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DECISION ECONOMICS, INC.
Information for Decisions™

Global Themes and Forecasts

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Contents

Overview and summary 1
U.S. 2
U.K. 3
Eurozone 3
Canada 3
Japan 3
Emerging Markets 4
China 5
Brazil 5
Turkey 5
Mexico 6

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Overview

- **Global:** Global recovery outlook has stabilized, despite the unfolding Eurozone recession. The Eurozone downturn has gotten no worse, while the US outlook has improved modestly and the growth slowdown in the EM is moderating. Monetary policy has shifted or is shifting towards accommodation to support growth in most regions of the world. Fiscal consolidation is ongoing most particularly in Europe and Japan, with the US unlikely to join the deficit reduction club to a sizeable degree until 2013.
- **U.S.:** Recent economic data point to a greater chance of a self-reinforcing sustainable though sub-par economic recovery for the U.S. 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:** The headwinds of a fragile banking sector and ongoing fiscal retrenchment have restrained growth to a crawl recently. All these factors are damaging confidence, meaning little growth this year with a downturn not out of the question. With inflation falling, the BoE may opt for additional stimulus measures.
- **Eurozone:** A Eurozone recession is surely underway, exacerbated by the ongoing credit crunch and fiscal consolidation. While we think the recession will end by the end of 2012, much worse outcomes are possible. The recent rating downgrade increases the pressure for the ECB to stepping up its bond purchases.
- **Japan:** Japan's rebound from the post-tsunami crash has petered out in Q4. Some improvements in exports, despite the strong yen, should help promote a modest reacceleration of growth in 2012.
- **Emerging Markets:** A substantial growth slowdown underway should draw to close later this year. Despite the evident loss of steam and the increase of external-sourced risks, the situation can hardly be called recessionary yet, as domestic demand is supported by a variety of different factors from country to country and region to region, including in many cases low unemployment rates and, lately, a turn towards neutral-to-expansionary monetary policy.

DE Global Economic Outlook
(Real GDP Growth)

	2011	2012F		2013F	
World*	3.0	2.7	↓**	2.9	↓
U.S.	1.8	2.6	↑	2.5	↔
U.K.	0.9	0.5	↓	1.4	↔
Eurozone	1.5	-0.5	↓	1.0	↓
Canada	2.3	2.0	↓	2.3	↓
Japan	-0.5	1.0	↓	1.5	↔
EM Asia, NICs	7.6	6.7	↔	6.4	↔
Brazil	4.0	3.7	↑	3.9	↑
Mexico	3.7	3.2	↑	3.4	↑
Russia	4.3	4.5	↓	4.2	↓
India	7.6	7.5	↔	7.3	↓
China	9.2	8.0	↔	7.4	↔

*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

US: a self-reinforcing recovery more evident.

But growth will still be subpar, below 3%.

Overview: Despite the ongoing worries about the downside risks, recent economic data increasingly point to a sustainable though sub-par economic recovery for the U.S. The improvement in the labor market, in which the unemployment rate has fallen to 8.5%, should continue to support consumer gains above 2% this year. While investment spending appears to have stalled in 2011Q4, this is mainly a pause after barn-burning gains earlier in 2011. With EM growth stabilizing at a relatively high rate, the export sector should be a mild supporter of growth this year. However, the government sector remains a considerable drag, a major reason why we think GDP growth of 2.6% this year falls short of its 3% plus historical average pace. Headline inflation will continue to fall to about 2.5% in the medium-term, with core inflation grinding higher to a similar pace.

Risks shifting favorably, with double dip worries much lower.

Downside risks still evident, though

Risks Shifting: Against this backdrop, DE has become more confident in its baseline outlook for the recovery, raising the "muddle-through" probability from 60% to the 60% to 65% range. The likelihood of a double-dip recession, which has been a high as 10% last year, fell to 5% in November and virtually zero in January. Nevertheless, downside tail risks to the outlook remain. A Japan-like growth recession alternative is holding at 10%, while risks from a credit crunch/debt crisis/Eurozone recession etc remain at 10%. But the possibility of a delayed takeoff, in which US expansion finally achieves a 3% "cruising" speed has been lifted from 15% to the 15% to 20% range.

