

Economic Risks

- Narrowing of cyclical underperformance of euro area growth relative to the US and UK
- China and India growth rates moderating further
- Continued weakness of primary exporters
- Deglobalisation gathers pace
- More financial repression in the US and beyond

Euro area: conjunctural problems could still spiral out of control. However:

- Heads of state and government now seem committed to a three stage plan on banking union:
 1. Completion of the legislative framework by 31 December 2012;
 2. Establishment of the Single Supervisory Mechanism in the course of 2013; and
 3. Perhaps direct recapitalisation in 2014.
- Harmonisation of national resolution and deposit guarantee frameworks under European supervision will likely be matters for the future
- And Greece has now received its latest instalment

Euro area in 2013: euro area GDP underperformance relative to the US and the UK may narrow:

- Increasing fiscal consolidation and corporate sector retrenchment will come to an end
- Destocking no greater than in 2012 would add 1pp to GDP growth
- While disparities will persist in the region, France may do better than envisaged by Consensus
- French competitiveness is increasingly seen as the stick with which to beat the administration
- Calls for wage restraint/cuts are growing in the face of supply side adjustments in the periphery
- *A priori* it is hard to see anything particularly dire about the current French position
- Vis-à-vis non-euro countries, the recent (two-year) slide in the euro seems likely to impact favourably, offsetting any changes in relative costs/prices
- Vis-à-vis euro countries, France still seems in better shape than most of its partners

Bottom line: policymaker resolve will continue to hold the euro area together

Watch for: inventories supporting GDP, fiscal plans in the core economies, progress on banking union

US in 2013: we remain of the view that GDP will grow below the economy's potential rate:

- The most visible risk is fiscal, with a real chance of a large consolidation knocking 1-2pp off US growth
- The inventory cycle is unlikely to support US GDP in 2013 to the extent that it did in 2012
- More positively but longer term, lower hydrocarbon prices will boost both consumption and investment

Bottom line: expect below-consensus growth (-0.8pp)

Watch for: the inventory cycle becoming less supportive; and fiscal consolidation plans

UK in 2013: we doubt that GDP will grow as fast as the consensus expects:

- Consensus seems likely to be right on UK growth (1.3%) only if it is wrong on the euro area (-0.1%)
- Fiscal consolidation continues, household debt is up, animal spirits are weak, exports disappoint
- We see a 1 in 3 risk of UK exit from the EU, with the euro area the 'new European single market'
- With no strategic plan for its place in the world – particularly concerning the City – the UK faces increasing marginalisation

Bottom line: sub-consensus 2013 GDP growth (-0.6pp)

Watch for: realisation that the UK is in many ways – especially financial – in worse shape than the euro area

Asia in 2013: we continue to dispute the decoupling from the West still implied by the consensus:

- China's exports have slowed sharply
- China's GDP grew at an annual rate of 7.4% in Q3, the slowest rate in more than three years
- India continues to run sizeable deficits and its structural reforms are key to avoiding a return to the so-called 'Hindu' rates of growth
- India and China are unlikely to do as well in 2013 as envisaged by consensus. The recent sharp stock market underperformance is a warning sign

Bottom line: below-consensus growth in both China and India in 2013 (-2pp and -1.3pp respectively)

Watch for: policy stimulus, exchange rate adjustments

Primary exporters: we strongly doubt that growth in 2013 will rebound as strongly as consensus suggests:

- Brazil: we expect below-consensus growth (-1.4pp): 2012 is turning out considerably below consensus

Watch for: declining terms of trade; more domestic demand stimulus; and domestic inflation ■

Financial Market Risks

- Escalating deglobalisation pushing up risk premia to levels not seen in decades
- Falling corporate profit margins
- Recent bounce in industrial commodities becoming unsustainable amid slowing growth

Risk premia: set to rise as deglobalisation gathers pace:

- Financial markets struggle to price in qualitative risks, due in part to the quantitative nature of modern finance
- This practically ensures that the myriad risks associated with deglobalisation are not yet priced
- The global slowdown implies a further sharp deterioration in government finances
- However, this is unlikely to lead to sharply higher bond yields as policymakers stand ready, through ‘financial repression’, to limit market discipline
- There is no free lunch: primary exporters and other trade surplus countries will nevertheless seek to de-risk reserve portfolios
- This implies general currency weakness in most developed importing economies
- Japan’s transition from trade surplus to deficit is important: yet another sovereign debt mountain is becoming dependent on external financing
- Many commentators argue that reserve currency status confers unique, ever-lasting privilege on the US; we doubt that

Currencies: recent dollar weakness is likely to continue:

- US dollar fundamentals are deteriorating. Safe-haven demand provides support, but it is likely to prove only temporary
- China and other developing economies will likely continue to intervene to slow their currencies’ appreciation
- However, we doubt that this will reverse the trend: this is contributing importantly to global de-leveraging and a re-balancing process
- Both have considerably further to run

Equity markets: recent QE-related gains are unlikely to be sustained as global growth disappoints:

- Much supportive action on the policy front has already been anticipated
- Oil and other commodity prices have risen strongly from recent lows, eating into margins
- A handful of earnings surprises have already cited rising input costs as an issue. This seems likely to spread across more industries
- Trade and currency disputes are increasing, and may become damaging to corporate profitability

Commodities: the recent range trade in commodities is likely to continue:

- Commodity prices are now consolidating gains from the cheap levels seen over the summer
- That said, being real assets, commodities cannot be ‘devalued’ as currencies can: indeed, deglobalisation implies growing supply constraints
- Gold and other ‘safe-haven’ commodities appear to have re-commenced a more sustainable uptrend

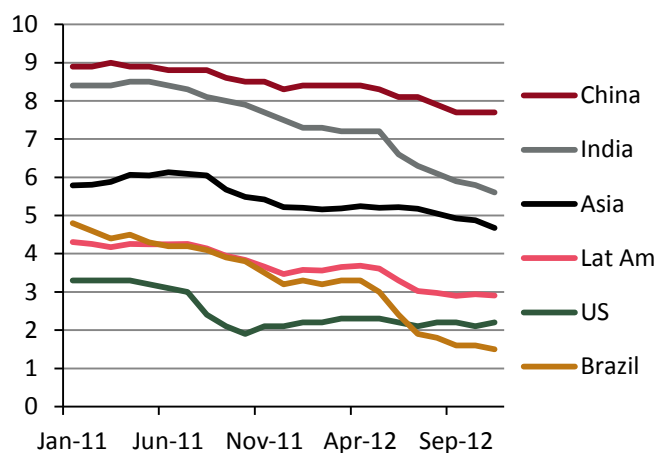
Asset valuations: increased downside risk:

- Deglobalisation is gathering pace, but asset prices have yet to price in these risks properly
- Public debt dynamics and strong global GDP headwinds are persisting longer, and are more obdurate, than consensus had been expecting
- More negative surprises may lie ahead for corporate profits, due to slower growth and margin pressures
- Worsening sovereign debt dynamics could also spill over into other markets as confidence wanes
- Moreover, the risks of trade and currency disputes are rising. Brazil is a notable example.
- Sanctions on Iranian oil exports could ignite other tensions – note the BRIC ‘Delhi Declaration’

Trade wars are significantly negative for productivity and corporate profitability ■

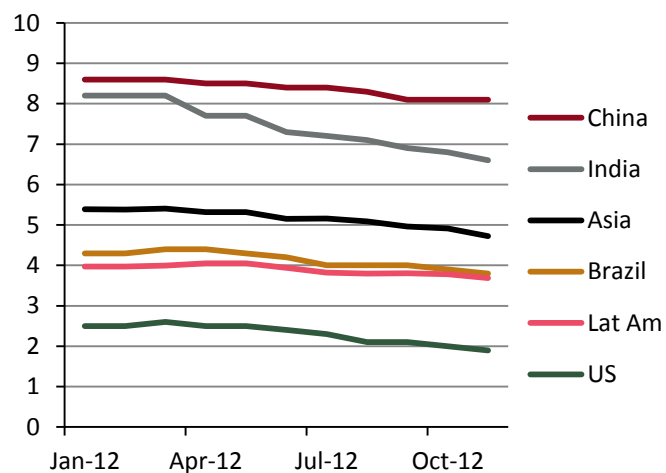
Charts of the month

Figure 1: Evolving consensus forecasts, 2012 real GDP growth



Source: Consensus economics

Figure 2: Evolving consensus forecasts, 2013 real GDP growth



Source: Consensus economics

Table: Real GDP growth and financial market rates

Region	Weight in world GDP	Real GDP growth (% y-o-y)						LLC Difference from Consensus (pp)		FX rate	Policy rate	10yr yield	Equities
		Average	Actual			Consensus							
	2010	1989-07	2009	2010	2011	2012	2013	2012	2013				
Europe	29	-	-4.1	2.0	1.9	-0.1	0.6	0.0	-0.1				
Euro area	19	2.2	-4.0	1.7	1.5	-0.6	-0.1	0.0	0.0	1.35	0.25%	N/A	N
Germany	5	1.9	-5.0	3.6	3.0	0.8	0.8	0.0	0.0			1.6%	
France	4	2.0	-2.2	1.5	1.6	0.1	0.2	0.0	0.2				
UK	4	2.4	-4.9	1.3	0.9	-0.1	1.3	0.0	-0.6	1.65	0.5%	2.0%	N
Italy	3	1.4	-5.0	1.1	0.6	-2.4	-0.7	0.0	0.0				
Spain	2	3.1	-3.7	-0.1	0.7	-1.5	-1.6	0.0	0.0				
North America	26	-	-2.5	2.8	1.8	2.2	1.9	-0.3	-0.8				
US	23	2.9	-2.4	2.8	1.7	2.2	1.9	-0.3	-0.8	N/A	0.25%	2.0%	U
Canada	3	2.6	-2.6	3.1	2.3	2.0	2.0	0.0	-0.5	0.96	1.0%	1.9%	U
Asia	27	-	1.5	7.2	4.7	4.7↓	4.7↓	-0.2	-1.1				
Japan	9	1.6	-5.2	3.9	-0.6	1.8↓	0.8↓	0.0	0.0	80	0.1%	1.0%	N
China	9	10.0	8.7	10.3	9.2	7.7	8.1	-0.5	-2.0	6.3	2.5%	N/A	U
India	2	6.3	5.7	8.6	7.2	5.6↓	6.6↓	0.0	-1.3	54	6.0%	N/A	U
Latin America	8	-	-2.0	6.0	4.1	2.9	3.7	0.0	-0.9				
Brazil	3	2.5	-0.2	7.5	2.9	1.6	3.8	0.0	-1.4	1.85	7.0%	N/A	N
Other	11	-	-2.0	3.8	4.1	4.0	3.8	-0.1	-0.7				
Global	100	-	-1.9	4.0	3.0	2.5	2.6	-0.1	-0.7				

Note: Regional weights may not sum to 100 due to rounding. Arrows indicate a revision of at least 0.2pp since last month.

O=overweight, U=underweight, N=neutral

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- Continued weakness of primary exporters
- Deglobalisation gathering pace
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Euro area in 2013: there are clear conjunctural problems, and matters could still spiral out of control:

- ECB lending continues to replace interbank lending, and the North-South divide has strengthened
- Banks are retrenching behind national borders, and cross-border financial flows have not recovered
- Financial integration appears to be in reverse
- There are still many hurdles to overcome, particularly Bundesbank opposition
- However some important progress has been made towards banking and fiscal union
- Market concerns about the risk of euro area break-up appear to have eased, at least for the moment

The euro area's GDP underperformance relative to the US and the UK may narrow:

- The inventory cycle may soon begin to support euro area GDP, as it has already done in the US
- Headwinds from fiscal consolidation may diminish
- While disparities will persist in the region, France may do better than envisaged by Consensus

Bottom line: we continue to judge that policymakers' resolve will be sufficient to hold the euro area together.

Watch for: any slackening of German political resolve; the inventory cycle supporting GDP.

