

ECONOMIC UPDATE



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We expect a prolonged multiyear global expansion. We believe that the moderate pace of global economic expansion implies that there is limited risk that consumer price inflation rates will rise high enough to move central banks to an expansion-killing restrictive policy any time soon. Stimulative monetary policy is currently experiencing some slippage in the transmission to strong growth in both credit and economic activity, due in part to restrictive regulatory policy in the financial sector. However, with the exception of the ECB, many central banks have adopted policies so aggressively stimulative that they are fostering sustained economic expansion. One consequence of sustained global expansion rather than a full-scale boom is that monetary policy is likely to remain supportive of economic expansion for an extended period of time. We thus expect a prolonged multiyear global expansion.

In the short run, the global economy has been in a subcycle of slower growth within its sustained expansion. This is due to a combination of the final months of the recession in the overall European economy, this year's fiscal drag in the U.S. and some rebalancing in China. However, we expect an acceleration in global economic growth near the end of 2013 and throughout 2014. We expect strong global economic growth in 2014.

How should the fact that commodity prices have dropped in recent months be interpreted? We believe that the recent drop in commodity prices was a valid signal of a subcycle of weakness in demand within the global economy. In addition, the commodity price weakness reflects large increases in the supply capacity for many commodities in recent years. These capacity expansions were motivated by expectations of a commodity supercycle due to increased demand from an emerging

market boom. We are in an emerging market expansion rather than an emerging market boom. In addition, China is rebalancing its economy in a way which is slowing the growth of its demand for some commodities. The result has been the emergence of some excess capacity. We believe that recent commodity price weakness reflects excess supply capacity just as much as it does the temporary subcycle of sluggish economic growth.

Energy commodities are a large and influential portion of global economic activity. We believe that the recent weakness in energy commodity prices should be viewed as both an effect of the temporary soft patch in the global economy and a likely cause of a future acceleration in the global economy. Moderate energy prices aid real income growth. From that perspective, the long-term prospect for moderate and relatively stable energy prices is likely to support global economic activity later this year and in 2014.

Hyperstimulative monetary policy tends to support economic expansion, although in an inefficient way. It also stimulates inflation in the price of existing assets. Evidence of asset price inflation has raised fears of the repetition of another bubble/bust pattern. We regard these fears as legitimate but premature. We believe that most of the recent improvement in the price of risky assets reflects a discounting of improved fundamentals and reduced negative tail risks.

If the eventual normalization of interest rates occurs in response to excessive consumer price inflation, a negative scenario becomes more likely, since monetary policy might become aggressively restrictive. However, we believe that the eventual normalization of interest rates will occur in response to a rise in economic activity.



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This would not validate excessive prices for risky assets but does imply that, in the scenario we expect, there would not be a severe deterioration in underlying fundamentals. Overall, we believe that rising rates are much less likely to trigger a recession and a major profit decline if central banks eventually normalize interest rates in response to higher economic activity rather than in response to excessive consumer price inflation.

The recent shift in Japanese economic policies has been dramatic, following two decades of economic stagnation. We believe that they will prove successful in the next two years in generating better economic growth, higher corporate profits, improved consumer and business confidence and a transition out of deflation. Given Japan's challenges with adverse demographics, energy supply, excessive sovereign debt and geopolitical issues, we are less confident that they will prove successful in the long run. That is likely to depend on whether major structural reforms can be implemented.

In China, we believe that recent changes in economic trends are primarily structural rather than cyclical. The export opportunities available to China have now weakened somewhat and the pace of export growth is likely to be slower from a high base. At the same time, the Chinese labor surplus is giving way to Chinese labor scarcity, especially for blue collar labor, as there has been a sharp drop in the number of young workers entering the labor force. The response of the Chinese government has been to tolerate high wage inflation, which helps start the process of rebalancing the economy towards domestic consumption. At the same time, symptoms of past overinvestment have increased. Chinese policymakers appear to accept that the deceleration of trend economic growth is unavoidable. We do not expect a "hard landing" in China but rather sustained economic expansion at a somewhat decelerated pace.

We expect the overall European economy to hit the "bottom of the saucer" in the last half of 2013. We expect a gradual saucer-shaped pattern in European economic activity rather than a V-shaped or U-shaped recovery. Overall, the global economic context of moderate expansion did little to mitigate the European recession, but we believe that the global interest rate context has helped mitigate the European financial stresses. While sovereign credit spreads of vulnerable European countries have improved substantially, only a portion of that is due to expectations of improved European fundamentals. Some of the improvement in sovereign risk spreads in Europe is the result of a "global yield

drought." A number of major developed countries have adopted a mix of (1) zero or near zero policy rates, (2) downward pressures on long-term yields via quantitative easing and (3) an aggressive flow of financial liquidity. These policies were designed to stimulate domestic demand in these countries, but a side effect has been to reduce financial stresses for peripheral sovereigns in Europe, due to an intense global "chase for yield."

We are hopeful that European financial stresses will remain calm and that the recession in the overall European economy will end later this year, even as most peripheral economies continue to decline. However, we are pessimistic about the strength of any subsequent European economic recovery given that structural reform to improve competitiveness has been limited so far.