Policy rates will remain low until at least 2013. Fed ready to do more.

Monetary Policy: The Fed will follow through on its "forward guidance" and not lift policy rates until mid-2013 at the earliest. The relatively positive 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.

Fiscal policy is turning restrictive at long-last, with the risk of too much tightening in early 2013.

Fiscal Policy: Fiscal policy is turning restrictive in 2012, even with the assumption that a small stimulus package (including the payroll tax cut and supplementary UI assistance) is extended through year-end. With the failure of the grand compromise, an automatic sequester will start in early 2013 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 2011 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. Finally, the bulk of the Bush era tax cuts will be extended past 2012 (costing $3.5 trillion over 10 years). The only question is whether the tax cuts to the wealthy (costing $0.8 trillion) will be extended. The risk is that fiscal policy could turn "too restrictive" in early 2013. All this risks another credit downgrade in 2012H1.

Investment implications:

While earnings are slowing, still positive fundamentals support equities. Fair value estimate remains 1300 for the S&P 500.

Equities: Earnings fundamentals remain positive for most sectors, despite the expected slowdown in Q4 earnings growth. DE estimates of earnings are unchanged from November at $98 (+13%) in 2011, $108 (+10%) in 2012, and $116(+8%) in 2013. These forecasts incorporate assumptions of positive though sub-par growth in the U.S., a mild Eurozone recession, and a relatively "soft-landing" in EM nations. Assuming a conservative PE multiple of 12, this implies a fair value estimate of roughly 1300 for the S&P 500 this year.

Even though policy rates remain low for long, longer-term interest rates will retreat to 3%.

Interest rates: At the moment, Treasuries are trading on a safe-haven bid and skepticism that the US recovery will continue this year, 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 3.0% by the end of this year.

Fundamentals suggest a lower dollar eventually but growth differentials favorable near-term.

Dollar: The underlying fundamentals suggest a weaker dollar, given the large current account gap. But growth differentials in the U.S. compared to other industrialized nations suggest some near-term support. Once the Eurozone recession has run its course this year, DE expects the trade-weight dollar to be down about 5% from its December 2010 average. (M. Cary Leahey)

GLOBAL THEMES AND FORECASTS IN DETAIL

UK: Little growth likely, with very clear downside risks…..

United Kingdom: 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. A flat, if not weaker, tone is likely in coming quarters with the risk of a modest contraction far from negligible as headwinds coming from the still very fragile banking sector and fiscal retrenchment continue. All these factors are damaging confidence, particularly and maybe increasingly, for the beleaguered consumer. The on-going impact is likely to mean GDP this year will grow by no more than around ½% and with very clear downside risks if there are deeper ructions emanating from the Eurozone. As for inflation, it is now falling and should drop significantly in coming months. All of which suggest that the BoE may opt to provide further stimulus by additional gilt purchases, probably as soon as next month. (Andrew Wroblewski)

With inflation falling, the BoE may provide more stimulus.

Eurozone is in recession, but far from a free-fall (yet).

Eurozone: The Eurozone economy is probably already in recession. While geographical divergences involving ever more acute weakness in some peripheral countries remain very much the order of the day, even the likes of Germany are probably experiencing some economic contraction. Even so, the Eurozone is far from being in free-fall: while downside risks may be amassing, the extent to which they may actually be materializing is still limited, with it notable that business surveys have seemingly stopped hemorrhaging.

Risks of a much worse outcome abound.

Even so, major hurdles still face the domestic economy, not least the on-going fiscal consolidation and the inter-related fragility of the banking system, the latter manifesting itself also in the form of an emerging credit crunch. Meanwhile, inter-related sovereign debt worries continue, while consumer spending seems to be in a clearer downturn. As a result, GDP growth, after a likely pace of 1½% in 2011, is likely to contract by around 0.5% in 2012, with the hope being that an easing in monetary conditions and some global recovery will allow the recession which started at the end of 2011 to end by mid-year.