US in 2013: we remain of the view that GDP will grow below the economy's potential rate:

- The most visible risk is fiscal policy: there is a real chance of a very large consolidation tipping the economy into recession
- The Obama victory will likely mean a smaller tightening than Romney would have produced
- Though the 'fiscal cliff' may be in part avoided, uncertainty is already hurting investment
- The inventory cycle is unlikely to support US GDP in 2013 to the extent it did in 2012
- The inventory-to-sales ratio is at its highest in years, and final demand has not strengthened

- Exports to China have doubled in four years; a slowing China could further constrain US growth
- The breadth of recent profit warnings, spanning most industries, is unusual outside recession

Bottom line: We expect below-consensus US economic 2013 growth (-0.8pp)

Watch for: the inventory cycle becoming less supportive; and post-election fiscal consolidation plans

UK in 2013: we doubt that GDP will grow as fast as the consensus expects:

- Consensus is likely to be right on UK growth (1.2%) only if it is wrong on the euro area (0%)
- A larger fiscal consolidation is outstanding in the UK than in the euro area
- Net exports have been weak: the Q2 current account deficit exceeded 5% of GDP
- More fundamentally, the UK faces the prospect of increasing marginalisation within Europe
- There is no evident strategic plan for the UK's place in the world – particularly concerning for the City

Bottom line: we expect below-consensus 2013 economic growth (-0.6pp)

Watch for: realisation that the UK is in many ways – especially financial – in worse shape than the euro area

Asia in 2013: we continue to dispute the decoupling from the West still implied by the consensus:

- China's exports to the US and euro area have slowed sharply in recent months
- China's GDP grew at an annual rate of 7.4% in Q3, the slowest in more than three years
- India's structural reform efforts have not revived, and the risk is of a return to 'Hindu' rates of growth
- The OECD composite leading indicators continue to point down, even more so than last month
- India and China are unlikely to achieve the bounce next year envisaged by consensus

Bottom line: we expect below-consensus growth in both China and India (-2pp and -1.3pp respectively)

Watch for: policy stimulus, exchange rate adjustments

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- Japan’s transition from trade surplus to deficit is important: yet another sovereign debt mountain is becoming dependent on external financing
- Many commentators argue that reserve currency status confers unique, ever-lasting privilege on the US; we doubt that

Currencies: recent dollar weakness is likely to continue:

- US dollar fundamentals are deteriorating. Safe-haven demand provides support, but it is likely to prove only temporary
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- Trade and currency disputes are increasing, and may become damaging to corporate profitability

Commodities: the recent rally lost momentum in September. We expect a range-trade ahead:

- Following a full-year downtrend, commodities appeared very cheap by June, both outright and relative to equity markets
- The strong bounce in July and August was broad, and included most industrial commodities. This is unsustainable amid weakening global demand
- That said, being real assets, commodities cannot be ‘devalued’ as currencies can: indeed, deglobalisation implies growing supply constraints
- Gold and other ‘safe-haven’ commodities may have re-commenced a more sustainable uptrend

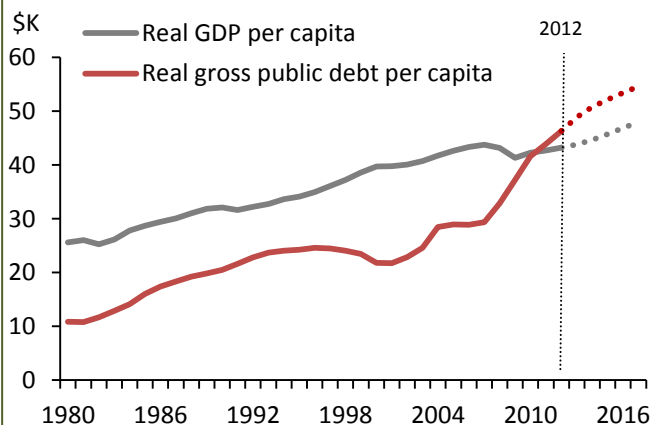
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- Sanctions on Iranian oil exports could ignite other tensions – note the recent BRIC ‘Delhi Declaration’

Trade wars are significantly negative for productivity and corporate profitability ■

Charts of the month

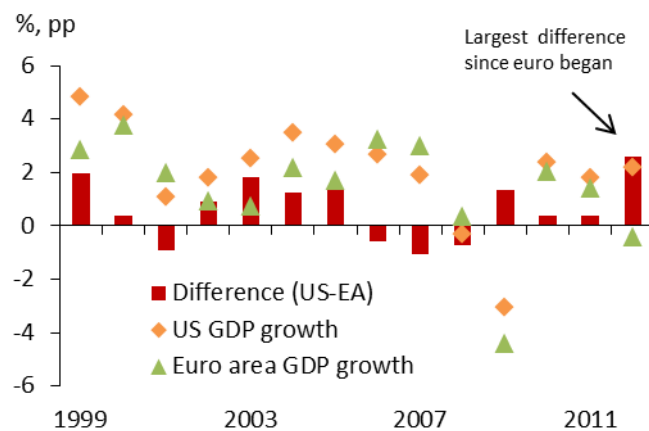
Figure 1: US Real GDP per capita and real gross public debt per capita



Source: IMF World Economic Outlook September 2012

Notes: 2005 is the base year

Figure 2: Comparing real GDP growth in the euro area and the US



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France	4	2.0	-2.2	1.5	1.6	0.1	0.3	0.0	0.2
UK	4	2.4	-4.9	1.3	0.9	-0.2	1.2	0.0	-0.6
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FX rate	Policy rate	10yr yield	Equities
Mid-2013			
1.35	0.25%	N/A	N
		1.6%	
1.65	0.5%	2.0%	N
N/A	0.25%	2.0%	U
0.96	1.0%	1.9%	U
76	0.1%	1.0%	N
6.3	2.5%	N/A	U
54	6.0%	N/A	U
1.85	7.0%	N/A	N

Note: Regional weights may not sum to 100 due to rounding. Arrows indicate a revision of at least 0.2pp since last month.

O=overweight, U=underweight, N=neutral

Recommended reading

The New York Times, 2012. China's Doldrums Put Pressure on US Exporters, [Click here](#)Rosenberg, D., 2012. My Evolving Macro And Market Thots, [Click here](#)

Economic Risks

- Cyclical underperformance of euro area growth relative to US and UK growth to narrow
- Chinese and Indian growth rates moderating
- Continued weakness of the primary exporters
- Deglobalisation gathers pace
- More financial repression in the US and beyond

In August and September we focussed on long-term risks, particularly political sentiment moving in the direction of financial repression and 'deglobalisation'.

We concluded that investors should watch for:

- A growing risk of competitive devaluations becoming a tool of economic warfare
- Financial repression, resource nationalisation, and trade wars increasingly restricting cross-border movements of capital and labour
- More policies which (directly or indirectly) keep interest rates/exchange rates artificially low; and
- Policies to create a captive domestic audience for public debt.

This (October) issue returns to shorter-term risk. With 2012 now in Q4, the main focus is on 2013.

2013: Consensus over past months has been coming further into line with the three major risks we have been identifying and analysing over the past two years:

1. **Weak recovery in the West**, particularly in the US, due to the nature of financially induced recessions
2. **Slowing Asia**, particularly China and India, due to the unlikelyhood of decoupling from the weak West
3. **Weakness in the primary exporters**, particularly Brazil, due to (1) and (2) above

These concerns may have somewhat further to run in 2013, but the gap between consensus and us has narrowed.

Euro area in 2013: There are clear conjunctural problems, and they could spiral out of control:

- ECB lending has replaced interbank lending, and a North-South divide has emerged
- Banks are retrenching behind national borders, and cross-border financial flows have not recovered
- Financial integration, as measured by a range of indicators, appears to be in reverse

That said, we continue to judge that policymakers' resolve will prove sufficient to overcome these issues.

If so, then euro area's GDP underperformance relative to the US and UK may narrow:

- The inventory cycle may soon begin to support euro area GDP, as it has already done in the US
- The headwinds created by fiscal consolidation will become less significant than at present

Watch for: the inventory cycle supporting GDP; clarification of plans for banking union in December

US in 2013: we continue to judge that GDP will grow below the economy's potential rate:

- The inventory-to-sales ratio is at its highest level in years, and final demand has not strengthened
- Fiscal policy will tighten by a massive 4% of GDP in 2013 unless Congress decides otherwise
- Though the 'fiscal cliff' may be avoided, uncertainty may already be hurting investment (Figures 1 and 2)
- We expect below-consensus growth (-0.8pp)

Watch for:

- The inventory cycle becoming less supportive
- Post-election fiscal consolidation plans

UK in 2013: we doubt that GDP will grow as fast as the consensus expects:

- More fiscal consolidation is outstanding than in the euro area
- Exports have been weak, given the massive depreciation of sterling
- We expect below-consensus 2013 growth (-0.6pp)

Asia in 2013: we continue to dispute the decoupling from the West implied by the consensus:

- Re-balancing of the Chinese economy may be beginning to take hold
- However serious re-balancing is likely to require either a slowing economy or household consumption to grow unrealistically quickly
- India's structural reform efforts have largely petered out, and the risk is of a return to so-called Hindu-rates of growth (3-4%)
- We expect below-consensus growth in both China and India (-2pp and -1.3pp respectively)

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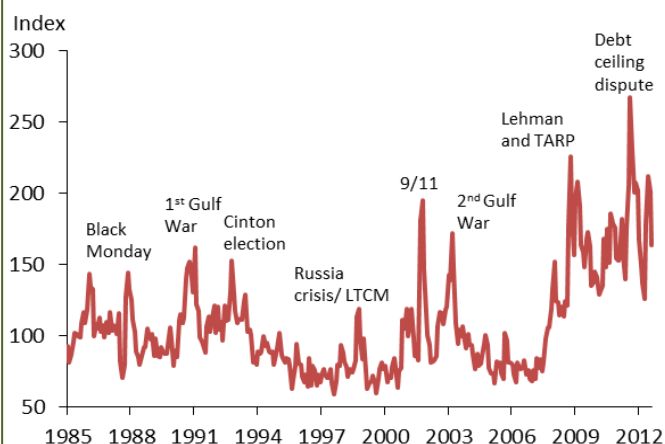
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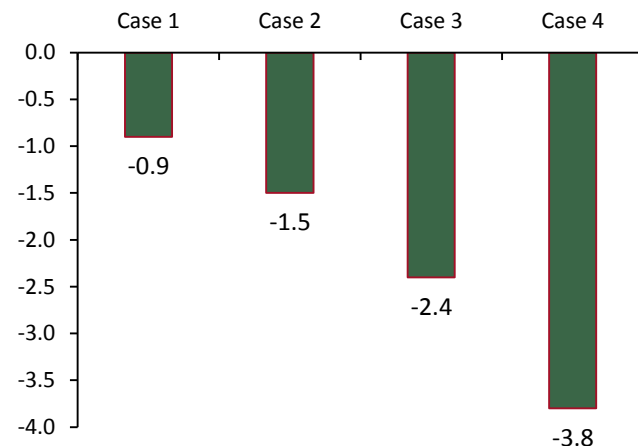
Charts of the month

Figure 1: US economic policy uncertainty index

Source: *policyuncertainty.com*

Notes: index based on media coverage of policy uncertainty; federal tax code provisions set to expire; and disagreement among economic forecasters

Figure 2: The effect on US nominal GDP: four potential fiscal cliff scenarios

Source: *Credit Suisse*

Notes: for more on cases 1-4 see below

Figure 2: Case 1 – in the most favourable scenario for GDP, only the CBO’s “other spending and revenue changes” and the Obamacare tax increases phase in. Case 2 – Case 1 (above) plus the payroll tax cut is not extended. Case 3 – Case 2 (above) plus the upper income tax increases, budget sequester, and expiration of emergency unemployment insurance benefits and the “other expiring provisions” (including the bonus depreciation allowance). Case 4 – Case 3 (above) plus the expiration of tax rates below the \$200K/\$250K threshold, failure to patch the AMT, and failure to enact the “Doc Fix”, gives the least favourable scenario for GDP.

