INVESTLOGIC
Your Investment Connection

EXECUTIVE SUMMARY

- The global recovery continues but remains lackluster, with growth now below the long-term average. Inflation moderates as oil prices trend erratically sideways. And monetary policy remains unusually accommodative.

- The recovery from the Great Recession began well enough, with global GDP surging 5.1% in 2010. But that reflected the momentum imparted by the early policy response to the financial crisis. Wealth destruction subsequently retarded consumption growth in the advanced economies; prior overbuilding, high unemployment and tight credit hurt real estate markets; and concerns about government deficits and debt led to fiscal tightening. Meanwhile, the initial policy stimulus produced rapid rebounds in the developing economies, which generated inflationary pressures and quickly prompted monetary tightening. This combination of factors slowed global growth to around 4.0% in 2011 and just 3.0% in 2012, preventing much if any gap closing. However, with policy already reversing in the developing economies, growth should reaccelerate to 3.3% in 2013.

- Global growth seems unlikely to surprise to the upside. Indeed, the risks remain skewed to the downside. The three major ones are: the US fiscal cliff; a Chinese hard landing; and the European crisis. The US fiscal cliff is the most immediate. If the economy falls off the cliff in its entirety then recession ensues for the US with negative implications for the global economy. Even if it is delayed and flattened somewhat, government spending will almost certainly become an even stronger headwind to growth. The prospects for the Chinese economy deteriorated progressively during 2012, primarily because of a surprisingly tepid policy response to the slowdown. We now expect something around 7.5% growth in 2012 (only just above the 7.0% mark that defines a “hard-landing”) with the anticipated reacceleration in 2013 far from assured. Despite the various aid packages, and the ECB’s introduction of “Outright Monetary Transactions,” the European crisis is far from over. Indeed, the need to assess conformity with the terms and conditions of existing loans makes the crisis a quarterly soap opera where it is always possible that a sovereign does not receive a crucial tranche, and is forced to exit the eurozone.

- Oil prices have largely driven headline inflation over the last four years. Brent surged to a high of $146 a barrel in mid 2008, collapsed to $34 by the end of that year, then climbed back to $94 by the end of 2010 and $108 by the end of 2011. Consequently, headline (consumer price) inflation in the advanced economies jumped to 3.4% in 2008, then slowed to just 0.1% in 2009, before reaccelerating to 1.5% in 2010 and 2.7% in 2011. Oil prices trended erratically sideways in 2012, rising to nearly $127 a barrel during the first quarter on supply concerns, then falling sharply to $89 a barrel during the second quarter on the resumption of the Iranian P5+1 talks and deteriorating prospects for global growth. At the time of writing, both the supply premium and demand discount seems to have exited, with Brent trading around $110. In the absence of action against Iran, we expect oil prices to continue to trend sideways around current levels through the end of next year, as the OPEC12 boasts around 6.0 million barrels per day of surplus capacity and demand grows only slowly. Meanwhile, core inflation remains benign as growth stays sluggish and output gaps wide.

- The risks to inflation seem broadly balanced. The loss of Iranian production or even a partial disruption to the flow of OPEC crude through the Persian Gulf would tighten the oil market considerably, potentially pushing prices to new all-time highs. However, any additional loss of momentum in the global economy would impart downside risks.

- The “Great Recession” prompted all G7 central banks to cut administered interest rates to extraordinarily low levels. Some have kept them there. The Federal Reserve (Fed) cut the funds target to 0-25 basis points, where it remains today. The Fed has also engaged in open-ended quantitative easing (QE) and “pledged” to keep the funds target at exceptionally low levels until the unemployment rate reaches 6.5%. The Bank of Japan (BoJ) cut the overnight target to 0-10 basis points, where it remains today. The BoJ has also engaged in asset purchases, and may do considerably more now that the Liberal Democratic Party (LDP) has returned to power. The Bank of England (BoE) cut the Bank Rate to 50 basis points, where it remains today. The Old Lady has also engaged in £375 billion of QE and a bank funding-for-lending program with Treasury. Other central banks began to tighten, only to pause or even reverse course. The Bank of Canada (BoC) cut the overnight cash rate to 25 basis points, raised it to 1.00% in mid 2010, and then stopped the tightening process when growth prospects deteriorated. The European Central Bank (ECB) cut the minimum bid rate to 1.00%, raised it to 1.50% in mid 2011, but has since lowered it to 75 basis points. The ECB has also engaged in QE, and recently introduced Outright Monetary Transactions to relive stresses on sovereigns in aid programs. The Reserve Bank of Australia (RBA) cut its overnight target to 3.00%, raised it to 4.75% by late 2010, but then cut it back to 3.00%. Only the BoC may take an opportunity to hike in 2013.