The ratings downgrade only increases pressures for more bond purchases by the ECB.

There are obviously risks of a much worse outcome should the sovereign debt situation worsen afresh, possibly a result of what could yet be a disorderly default in Greece. This clearly weak backdrop, together with weak monetary dynamics, implies 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 implies that the ECB may put in place both more conventional and unconventional easing in coming months. (Andrew Wroblewski)

Canada: external risks remain but growth should top 2%

Canada: External headwinds continue to buffet the economy, as a lurch lower in developed market growth estimates, and deceleration in key emerging-markets hit the resource sector hard in the second half of 2011. Looking ahead, intact upward momentum in the U.S. should keep the Canadian economy supported at about 2% growth in 2012, perhaps a bit firmer thereafter if European crises remain contained. Any firmer a track will be limited by deleveraging in advanced economies, the strong Canadian dollar, and weak productivity trends.

Canada in 2012 looks a little like the US in 2006.

As global growth slows, household spending and business investment will have to take up the slack, leaving the Bank of Canada hoping low rates – at least on the business side – spur investment despite the more-uncertain business environment. The problem is household spending faces its own unique set of risks, with consumer balance sheets along some metrics as-or-more stretched than U.S. consumers' were during the housing bubble. Policymakers' hope is that earlier moves to tighten mortgage requirements, and warnings about high debt levels, keep downside risks at bay. But stern words can only do so much; rates are low, and recent history has done little to dissuade prospective homeowners from seeing housing as a good investment. That will change, given how housing cycles have always gone, but could be pushed beyond 2012, given elements of DE's U.S. and global baseline scenario. Risks remain, and catalysts linger. (Andrew Husby)

Japan: rebound from the post-tsunami crash has petered out.

Japan: Japan's economy has finished its immediate rebound from the post-tsunami crash, with most national indicators turning uneven since the summer and many turning clearly negative in November—though rebuilding activity in the affected region remains very restrained and should pick up gradually. Meanwhile, the external environment has deteriorated considerably, and the outlook there continues to be highly uncertain. December TANKAN results showed widespread expectation among business leaders that general conditions will deteriorate further in the first calendar quarter. Currently, odds favor roughly flat GDP in Q4, and not much more in 2012Q1,

with risks tilted to the downside until the international situation is more stabilized.

Stronger exports should led to a modest growth reacceleration.

Bank of Japan analysis, incorporating the TANKAN results, has portrayed the economy as being in a sideways-motion phase shaped by an offset between weakening exports and upward pushes coming from domestic consumption and disaster-area recovery spending. On the basis of newly arriving data, that portrayal of the situation is becoming slightly ragged around the edges. Exports have indeed weakened, and will likely continue to weaken until the general Asian economic situation is decisively stabilized. Meanwhile, consumption indicators took a big seasonally adjusted step down in November, from an October level that just matched the third-quarter pace. There was a more positive indication on business investment, with November machinery orders rebounding after two months of decline, but the underlying trend is flat at best—and officially projected to be in decline.

Business confidence is the issue, with employment the link by which it could shift consumer spending, and the economy, most directly. So far, indications are neutral, with TANKAN employment indexes showing levels mildly "excessive," on net, as of December and pointing to little change in the first quarter. On a month-by-month basis, however, labor demand is still picking up gradually, with the jobs to applicant ratio ticking up slowly but steadily. But, that indicator is less than half way back to the pre-crash level.

In BOJ thinking, the engine of eventual growth re-acceleration will be strengthening exports to emerging economies, where domestic development will create demand for Japan's advanced products. But, the emerging-market outlook is very cloudy at the moment. Meanwhile, concerns are growing about adverse export effects from yen strength, particularly with respect to Asian economies with dollar-pegged exchange rates, and about the prospect of lasting domestic-employment losses as production is shifted abroad.

Currency intervention could continue.