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Italy	3	1.4	-5.0	1.1	0.6	-2.2	-0.6	0.0	0.0
Spain	2	3.1	-3.7	-0.1	0.7	-1.6	-1.4	0.0	0.0
North America	26	-	-2.5	2.8	1.8	2.2	2.1	-0.3	-0.8
US	23	2.9	-2.4	2.8	1.7	2.2	2.1	-0.3	-0.8
Canada	3	2.6	-2.6	3.1	2.3	2.0	2.0	0.0	-0.5
Asia	27	-	1.5	7.2	4.7	4.9↓	5.0	-0.2	-1.1
Japan	9	1.6	-5.2	3.9	-0.6	2.4	1.3	0.0	0.0
China	9	10.0	8.7	10.3	9.2	7.7↓	8.1↓	-0.5	-2.0
India	2	6.3	5.7	8.6	7.2	5.9↓	6.9↓	0.0	-1.3
Latin America	8	-	-2.0	6.0	4.1	2.9	3.8	0.0	-0.9
Brazil	3	2.5	-0.2	7.5	2.9	1.6↓	4.0	0.0	-1.4
Other	11	-	-2.0	3.8	4.1	4.0	4.0	-0.1	-0.7
Global	100	-	-1.9	4.0	3.0	2.5	2.8	-0.1	-0.6

FX rate	Policy rate	10yr yield	Equities
Mid-2013			
1.35	0.25%	N/A	N
		1.6%	
1.65	0.5%	2.0%	N
N/A	0.25%	2.0%	U
0.96	1.0%	1.9%	U
76	0.1%	1.0%	N
6.3	2.5%	N/A	U
54	6.0%	N/A	U
1.85	7.0%	N/A	N

Note: Regional weights may not sum to 100 due to rounding. Arrows indicate a revision of at least 0.2pp since last month.

O=overweight, U=underweight, N=neutral

Recommended reading

Congressional Budget Office., 2012. *An Update to the Budget and Economic Outlook: Fiscal Years 2012 to 2022*, [click here](#)Baker, S., Bloom, N. and Davis, S., 2012. *Measuring Economic Policy Uncertainty*, [policyuncertainty.com](#), [click here](#)

Economic Risks

- Deglobalisation gathers pace
- More financial repression in the US and beyond
- Excess underperformance of euro area growth relative to US and UK growth to end
- Chinese and Indian growth rates moderating to 4-5% a year
- Continued weakness of the primary exporters

Global: sentiment in favour of the free movement of the factors of production may have peaked, with a risk of globalisation reversing – “deglobalisation”.

- With GDP in Western economies weak, unemployment widespread, public debt at peacetime highs and rising, national pressures are increasing
- There is increasing likelihood of Western governments not paying their debt back in full
- Many will choose to renege, *de facto*, finding innovative ways to ‘screw the saver’
- Chosen method(s) – default; devaluation; financial repression; or inflation, will differ by region
- The German preference is probably for eventual debt restructuring, not repression and/or inflation
- In the US and UK, repression raises fewer cultural and political objections
- Trade wars, financial repression, and resource nationalisation could increasingly restrict the movement of capital and labour across borders

Watch for: more policies which (directly or indirectly)

- Keep interest rates/exchange rates artificially low
- Require savers/financial institutions to hold more government bonds
- Reduce central bank independence/expand the central banks’ mandate
- Control capital movements; demonise foreigners and speculators; and create a ‘home bias’ in product, labour, and financial markets

Euro area relative to the US and UK: the adjustment required to restore a sustainable path for real GDP is no closer to completion in the US or the UK.

- In aggregate the euro area fiscal position is not as bad as that of the US, the UK, or Japan
- However, the regional debt crisis is fragmenting the union, along national lines

- Re-orientation of financial activity along national lines has contributed to difficulties in the monetary transmission mechanism
- Convertibility premia are now a stated motivation for the ECB’s expected bond-buying programme
- Central banks can buy time, but economy-wide deleveraging must occur in the US and Europe
- In the euro area the inventory cycle could soon begin to support GDP, as it already has in the US
- Moreover, the headwinds created by fiscal consolidation will not be as significant after 2013
- In the US, fiscal consolidation at federal level is yet to be discussed seriously. In the UK, more consolidation is outstanding than in the euro area
- Recovery to potential growth may come sooner in Europe than in either the US or the UK
- We expect below-consensus 2013 growth in both the US (-0.8pp) and UK (-0.6pp)

Watch for:

- The inventory cycle supporting GDP in the euro area; but becoming less supportive in the US
- Post-election fiscal consolidation plans in the US

Asia: we continue to dispute the decoupling from the West implied by the consensus.

- The re-balancing of the Chinese economy may be beginning to take hold
- However, rebalancing is likely to happen amidst economic slowdown: the requisite measures themselves are likely to slow growth
- With inflation now falling more quickly than interest rates, the real return for household savers has risen, as has the real cost of borrowing
- There is a growing risk of competitive devaluations becoming a tool of economic warfare
- India’s structural reform efforts have petered out. Trade and current account deficits are large, and inflation remains stubbornly high
- India is in danger of a return to the so-called Hindu-rates of growth (3-4%) seen post-independence
- We expect below-consensus 2013 growth in both China and India (-2pp and -1.3pp respectively)

Watch for: policy stimulus, exchange rate adjustments

Primary exporters: we doubt that growth in 2013 will rebound as strongly as consensus.

Watch for: declining terms of trade; domestic demand stimulus; and domestic inflation.■

Financial Market Risks

- Escalating de-globalisation pushing up risk premia to levels not seen in decades
- Falling corporate profit margins
- Recent bounce in industrial commodities becoming unsustainable amid slowing growth

Risk premia rising as de-globalisation gathers pace.

- Financial markets struggle to price in qualitative risks, in part due to the quantitative nature of modern finance
- This practically ensures that the myriad risks associated with de-globalisation are not yet priced
- The global slowdown implies a further sharp deterioration in government finances
- However, this is unlikely to lead to sharply higher bond yields as policymakers stand ready, through ‘financial repression’, to limit market discipline
- There is no free lunch: primary exporters and other trade surplus countries will nevertheless seek to de-risk reserve portfolios
- This implies general currency weakness in most developed importing economies
- Japan’s transition from trade surplus to deficit is important: yet another sovereign debt mountain is becoming dependent on external financing
- Many commentators argue that reserve currency status confers unique, ever-lasting privilege on the US; we doubt that

Currencies: renewed dollar weakness is likely, vis-à-vis most currencies.

- US dollar fundamentals are deteriorating. Safe-haven demand provides support, but it is likely to prove only temporary
- China and other developing economies will likely continue to intervene to slow their currencies’ appreciation
- However, we doubt that this will reverse the trend: this is contributing importantly to global de-leveraging and a re-balancing process
- Both have considerably further to run

Equity markets: the strong recovery over the past two months seems unsustainable.

- Much supportive action on the policy front has already been anticipated
- Oil and other commodity prices have risen strongly from recent lows, eating into margins
- A handful of earnings surprises have already cited rising input costs as an issue. This seems likely to spread across more industries
- Trade and currency disputes are increasing, and may become damaging to corporate profitability

Commodities: The sharp bounce in commodities prices, while not unexpected, is unlikely to continue.

- Following a full-year downtrend, commodity prices appeared very cheap by June, both outright and relative to equity markets
- The strong bounce in July and August was broad and included most industrial commodities. This is unsustainable amid weakening global demand
- That said, as real assets, commodities cannot be ‘devalued’ as currencies can: indeed, de-globalisation implies growing supply constraints
- Gold and other ‘safe-haven’ commodities may have re-entered a more sustainable uptrend

Asset valuations: increased downside risk.

- De-globalisation is gathering pace yet asset prices have yet to price in these risks properly
- Public debt dynamics and strong global GDP headwinds are persisting longer, and are more obdurate, than consensus had been expecting
- Negative surprises may lie ahead for corporate profits, due to slower growth and margin pressures
- Worsening sovereign debt dynamics could also spill over into other markets as confidence wanes
- Moreover, the risks of trade and currency disputes are rising
- Sanctions on Iranian oil exports could ignite other tensions – note the recent BRIC ‘Delhi Declaration’

Trade wars are significantly negative for productivity and corporate profitability ■

Table: Real GDP growth and financial market rates

Region	Weight in world GDP	Real GDP growth (% y-o-y)						LLC Difference from Consensus (pp)		FX rate	Policy rate	10yr yield	Equities	
		Average	Actual			Consensus								
	2010	1989-07	2009	2010	2011	2012	2013	2012	2013					
Europe	29	-	-4.1	2.0	1.9	0.0	0.8↓	0.0	-0.1	Mid-2013	1.35	0.25%	N/A	N
Euro area	19	2.2	-4.0	1.7	1.5	-0.5	0.2↓	0.0	0.0					
Germany	5	1.9	-5.0	3.6	3.0	0.9	1.2	0.0	0.0					
France	4	2.0	-2.2	1.5	1.6	0.1	0.5↓	0.0	0.0					
UK	4	2.4	-4.9	1.3	0.9	-0.2↓	1.4↓	0.0	-0.6					
Italy	3	1.4	-5.0	1.1	0.6	-2.1	-0.5↓	0.0	0.0					
Spain	2	3.1	-3.7	-0.1	0.7	-1.7	-1.4↓	0.0	0.0					
North America	26	-	-2.5	2.8	1.8	2.2	2.1↓	-0.3	-0.8	N/A	0.25%	2.0%	U	
US	23	2.9	-2.4	2.8	1.7	2.2	2.1↓	-0.3	-0.8					
Canada	3	2.6	-2.6	3.1	2.3	2.0	2.1	0.0	-0.5					
Asia	27	-	1.5	7.2	4.7	5.1	5.1	-0.3	-1.1	76	0.1%	1.0%	N	
Japan	9	1.6	-5.2	3.9	-0.6	2.5	1.4	0.0	0.0					
China	9	10.0	8.7	10.3	9.2	7.9↓	8.3	-0.7	-2.0					
India	2	6.3	5.7	8.6	7.2	6.1↓	7.1	0.0	-1.3					
Latin America	8	-	-2.0	6.0	4.1	3.0	3.8	0.0	-0.9	1.85	7.0%	N/A	N	
Brazil	3	2.5	-0.2	7.5	2.9	1.8	4.0	0.0	-1.4					
Other	11	-	-2.0	3.8	4.1	4.0	4.0	-0.2	-0.7					
Global	100	-	-1.9	4.0	3.0	2.6	2.9	-0.2	-0.7					

Note: Regional weights may not sum to 100 due to rounding. Arrows indicate a revision of at least 0.2pp since last month.

O=overweight, U=underweight, N=neutral

Recommended reading**Pettis, M. (2012)**, *Has the Great Rebalancing Already Started?* China Financial Markets (Michael Pettis' finance blog) [click here](#)**The Economist (2012)**, *International trade: Boxed in*, The Economist, 8 September 2012, [click here](#)**The Economist (2012)**, *Trade: Goodbye Doha, hello Bali*, The Economist, 8 September 2012, [click here](#)

Economic Risks

- Financial repression in the US and beyond
- Progress with closer euro area integration
- China's domestic demand unable fully to offset slowing export-led growth
- Continuing weakening of India's fundamentals
- Continued weakness of the primary exporters

This month we look further ahead than our customary 12 to 18 month horizon, to evaluate risks that we judge may eventuate over the coming 2 to 3 years.

