

## GLOBAL ECONOMIC OUTLOOK



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## Another Year of High Volatility Ahead

**SENTIMENT IN GLOBAL CAPITAL MARKETS** fluctuated wildly in 2011 between fears that the European sovereign debt crisis may cause another global financial contagion and hopes that credible backstop mechanisms can be found. We believe that the generous liquidity provision for European banks put in place by the European Central Bank (ECB) in December will be sufficient to avert another financial disaster, but are also mindful that restoring credibility to the shaken European currency union will take time.

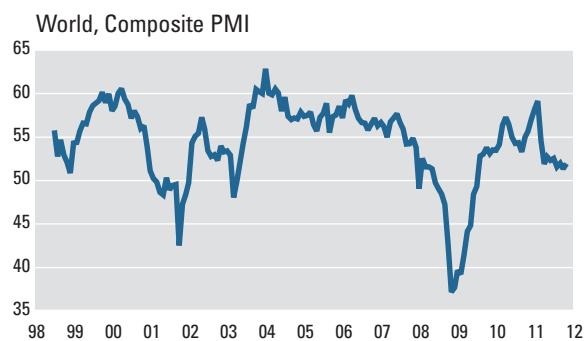
Meanwhile, the world economy has slowed sharply (**Figure 1**). Europe has entered a classic recession and hard-landing fears have resurfaced in China. On the positive side, the US economy

has shown signs of strength recently, including positive momentum in the capital goods and automotive industries.

We believe the global cyclical environment will remain challenging in 2012, and we are cautious in our growth outlook. Europe's recession will take time to play out, and China's economy is unlikely to recover before the second half of 2012. The US will be vulnerable to growth setbacks as it will have to address its fiscal imbalances over the next two years.

**Figure 1**

### Global Cycle Stabilizes Near Recessionary Levels



Source: JPMorgan

### KEY POINTS

- ▶ While the ECB has addressed near-term liquidity needs, the euro area needs a sustainable fiscal framework to restore market confidence.
- ▶ We expect continued economic expansion in the US, underpinned by falling inflation and only modest fiscal restraint.
- ▶ While China faces a near-term slowdown in its property sector, it should again be a growth engine for the global economy by the second half of 2012 and into 2013.

**Policy and Political Reform Only Go So Far**

Monetary policy is responding to the freeze in global credit markets. In Europe, central bank balance sheets are expanding aggressively (Figure 2), somewhat in contrast to the conservative rhetoric maintained by the ECB. In China, the prospect of lower inflation will give policymakers the necessary flexibility to inject much-needed liquidity again. Even the Federal Reserve has hinted that it could launch another round of quantitative easing should the US economy warrant this stimulus. In our experience, however, quantitative easing can be a shock absorber but can't propel the economy to a path of sustainable expansion.

It seems likely that high macro and financial market volatility are here to stay. Previous quantitative easing programs led to short-term risk rallies, but higher commodity prices soon undermined the purchasing power of the global consumer. Economic weakness is also eroding political support for tough economic and fiscal reforms worldwide. The world economy will require more financial sector healing, credible fiscal consolidation strategies, and stronger institutional arrangements in the euro area before it can enter a sustainable expansion.

**Rebuilding Credibility in Europe**

The current pessimism about the euro area seems excessive. The ECB has switched to a crisis-mode strategy, expanding its balance sheet aggressively and providing banks with

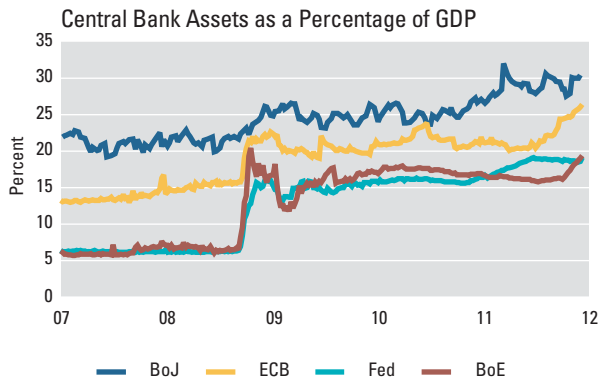
sufficient funds to secure their entire wholesale funding operations for 2012. The ECB remains reluctant to commit substantial resources to bond purchases in individual countries, but the plan to shore up the resources of the International Monetary Fund (IMF) is meaningful in this regard. With the help of the IMF and the European Financial Stability Facility (EFSF), the 2012 funding needs of the struggling peripheral European governments should be met.

