

# The search for growth

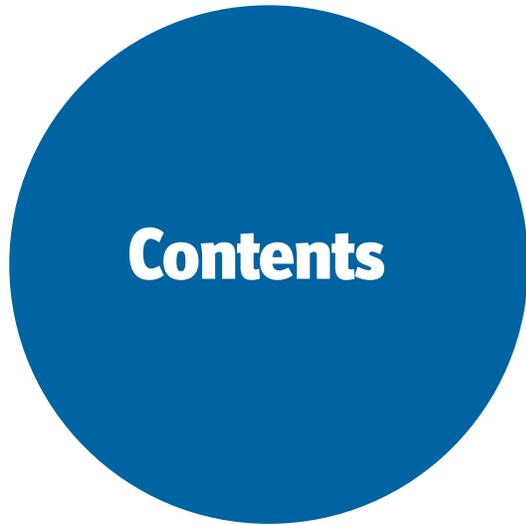
Fiscal decision time for political leaders

A report from the Economist Intelligence Unit

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## 1

## Will governments do what's necessary to avoid a global recession?

The global economy is at a crossroads. On both sides of the Atlantic, governments have delayed bold fiscal reform in favour of half-solutions. What governments and policymakers do or fail to do over the next few months will have profound consequences on capital markets around the world—and on investment portfolios.

Governments have spent decades avoiding tough fiscal decisions by taking the more politically expedient course of infusing economies with cash. Europeans have agreed to austerity measures in an attempt to face their growing debt issues. But age-old issues of national sovereignty continue to stymie real progress. In the United States, politicians continue to squabble over the role of the federal government in a post-election showdown as the country moves ever-closer to the so-called fiscal cliff.

The continued uncertainty is no help to a global economy already in a prolonged slump. The inability to decide on the best course forward has become a growing drag on the markets. Uncertainty helps explain why the International Monetary Fund (IMF) recently lowered its global economic growth forecasts to 3.3% for the

remainder of the year and 3.6% for 2013, down from 3.5% and 3.9%, respectively. The IMF now foresees a one-in-six chance that growth could slow even more, to 2%, in 2013. The Economist Intelligence Unit is even more bearish, forecasting the global economy to expand by 3.4% in 2013. The EIU also cites the uncertainty caused by continued political brinksmanship as being the key drag on global growth—although the growth forecast does assume that political leaders eventually take the necessary steps to avoid economic collapse.

The EIU recently asked nine prominent economists, institutional investors and financiers what is likely to happen in two scenarios:

1. governments continue on their current course or
2. they make significant progress in dealing with fiscal problems. We also asked what kinds of investment strategies they would recommend in either case. Answers ranged from inaction will inevitably lead to another recession to the very threat of economic collapse will finally prod governments to act. But all agree on one thing: The global economy is likely to face serious challenges in any scenario. ■

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## 2

## The US dilemma

“I’m concerned that the election per se has really not changed the balance very much of what’s going on.”

Alan Greenspan, former chairman of the Federal Reserve.

If President Obama and lawmakers in a divided Congress cannot agree on a new tax and spending plan, the country will face a fiscal squeeze of more than US\$600bn in 2013. The pessimists believe that Congress is unlikely to reach a full compromise and that the nation’s economy is doomed to fall over the cliff’s edge. They have recent history on their side. Despite the comprehensive recommendations set forth by the National Commission on Fiscal Responsibility and Reform—better known as the Simpson-Bowles plan—both parties in Congress voted against implementing those proposals and dug in their heels.

But other scenarios are also possible. Congress and the president could cobble together a broad agreement, in principle, in the coming months on a series of revenue increases and spending reductions that both sides can live with. This might include the elimination of a significant number of tax deductions for the wealthy, but not an increase in the marginal tax rate—a compromise that would allow both Mr Obama and the Republicans to keep their promises. More substantive negotiations would then take place to iron out the details of a deal.

The EIU expects the president and Congress to delay the onset of tax hikes and spending cuts until they come to some sort of agreement. This could involve some elements of a “grand compromise”, such as preliminary movements towards fundamental tax reform, in the coming months. Getting to an agreement on simplifying the US tax

code could take as much as six months to a year, but, while lawmakers take the time to agree on the details, they could delay the expiration of the Bush-era tax cuts. The US last reformed the tax code in 1986, and many lawmakers in both parties would welcome an overhaul—although they would disagree sharply on the changes required.