Global: total debt is multiples of GDP, and public debt is at peacetime highs across the advanced economies

- There is little likelihood of Western governments paying their debt back in full and in real terms
- Many will choose to renege, one way or another
- The chosen method(s), whether outright default; devaluation; financial repression; or inflation, will likely differ by region

Watch for: policies which

- Increase official sector exposure to public debt
- Keep interest rates artificially low
- Require savers to hold more government bonds
- Reduce central bank independence
- Control capital movements
- Demonise foreigners and speculators; as well as
- Other innovative ways to 'screw the saver'

Euro area:

- In aggregate the euro area fiscal position is not as bad as that of the US, the UK, or Japan
- However, the regional disparities problem is fragmenting the union, along national lines
- The euro area does not lack the resources to deal with its regional debt problem: the problem remains one of political will and feasibility
- The crisis will lurch on until the ECB judges that it can become a full partner in contributing to resolution of the situation
- However the ECB can only be part of solution: it can rescue the euro area, but it cannot repair it
- Member states will not pay back in full in real terms: the European cultural preference is probably for debt restructuring rather than repression

U.K: The situation looks as bad as that on the continent

- Recovery has been weak compared with other G7 economies and the euro area as a whole
- We expect below-consensus 2013 growth (-0.6pp)

US: trouble lies ahead when markets lift their eyes from the European kerfuffle

- Public debt is above 100% of GDP and rising fast
- Taking the public-debt ratio down sustainably requires a massive, hence unlikely, fiscal tightening
- The US can maintain unsustainable policies for longer than other countries can, but eventually the debt problem will have to be addressed
- Politicians hate paying debt service. History suggests that financial repression will be used increasingly as national interest pressures surge
- We expect below-consensus 2013 growth (-1pp)

Asia: we continue to dispute the decoupling from the West implied by the consensus

- Chinese data continue to paint a confusing picture
- The latest flash PMI was the best in five months: however the employment sub-index hit a 40-month low
- The 7.6% expansion in Q2 was the slowest since Q2 2009
- The authorities have responded by spending more and easing monetary policy; more is likely to the extent that inflation remains subdued
- But this would only serve to delay the inevitable; investment-led growth cannot continue rapidly forever
- India's structural reform efforts are petering out. Trade and current account deficits are widening, inflation remains stubbornly high
- India's Q1 GDP grew at 5.3%, slowest in a decade
- We expect below-consensus 2013 growth in both China and India (-2pp and -1.3pp respectively)

Watch for: below-consensus Asian output data

Primary exporters: perhaps near the trough

- We doubt growth in 2013 will rebound as strongly as consensus, given the West's sluggishness
- We expect below-consensus growth in Brazil and Latin America in 2013 (-1.4pp and -0.9pp respectively)

Watch for: declining primary terms of trade; policy stimulus to offset the effects on domestic demand; and domestic inflation■

Financial Market Risks

- Growing recognition that sovereign finances are deteriorating rapidly, and that neither the US nor the UK are safe havens
- Falling corporate profit margins
- Relative commodity underperformance has probably ended

Debt dynamics as a result of the global slowdown

- QE and other central bank and regulatory policies increasingly disguise the extent to which sovereign finances have deteriorated
- This applies across nearly all developed economies
- The global slowdown implies a further sharp deterioration
- However, this is unlikely to lead to sharply higher bond yields as policymakers stand ready, through ‘financial repression’, to limit market discipline
- There is no free lunch: primary exporters and other trade surplus countries will nevertheless seek to de-risk reserve portfolios
- This implies general currency weakness in most developed importing economies
- Japan’s transition from trade surplus to deficit is important: yet another sovereign debt mountain is becoming dependent on external financing
- Many commentators argue that reserve currency status confers unique, ever-lasting privilege on the US; we doubt that
- Increasing recognition of this would affect the present value of a range of financial assets globally

Currencies: renewed dollar weakness is likely, vis-à-vis most currencies

- US dollar fundamentals are deteriorating. Safe-haven demand provides support, but it is likely to prove only temporary
- China and other developing economies will likely continue to intervene to slow their currencies’ appreciation
- However, we doubt that this will reverse the trend: this is contributing importantly to global de-leveraging and a re-balancing process
- Both have considerably further to run

Equity markets: the strong recovery over the past month seems unsustainable

- Much supportive action on the policy front has already been anticipated
- Oil prices have risen strongly from recent lows
- A handful of earnings surprises have already cited rising input costs as an issue. This seems likely to spread across more industries
- Trade and currency disputes are increasing, and may become damaging to corporate profitability

Commodities: sharp underperformance over the past year is probably approaching a trend reversal

- Commodity prices have trended lower for over a full year now, the longest such period for a decade
- Commodity prices have also fallen somewhat further than recent weakness in equity markets implies. In relative terms, they appear ‘cheap’
- While demand may be weak in 2012-13 and supply is relatively stable by comparison, the escalating supply of sovereign debt implies currency weakness
- Viewed in these terms, commodities may now represent a superior store of value, leading to inventory stockpiling and slower depletion rates
- Gold may be a leading indicator in this regard. It appears that gold has put in a floor near \$1,500 and central bank buying has accelerated

Asset valuations: widespread downside risk

- Public debt dynamics and strong global GDP headwinds are persisting longer, and are more obdurate, than consensus had been expecting
- This persistence is increasingly likely to weigh on asset valuations
- Negative surprises may lie ahead for corporate profits, due to slower growth and margin pressures
- Worsening sovereign debt dynamics could also spill over into other markets as confidence wanes
- Moreover, the risks of trade and currency disputes are rising
- Sanctions on Iranian oil exports could ignite other tensions – note the recent BRIC ‘Delhi Declaration’
- Trade wars are significantly negative for productivity and corporate profitability ■

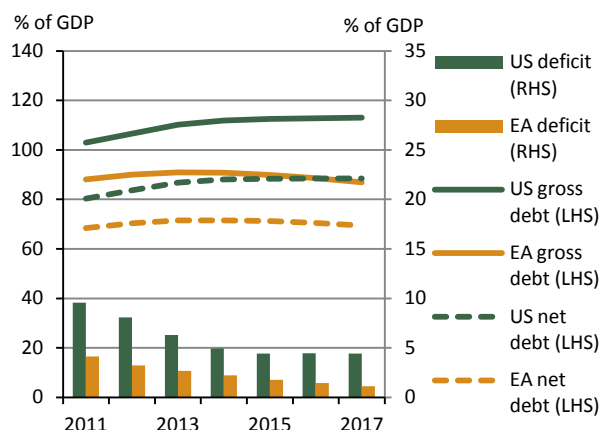
Charts of the month

Total debt/GDP ratios are several multiples of GDP in the major economies

Gross debt (% of 2012 GDP)	IRE	JAP	POR	SPA	UK	FRA	GRE	EA	ITA	US	GER
Nonfinancial Corporates	244	143	154	196	118	152	75	138	112	87	63
Households	120	74	105	89	99	63	70	70	51	88	59
Government	113	236	112	79	88	89	153	90	123	107	79
Total	477	453	371	364	305	304	298	298	286	282	201
Financial Institutions	691	177	63	109	742	169	33	142	97	87	97

Source: IMF Global Financial Stability Report, April 2012

The US fiscal position is much worse than the euro area in aggregate



Source: IMF Fiscal Monitor, April 2012

Table: Real GDP growth and financial market rates

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Euro area	19	2.2	-4.0	1.7	1.5	-0.5	0.4↓	0.0	0.0	1.30	0.25%		N
Germany	5	1.9	-5.0	3.6	3.0	0.9	1.3	0.0	0.0			1.6%	
France	4	2.0	-2.2	1.5	1.6	0.2	0.7↓	0.0	0.0				
UK	4	2.4	-4.9	1.3	0.9	0.1↓	1.6↓	0.0	-0.6	1.60	0.5%	2.0%	N
Italy	3	1.4	-5.0	1.1	0.6	-2.0↓	-0.3	0.0	0.0				
Spain	2	3.1	-3.7	-0.1	0.7	-1.7	-0.9↓	0.0	0.0				
North America	26	-	-2.5	2.8	1.8	2.1	2.3	-0.3	-1.0				
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Asia	27	-	1.5	7.2	4.7	5.2	5.2	-0.4	-1.1				
Japan	9	1.6	-5.2	3.9	-0.6	2.5	1.4	0.0	0.0	76	0.1%	1.0%	N
China	9	10.0	8.7	10.3	9.2	8.1	8.4	-0.9	-2.0	6.3	3.0%	N/A	U
India	2	6.3	5.7	8.6	7.2	6.3↓	7.2	0.0	-1.3	52	6.0%	N/A	U
Latin America	8	-	-2.0	6.0	4.1	3.0↓	3.8	0.0	-0.9				
Brazil	3	2.5	-0.2	7.5	2.9	1.9↓	4.0↓	0.0	-1.4	1.75	8.0%	N/A	N
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Global	100	-	-1.9	4.0	3.0	2.6	3.0	-0.2	-0.7				

Note: Regional weights may not sum to 100 due to rounding. Arrows indicate a revision of at least 0.2pp since last month.

O=overweight, U=underweight, N=neutral

Recommended reading

Eichengreen, B. (2012), *The Meaning of China's Economic Slowdown*, The Diplomat Blogs, 31 July 2012, [click here](#)Eichengreen, B., Park, D. and Shin, K. (2011), *When Fast Growing Economies Slow Down: International Evidence and Implications for China*, National Bureau of Economic Research, [click here](#)Wyplosz, R. J. (2012), *End of game? Don't bet on it*, VoxEU, 25 July 2012, [click here](#)Wyplosz, R. J. (2012), *Welcome to the ECB*, VoxEU, 30 July 2012, [click here](#)

Economic Risks

- Financial repression in the US and beyond
- Closer euro area integration, and the marginalisation of any 'outside the tent'
- China's domestic demand unable fully to offset slowing export-led growth
- Continuing weakening of India's fundamentals
- Continued weakness of the primary exporters

US: trouble lies ahead when markets lift their eyes from the European kerfuffle

- US GDP has recovered its pre-crisis-peak level
- But the falling investment/GDP ratio after 2007 has not rebounded much, and remains low
- Animal spirits in the (flush) corporate sector seem likely to remain subdued
- Public debt has breached 100% of GDP and, with the public deficit over 8% of GDP, is rising fast
- Fiscal policy will tighten by a massive 4% of GDP in 2013 unless Congress postpones it
- Yet even more would be needed to reduce the public-debt ratio, particularly given age-related spending
- The US can maintain unsustainable policies for longer than other countries can, but eventually the debt problem will have to be addressed
- Politicians hate paying debt service. History suggests that financial repression will be used increasingly as national interest pressures surge
- We expect below-consensus growth in both 2012 and 2013 (-0.3pp and -1pp respectively)

Watch for: policies which

- Keep interest rates artificially low
- Create a 'captive domestic audience' for public debt
- Reduce central bank independence
- Require savers to hold more government bonds
- Control capital movements
- Demonise foreigners and speculators; and
- Other innovative ways to 'screw the saver'

Europe: point of inflection?

- Fiscal consolidation and bank deleveraging are constraining growth in the bank-dependent system
- Dependence on the ECB is high; the LTRO palliative is wearing off; and the negative feedback loop between banks and sovereigns remains strong

- We have long agreed with consensus that large GDP falls are likely in the weaker southern economies
- However, we have also judged that this would not feed through as strongly as consensus expected into domestic demand in the larger economies
- Since January consensus has risen to meet us; and we have now closed out our positive differences for France and Germany in 2012
- The Summit Van Rompuy 10-year plan was genuinely important, and both confirms and reinforces the positive dynamic, as was intended
- We are starting to think that sentiment towards Europe may be at or near an inflection point

Watch for: a decline in the shrillness with which commentators assert that the euro is doomed; and a correspondingly growing risk of UK marginalisation

Asia: we continue to dispute the decoupling from the West implied by the consensus

- China's June manufacturing PMI was the lowest since January; with large increases in finished goods inventories, and large falls in new orders
- Questions are again being asked about the trustworthiness of China's economic data
- But the divergence between China's 'official' PMIs and HSBC/Markit PMIs is closing
- India's structural reform efforts are petering out. Trade and current account deficits are widening, inflation remains stubbornly high
- India's Q1 GDP grew at 5.3%, slowest in a decade
- We expect below-consensus growth in both China and India in 2013 (about -2pp for each)

Watch for: below-consensus Asian output data

Primary exporters: perhaps near the trough

- Consensus has revised down its forecasts for Brazil and Latin America substantially for 2012
- We have closed our negative difference for 2012
- We doubt growth in 2013 will rebound as strongly as consensus, given the West's sluggishness
- From Brazil to Australia, primary producers' terms of trade are likely to remain weak
- Oil is the one major potential exception
- We expect below-consensus growth in Brazil and Latin America in 2013 (-1.4pp and -0.8pp respectively)

Watch for: declining primary terms of trade; policy stimulus to offset the effects on domestic demand; and domestic inflation■

Financial Market Risks

- Sharply worsening sovereign debt dynamics
- Renewed dollar weakness
- Falling profit margins weighing on equities
- Commodity underperformance nearing an end
- General downside risk to asset prices

Sharply worsening sovereign debt dynamics as a result of the global slowdown

- QE and other central bank and regulatory policies increasingly disguise the degree to which sovereign finances have deteriorated
- This applies across nearly all developed economies
- The global slowdown implies a further sharp deterioration
- However, this is unlikely to lead to sharply higher bond yields as policymakers stand ready, through ‘financial repression’, to limit market discipline
- There is no free lunch: primary exporters and other trade surplus countries will nevertheless seek to de-risk reserve portfolios
- This implies general currency weakness in most developed economies
- Japan’s transition from trade surplus to deficit is important: yet another sovereign debt mountain is becoming dependent on external financing
- Many commentators argue that reserve currency status confers unique, ever-lasting privilege on the US; we doubt that
- Increasing recognition of this would affect the present value of a range of financial assets globally