OUTLOOK FOR THE MAJOR ADVANCED ECONOMIES

US: Possibility of Upside or Downside Surprise in 2013

The recovery from the Great Recession has been respectable by international standards but lackluster by historical ones. Indeed, over the first 12 quarters of the upswing, growth averaged just 2.2%, well below the post-War average. There appear to be three reasons for this. The destruction of household wealth—particularly the drop in home prices—retarded consumer spending. The residential construction boom of 2001-2005 left the US with an excess of housing units and removed any incentive to build, especially given the drop in household formation in 2009-2010. And, cutbacks in government spending—particularly in the state and local sector—imparted a sizable fiscal drag on the economy.

There are some encouraging signs that portend improvement in 2013. Balance sheet repair is winding down as home prices stabilize. Indeed, households are now taking on short-term debt to finance expenditures, especially on motor-vehicles. And residential construction has picked up over the course of 2012 as household formation revived and affordability improved. Moreover, the two sectors that have lost momentum, business investment and exports, may revive in 2013. It is unusual for investment to slow when consumption and housing are improving, suggesting that the weakness may reflect uncertainty surrounding the fiscal cliff, which if removed, could lead to a reacceleration that further boosts demand. Exports may also revive along with the global economy, or at least not be a drag on growth. Hence, assuming an unchanged fiscal stance, the economy could grow 3.0% in 2013.

Unfortunately, the economy could also contract. Under current law, the Bush tax cuts and the payroll tax holiday end on December 31, 2012. Emergency unemployment insurance benefits and depreciation incentives expire. And, the sequestration agreed to as part of the debt ceiling "debacle" of 2011 takes effect. It is also possible that the Alternative Minimum Tax (AMT) will broaden, and Medicare payments to doctors will drop. If all these occur, fiscal policy will tighten by around $600 billion or 4.0% of GDP, which (assuming a one-to-one pass-through) implies the economy will contract by 1.0%. Hopefully a compromise will be reached, which at least flattens the cliff next year. Indeed, we assume that policy tightens by nearly 1.0% of GDP (about 25% of the total) lowering growth to 2.1%. But obviously, it could be more or less.

Oil prices have dominated movements in headline consumer prices (CPI) over the last four years, pushing CPI inflation as high as 5.6% y/y in July 2008, as low as -2.1% in July 2009, then back to 3.9% in September of last year, and back down to 1.8% currently. Meanwhile, core CPI inflation—which excludes food as well as energy—has followed a much less erratic path, trending down from 2.5% in mid 2008 to just 0.6% in October 2010, and then reaccelerating steadily to 2.3% in April of this year, before slipping to 1.9% currently. We expect core inflation to trend sideways around current levels, while headline inflation actually decelerates further as oil prices stabilize.

The Fed adopted an extremely accommodative monetary policy in response to the financial crisis and has maintained it throughout the recovery. It has kept the funds target at 0-25 basis points. And, it has sought to lower longer-term interest rates, through forward policy guidance and purchases of US Treasuries, agency debt and mortgage-backed securities (dubbed quantitative easing or "QE"). Given our outlook for moderate growth and only modest declines in unemployment, the Fed should not tighten in 2013. Indeed, it recently stated that the current funds target will remain appropriate "at least as long as the unemployment rate remains above 6.5%," which it almost certainly will next year. Moreover, the Fed decided to purchase an additional $45 billion a month of longer-dated Treasury securities to compensate for the end of "Operation Twist" on December 31. And it will ease much more aggressively if fiscal drag increases markedly.