Many financiers and economists nevertheless remain steadfastly in the pessimist camp. “I’m concerned that the election per se has really not changed the balance very much of what’s going on,” the former chairman of the Federal Reserve, Alan Greenspan, said in a post-Election Day interview. “Unless and until we come to grips with this issue, we are not going to be able to look to the future with a considerable state of equilibrium and hope”.

Christopher Cole, CEO and managing director of Artemis Capital Management, believes political leaders in the US and Europe are hopelessly stuck in an advanced state of denial and unlikely to take the bold fiscal steps necessary. “This is akin to a cancer patient refusing chemotherapy in a mistaken conviction that temporary pain relief through morphine injection is a long-term solution for serious illness,” says Cole, a former Merrill Lynch investment banker who structured \$10 billion in derivatives and debt transactions. Instead of developing a credible plan for US debt reduction and European fiscal integration, he believes politicians will continue to rely on

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Bryon Green, president and lead portfolio manager of Green Investment Management, Inc.

“morphine injections” from central banks and currency wars to maintain the status quo. As a result, he believes the global economy will “muddle through” 2013 at below-trend growth as long as the major central banks maintain market credibility. But he expects that “without real structural solutions, the patient will experience a shock worse than 2008 over the next decade”.

Lewis E. Lehrman, the CEO of L.E. Lehrman & Co. and a former senior adviser and director of Morgan Stanley Asset Management, also believes that monetary efforts are having a deleterious effect. He argues that most of the money being printed by central banks is being reabsorbed by private market debt repayments and deleveraging. Plus, when the Fed issues new money, he asserts that it’s absorbed around the world by a generalised panic to hold dollars instead of spending or investing them in new, productive facilities and new employment. “Under these circumstances, the new issues of central bank money do not cause inflation, but they do finance unproductive Treasury deficits,” Lehrman says.

Lehrman believes that the US economy will suffer regardless of what happens in Washington in the next few months. The US economy will show little growth quarter-to-quarter, seasonally adjusted, during the coming year. Top-line growth, which is slowing, may not exceed 2%. Although this might not meet the official definition of a recession, “it will certainly feel like one”. He also expects corporate after-tax earnings in the US to decline by as much as 15-20%, year-over-year.

Others point out that viewing the fiscal cliff as a binary event distorts what’s likely to happen. “People are speaking about it as if the only two outcomes are either to go off the cliff or not to go off the cliff,” observes Jason DeSena Trennert, managing partner and chief investment strategist of Strategas Research Partners. “Rational people don’t go off cliffs. But just because we don’t go off the cliff doesn’t mean there won’t be a fiscal drag that sets in,” says Trennert, one of Wall Street’s most well-known commentators.

Trennert conservatively estimates that the

coming fiscal drag could top US\$220bn. The expiration of the payroll tax cut and extended unemployment benefits comes to US\$93bn. Add in the ObamaCare taxes that go into effect in 2013, combined with a potential 3.8% surcharge on dividends and capital gains. That doesn’t even take into account the Bush tax cuts, the end of which could add another US\$100bn to the tab. That drag of US\$220bn is about 1.5% of the nominal GDP of the United States.

On the other hand, if lawmakers manage to achieve what even appears to be structural reform, Trennert expects the markets to rebound. Even if investors don’t necessarily like aspects of the new reforms, they will at least be pleased with knowing the new rules of the game.

While politicians argue over the finer points of a compromise, Western investors will need to put their money somewhere. “Even if the US works out the most desirable tax reforms possible, it’s still going to take time. And, some of that money is going to instead focus on the emerging markets, which continue to grow at a good clip,” offers Bryon Green, president and lead portfolio manager of Green Investment Management, Inc.

As the threat of an imminent collapse abates in the West and lawmakers compromise on a number of issues, Green expects Western companies to look to Asian markets. Green asserts that stocks and bonds would benefit from companies’ finding steady growth outside their traditional home markets. Asian companies will also begin to target their products and services to the growing middle class in their midst instead of relying on the traditional Western markets. “There’s a subtle shift happening in places like China, where companies are becoming much less dependent on the US and Europe because they’re seeing significant internal demand,” Green observes.

Cliff or no cliff, Jeffrey Wallis, managing partner of SunGard Consulting Services, believes that investors with large positions in the stock market are going to start divesting now. He believes that investors are anticipating some sort of change to the capital gains tax in the next year or two—and

investors remember full well the last time the government tinkered with it during the Clinton years. "Investors are concerned about what their tax bill will be going forward," Wallis says.