Longer term, the euro area needs a sustainable fiscal framework to restore market confidence. It is still shying away from a common Eurobond, which implies that the struggling peripheral countries will have to implement draconian fiscal cutbacks to rebuild credibility. In 2012, all eyes will be on France, where parliamentary and presidential elections will make sticking to the government's commitment to deep fiscal cutbacks a daunting political task.

Countries outside the euro area, including the UK, Sweden, Norway, and Switzerland, continue to fare better, helped by a much more favorable sovereign lending environment (Figure 3). The UK will also be helped by a noticeable decline in inflation as previous value-added tax (VAT) hikes drop out of annual comparisons, providing moderate support to consumption spending.

Figure 2

**Balance Sheets of European Central Banks Have Been Expanding**

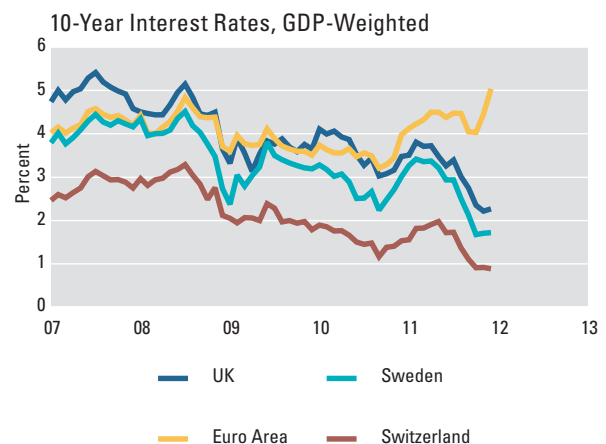


Assets as of 16 November 2011; GDP as of 3Q2011 (4Q GDP figures are forecasted based on last Q/Q growth rate).

Sources: Bank of Japan, ECB, Federal Reserve, Bank of England, Wellington Management

Figure 3

**Euro Area: A Sovereign Funding Crisis**



Source: OECD

### US Growth Despite Weakness in Europe

We expect continued economic expansion in the US, underpinned by falling inflation and only modest fiscal restraint. After a strong fourth quarter in 2011, we look for a growth setback in the first quarter of 2012 due to the expiry of tax incentives for capital goods purchases, as well as weaker exports to Europe. Still, the US economy should eke out another 2% growth performance in 2012. We see the potential for a bigger growth setback in 2013, given the possibility of drastic fiscal tightening in the aftermath of the US presidential election.

US growth and European growth have been quite synchronized in recent years, which raises the question of whether the US economy can withstand a European recession. There is a precedent that suggests it can, however. In the early 1990s, the global economic landscape was quite similar to today's, with the US recovering from a banking crisis and a housing market crisis in New England and California, while Europe experienced speculative attacks on its fixed-exchange-rate regime, which led to the collapse of the European exchange rate mechanism (ERM). **Figure 4** shows that in that instance the US economy managed to decouple from the European economy as the latter fell into recession. The magnitude of the growth divergence between the two regions at that time is similar to the growth divergence we project for 2012. However, in 2013, the outlook for Europe should brighten. The lion's share of the region's fiscal adjustment should be complete, while the outlook for the US may begin to dim as fiscal consolidation efforts intensify.