Currency-market intervention, already conducted in a very big way in Q4, remains a live possibility, with the Noda Government moving to increase the cap on Ministry of Finance borrowing to finance operations by the equivalent of nearly $400B, and the Bank of Japan, so far, content to accommodate the moves on an unsterilized basis. Still, Governor Shirakawa, he of the Chicago monetarist background, has chosen to emphasize that a strong currency has advantages too, and to recommend that the non-export-driven sector of the economy adjust itself to capitalize on them. In any case, the common perception of yen strength as reflecting safe-haven flows would imply that the situation is not permanent—as would the demographic trends reducing Japan's savings over time.

Controversy over fiscal reform and the consumption tax proposals

Prime Minister Yoshihiko Noda has lived up to his reputation as a comparative fiscal hawk, proposing staged increases in the rate of consumption tax in combination with social security reforms. He argues that "there are no differences between the ruling and opposition camps, the responsibility of all politicians has been called into question," but has encountered a firestorm of opposition, with members of his own Democratic party leaving on the grounds that the move conflicts with campaign promises, and the main opposing Liberal Democratic Party refusing to negotiate, and demanding new national elections, on the same premise. Noda himself has said "I pledge that I will seek the opinion of the people after carrying through what we should do," and has indicated that an earlier dissolution of the lower house is "among various options (that) may be considered…I'll stake my political life on carrying out the reform." (Pierre Ellis)

EM: Substantial growth slowdown underway

Emerging Markets. The most evident trend in emerging markets towards the turn of the year is a substantial slowdown. Manufacturing indicators, in particular, appear rather soft, in some cases lower than a year ago, while in others (China) are moving along a still decelerating trend. Emerging market trade flows are, unsurprisingly, reflecting the weakening of manufacturing, especially in the industrial centers of Asia. Asia ex-Japan's exports, for example grew as of November at an annual pace only comparable with the beginnings or endings of the two previous global recessions (2001, 2009). Excluding China's exports, the performance was even more subdued, with totals barely rising on a year-on-year basis.

But no recession as domestic demand is supported by strong labor markets and a turn towards expansionary monetary policy.

Despite the evident loss of steam (and the increase of external-sourced risks, i.e., Europe's apparent march into recession) the EM situation can hardly be called recessionary yet, as domestic demand is supported by a variety of different factors from country to country and region to region, including in many cases low unemployment rates and—lately—a turn towards neutral-to-expansionary monetary policy. Central bankers are breathing more easily as inflation, fueled in recent years by rising commodity prices and fast growth, has eased very notably.

The dark side of this positive development is, for some emerging markets, that the key source of

Falling commodity prices a mixed blessing.

the ongoing disinflation is lower commodity prices, which hurt export revenues for an important subset of the EM world, including Brazil and the rest of South America. Still, the decline of inflation helps bring about a very important short-term change that might, within months, push the decelerating-growth trend in reverse: a turnaround in China's macroeconomic policy as the authorities there act on what they, with increasing clarity, describe as a shift in the balance of risks in the direction of recession. (Francisco Larios)

China: Within the export-led economic slowdown are signs of improving consumer spending.

China. The latest data batch on the Chinese economy provides no surprises, no significant deviation from what has been a visible but seemingly benign cooling trend. One exception: a hint of improvement on the domestic consumption front is contained in the retail sales statistics, which has moved opposite real GDP growth and accelerated in the last few months of the year. This is a constructive development because export growth continues to slow and China's export markets in Europe are entering recession, and also because a rising consumption share of GDP is a key medium-term necessity from the standpoint of China's policymakers.

The turn to expansionary monetary policy will continue, helping to stabilize growth later this year.

Policymakers will probably not find in the latest figures any reason to change course, but rather additional validation for their approach, especially as regards timing: the tighter monetary policy applied for the past 18 months would be seen as successful in putting the economy on a cooling path, yet far from recession; and as the global environment becomes more challenging and risky, while domestic inflation drops, a policy easing should now be applied to keep growth at the desired levels by supporting consumer spending. And incidentally, consumption would be not only the desired beneficiary of easier and cheaper credit, but also the recipient of targeted fiscal stimulus.

