remain heightened, but under DE's expectation that U.S. growth trundles higher, the Canadian economy should stave off recession fears as well. Nevertheless, the export sector remains overwhelmingly exposed to deleveraging dynamics in developed economies, leading to export underperformance relative to broader recovery in global trade volumes. CAD strength, weak productivity trends, and higher labor costs continue to weigh on competitiveness. Consumer spending was a bright spot early in the recovery, but still-elevated energy prices and high consumer debt loads are tempering households' willingness to spend, with real retail sales flat for much of 2011. Debt burdens on some metrics exceed those seen during the U.S. consumer boom, and are a concern if the housing market stumbles.

On the monetary policy front, global financial system fragility, fiscal consolidation in advanced economies, and downshifting EM growth all support maintaining an accommodative policy stance for an extended period – likely deep into 2012 with a good chance of longer. Core inflation pressures remain well contained, and headline inflation is decelerating as energy prices come down from earlier peaks. Cuts (from the current 1%) face a high bar – rates are still stimulative, credit available, and there are lingering worries about future debt service costs. Benefits of further accommodation could very well be offset by risks of a less robust household balance sheet situation down the road. For investors, the consensus view holds that relatively better fundamentals in terms of lower deficits and debt make Canada a safe haven in the developed market government bond space, while the energy and precious metals sectors provide indirect exposure to the EM growth story. But price matters. Widely-held views have a habit of resulting in poorer relative long-term returns, on average. For now, while the government balance sheet argument could be upended in an absolute sense, it should still hold up relative to DM peers, even under more pessimistic growth outcomes. Finally, the commodity sector view is a longer term theme, with the "China story" to be closely watched, given outsized impact of developments there on marginal demand in the resource-sector.

Japan: Japan's economy has rebounded from the post-Tsunami crash, but generally not back to pre-disaster levels, and now confronts the global-demand uncertainties faced by all the Asian exporting nations—with difficulties compounded by the strength of the yen. Third-quarter GDP results will show the main force of the recovery, though monthly data, particularly on exports, became very mixed as the quarter-end approached. Fourth-quarter growth will likely settle back to trend, at best.

There is still underlying shakiness in private consumption, and labor-market uncertainty remains serious. Business investment, meanwhile, has slid dramatically from the peak rates, with no clear bottom formed even yet. The March 11 earthquake, tsunami and nuclear crisis made the situation even more precarious for a while, and confidence has remained shaky—business expectations, at least as measured by the TANKAN survey, point to little net progress beyond the disaster recovery phase. Meanwhile, concerns are growing about adverse effects from yen strength, and about the prospect of lasting employment losses as production is shifted abroad. External factors have become much more important, and the outlook is very cloudy.

PM Kan, following through on a promise made to obtain legislative cooperation, tendered his resignation, and the Democratic Party of Japan chose Finance Minister Yoshihiko Noda as its new leader, and as new PM. Noda, a self-made man, is regarded as a comparative fiscal hawk, reasonably pro-business, and perhaps more willing to compromise with the opposition parties that have stymied DPJ initiatives in the Upper House. As Finance Minister, Noda conducted a major unilateral currency-market intervention aimed at weakening the yen, but the lack of any lasting impact may have cooled his enthusiasm for such steps.

On the monetary policy front, financial market functioning has improved from the worst, but Eurozone ripples and economic weakness abroad have prompted a new surge in the yen—and intense concern about it among government and central-bank officials. However, currency-market intervention is not the first-choice policy, and any of it done will be opportunistic. Some BOJ credit-easing programs have been allowed to expire, but a large new bank-liquidity facility was put in place to ease deflation fears in late 2009—and expanded since. Another newly instituted facility is buying higher-risk assets, as well as JGBs—possibly in excess of the BOJ's long-standing internal limits.

Emerging Markets. The global growth slowdown has clearly reached emerging market shores and substantially changed the balance of risks that guides policymaking. To be sure, a static snapshot of economic activity across EMs would show these countries as still-in-expansion-phase. Moreover, those which have decelerated most significantly (such as Brazil) continue to post rates of growth that are solid in their own historical context. It should also be noted that the slowdown is not uniform across and within regions as the EM term obviously groups economies of a broad diversity not just on account of growth history and potential but also risk.

The slowdown is perhaps most noticeable in the EM manufacturing sectors. From Brazil to China, and even still-booming Turkey, industrial production has slowed markedly in the past two quarters. This deceleration, along with a strengthening US dollar and market fears of a global recession, have brought commodity prices down from their recent peak, eroding the outlook for commodity-exporting nations in South America and elsewhere.

These adverse trends are unfolding in the midst and against the background of relatively high capacity utilization and, in a number of important cases (Brazil, for example) labor market conditions that approach full employment. As a result, central banks continue to exhibit some reluctance to ease policy in an aggressive manner. The turn towards easier money has begun, but lingering inflation-concerns (and still-high, although diminishing, annual inflation) induce caution among policymakers. Nonetheless, it is hard to see how—given EU and US trends—further easing can be avoided, to prevent the current situation from morphing into recessionary conditions. This latter outcome remains unlikely, unless a new global financial crisis takes place.

China. Recent data point toward continued growth at a pace consistent with gradually-easing inflation; a soft-landing—*for now*. This caveat reflects not only anecdotal and statistical municipal-level information that suggests a weakening trend in real estate, but the lingering uncertainties that taint the global economic outlook. The former could still mean a downward surprise in investment. A recession-hit global economy would translate into a further deceleration of manufacturing, a softening of the labor market, a weakening of household spending and very likely a renewed fiscal push. Moreover, the policy-tightening of the past 18 months has been considerable. Such policies have lagged consequences that might still intensify what, thus far, appears like a benign cooling. The risk of a hard-landing has therefore not gone away; it has actually increased during the past few months, if one considers both the still-uncertain consequences of earlier policy steps and the deterioration of China's export markets.