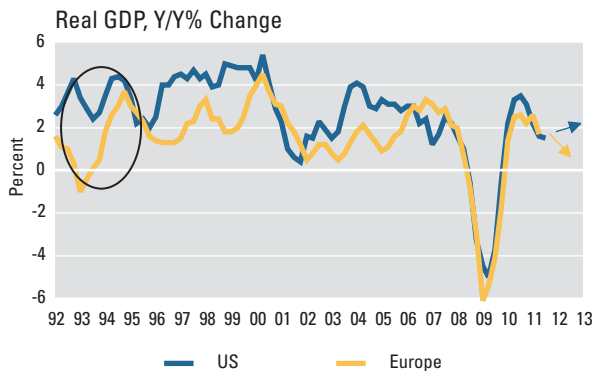
### After Deceleration, China Will Again Power the Global Economy

The Chinese government's forceful attempts to cool the country's credit and housing cycles were quite effective. Demand for private housing is weakening even as the rate of new construction completion is still rising, leading to a meaningful increase in housing inventories. We are still in the very early stages of a price correction. Even with the expected policy easing in coming months, it will take time for this inventory to be absorbed by the market. In the meantime, public-sector housing development could be the silver lining. Social-housing starts have been lackluster recently, implying a big pipeline for construction activity. It seems likely that the development of social housing will be a key goal for China's central government in 2012.

China's importance to the global economy should not be underestimated. We do not foresee a collapse in activity, but weaker housing activity and a challenging export market will imply deceleration of GDP growth to approximately 7% in 2012. Policy will ease, however, as we expect a meaningful drop in inflation in coming months (**Figure 5**), which will give Chinese officials the flexibility to counteract the slowdown. By the second half of 2012 and into 2013, China will again be a growth engine for the global economy.

Figure 4

#### The US Can Withstand a European Recession



Sources: Bureau of Economic Analysis, Wellington Management

Figure 5

#### China's Policy Flexibility Is Rising



Sources: China National Bureau of Statistics, S&P

## Summary and Conclusions

We expect that high macro and financial-market volatility will continue in 2012. The ECB's aggressive injection of liquidity into the euro-area banking system should help stem the crisis in the short term, but further institutional reforms will be required to restore the credibility of the shaken currency union. Finding the political will to implement more reforms during a recession will be difficult. The US economy is still better positioned in a global context, but it too will be vulnerable to growth setbacks as the US will have to address its fiscal imbalances in coming years. China will not be immune to slower growth in the developed world and has a cooling property sector to deal with, but should have the means and the policy flexibility to counteract a slowdown. We expect that 2012 will lay the foundation for more financial healing and the beginnings of fiscal reforms and a sounder institutional structure in the euro area — all of which will contribute to a more sustainable global expansion in 2013 and beyond.

## About the Author

**Robert Scherfke, PhD**, is a senior member of Wellington Management's Global Macroanalysis Research Group. He leads the firm's thinking on global macro activity, conducting cyclical research to identify important inflection points and well-positioned equity markets, which he communicates firmwide in his strategy publication *The Macro Wheel of Fortune*. For our clients, he authors the *Global Economic Outlook* and *Global Macro Insights*, as well as providing regular video updates in the series *Watch the World*.

## Global Economic Forecast

	Real GDP			Inflation			Stock Market Earnings <sup>2</sup>		
	2010 <sup>1</sup>	2011	2012	2010 <sup>1</sup>	2011	2012	2010	2011	2012
US	2.9%	1.6%	2.0%	1.6%	3.0%	2.3%	38%	14%	10%
Euro Area	1.7	1.0	-1.0	1.6	2.7	2.0	46	3	9
UK	1.3	0.9	0.0	4.7	4.0	2.0	34	16	8
Japan <sup>1</sup>	3.9	-0.6	2.0	-0.7	-0.2	-0.2	66	14	25
China	10.3	8.9	7.0	3.3	5.8	4.0			
World	4.0	2.9	2.4	2.6	4.0	3.2			

<sup>1</sup>Consensus Economics

<sup>2</sup>Based on FactSet

Sources: Wellington Management, Consensus Economics



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