Currencies: renewed dollar weakness is likely, vis-à-vis most currencies

- Recent dollar strength has reflected a general rise in risk aversion, which may now be dissipating
- China and other developing economies will likely continue to intervene to slow their currencies’ appreciation
- However, we doubt that this will reverse the trend: this is contributing importantly to global de-leveraging and a re-balancing process
- Both have considerably further to run

Equity markets: the strong recovery over the past month seems unsustainable

- Much supportive action on the policy front has already been anticipated
- Oil prices have risen strongly from recent lows
- A handful of earnings surprises have already cited rising input costs as an issue. This seems likely to spread across more industries
- The risk of trade and currency disputes is increasing, and would be damaging to corporate profitability

Commodities: sharp underperformance over the past year is probably approaching a trend reversal

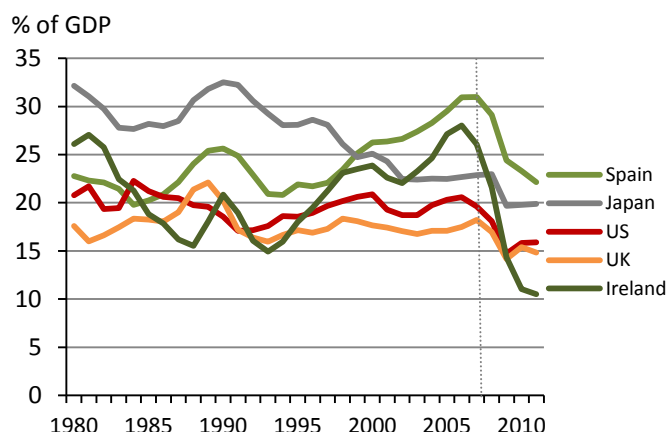
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- Viewed in these terms, commodities may now represent a superior store of value, leading to inventory stockpiling and slower depletion rates
- Gold may be a leading indicator in this regard. It appears that gold has put in a floor near \$1,500 and central bank buying has accelerated

Asset valuations: widespread downside risk

- Public debt dynamics and strong global GDP headwinds are persisting longer, and are more obdurate, than consensus had been expecting
- This persistence is increasingly likely to weigh on asset valuations
- Potential negative surprises remain in store for corporate profits due to slower growth and margin pressures
- Worsening sovereign debt dynamics could also spill over into other markets as confidence wanes
- Moreover, the risks of trade and currency disputes are rising
- Sanctions on Iranian oil exports could ignite tensions in other areas – note the recent BRIC ‘Delhi Declaration’
- Trade wars are significantly negative for productivity and corporate profitability ■

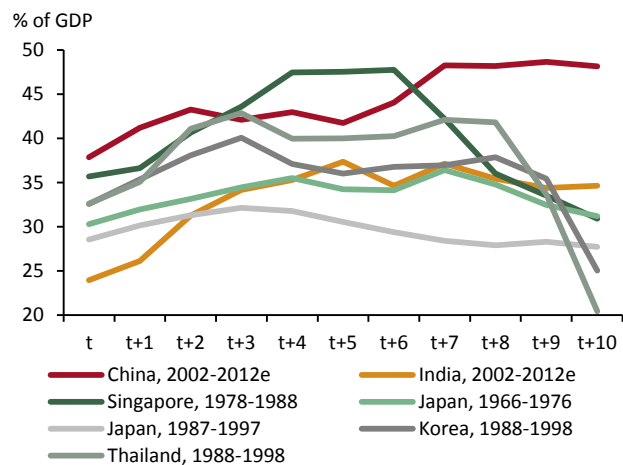
Charts of the month

Investment/GDP ratios 1980-2011, selected advanced economies



Source: IMF World Economic Outlook April 2012

Asian investment/GDP ratios during and after economic boom periods



Source: IMF World Economic Outlook April 2012, Nomura, and LLC

Table: Real GDP growth and financial market rates

Region	Weight in world GDP	Real GDP growth (% y-o-y)						LLC Difference from Consensus (pp)		FX rate	Policy rate	10yr yield	Equities
		Average	Actual			Consensus							
	2010	1989-07	2009	2010	2011	2012	2013	2012	2013				
Europe	29	-	-4.1	2.0	1.9	0.1	1.2	0.0	-0.1				
Euro area	19	2.2	-4.0	1.7	1.5	-0.4	0.6↓	0.0	0.0	1.30	0.25%		N
Germany	5	1.9	-5.0	3.6	3.0	0.9	1.4↓	0.0	0.0			1.6%	
France	4	2.0	-2.2	1.5	1.6	0.3	0.9	0.0	0.0				
UK	4	2.4	-4.9	1.3	0.9	0.3	1.8	0.0	-0.3	1.60	0.5%	2.0%	N
Italy	3	1.4	-5.0	1.1	0.6	-1.8↓	-0.2↓	0.0	0.0				
Spain	2	3.1	-3.7	-0.1	0.7	-1.6	-0.7	0.0	0.0				
North America	26	-	-2.5	2.8	1.8	2.2	2.4	-0.3	-1.0				
US	23	2.9	-2.4	2.8	1.7	2.2	2.4	-0.3	-1.0	N/A	0.25%	1.8%	U
Canada	3	2.6	-2.6	3.1	2.3	2.1	2.2	0.0	-0.5	0.96	1.0%	1.9%	U
Asia	27	-	1.5	7.2	4.7	5.2	5.2	-0.4	-1.1				
Japan	9	1.6	-5.2	3.9	-0.6	2.5↑	1.3↓	0.0	0.0	76	0.1%	1.0%	N
China	9	10.0	8.7	10.3	9.2	8.1↓	8.4	-0.9	-2.0	6.3	3.0%	N/A	U
India	2	6.3	5.7	8.6	7.2	6.6↓	7.3↓	-0.2	-1.3	52	6.0%	N/A	U
Latin America	8	-	-2.0	6.0	4.1	3.6↓	3.9↓	-0.2	-0.8				
Brazil	3	2.5	-0.2	7.5	2.9	3.0↓	4.2	0.0	-1.4	1.75	8.0%	N/A	N
Other	11	-	-2.0	3.8	4.1	4.0	4.1	-0.2	-0.8				
Global	100	-	-1.9	4.0	3.0	2.7	3.0↓	-0.2	-0.6				

Note: Regional weights may not sum to 100 due to rounding.

O=overweight, U=underweight, N=neutral

Recommended reading

Laing, R. J. (2012), *Falling Star*, Barron's Cover Story, 30 June 2012, [click here](#)Standard and Poor's (2012), *Will India Be The First BRIC Fallen Angel?*, 8 June 2012, [click here](#)

Economic Risks

- Below-consensus US growth in 2012 and 2013
- Above-consensus growth in Germany and France
- Asia not as decoupled as implied by consensus
- Primary exporters' growth below consensus

US growth: we doubt that economic growth will strengthen in 2013:

- The recovery continues in a manner typical of the aftermath of a major banking crisis
- US GDP has now recovered its pre-crisis peak level
- But public debt has breached 100% of GDP
- A massive fiscal tightening – 4% of GDP – will take place in 2013 unless Congress postpones it
- Yet much more is needed to reduce debt, particularly given age-related spending obligations
- Household deleveraging meanwhile has a way to go
- The US can maintain unsustainable policies for longer than others without facing similar pressures
- The day of reckoning is some way off, but the US is at increasing risk of losing its privileged status
- We expect below-consensus growth in both 2012 and 2013 (-0.3pp and -1pp respectively)

Watch for: increases in the US household savings rate and, later, post-election fiscal tightening

German / French growth: we doubt domestic demand in 2012 will be as weak as implied by consensus:

- Fiscal consolidation and bank deleveraging are constraining growth across the euro area
- Europe's financial system is bank-dependent, and the ECB's LTRO palliative is wearing off
- Large falls in GDP are likely in the weaker southern European economies, as predicted by consensus
- However, this need not feed through strongly into France and Germany
- Much will depend on events in Spain, now the lynchpin of the crisis
- The Greek election is unlikely to prove conclusive, and the issue is likely to linger for much longer
- Bank runs are a faster-moving risk; were recent trends to intensify, action would need to be swift
- As the crisis continues, a weak euro and low interest rates will help 'core' Europe

- German Q1 GDP data beat expectations, driven by net trade, particularly exports outside the euro area. Unemployment is at historically low levels
- We expect above consensus German and French growth in 2012 (by 0.5pp and 0.3pp respectively)

Watch for: better-than-expected domestic consumption and business fixed investment in Germany and France

Decoupling Asia: we dispute the decoupling from the West implied by the consensus forecasts:

- The high growth rates of the past stand to be difficult to maintain in the face of a soggy West
- A substantial slowdown in investment, particularly in China, will come at some stage
- At issue is whether this could, or would, be offset by consumption, whether aided by policy or not
- Recent Chinese data have been negative on this¹
- Trade data have been weak; electricity power output has fallen sharply; industrial production and retail sales both came in weaker than expected
- There is increasing divergence between 'official' PMIs and HSBC/Markit PMIs, with the latter more consistent with recent industrial data
- Inflation does appear to be slowing, and this could lead to more scope for policy easing
- This would, however, probably only delay the inevitable, given the West's continuing sluggishness
- We expect below-consensus growth in China and India in 2013 (about -2pp for each)

Watch for: further policy stimulus, more willingness to accept a lower growth rate, and food price inflation

Growth in the primary exporters: sluggish global growth will reduce both export volumes and prices:

- From Brazil to Australia, primary producers' terms of trade are likely to weaken further
- Oil is the one major potential exception
- Evidence continues to mount of a slowdown in the primary exporting economies
- In Brazil, industrial production fell again in April, and the benchmark interest rate fell to record lows²
- We expect below-consensus growth in Brazil and Latin America in 2013 (-1.4pp and -0.8pp respectively)

Watch for: declining primary terms of trade; policy stimulus to offset the effects on domestic demand; and domestic inflation■

¹ See [China's economic data disaster](#)

² See [Brazil signals more cuts after reducing rate to record low](#)

Financial Market Risks

- Global bond yields have fallen to new lows
- Renewed dollar weakness is likely
- Falling profit margins weighing on equities
- Industrial commodity prices sharply lower
- Trade and currency disputes escalating

Major-country bond yields have plummeted to new lows, due to a surge in risk aversion

- Markets appear sanguine about the US and UK debt situations, which continue to deteriorate
- Bond yields near term could increase as debt ratios rise, but not necessarily: central banks could buy more bonds
- Moreover, there is a risk that bond yields in ‘safe’ economies go lower because of Europe
- In this case the risk would manifest itself differently, probably through currency depreciation and price-level effects
- Ultimately, however, creditors will start to require compensation for increased inherent risk
- The closing-out of Japan’s trade surplus too is likely to place upward pressure on global bond yields in time as Japan’s net savings position declines
- Many commentators argue that reserve currency status confers unique, ever-lasting privilege on the US: we doubt that
- Increasing recognition of this would affect the present value of a range of financial assets globally

Currencies: renewed dollar weakness is likely, vis-à-vis most currencies

- Recent dollar strength reflects primarily a general rise in risk aversion. As the US runs a large current account deficit, this will become unsustainable
- China and other developing economies will likely continue to intervene to slow their currencies’ appreciation
- However, we doubt that this will reverse the trend: this is contributing importantly to global de-leveraging and re-balancing
- The yen has strengthened somewhat of late, but from the weakest level in a year. Further strength is likely as long as the dollar remains generally weak

Equity markets: valuations have improved somewhat following the recent sharp correction.