A rise in the capital gains tax rate will also have a big effect on small-to-mid-sized companies. That threat will discourage business owners from

considering mergers and acquisitions. "There's a reticence to merge or to search for economies of scale because of concern over the additional costs that could be coming in 2013," Wallis says.

"Whether the fiscal cliff happens or not, there's going to be pressure on Washington to raise some portion of the capital gains tax." ■

## 3

## The Europe dilemma

Europe faces a completely different set of issues. European countries with debt problems have been painfully aware of their predicaments for quite some time and have passed austerity budgets in an attempt to address those problems. The central dilemma, according to the EIU's Global Forecasting Director, Leo Abruzzese, is that those austerity measures are often so severe that they stand to cripple the economies they are intended to help. "With Europe, the issue is whether the plan is right and if it is too severe. The US issue is that there's no plan at all," observes Abruzzese.

The European Central Bank (ECB) has proposed building a firewall around Europe's troubled economies by doing "whatever it takes" to save the Eurozone. Its programme to buy the bonds of countries under pressure is designed to reduce the likelihood of market panic and limit the risk of contagion to other countries. Countries that wish to participate must request support and submit to a package of fiscal targets that will be enforced from the outside—most likely by a "troika" of the ECB, EU and IMF that oversees programmes to current aid recipients.

But, will the plan work? It's uncertain whether a major European economy would ever submit to outside fiscal control. Neither Spain nor Italy has yet shown any inclination to apply for support, although they may ultimately be forced to do so. If the ECB buys the bonds of troubled governments and the governments then fail to meet conditions

for the loans, the ECB would be forced to cut those countries off from further support. That, in turn, could trigger precisely the kind of market panic that the programme seeks to avoid. The plan could also be a victim of rising unrest from voters tired of austerity. Protests have erupted in both Greece and Spain in response to severe budget cuts.

The markets have certainly welcomed the programme with open arms. Spanish and Italian bond yields have plummeted—for Spain from 7.6% in late July for ten-year instruments to 5.6% in mid-September (the rate remained at about that level in early November). The decline in two-year notes has been even greater—down by nearly 400 basis points, to around 3%. (Italy, which is facing lower borrowing costs, has also benefited from lower bond yields.)

European economies, meanwhile, are edging deeper into recession. Europe's economy shrank by 0.4% this year. Next year, the EIU has revised its Euroarea forecast lower, expecting it to contract by 0.2%. It's a vicious circle: the more you cut, the less growth, and the less growth, the more you have to cut. The positive effects of these potential reforms will take time. The wise investor should, arguably, be pushing for less austerity in favour of positive growth and a recovery over a longer time frame.

Making the ECB a supervising lender of last resort for the entire region could bring the kind of cohesive structural reform needed to allow Europe

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Leo Abruzzese, Global Forecasting Director, EIU.

to regain positive momentum. "Going forward, there is a need for one entity to take the lead role. And that entity is Europe as a whole," says Fernando Sotelino, a former managing director at Citibank and now a professor at Columbia University's School of International and Public Affairs. Only then, he believes, can Europe solve many of its fiscal problems.

Although some countries are reluctant to yield influence to the ECB, they are beginning to understand the advantage of keeping the euro intact. Sotelino points out that "the export capacity of Germany would be severely affected if it ever went back to the Deutschemark." Clark Yingst, the chief market analyst and equity strategist at Joseph Gunnar & Co., agrees. Germany is the world's third-largest export economy and its biggest market is not the US or Asia, but the rest of Europe. Yingst adds that German factory orders from the rest of Europe were down 10% year-over-year in September. The European Commission's GDP forecast expected Germany to grow at a 1.7% rate for 2013. That is, until the Commission reduced that estimate to 0.8% on November 7. "I hope I'm wrong, but that's probably not the last of the reductions," says Yingst.

Yingst believes that if current forecasts for Spain hold, it could be in a good position to ask the ECB to buy its bonds. "That might be a trigger for Spain to request assistance, which could serve as the basis for a rally at least in the short term," he says.

The next challenge Europe faces on the road to recovery would be to move toward greater fiscal and regulatory integration. A banking union in Europe would be an important prerequisite to a monetary union. But here, too, the outcome is far from certain. Creditor countries such as Finland and Holland are retracting earlier commitments to establish a stronger banking union. Germany has also been generally reluctant to establish a banking union because it wishes to retain sovereignty and control.

