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Economic Update

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We believe that the most likely outlook for the world economy in 2012 is a global growth recession with global real GDP growth in 2012 of about 3%, down from about 3.7% in 2011 and 5.0% in 2010. The overall economic outlook reflects disparate trends in different regions: a full-scale recession in Europe, stagnation or moderate recession in the nearby U.K., near-trend growth in the U.S., continued expansion in Japan and moderate slowdowns in China and most other emerging market countries. While European financial stresses are serious, the global shift towards monetary ease should help mitigate the spillover effect of European weakness to the rest of the world. The result should be a global growth recession rather than either a full-scale global recession or a strong expansion, assuming that there is neither a full break-up of the euro nor a major oil spike. We expect that the weakest period for the global economy should be in the first half of 2012, when European economic weakness is likely to be most intense and the full benefit of global monetary easing will not yet be felt, due to the usual lags.

The broad background factors for the economic and financial stresses in the developed world include (1) demographics, (2) weak income growth (due to economic imbalances, global wage competition and technological innovation), and (3) deleveraging.

The population is aging in many developed countries and in some developing countries. This challenges the sustainability of rising government spending on pensions and health care, contributing to the risk of both persistent budget deficits and rising tax burdens.

In addition, there is a tendency towards weak income growth for many workers in the developed countries. Technological innovation and global wage competition have restrained income growth, especially in low-skill and medium-skill jobs. This has been exacerbated by the Great Recession and the sluggish recovery. There is a link between weak income growth and the problem of imbalances. At a global level, the huge accumulation of excess reserves by current

account surplus countries reflects a failure to recycle economic demand. For a while, these surpluses were easily offset by rising debt in current account deficit countries. A similar pattern occurred within the Eurozone, as German surpluses were matched by persistent deficits in southern Europe, financed by rising debt. However, both the global economy and the Eurozone are now “rebalancing down” as it is no longer as easy to finance these persistent deficits.

The developed world is also under pressure to deleverage in the aftermath of a major increase in both private debt and public debt. The main story is that credit was often priced too cheaply for risky borrowers, generating first a debt boom and then a debt bust. For example, government policy in the U.S. encouraged mortgage loans to risky borrowers, while regulatory rules in Europe encouraged the view that the sovereign debt of Greece (a country which has been in default for much of its existence) was nearly as good as the debt of Germany (a country with a cultural commitment to financial discipline). This problem of mispriced credit was then exacerbated by excessive leverage.

The macroeconomic policy response to the deleveraging stresses has varied in different developed economies. In many developed countries, policy real yields (policy interest rates minus inflation) are negative, mitigating the burden of past debt, at least for now. In the U.S., monetary policy has been easy and is supportive of a “nominal growth fix,” so that an upward drift in nominal GDP (real growth plus inflation) and nominal incomes can improve debt-to-income and debt-service-to-income ratios over time. However,

structural fiscal normalization in the Federal budget in the U.S. has been postponed indefinitely as the stalemate between the two parties persists. The Bowles-Simpson budget plan drew bipartisan support but was never adopted. Necessary fiscal reform has been postponed. In the near-term, however, the U.S. Treasury faces little difficulty in financing persistent budget deficits, in contrast to many countries in Europe.

The U.K. has an easy monetary policy, but it has been tightening its structural budget settings. Europe has had a tight monetary policy, contracting bank balance sheets and a tightening of fiscal policy in both northern Europe and southern Europe. These differing policies in different regions should contribute to different regional growth rates in 2012: near-trend growth in the U.S., stagnation or moderate recession in the U.K., full-scale recession in Europe.

We believe that five financial policies pursued in Europe in 2011 should contribute to a full-scale European recession in 2012: (1) two rounds of ECB monetary policy tightening in mid-2011, which should have a lagged negative impact on the European economy (despite the belated reversal of this tightening in November 2011 and December 2011), (2) tight fiscal policy which has been forced on many peripheral countries in Europe, (3) tight fiscal policy which has been voluntarily chosen by many core countries in Europe, (4) limited systemic support for vulnerable countries, which has contributed to high interest rates on sovereign debt and on private sector debt in a number of countries, and (5) a contraction of European bank balance sheets and liquidation of assets partially attributable to a pro-cyclical tightening of financial