- Declines have been largest in Europe and in some developing markets, with the US outperforming
- The correction may not yet be over, although the downside may be limited by anticipation of action on the policy front
- Lower oil prices may also help to support equity markets going forward
- A handful of earnings surprises have already cited rising input costs as an issue. This seems likely to spread across more industries

Commodities: recent falls / underperformance in the prices of some commodities are likely to continue:

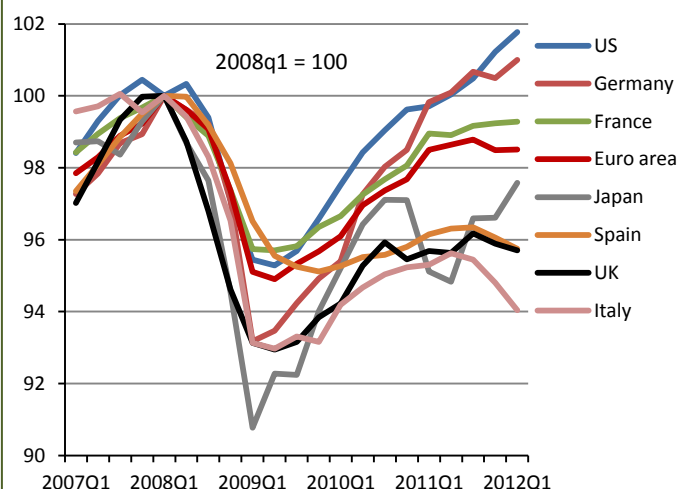
- Commodity prices have fallen more sharply recently than at any time since 2008
- As long as developing economies continue to slow, industrial commodity prices in particular are likely to move sideways to lower and, in any case, underperform non-industrial commodities
- Gold has also been declining but may now have found a floor above \$1,500 as central bank purchases have accelerated of late

Asset valuations: unfavourable public debt dynamics, strong global GDP headwinds, and escalating trade and currency disputes are increasingly likely to weigh on asset valuations:

- Negative surprises may be in store for corporate profits if the developing economies, which have driven global growth since 2008, are indeed slowing more rapidly than consensus expects
- Weaker-than-expected global growth will complicate attempts to reduce deficits and get debts under control in the developed economies
- The risks of trade and currency disputes are rising. Sanctions on Iranian oil exports could ignite tensions in other areas, as the recent BRIC ‘Delhi Declaration’ makes plain
- Trade wars are significantly negative for productivity and corporate profitability■

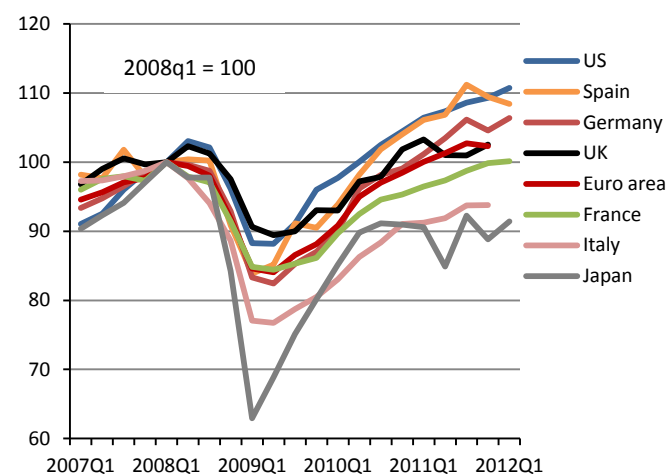
Charts of the month

The (non) recovery in real GDP levels since 2008



Source: Eurostat

The recovery in real export levels since 2008



Source: Eurostat

Table: Real GDP growth and financial market rates

Region	Weight in world GDP	Real GDP growth (% y-o-y)						LLC Difference from Consensus (pp)		FX rate	Policy rate	10yr yield	Equities
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Germany	5	1.9	-5.0	3.6	3.0	0.8	1.6	0.5	0.0			1.6%	
France	4	2.0	-2.2	1.5	1.6	0.4	1.0	0.3	0.0				
UK	4	2.4	-4.9	1.3	0.9	0.4↓	1.8	0.0	-0.3	1.60	0.5%	2.0%	N
Italy	3	1.4	-5.0	1.1	0.6	-1.5	0.1	0.0	0.0				
Spain	2	3.1	-3.7	-0.1	0.7	-1.7	-0.6↓	0.0	0.0				
North America	26	-	-2.5	2.8	1.8	2.3	2.5	-0.3	-1.0				
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Asia	27	-	1.5	7.2	4.7	5.2	5.3	-0.5	-1.1				
Japan	9	1.6	-5.2	3.9	-0.6	2.0	1.5	0.0	0.0	76	0.1%	1.0%	N
China	9	10.0	8.7	10.3	9.2	8.3	8.5	-0.9	-2.0	6.3	3.0%	N/A	U
India	2	6.3	5.7	8.6	7.2	7.2	7.7	-0.8	-1.7	52	6.0%	N/A	U
Latin America	8	-	-2.0	6.0	4.1	3.6	4.1	-0.2	-0.8				
Brazil	3	2.5	-0.2	7.5	2.9	3.0	4.3	-0.3	-1.4	1.75	8.0%	N/A	N
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Global	100	-	-1.9	4.0	3.0	2.7	3.2	-0.2	-0.7				

Note: Regional weights may not sum to 100 due to rounding.

O=overweight, U=underweight, N=neutral

Recommended reading

Bristow, M. and Colitt, R. (2012), *Brazil Signals More Cuts After Reducing Rate To Record Low*, Bloomberg, 31 May 2012, <http://www.bloomberg.com/news/2012-05-30/brazil-cuts-rate-to-record-low-8-5-as-euro-crisis-deepens-1-.html>

Mackenzie, K. (2012), *China's economic data disaster: Financial Sector Assessment*, FT Alphaville, May 14, 2012, <http://ftalphaville.ft.com/blog/2012/05/14/997661/chinas-economic-data-disaster/>

Economic Risks

- Below-consensus US growth in 2012 and 2013
- Above-consensus growth in Germany and France
- Asia not as decoupled as implied by consensus
- Primary exporters' growth below consensus

US growth: we doubt that economic growth will strengthen in 2013:

- The recovery continues in the typical pattern following a major banking crisis.¹
- Household deleveraging could have a way to go.
- US public debt has breached the 100% of GDP mark.
- Fiscal policy is expected to tighten, both this year and next, by around 1.5pp of potential GDP.
- An even more eye-watering tightening will occur in 2013 if unemployment benefits are not extended.
- Yet much more is needed to reduce debt, particularly given age-related spending obligations.
- Many commentators argue that reserve currency status confers unique privilege; but we doubt that.
- The US can maintain unsustainable policies for longer than others without facing similar pressures.
- However, ultimately creditors start to require compensation for the increased inherent risk.
- The day of reckoning will be some way off, but the US is at increasing risk of losing its privileged status.
- Increasing recognition of this would affect the present value of a range of financial assets.
- We expect below-consensus growth in both 2012 and 2013 (-0.3pp and -1pp respectively).

Watch for: increases in the US household savings rate and, later, post-election fiscal tightening.

German / French growth: we doubt domestic demand in 2012 will be as weak as implied by consensus:

- Fiscal consolidation and bank deleveraging are constraining growth across the euro area.
- Fiscal policy is expected to tighten across the euro area as a whole by around 1.5pp of potential GDP.
- Europe's financial system is bank-dependent and the ECB's LTRO palliative seems to be wearing off.
- Large falls in GDP are likely in the weaker southern European economies, as predicted by consensus.
- However, this need not feed through strongly into France and Germany as is implied by the consensus.

- Much will depend on events in Spain, which has become the lynchpin of the crisis.²
- Political developments will also be important, particularly around this year's remaining elections.
- In Germany, unemployment (6.7%) is at a post-unification low. Consumer and business confidence are commensurately high.
- Both factors stand to support domestic demand.
- We remain above consensus for German and French growth in 2012 (by 0.5pp and 0.3pp respectively)

Watch for: better-than-expected domestic consumption and business fixed investment in Germany and France.

Decoupling Asia: we doubt the decoupling from the West implied by the consensus forecasts:

- The high growth rates of the past stand to be difficult to maintain in the face of a sluggish West.
- A substantial slowdown in investment, particularly in China, will come at some stage.
- At issue is whether this could, or would, be offset by consumption, whether aided by policy or not.
- Exports are a drag and domestic demand is still in a corrective phase.
- Policy has been eased in China, and could be eased further before the end-year leadership transition.
- This would, however, probably only delay the inevitable, given the West's continuing sluggishness
- For growth, in both China and India in 2013, we remain around 2pp below consensus.

Watch for: further policy stimulus, more willingness to accept a lower growth rate, and food price inflation.

Growth in the primary exporters: sluggish global growth will reduce both export volumes and prices:

- From Brazil to Australia, primary producers' terms of trade are likely to weaken further.
- Oil is the one major potential exception.
- Evidence is mounting of a slowdown in the primary exporting economies.
- We expect below-consensus growth in Brazil and Latin America in 2013 (-1.4pp and -0.8pp respectively).

Watch for: declining primary terms of trade; policy stimulus to offset the effects on domestic demand; and domestic inflation.■

¹ See Posen (2012)

² See IMF (2012)

Financial Market Risks

- Global bond yields back near recent lows
- Additional dollar weakness is likely
- Falling profit margins weighing on equities
- Industrial commodity prices moving lower
- Trade and currency disputes escalating

Major-country bond yields seem to reflect central bank interventions and weak growth expectations, rather than concerns over public debt or inflation.

- The recent decline in major-country yields points to further central bank policy soon.
- Markets appear sanguine about the US debt situation, which continues to deteriorate.
- The closing-out of Japan's trade surplus is likely to place upward pressure on global bond yields as Japan's net savings position declines.
- UK gilt yields remain low, reflecting lingering optimism that austerity will be effective in time.
- Bond yields could increase as debt ratios rise, but not necessarily: central banks could buy more bonds.
- In this case the risk would manifest itself differently, probably through currency depreciation and price-level effects.

Currencies: additional dollar weakness is likely, vis-à-vis most currencies.

- While most economies appear to be slowing, the dollar is at particular risk, given US dependence on external financing.
- China and other developing economies will likely continue to intervene to slow their currencies' appreciation.
- However, we doubt that this will reverse the trend: this is contributing importantly to global de-leveraging and re-balancing.
- The yen has probably weakened sufficiently, however, to restore a degree of competitiveness: additional weakness seems unlikely.

Equity markets: valuations for some sectors look unsustainably rich.

- Some recovery from the depressed levels resulting from huge selling pressure in Q4 was justified.

- However, the continuing rise in equity markets has taken valuations to levels that require not only steady global growth ahead, but also continued high corporate profit margins.
- The twin input-cost negatives of higher oil prices and rapid developing-world wage growth imply that profit expectations are unwarrantedly high.
- Transportation shares have lagged due to their direct oil exposure, but nevertheless are also vulnerable to general margin pressure.
- A handful of earnings surprises have already cited rising input costs as an issue. This seems likely to spread across more industries.

Commodities: recent falls / underperformance in the prices of some commodities are likely to continue:

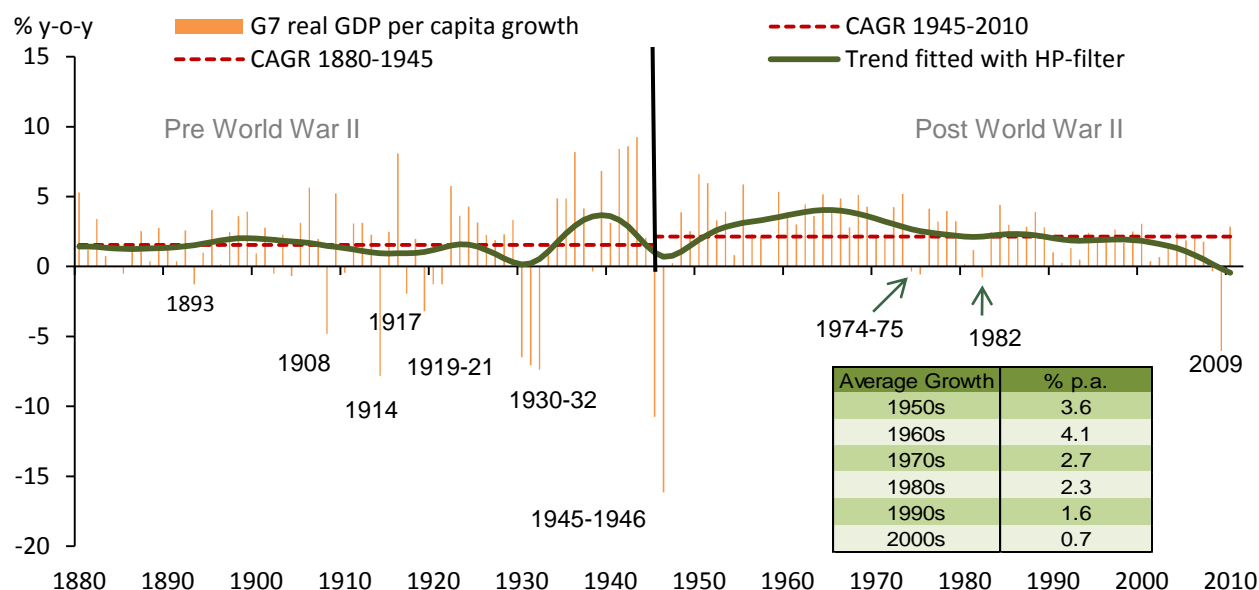
- Commodity prices have not risen as much as equities: perhaps another sign that the developing world is slowing faster than the consensus expects.
- The general rise in commodity prices early this year came to an abrupt halt in March: the recent surge in certain agricultural commodity prices was supply-related, and now appears to have subsided.
- As long as developing economies continue to slow, industrial commodity prices in particular are likely to move sideways to lower and, in any case, underperform non-industrial commodities.