Canada: Muddling Through

Canada's recovery has been better than most other in the G7, with the economy expanding at a respectable 2.8% pace over the last three years. Consumer spending, housing, and business investment rebounded strongly enough to more than offset headwinds from international trade and eventually fiscal consolidation. However, the recovery has been more anemic recently, with growth falling below 2.0% over the last three quarters and posting at just 0.6% in the most recent (Q3). The drags from fiscal policy and trade have continued. Consumer spending has become more restrained. Housing has slowed as lending regulations have tightened. And businesses have become more cautious as global economic prospects have deteriorated. Looking ahead, the recovery should be sustained but seems likely to remain sluggish into next year. The extremely easy monetary policy stance should help underpin the consumer and also buttress residential and nonresidential investment. But, fiscal consolidation continues. And international trade is likely to contribute little to overall growth given sluggish external demand and the strong Canadian dollar. Thus, after expanding 2.0% in 2012, the economy should expand just below 2.0% in 2013.

After slipping to as low as 1.0% y/y in mid-2010, inflation accelerated to as high as 3.7% in mid-2011, reflecting the 2010 rebound in commodity prices amplified by the "Arab-spring" oil shock early last year. The comparative stability of oil prices over the past year has allowed headline inflation to moderate once again, especially as core inflation has decelerated on a persisting output gap and strong Loonie. Consequently, inflation has slipped well below the BoC's 2.0% target. Looking ahead, the prospects of lackluster growth in 2013 suggest the output gap will not close, which along with CAD strength should limit any inflationary pressures. Hence, assuming energy prices remain stable around current levels, headline inflation likely stays below 2.0% through 2013.

Against the backdrop of global recession and financial dislocation in 2008-09, the BoC cut its policy rate to a record low 0.25%. As the economy rebounded and inflation accelerated, the BoC began normalizing policy, hiking the rate a cumulative 0.75 percentage points between June and September of 2010. However, the recovery soon lost moment and the BoC stopped tightening. It has been on hold at 1.00% since.This past spring, the BoC flashed hawkish signals that rate hikes would soon be appropriate if, as it expected, the output gap began to close. Moreover, the Bank expressed concern that the persistently easy stance could exacerbate domestic imbalances. However, sluggish growth and the persistence of serious downside risks (the US fiscal cliff perhaps most notably) has stayed the BoC's hand, although it is likely to look for an opportunity to hike before the end of next year. Governor Mark Carney's decision to leave the BoC next summer and the lack of a successor creates additional uncertainty about monetary policy over the forecast horizon.

UK: Struggling To Grow

The UK's recovery from the Great Recession has been disappointing. From mid-2009 to mid-2011, the economy expanded at just a 1.5% average annual rate. The banking system, severely weakened by the 2008-09 financial crisis, restricted lending. Households struggled to repair their battered balance sheets, retarding consumer demand. Fiscal consolidation was a clear drag. Unfortunately, as the euro crisis intensified—eroding confidence, and the eurozone fell back into recession— retarding exports, the UK's anemic recovery gave way to recession. The economy contracted for three consecutive quarters, falling a cumulative 1.0%, from Q4 2011 to Q2 2012. GDP rebounded 1.0% in the third quarter of this year, partly on the London Olympics.But the powerful headwinds of restrictive fiscal consolidation, generally tight credit, cautious households, and eurozone recession dominant the forecast, keeping growth sluggish next year. Indeed, after contracting slightly in 2012, the economy appears poised to expand less than 1.0% in 2013.

As elsewhere, CPI inflation has gone through dramatic swings largely because of oil prices. The overall inflation rate rose to as high as 5.2% y/y during 2008, slowed to as low as 1.1% during 2009, then re-accelerated to 5.2% again last year. The VAT hikes at the beginning of each of the last two years, and the delayed effects of sterling depreciation have also played roles in sending inflation to uncomfortably high levels. Fortunately, inflation has slowed as the VAT hikes dropped out of the year-over-year calculations, the inflationary impetus from the exchange-rate depreciation faded, and oil prices stabilized. Indeed, by September, the headline rate was down to around 2.2%, its lowest in nearly three years and only just above the BoE's 2.0% target. The government's decision to increase university tuition fees this fall (as part of its package of fiscal tightening) pushed headline inflation further away from the target in October. But weak demand and the still sizable output gap should keep inflation under control over the forecast horizon. Indeed, we expect inflation to run just above target in 2013.