It remains reasonable to expect some acceleration of lending, further reserve requirement cuts, and possibly some interest rate reductions over the foreseeable future. It also remains reasonable to expect the Chinese economy, in the absence of a financial implosion in Europe, to do relatively well in terms of real GDP growth, even if near-term (the next two or three quarters) the pace of activity might decelerate further. (Francisco Larios)

Brazil: While risks have risen, the strong labor market gives a solid floor to GDP growth.

Brazil. Given presently known trends and risks, plus the central bank's public statements and their recent policy history, further interest rate cuts are nearly certain in the next few months, possibly as much as 200 basis points. The key determinant of the central bank's policy shift is the deceleration of domestic economic activity and the darkening clouds of Europe's financial problems and recession. The external-sector impact of the global slowdown 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 rates while formal-sector jobs continue to expand at a strong, although on average somewhat-slower pace.

The central bank is willing to absorb higher inflation to support growth and avoid a recession.

Real GDP growth in this down phase of the business cycle seems to have a solidly-supported floor that could keep growth in the 3%-to-3.5% 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. On the other hand, because of the tight conditions that prevail in the labor market, the central bank is also taking a risk as it eases monetary policy. From a near-term perspective the bank is implicitly signaling a willingness to tolerate higher-than target inflation in exchange for an insurance policy against the potential disruptions arising from the European recession and the continent's debt woes. (Francisco Larios)

Turkey: Policy dilemma…

Tighter policy to slow growth and contain inflation risks a recession…

Turkey: Debate regarding monetary policy has turned political in Turkey, with the prime minister warning that the central bank must not give into the demands of what he calls "the interest rate lobby". The Turkish central bank has maintained its benchmark repo rate stable but let the cost of overnight borrowing to move up sharply since mid-October. There has been some downward movement in the overnight rate in recent days. While there were external reasons for such drop (an improvement of financial sentiment in the Eurozone) the decline of the overnight rate coincided with Erdogan's "offensive", and this has left markets with reasonable doubts as to the central bank's present--and most importantly, future--independence. Overt political intromission adds to the complexity of monetary policy-making at a time when the TCB appears to be conflicted about its strategy, given both internal conditions (the rebound of inflation and a large and resilient current account deficit) and external uncertainties and risks related to Europe's troubled economy.

Keeping policy loose

Since the last quarter of 2010, facing declining inflation and a widening current account deficit

could weaken the currency and exacerbate inflation

(approximately 10% of GDP, above the historical norm, which is closer to 7%) the central bank adopted the unconventional approach of lowering rates in the midst of an accelerating expansion, with the aim of weakening the lira. Lira adjustment would lead to a narrowing of the current account shortfall, identified back then as the most important threat to the economy's stability. Within the strategy, money creation would be slowed by increasing bank reserve requirements. One year later, though, a strong consumption-led expansion has impeded progress on the current-account front, precisely at a time when the risk of financing the external shortfall has risen as a consequence of recessionary conditions in much of Europe. Meanwhile, consumer price inflation is back into double-digits, a development which at least some policymakers attribute to the "success" of earlier policy in helping lower the value of the lira.

Political intervention in Turkey seems to push the central bank to loosen policy to support growth.

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Hence the policy dilemma: to tighten money now, for the purpose of containing domestic demand and slowing the pace of imports, as well as to reduce inflation, means to accept a high risk that such policy would be intensifying the cooling already underway to the point of recession; to keep policy loose for the purpose of protecting against mounting risks to growth means, probably, additional weakening of the lira (especially as foreign reserves become less abundant) and faster double-digit inflation down the road, making a sharp policy turnaround inevitable at some point. Either of these choices carries potentially high costs. Political intervention seems to be pushing the central bank into the second approach, on the expectation that it would be less disruptive of growth. There is a significant question mark around this expectation, however, as monetary policy becomes a more evident concern for the markets, and because of Turkey's substantial trade exposure to Europe. The bottom line is that the near-term growth outlook for Turkey seems increasingly challenging, with likely growth in the low single-digits and broad room for a downside surprise. (Francisco Larios)

Mexico: Growth has moderated to a lackluster 3%.

Tame inflation allows the central bank to focus on growth

Mexico: The data confirm 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 positive employment and labor incomes trends would add some potential upside. (Francisco Larios)

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