Asset valuations: unfavourable public debt dynamics, strong global GDP headwinds, and escalating trade and currency disputes are increasingly likely to weigh on asset valuations:

- The rising equity market looks increasingly like an outlier, given declining government bond yields and wide credit spreads.
- Negative surprises may be in store for corporate profits if the developing economies, which have driven global growth since 2008, are indeed slowing more rapidly than consensus expects.
- Weaker-than-expected global growth will complicate attempts to reduce deficits and get debts under control in the developed economies.
- The risks of trade and currency disputes are rising. Sanctions on Iranian oil exports could ignite tensions in other areas, as the recent BRIC 'Delhi Declaration' makes plain.
- Trade wars are significantly negative for productivity and corporate profitability. ■

Chart of the month

Readers asked to see last month's GDP chart re-worked on a per-capita basis: the data look interestingly similar.



Source: Angus Maddison Historical Statistics on GDP per capita and the IMF World Economic Outlook database, April 2012

Notes: Growth was volatile pre-WWII, with both large increases and large falls. Post-WWII GDP per capita has been less volatile, but growth has trended down. The compound annual growth rate (CAGR) has been higher post-WWII, indicating that GDP per capita increased by more on a cumulative basis.

Table: Real GDP growth and financial market rates

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UK	4	2.4	-4.9	1.3	0.9	0.7	1.8	0.0	-0.3	1.60	0.5%	2.4%	U
Italy	3	1.4	-5.0	1.1	0.6	-1.5	0.2	0.0	0.0				
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Japan	9	1.6	-5.2	3.9	-0.6	2.0	1.5	0.0	0.0	74	0.1%	1.0%	N
China	9	10.0	8.7	10.3	9.2	8.4	8.5	-0.9	-2.0	6.2	3.0%	N/A	U
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Note: Regional weights may not sum to 100 due to rounding.

O=overweight, U=underweight, N=neutral

Recommended reading

Posen (2012), *Why is their recovery better than ours? (Even though neither is good enough)*, Speech given by Adam Posen at the National Institute of Economic and Social Research, London 27 March 2012

IMF (2012), *Spain: Financial Sector Assessment*, Preliminary Conclusions by the Staff of the International Monetary Fund, April 25, 2012

Economic Risks

- Below-consensus US growth in 2012 and 2013
- Above-consensus growth in Germany and France
- Asia not as decoupled as implied by consensus
- Primary exporters' growth below consensus

US growth: we doubt that economic growth will strengthen materially in 2013:

- While recent data continue to paint a somewhat positive picture, the fundamentals remain weak.
- Recovering from a financial recession is typically a long drawn-out process.
- US public debt has breached the 100% of GDP mark.
- On present policies, fiscal policy tightens, both this year and next, by around 1.5pp of potential GDP.
- Moreover, household deleveraging probably has a long way to go.
- Following the November elections the new President is likely to front-load fiscal tightening.
- Hence we forecast below-consensus growth of 2% in both 2012 and 2013 (-0.3pp and -0.6pp respectively).

Watch for: an increase in the US household savings rate, and post-election fiscal tightening.

Growth in Germany/France: we doubt that domestic demand in 2012 will be as weak as implied by consensus:

- Fiscal policy is tightening across the euro area as a whole by around 1.5pp of potential GDP in 2012.
- Meanwhile, the household, corporate, and/or financial sectors are also deleveraging.
- All this points to sub-par euro-area growth.
- The planned fiscal tightening is particularly big in Italy, Spain, and countries in a Troika programme – Greece, Portugal, and Ireland.
- Large falls in GDP are likely in the weaker southern European economies, as predicted by consensus.
- However, this need not feed through strongly into the larger, core economies (France and Germany) as is also implied by the consensus.
- Much will depend on events in Spain,¹ possible contagion to Italy and beyond, and political developments across the euro area.²

- In Germany, unemployment (6.7%) is at a post-unification low. Consumer and business confidence are commensurately high.
- Both factors should support domestic demand.
- German exports are also now more diversified away from the euro area.
- Recent data point to a weak start to the year in France, but we expect that domestic demand will not be as weak as implied by the consensus.

Watch for: better-than-expected domestic consumption and business fixed investment in Germany and France.

Decoupling Asia: we doubt the decoupling from the West implied by the consensus forecasts:

- The high growth rates of the past stand to be difficult to maintain in the face of a sluggish West.
- Downward revisions to consensus growth forecasts for the West have so far not been reflected in revisions for Asia, and particularly for China.³
- A substantial slowdown in investment will however come at some stage.
- At issue is whether this could or would be offset by consumption, whether aided by policy or not.
- China would almost certainly attempt to limit material slowdown until after the end-year leadership transition.
- But that would serve only to delay the inevitable, given the continuing sluggishness in the West.
- For both China and India, we forecast growth in 2013 at around 2pp below consensus.

Watch for: possible policy stimulus until the leadership change; but more willingness to accept a lower growth rate thereafter.

Growth in primary exporters: sluggish global growth will reduce both export volumes and prices:

- From Brazil to Australia, primary producers' terms of trade are likely to weaken further.
- Oil is the one major potential exception.
- Evidence is mounting of a slowdown in the primary exporting economies.
- We expect below-consensus growth of just 3% in both Brazil and Latin America as a whole in 2013.

Watch for: declining primary terms of trade; policy stimulus to offset the effects on domestic demand; and domestic inflation.■

¹ For a good analysis of the risks in Spain, see [Citigroup \(2012\)](#).

² On the importance of politics in Europe, see [article](#) by Wyplosz.

³ For more on the risks in China, see [article](#) by Michael Pettis.

Financial Market Risks

- Global bond yields rising further
- Additional dollar weakness is likely
- Falling profit margins weighing on equities
- Industrial commodity prices moving lower
- Trade and currency disputes escalating

Major-country bond yields seem to reflect central bank interventions and weak growth expectations, rather than concerns over public debt or inflation.

- The recent rise in major-country yields mostly reflects reduced risk aversion in Q1, as global equity markets recovered much of their 2011 losses.
- Markets appear sanguine about the US debt/GDP ratio, which has now risen through the 100% mark.
- The closing-out of Japan's trade surplus is likely to place some upward pressure on global bond yields as Japan's net savings position declines.
- Despite the UK's relatively poor fiscal position, Gilt yields are low, historically and relative to Bunds.
- Bond yields could increase, but not necessarily: central banks could buy many more bonds.
- In this case the risk would manifest itself differently, probably through currency depreciation and price-level effects.

Currencies: additional dollar weakness is likely, vis-à-vis most currencies.

- While the dollar continues to trade strongly, it risks weakening in 2012, alongside rising dollar money and credit growth.
- The risk is all the greater because the US is more dependent on external financing than are other developed economies.
- China and other developing economies will likely continue to intervene to slow their currencies' appreciation, although we doubt that they will reverse the trend, which is contributing importantly to global de-leveraging and re-balancing.
- The yen has probably weakened enough, however, to restore a degree of competitiveness: additional weakness seems unlikely.

Equity markets: valuations for some sectors look unsustainably rich.

- While some recovery from the depressed levels resulting from huge selling pressure in Q4 was justified, the continuing rise in equity markets has

taken valuations to levels that require not only steady global growth ahead, but also continued high corporate profit margins.

- The twin input cost negatives of higher oil prices and rapid developing-world wage growth imply that corporate profit expectations now seem unwarrantedly high.
- Transportation shares have lagged due to their direct oil exposure, but nevertheless are also vulnerable to general margin pressure.
- A handful of earnings surprises have already cited rising input costs as an issue. This seems likely to spread across more industries.

Commodities: recent falls/underperformance in the prices of some commodities are likely to continue:

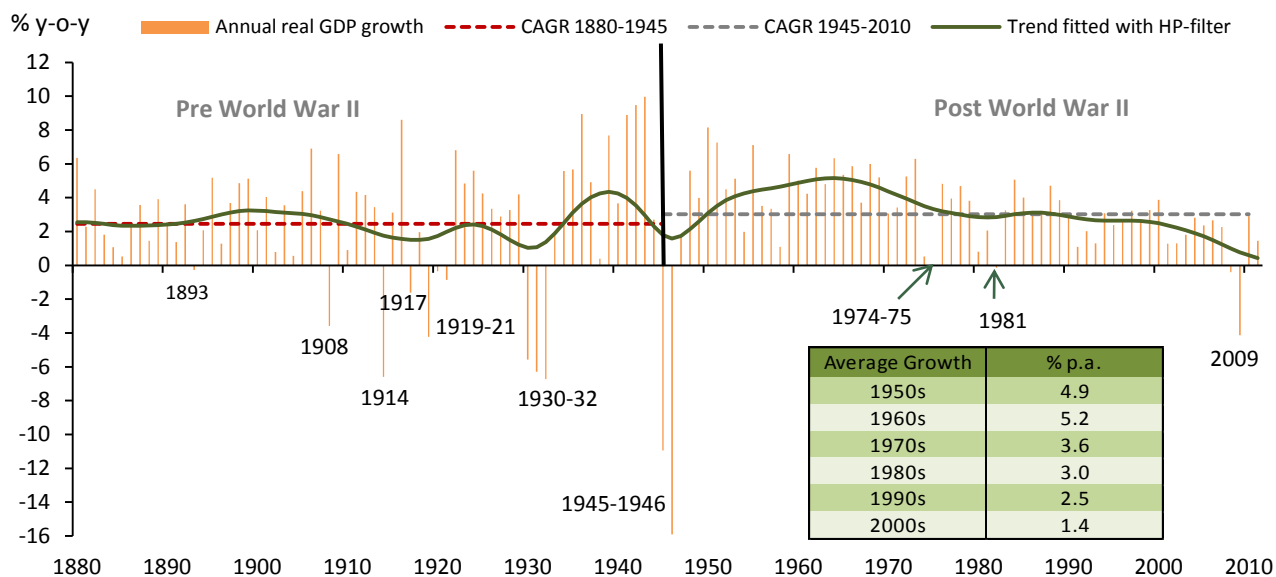
- Commodity prices have not risen to the extent that equities have. This may be another sign that the developing world is slowing more rapidly than the consensus expects.
- The general rise in commodity prices early this year came to an abrupt halt in March: the surge in certain agricultural commodity prices in recent weeks was for supply-related reasons.
- As long as developing economies continue to slow, industrial commodity prices in particular are likely to move sideways to lower and, in any case, underperform non-industrial commodities.

Asset valuations: unfavourable public debt dynamics, strong global GDP headwinds, and escalating trade and currency disputes could continue to weigh on asset valuations:

- The recent improvements in the US leading indicators, and the easing of euro-area tensions, may not be as permanent as investors seem to be expecting.
- Negative surprises may be in store for corporate profits if indeed the developing economies, which have driven global growth since 2008, are slowing more rapidly than consensus expects.
- Weaker-than-expected global growth will complicate attempts to reduce deficits and get debts under control in the developed economies.
- The risks of trade and currency disputes remain elevated. Sanctions on Iranian oil exports could ignite tensions in other areas, as the recent BRIC 'Delhi Declaration' makes plain. Trade wars are significantly negative for productivity and corporate profitability. ■

Chart of the month

G7 real GDP growth has trended downwards post-World War II; this could have been expected to continue even without the recent crisis



Source: Angus Maddison Historical Statistics on GDP and the IMF World Economic Outlook database, September 2011

Notes: GDP growth was volatile pre-WWII, with both large increases and large falls in GDP. Post-WWII GDP has been less volatile, but GDP growth has trended down. The compound annual growth rate (CAGR) has been higher in the post-WWII period, indicating that GDP increased by more on a cumulative basis.