In response to the global financial crisis, the BoE cut its official Bank Rate to a record low 0.50% by early 2009. Although the policy rate was not cut further, the BoE continued easing in 2009 via a £200 billion QE program. The BoE remained on the sidelines through 2010 and much of 2011 but seemed poised to raise rates, and thus begin normalizing its policy stance, by the end of last year. However, weakening economic prospects and intensifying financial market stresses associated with the European crisis quashed the chances of any near term tightening. Indeed, the Bank actually eased policy last October by expanding its asset purchase program by £75 billion. The Bank then expanded QE by £50 billion two times this year (February and July), raising the total program to £375 billion. Also this summer, the BoE began an enhanced liquidity program and in coordination with the UK Treasury launched a "funding for lending scheme" to improve the domestic flow of credit. Looking ahead, there appears more ambivalence on the BoE's Monetary Policy Committee about further quantitative easing, although given the downbeat economic prospects for 2013 and the still sizable downside risks, further easing cannot be ruled out. Meanwhile, the BoE should leave its policy rate unchanged at 0.50% for the foreseeable future. Finally, Governor Mervin King's departure from the BoE this year elevates the monetary policy uncertainty for 2013.

Eurozone: Mild Recession, Lackluster Recovery, Existential Threat

The all-to-brief recovery from the Great Recession formally ended in the second quarter of 2012, when the economy began to "double-dip." Overall eurozone GDP fell 0.2% after remaining unchanged in the first quarter and falling 0.4% in the fourth quarter of last year. The good news is that the recession should be relatively mild for the region as a whole. Indeed, stagnation is probably a better description of economic conditions. The bad news is that the ensuing recovery is likely to be thoroughly lackluster. Moreover, there is a marked divergence between the performance of the members, even within the Big-Three. Germany continues to grow slowly, while France stagnates and Italy contracts sharply. The net result is that eurozone GDP falls 0.4% in 2012 and 0.3% in 2013, although as exports revive and consumer and business confidence improve, growth resumes during the course of next year.

The 2008-09 recessions in the Big-Three were severe. The initial recoveries were mixed. Now, one has faded, one has essentially stopped, and one has reversed. Through the first quarter of 2011, the German rebound was robust, with GDP rising an impressive 4.9% y/y. The French rebound was more moderate, with GDP rising 2.4%. And the Italian rebound was anemic, with GDP rising just 1.3%. Then growth slowed everywhere. Indeed, the comparable figures for the latest (third) quarter are 0.9% for Germany, 0.1% for France and -2.4% for Italy. Germany should continue to grow modestly, France stagnates and Italy contracts over the next quarter or two. Then growth should accelerate in all three countries, although it remains anemic. Indeed, Germany grows just 1.1% in 2013, while France advances just 0.3%, and Italy contracts 1.0%.

The eurozone's multidimensional crisis will continue to fester through the forecast horizon, imparting downside risk to the global economic outlook. Admittedly, there is some good news. Recent assessments of Ireland's and Portugal's program implementations were generally positive. Spanish banks are receiving much needed capital from the stability funds. The ECB has introduced a new policy tool, “Outright Monetary Transactions” (OMT) designed to reduce excessively high financing costs for sovereigns under stress. And the German Constitutional Court has approved German participation in the European Stability Mechanism (ESM). But the Greek crisis is becoming a soap opera in quarterly episodes. Thus far, the troika has found ways to disburse funds despite missed targets, and while we expect that to continue (and Greece to remain in the eurozone), there is growing resistance to austerity inside the country and waning patience with the lack of progress outside the country, keeping alive the possibility of a “Grexit.”