regulation and capital requirements. We expect that the lagged impact of these five policies will be economic decline in many European countries in 2012. We believe that the European recession has already begun. Support for the growth-hostile policies cited above should gradually erode as evidence of declining economic activity in Europe accumulates. While the ECB was unwilling to pre-commit to intensified financial support for peripheral countries in response to the recent "fiscal contract" proposal, it can be expected to adopt more supportive measures on traditional central bank grounds as economic activity drops and the inflation forecast falls. In response to early signs of economic weakness, the ECB has already cut reserve requirements, adopted a three-year liquidity vehicle for banks and broadened collateral eligibility. While European monetary policy has already started to ease, the path to a redesign of the flawed Eurozone system and to a narrowing of the competitiveness gap between the very disparate Eurozone economies is less advanced. Our most likely case is for a semi-orderly pattern in resolving the European financial crisis over the course of 2012, with alternating phases of hope and fear.

In the U.S., real GDP growth for 2011 is expected to be reported at a rate slightly below 2%, as the growth stall in the first half of 2011 was followed by renewed growth in the second half. In the end, the argument that the first half slowdown in 2011 was due to temporary factors and that the U.S. economy would avoid a double-dip recession in 2011 proved correct. In 2012, we expect near-trend real GDP growth close to 2.5% in the U.S. over the course of the year. Since the strengthening of the

banking system is more advanced in the U.S. than in Europe, financial conditions are quite different in the U.S. and Europe. Credit is beginning to expand at a slow pace in the U.S. while Europe remains in a credit crunch.

Consumption spending in the U.S. has been trending moderately higher. Several years of low auto sales have aged the auto fleet. That should continue to support spending in the auto sector. A key point of controversy in the U.S. consumption outlook is the savings rate. Economic pessimists argue that Americans should raise their savings rate to restore their damaged net worth (we agree) and would quickly do so (we disagree). Although there are measurement issues, it is clear that the U.S. savings rate has not risen to the degree that was widely expected. A major reason for this is that Federal Reserve policy is designed to encourage continued spending rather than increased saving. There are limited financial incentives to save in an environment of zero interest rates and continuing, if falling, inflation. The tendency of Americans to spend rather than save in the current environment is not accidental, but rather is the intended effect of easy monetary policy. Federal Reserve policy should remain easy. We expect that the U.S. economy should be strong enough that the Federal Reserve will not need to adopt QE3. But we have no doubt as to its willingness to do so if necessary.

We expect that residential construction should actually make a positive contribution to U.S. economic growth in 2012 as it recovers from the sub-sub-basement to the sub-basement. Residential construction includes not just single-

family building, which is weak, but also multi-family building and residential remodeling, which have better prospects for some growth.

The growth rates of the emerging market countries should be somewhat impacted by the European recession. Many emerging markets have favorable underlying fundamentals which should support higher economic growth rates than in the developed countries in the long run. A crucial positive fundamental is the uptrend in the productivity of their labor forces due to the adoption of modern technology and business practices, benefiting from the accumulation of intellectual capital in the developed world over the last several centuries.

Cyclically, many emerging market countries are subject to weakening exports and volatile capital flows. However, most of them benefit from substantial policy flexibility. It is notable that many emerging countries were proactive in quickly reversing from monetary tightening to monetary easing as the European outlook weakened. In 2012, we expect a substantial drop in inflation in many countries, including most emerging market countries. We believe that if these countries had waited for the full evidence of inflation deceleration before shifting towards a more accommodative policy, the degree of their growth deceleration in 2012 would have proved more severe.

Policy interest rates are at or near zero in the U.S., U.K., and Japan and are likely to move closer to zero in the Eurozone. Few emerging markets face the problems that the developed countries face with the “zero bound” in policy interest rates. Since their interest rates are higher, emerging market countries have the flexibility to cut them and they have used that flexibility on a timely basis in late 2011, a pattern that should continue in 2012.

With respect to China, its property markets have made the transition from boom to bust, which should contribute to a slower pace of growth in 2012. However, China’s ample international reserves give it a great deal of policy flexibility. Inflation has peaked and should continue to decelerate, freeing the country to move towards easier monetary policy. It has already made a cut in some reserve requirements, but we expect more substantial easing over the course of 2012, which should limit the magnitude of the growth deceleration.

Global economic forecasts are subject to heightened uncertainty during the current European financial crisis. Fortunately, underlying fundamentals and evolving policy are more favorable elsewhere in the world. On balance, we expect a global growth recession rather than either a full-scale global recession or a strong expansion.



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