German leaders might want to reflect on what happened in Mexico in the mid-1990s, according to Sotelino. In a period of political transition and

uncertainty, capital fled. The peso devalued, inflation skyrocketed, and the country appeared to be insolvent. The combination of a sovereign debt crisis and banking crisis impelled Mexico to seek an agreement with the IMF. Accordingly, the country had to look to the US Treasury for support. Europe, says Sotelino, needs a lead player, although Germany doesn't want to be the only one.

The ECB's measures give policymakers more time to implement Europe's much needed structural reforms. The risk, of course, is that they won't use the time to their advantage. European monetary policy has helped keep interest rates for all Eurozone member countries at manageable levels, notes Joseph Zveglic, assistant chief economist at the Asian Development Bank, but what confidence remains won't last forever. "We expect low GDP growth of 0.5% in the Euroarea in 2013, but even this may be optimistic," according to Zveglic.

The ECB's bond-buying programme could also create a new form of moral hazard. What remains unclear is whether countries will submit to outside controls that some view as too restrictive. If the outside troika does not enforce the programme, a government benefiting from its bond purchases might be tempted to slow or even stop efforts at reform. In such case, would the ECB stop supporting the government and risk letting Europe slip back into financial instability? While the moral hazard argument has gained traction in some camps, a government default remains a highly unlikely scenario. Political leaders are more likely to find alternative solutions acceptable when faced with the prospect of a historic default that would sully their legacy.

A European banking union won't be completed anytime close to when leaders originally promised. So, the only certainty in the months ahead will be the markets' wild ride. "We are in the middle of the bull market for fear," says Christopher Cole of Artemis. He defines the "new regime of volatility" as investors' willingness to pay almost anything to shield portfolios from the next round of deflation. Cole also attributes the current volatility to "emotional scars" inflicted in 2008 by overpriced

tail risk, high implied volatility of volatility, abnormally steep volatility curves and the underperformance of portfolio insurance.

The central challenge facing Eurozone governments is finding a way to implement a viable solution to the current crisis. The difficulties facing the single-currency area include not only the related problems of weak public finances and undercapitalised financial systems, but also a lack of democratic legitimacy for the policy and institutional changes needed to remedy the region's ills over the longer term. While market confidence continues to fluctuate with the almost daily barrage of half-measures and palliative

rhetoric, a real solution remains many years away.

Add to this list of problems the likelihood that Germany will not achieve a clear majority of Social Democrats or Christian Democrats in next year's federal elections. If Germany is concentrating on its own Grand Coalition, it can hardly be the kind of decision-maker that Europe needs at the moment. That role could be assumed by England, whose central bank will be governed by the former Goldman Sachs executive Mark Carney. During his time at the Bank of Canada, Carney managed to avoid the mess that plagued many of his counterparts. ■

## 4

## Conclusion

The United States and Europe remain in grave danger of giving up the gains they've made since the financial crisis. Progress has been slow and delays have been frequent. This was, in some ways, predictable. The slow recovery from the recession has sharpened the divide between right and left. Conservatives have pushed aggressively for fiscal consolidation and debt reduction as the only prudent response to the crisis. Those on the left

have argued, with equal fervour, that austerity will simply depress growth further, delaying a recovery and punishing the less well-off. The answer is naturally somewhere in the middle; the threat of a return to financial instability may inspire politicians on both sides of the Atlantic to make the difficult political and fiscal decisions they've avoided for decades. ■

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**London**  
26 Red Lion Square  
London  
WC1R 4HQ  
United Kingdom  
Tel: (44.20) 7576 8000  
Fax: (44.20) 7576 8476  
E-mail: london@eiu.com

**New York**  
750 Third Avenue  
5th Floor  
New York, NY 10017  
United States  
Tel: (1.212) 554 0600  
Fax: (1.212) 586 0248  
E-mail: newyork@eiu.com

**Hong Kong**  
6001, Central Plaza  
18 Harbour Road  
Wanchai  
Hong Kong  
Tel: (852) 2585 3888  
Fax: (852) 2802 7638  
E-mail: hongkong@eiu.com

**Geneva**  
Boulevard des  
Tranchées 16  
1206 Geneva  
Switzerland  
Tel: (41) 22 566 2470  
Fax: (41) 22 346 93 47  
E-mail: geneva@eiu.com