Even if the current membership of the eurozone is maintained over the intermediate term, there are underlying flaws in its structure that pose a threat over the longer term. Specifically, relative competitiveness has shifted markedly since EMU began in 1999. Over the last 13 years, output prices have risen approximately 13% in Germany, 27% in France and 31% in Italy. Given that nominal exchange rates are locked, this implies that Germany has gained a 14%-18% competitive advantage against two of its major trading partners. (Moreover, most of the other 14 “non-core” countries in the eurozone share this sizable competitive disadvantage to Germany.) Not surprisingly then, over the same interval, industrial production has risen around 19% in Germany, slipped 7.0% in France and slumped 18% in Italy. In short, Germany is destined to chronically outperform, while France and Italy are doomed to chronically underperform... hardly a stable structure.

Oil prices have buffeted headline inflation continuously over the last four years. Gyrations in the energy component were primarily responsible for pushing eurozone CPI inflation to a high of 4.0% y/y in July 2008, a low of -0.7% in July 2009, and back to 2.2% currently. Core inflation (which excludes food, alcohol and tobacco as well as energy) has been generally much better behaved, hovering around 1.5% over the last 18 months. Going forward, headline inflation will remain hostage to the vagaries of oil (and food) prices. Given our projection that oil prices will trend sideways, we expect headline inflation to decelerate progressively from 2.7% in 2011 overall to 2.4% for 2012 and to 2.0% in 2013. Core inflation should remain close to the current benign level as the economy stagnates, keeping output gaps wide.

Unlike the other major central banks, the ECB began to raise administered interest rates in mid 2011, although it abruptly reversed course, cutting the minimum bid rate back to 1.00% by December of that year, and to a new low of 75 basis points in July of 2012. The ECB also undertook long-term refinancing operations (LTRO) which were widely credited with easing strains in the banking system and indirectly lowering yields on peripheral government debt. More recently, the Bank has introduced OMTs, which are “ex ante” unlimited purchases of short term bonds of compliant sovereigns that are in or just exiting a support program. Spain appears the most likely candidate to enter such a program during 2013 and therefore qualify for OMTs, although its government frets about the terms and conditions that would be attached. We expect administered interest rates to remain unchanged at current levels through 2013, although there is some chance that at least the minimum bid rate (and possibly the other administered rates) will be cut by a further 25 basis points.

Japan: Third Recession in Four Years

The initial recovery from the Great Recession was robust, but ended abruptly with the devastating earthquake, tsunami and nuclear disaster of March 2011. The subsequent recovery was also quite robust, but proved equally short lived. As the yen strengthened on the BoJ's relative tightness (its balance sheet has expanded a lot less than the Fed's) and the global economy slowed, the all-important export sector lost momentum and the economy began to contract for the third time in four years. Indeed, GDP fell 0.9% (3.5% annualized) in the third quarter, and appears poised to contract further in the fourth quarter. Growth picks up moderately in 2013 as the global economy revives and domestic reconstruction efforts finally ramp up, but because of the timing of the latest slowdown the year-over-year increase in GDP is limited to just 0.4%. However, with the timing of both government expenditures and actual rebuilding from the earthquake/tsunami unclear, there is a high degree of uncertainty around the forecast.

All three widely used measures of consumer price inflation accelerated between early 2010 and early 2012. Two of those measures, headline and national core inflation (which excludes fresh food products) actually turned positive last spring, while conventional core (which excludes food and energy) stayed negative, but reached a three-year high of -0.3% y/y in April. However, the pick-up at least partly reflected a confluence of special factors, most obviously rises in oil, electricity and food prices on the headline, but also temporary shortages created by the earthquake/tsunami, higher cigarette taxes, and one-off changes affecting accident insurance costs and high-school fees on all three indexes. Now that some of those special factors are falling out of the year-over-year calculation, deflation is re-emerging. Moreover, because we project oil prices to hover around current levels over the forecast, underlying deflation should continue and even intensify. Indeed, we expect headline consumer prices to fall 0.5% in 2013 after remaining unchanged in 2012.