Nonetheless, it is hard not to view the most recent data as constructive from a financial investor's perspective: the economy seems to be functioning satisfactorily (against official targets) and there would appear to be no need for further policy tightening. On the contrary, because of global conditions, the rather sideways growth and inflation motion that has been documented recently--the incipient *soft-landing*--would probably need to be supported in the quarters ahead by a moderate-to-strong easing of monetary policy. The timing of such shift is unusually difficult to pinpoint because much depends on trends and policymaking elsewhere. From today's perspective, if --as DE expects-- annual inflation falls towards 5% in the next few months, either interest rates or bank reserve requirements could begin to come down as early as the first quarter of 2012. Interestingly, the central bank and the government still appear reluctant to give a (strong) signal regarding such possible policy shift, but the process of turning the ship around has already started, judging by recent statements urging the banking system to improve their provision of credit to smaller firms.

Brazil. As expected, the central bank of Brazil (BCB) reduced the target for its benchmark Overnight-Selic rate by 50 basis points, to 11.5 percent. Given presently known trends and risks, plus the central bank's public statements and their recent policy history, further cuts are nearly certain in the next few months, likely as little as 100 basis points, possibly as much as 200—unless external events push policymakers into a more aggressive easing. The central bank is thus revealing a rather dovish view of the outlook, especially because *current* annual inflation is outside the tolerance range's upper boundary (6.5%). To be sure, there is a reasonable expectation that annual inflation has probably peaked for now.

Nonetheless, the key determinant of the central bank's policy shift is the deceleration of domestic economic activity and the darkening clouds of Europe's and the US's growth and financial problems. The external-sector impact on Brazil's economy is already visible in the performance of the country's industrial sector, which is now expanding at a minimal rate. To be sure, the underlying industry detail is not indicative of a depressed outlook. Moreover, on the dominant services side of the economy demand continues to benefit from a solid and improving labor market. Unemployment is oscillating around record-low while formal-sector jobs continue to expand at a strong, although on average somewhat-slower pace.

*R*eal GDP growth in this down phase of the business cycle seems to have solid support that could keep growth in the 3%-to-4% range if a global financial crisis is avoided. It is nonetheless clear to the BCB that risks to growth, even in a no-global-crisis scenario have risen to the extent that the outlook for China and other key economies deteriorates and turns uncertain. On the other hand, given tight conditions in the labor market the central bank is also taking a risk as it eases monetary policy. In fact, from a near-term perspective what the bank is implicitly signaling is a willingness to tolerate higher-than target inflation in exchange for an insurance policy against the developing downward growth-dynamics in the world economy and the chance that conditions might be even more challenging in 2012.

Korea: Third quarter data show seasonally adjusted GDP growing at a marginally slower pace (0.7% quarter-on-quarter versus 0.9% quarter on quarter in the previous three-month period). Expenditure components of GDP display (by and large) a similar pattern, but the pick up in Construction and Exports (plus some help from government consumption) is suggestive of a stable-growth economy, rather than one descending gradually into a deeper slowdown. It should be noted, however, that the data release also suggests that risks to the outlook have in some ways increased. Real GDP growth has, for example, become more dependent on exports (+2.0% quarter-on-quarter in July-to-September; 1.2% in the second quarter).

This is a plus as long as trade (particularly China-centered flows) remains strong— questionable in light of global developments and of what seems to be Chinese policymakers' own expectation of a considerably slower industrial activity in that country. Meanwhile, facilities investment is feeble, having posted a negative 0.4% quarterly rate in the third quarter, following the only positive quarter of growth in one fully year, and private consumption continues to expand at an annualized rate considerably below that of GDP's-- pointing towards the potential for the latter to slow toward the 2% range (from the current 3.4% pace) with relative ease if the export sector weakens in the months ahead.

Thus the picture, which can be read through the optimistic lens as a *glass-half-full (that is not emptying)*, should also be viewed as vulnerable against the background of a challenging global outlook. From the policy standpoint the data do not reveal such deterioration on the growth side that would force the Bank of Korea to ease policy. The situation is rather one of mediocre but stable growth, seemingly non-inflationary and perhaps soft enough as to justify in principle a shift of attention in the direction of recession risk. In this context, it is hard to see the central bank, who sees current performance as sub-par, hiking rates again (the last increase was in June, bringing interest rates to 3.25%) and in fact the odds of a turn towards easier money are marginally increased—given a decelerating annual inflation, likely to drop below 4% in the near-term. However, such move would probably occur only as a reaction to a significant deterioration of conditions, particularly in Korea's key foreign markets.

Mexico: The data confirm suggest that Mexico's economy has settled—at least for now—into a pattern of growth that would have real GDP expand in the 3% neighborhood, down from 5.4% in 2010 and below earlier, more optimistic, forecasts. To be sure, this is certainly not a bullish outlook, and it is also vulnerable given Mexico's close economic ties with the United States. Still, it is clear that the numbers do not (yet) point to recessionary conditions as the next stage in the cycle. Were it not for the risk that adverse developments could originate north-of-the border, one would be tempted to say that that there is a solid floor under the Mexican economy's cyclical oscillation, with a high likelihood that the pace of growth during the foreseeable future would be neither impressive (i.e. 5% or more), nor sub-par. If anything, the continuation of a tame inflation environment (CPI and core CPI are rather stable and within the central bank's tolerance range) plus the maintenance of a positive employment and labor incomes trend would add some potential upside. Policy implication: a modestly growing economy subject to high external risk and tame inflation suggest that Banco de Mexico's may be forced to ease further to keep domestic demand on track.

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