While fears of European financial stresses have dropped, the underlying fundamental problems persist. Disparate countries are bound together to a single currency and a single monetary policy without a fiscal union. The strengthening of the banking system has proceeded at a much slower pace in Europe than in the U.S. As a result, credit availability in the peripheral countries remains quite tight. Most peripheral and soft core countries in Europe face a combination of (1) challenging demographics, (2) a substantial sovereign debt burden and (3) a competitiveness gap relative to Northern Europe, especially Germany. Closing the competitiveness gap is likely to prove very challenging. Relative competitiveness within Europe could be restored by high inflation in Germany and/or substantial wage deflation in Southern Europe. These are not appealing alternatives. We do not believe that the competitiveness gap is likely to close quickly.

Now that financial stresses have eased and voters in peripheral countries have revolted against austerity, a shift to more gradual austerity is likely among the vulnerable countries of Europe. For these countries, fiscal austerity was not voluntary. It was demanded by the creditor countries at a time when many vulnerable countries were regarded as insolvent and had lost or were losing access to market financing. Fiscal austerity is likely to persist, but at a diminished pace.

The economic recovery in the U.S. since its recession has been slower than normal. Real GDP growth has averaged about 2.1% since the expansion began. We expect real GDP growth to be at or slightly above that pace this year, despite the drag from substantial fiscal tightening. The employee portion of the Social Security tax was raised back to the normal 6.2% from its temporary level over the

prior two years of 4.2%. There was a rise in the tax rate for upper-income individuals. The multiyear sequester, intentionally designed to be a policy so rigid and politically unattractive that it would never go into effect, is reducing the growth rate of Federal spending. Despite this fiscal drag, the U.S. will still be able to have a real GDP growth rate this year close to what it has been averaging in this expansion. Updated to current house prices and stock prices, total household net worth in the U.S. has risen to an all-time high, led by gains by upper-wealth households, often the same households which now face higher tax rates. The Social Security tax hike is a significant drag on low-income and middle-income households. However, with layoffs near a cyclical low, job security has improved for those currently employed.

Rapid growth in the domestic supply of oil and gas and lower oil and gas prices than are available to international competitors are strengthening confidence in the long-term prospects for the U.S. economy. Another implication is a reduction in the risk of a deterioration in the trade balance or current account balance.

Next year, we expect a faster pace of growth in the U.S. economy, probably 3% or more. Housing is doing well: new home and existing home inventories have come down, house prices are rising, and residential construction is increasing. The automobile fleet is old. There is continued demand for automobiles, and especially for pick-up trucks, which are used in housing. With corporate profits high and balance sheets strong, companies are likely to spend more on capital spending over the course of the next several years. State and local tax revenues are rising, implying less of a drag from that sector in the coming months.

The current budget deficits in the U.S. are not a major financial problem in the short run. The U.S. budget deficit is declining faster than many analysts had expected due to cyclical expansion, tax hikes and the sequester spending cuts. Current budget deficits are easy to finance in a context of limited private sector credit demand and aggressively easy monetary policy. The major long-term problem is the projected rise in health care costs. Since the demographically-driven problem of high health care spending is likely to worsen only gradually, our most likely case is that U.S. policymakers may postpone any major entitlement reform for a number of years.

There has been a clarification of U.S. fiscal policy which could contribute to a recovery of confidence. The fiscal

cliff has passed and many individual tax provisions have been made permanent, reducing uncertainty. Because of the complexities of the linkage between corporate income taxes and taxes on pass-through entities (where the profits of enterprises are taxed at individual tax rates), we believe that the prospects for a major growth-oriented comprehensive corporate tax reform have been reduced by the recent increase in the top individual tax rates. We do not expect the passage of major corporate tax reform any time soon.

The Federal Reserve is likely to continue with an easy monetary policy in a context of persistent fiscal tightening. We classify monetary policy into five phases: (1) aggressively stimulative, (2) stimulative, (3) neutral, (4) restrictive, and (5) aggressively restrictive. We would describe the current monetary policy setting as aggressively stimulative. We expect that it will take about three years for the Fed to complete a shift to neutral. While we would classify gross monetary policy as aggressively stimulative, we would classify net monetary policy (adjusted for regulatory tightening in the financial sector) as only stimulative. By the time the Fed begins the shift in gross monetary policy from aggressively stimulative to stimulative, it is possible that incremental regulatory tightening may become less intense. If so, net monetary policy might tighten more slowly than gross monetary policy at that time. We do not expect the early emergence of substantial inflationary pressures any time soon, so a shift to truly restrictive monetary policy is likely to be many years in the future. As a result, we expect the next recession in the U.S. is likely to be postponed until after the next Presidential election in November 2016.

The U.S. has benefited from declining interest rates for about three decades. We outlined the logic for a persistent decline in long-term yields in our May 25, 1981 Forbes column, entitled "Last Chance This Century." Our view is that the secular decline from the peak at 16% on September 30, 1981 in 10-year Treasury bond yields has now ended. Treasury bond yields in 2013 are not free market yields but have been artificially suppressed by the supply effects of the Fed's quantitative easing. We expect the Fed to begin to taper down its bond purchases by early 2014 and to begin to raise the Federal funds rate in 2015. We believe that the upward drift in long-term rates has begun but expect it to be gradual enough to frustrate investors waiting for more attractive yields.



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