During the Great Recession, the BoJ cut its policy rate to 10 basis points, where it remained until October of 2009, when it was lowered to 0-10 basis points. The BoJ did not cut further, because the current Governor—Masaaki Shirakawa—was opposed to the resumption of the zero interest rate policy (ZIRP), arguing that it hampers the smooth functioning of the money markets. However, the Bank did engage in quantitative easing. It introduced an asset-purchase fund that currently stands at ¥66 trillion and a credit lending facility that stands at ¥25 trillion, both of which could be increased modestly in the near future. That would amount to fine tuning. There is a possibility that monetary policy could change much more dramatically in 2013. The new Prime Minister, Shinzo Abe, has called for unlimited monetary easing to end deflation, and for the government's right to set the BoJ's policy goals. (Currently, the BoJ establishes its own goals.) Moreover, Governor Shirakawa and two deputies are leaving in the spring, providing the government an opportunity to change the composition of the Monetary Policy Board. Hence, the BoJ might begin to expand its balance sheet much more aggressively, which creates downside risks for the yen, and upside ones for growth and inflation.

Australia: Fighting Through Global Headwinds

Australia avoided the worst of the Great Recession. Indeed, while most major advanced economies contracted sharply in 2009, Australia expanded, although only by 1.4%. Growth reaccelerated to 2.6% in 2010 as the headwinds of global recession and financial dislocation eased. However, as 2011 began, severe flooding interrupted the improvement. Production in the export-oriented coal industry was especially hard hit. But, the economy bounced back solidly as coal production resumed and exports rebounded. Fixed investment also soared on the rebuilding and replacing of damaged public and private infrastructure. Hence, despite a rough start to the year, the economy still expanded 2.4% in 2011 overall. And the rebound in exports along with buoyant domestic demand has put growth on track to expand a solid 3.5% this year. Looking ahead, investment should continue to bolster GDP growth. In particular, mining is expanding its capacity to meet strong long run global demand for Australia's mineral bounty. Monetary easing should also boost housing and consumer spending. However, the relatively strong Aussie dollar and slowing global demand are weighing on trade-exposed sectors and may even undermine investment in mining capacity. Fiscal consolidation will also create headwinds. Consequently, growth should moderate next year to 2.8%—a bit below potential. Moreover, there remain serious downside risks if global and particularly Chinese growth slow more than expected.

Overall CPI inflation accelerated during 2010 and the first half of 2011, eventually hitting 3.5% y/y in the second quarter of last year on the post-recession rebound in commodity prices, flood-induced fresh produce shortages, and the Arab spring-related oil price spike. However, inflation has moderated as these effects have dissipated and indeed it dropped to 1.2% by the second quarter of this year— well below the RBA's 2.0-3.0% target range. Meanwhile, underlying inflation has been benign—trending recently in the lower half of the target range—as the strong Aussie dollar has helped contain inflation pressures in an economy likely running near full employment. Headline inflation will most likely reaccelerate sharply over the next few quarters, even briefly topping 3.0%. However, this acceleration mostly reflects a temporary boost caused by the launching of the carbon tax this year (which began showing up in the Q3 CPI data). In the second half of 2013, headline inflation should settle comfortably within the target range as the carbon tax effect drops out.

Although Australia ducked the worst of the global downturn, the RBA slashed its policy rate by over four percentage points to 3.00% by April 2009. But, by October of that year, it decided that such substantial monetary policy accommodation was no longer necessary and began the rate normalization process, eventually raising the cash target 175 basis points to 4.75% over the following thirteen months. The RBA then went on hold. Although the Bank contemplated a further rate hike in 2011, it eventually decided to ease, cutting its policy rate a quarter point in November and again in December. It eased four more times this year, leaving the cash rate target at a distinctly accommodative 3.00%. The Bank's motivation for easing appears to be precautionary, reflecting headwinds from sluggish global growth and lower commodity prices. Moreover, it anticipates some rebalancing of the economy as the outsized contribution from resource investment gives way to more even contributions across business, consumers and housing, and hopes the easy policy stance will support this process. Looking ahead, we believe that the RBA will hold the line in 2013, leaving the Bank to monitor the impact of this year's cuts. However, we can't rule out the possibility that further cuts will prove necessary if downside risks to growth materialize.

Thanks to :
Geoffrey Somes
Vice President & Senior Economist
State Street Global Advisors