Table: Real GDP growth and financial market rates

Region	Weight in world GDP	Real GDP growth (% y-o-y)						Difference from Consensus (pp)		FX rate	Policy rate	10yr yield	Equities
		Average	Actual			LLC Forecast							
	2010	1989-07	2009	2010	2011	2012	2013	2012	2013	End 2012			
Europe	29	-	-4.1	2.0	1.9	0.3	1.3	0.2	-0.1				
Euro area	19	2.2	-4.0	1.7	1.5	-0.2	0.8	0.2	0.0	1.4	1.0%		U
Germany	5	1.9	-5.0	3.6	3.0	1.1	1.5	0.5	0.0			2.0%	
France	4	2.0	-2.2	1.5	1.6	0.5	0.9	0.3	0.0				
UK	4	2.4	-4.9	1.3	0.9	0.6	1.5	0.0	-0.3	1.60	0.5%	2.4%	U
Italy	3	1.4	-5.0	1.1	0.6	-1.6	0.1	0.0	0.0				
Spain	2	3.1	-3.7	-0.1	0.7	-1.4	0.1	0.0	0.0				
North America	26	-	-2.5	2.8	1.8	2.0	2.0	-0.3	-0.6				
US	23	2.9	-2.4	2.8	1.7	2.0	2.0	-0.3	-0.6	N/A	0.25%	2.2%	U
Canada	3	2.6	-2.6	3.1	2.3	2.1	2.0	0.0	-0.3	0.96	1.25%	2.2%	U
Asia	27	-	1.5	7.2	4.7	4.7	4.2	-0.5	-1.2				
Japan	9	1.6	-5.2	3.9	-0.6	1.9	1.5	0.0	0.0	74	0.1%	1.0%	N
China	9	10.0	8.7	10.3	9.2	7.5	6.5	-0.9	-2.1	6.2	3.5%	N/A	U
India	2	6.3	5.7	8.6	7.2	6.4	6.0	-0.8	-2.2	48	6.0%	N/A	U
Latin America	8	-	-2.0	6.0	4.1	3.4	3.1	-0.2	-0.8				
Brazil	3	2.5	-0.2	7.5	2.9	3.0	3.0	-0.2	-1.3	1.65	9.0%	N/A	N
Other	11	-	-2.0	3.8	4.1	3.7	3.5	-0.1	-0.6				
Global	100	-	-1.9	4.0	3.0	2.5	2.6	-0.1	-0.6				

Note: Regional weights may not sum to 100 due to rounding

O=overweight, U=underweight, N=neutral

Recommended reading

Citi Economics (2012), *Focus on Spain*, Citigroup Global Markets ([click here](#))

Wyplosz, C. (2012), *Euro-Doom Is Fantasy, Why the Currency Won't Collapse*, Bloomberg View ([click here](#))

Pettis, M. (2012), *The Japan Debt Disaster and China's (Non) Rebalancing*, China Financial Markets (Michael Pettis' finance blog) ([click here](#))

Economic and Financial Risks

- Global growth failing to strengthen in 2013, due to fiscal policy tightening in all G7 economies
- Profit margins in the developing world falling due to strong wage growth and high oil prices
- Market discombobulation as investors realise that G7 fiscal tightening has to go much further

US growth: we doubt that growth will strengthen materially in 2013:

- Recovering from financial recessions takes years,¹ and US household deleveraging has scarcely begun
- Following the November elections the new President is likely to front-load fiscal tightening
- Hence we forecast growth of 2% both for 2012 and 2013 (-0.2pp and -0.5pp below consensus)

Watch for: an increase in the US household savings rate, and faster than currently expected fiscal adjustment

Growth in Germany/France: we doubt that domestic demand in 2012 will be as weak as implied by the Consensus forecasts:

- The grim outlook in the periphery need not feed through importantly into Germany and France
- Italy is more important for euro area confidence, but its fiscal challenge appears surmountable²

Watch for: better than expected consumer confidence and business fixed investment in France and Germany

Decoupling Asia: we doubt the decoupling from the West implied by consensus forecasts:

- Downward revisions to consensus have so far been small, not reflecting the downward-revised West
- China will almost certainly attempt to limit material slowdown until after the end-year leadership transition³
- For both China and India we forecast growth in 2013 at around 2pp below consensus

Watch especially for: growing signs of real and financial stress, and a tightening of policy around year-end

Growth in primary exporters: sluggish global growth will knock on both to export volumes and prices:

- From Brazil to Australia, primary producers' terms of trade are likely to weaken further
- Oil is the one major potential exception

- We expect below-consensus growth of just 3% in both Brazil and Latin America as a whole in 2013
- **Watch for:** declining primary terms of trade; domestic policy stimulus to offset the effects on domestic demand; and rising domestic inflation

Bond yields: recent fluctuations in yields seem unlikely to reflect anything fundamental:

- The modest pullback may be a response to recent actions by major central banks, including the ECB's LTRO and BoJ FX intervention
- While we doubt these policies will get much traction in the near-term – they may just help to offset fiscal tightening – they help to tilt the longer-term risks toward deflation

FX: we expect renewed dollar weakness in 2012:

- The recovery of the euro seems justified, given that neither a general euro break-up nor aggressive ECB peripheral debt monetisation appears likely
- Meanwhile the US continues to run a large current account deficit, and its interest rates remain unattractive: both point to dollar weakness
- Recent BoJ intervention has weakened the yen but, as with all such previous interventions, we doubt it will have a lasting impact

Equities: the recent recovery may be just a pullback from oversold levels:

- It may also reflect recent reflationary actions by major central banks
- Caution: narrowing profit margins may produce negative earnings surprises in 2012, even if headline revenues do not disappoint
- Oil prices could be important in this regard

Commodities: prices have generally not recovered to the extent that equity markets have:

- Nevertheless, the recent rise is unsustainable unless emerging markets decouple from the developed market slowdown, which we consider unlikely
- We therefore see a more neutral outlook for commodities, in particular industrial commodities
- Recent oil price outperformance probably reflects Mideast tensions, rather than anything more fundamental: the US supply glut continues to grow.

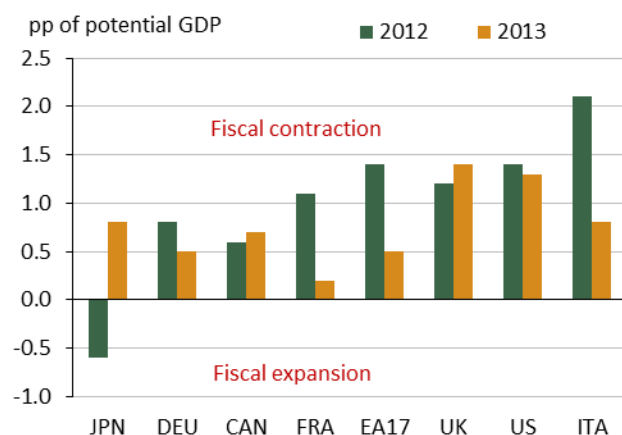
¹See Abiad et al. (2009)

²See Llewellyn Consulting and Penrich Capital (2012)

³See Nomura (2011)

Charts of the month

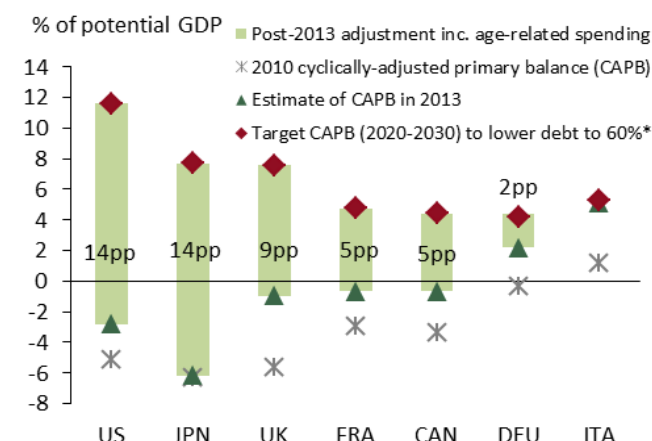
Fiscal policy is tightening, and significantly, in every G7 economy



Source: IMF Fiscal Monitor Update, January 2012

Note: Data on the (change in) the cyclically-adjusted budget balance in 2012 and 2013 are IMF forecasts, and expressed as percentage points of potential GDP.

Much more fiscal adjustment is needed to reduce debt significantly



Source: IMF Fiscal Monitor and Llewellyn Consulting

*For Japan, the IMF illustrative calculations target an 80% net debt ratio. Estimates of 2013 balances are from the IMF Fiscal Monitor September 2011 and adjusted in line with recent revisions in the January update.

Table: Real GDP growth and financial market rates

Region	Weight in world GDP	Real GDP growth (% y-o-y)						Difference from Consensus (pp)		FX rate	Policy rate	10yr yield	Equities
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Europe	29	-	-4.1	2.0	1.9	0.3	1.3	0.2	-0.1				
Euro area	19	2.2	-4.0	1.7	1.5	-0.1	0.9	0.3	0.0	1.4	1.0%		U
Germany	5	1.9	-5.0	3.6	3.0	1.1	1.5	0.5	0.0			2.0%	
France	4	2.0	-2.2	1.5	1.6	0.5	1.0	0.5	0.0				
UK	4	2.4	-4.9	1.3	0.9	0.5	1.5	0.0	-0.3	1.60	0.5%	2.4%	U
Italy	3	1.4	-5.0	1.1	0.6	-1.4	0.1	0.0	0.0				
Spain	2	3.1	-3.7	-0.1	0.7	-1.3	0.3	0.0	0.0				
North America	26	-	-2.5	2.8	1.8	2.0	2.0	-0.2	-0.5				
US	23	2.9	-2.4	2.8	1.7	2.0	2.0	-0.2	-0.5	N/A	0.25%	2.2%	U
Canada	3	2.6	-2.6	3.1	2.3	2.0	2.0	0.0	-0.3	0.96	1.25%	2.2%	U
Asia	27	-	1.5	7.2	4.7	4.7	4.2	-0.5	-1.2				
Japan	9	1.6	-5.2	3.9	-0.6	1.8	1.4	0.0	0.0	74	0.1%	1.0%	N
China	9	10.0	8.7	10.3	9.2	7.5	6.5	-0.9	-2.1	6.2	3.5%	N/A	U
India	2	6.3	5.7	8.6	7.2	6.5	6.0	-0.8	-2.2	48	6.0%	N/A	U
Latin America	8	-	-2.0	6.0	4.1	3.4	3.1	-0.2	-0.8				
Brazil	3	2.5	-0.2	7.5	2.9	3.0	3.0	-0.2	-1.3	1.65	9.0%	N/A	N
Other	11	-	-2.0	3.8	4.1	3.9	3.7	-0.1	-0.6				
Global	100	-	-1.9	4.0	3.0	2.5	2.7	-0.1	-0.6				

Regional weights may not sum to 100 due to rounding

2011 actual is estimated by Consensus forecasts, December 2011

O = overweight, U = underweight, N = neutral

Recommended reading

Abiad, A. et al. (2009), *What's the Damage? Medium-term Output Dynamics after Financial Crises*, IMF World Economic Outlook, Chapter Four, October

Llewellyn Consulting and Penrich Capital (2012), *Italy's fiscal position: a surmountable challenge* ([click here](#))

Nomura (2011), *China risks*, Nomura Global Economics and Strategy

Our main differences from consensus for 2012

- A slightly stronger core Europe (0.4pp) and Spain (0.4pp)
- A weaker US (0.6pp) and Asia (1.3pp)
- A weaker outlook for the primary exporting economies in particular

Economic summary

- The downward shift in the consensus outlook over the months is a belated acceptance of the atypical nature of this recovery
- Growth in the developed economies stands to be muted for years yet, with the impact being felt globally
- The US has seen further signs of recovery, but animal spirits are yet to return, and necessary fiscal consolidation is yet to start
- In Europe, progress by crisis continues: but a clearer path towards closer fiscal union is starting to emerge
- The primary exporting economies are being affected by the slowdown in world demand
- **Risks:** Further financial and real instability in Europe or the US; a sharper than expected slowdown in Asia and the BRICs

Market summary (provided by Amphora Capital)

- **Policy rates and bond yields:** Policy rates moved lower in the developed economies in late 2011. In 2012, those in the major developing economies will follow. Bond yields have already priced in the global slowdown.
- **FX:** Following a brief period of strength in late 2011, the dollar is likely to re-enter a downtrend in 2012.
- **Equities:** The recent rally in equities appears to be a short-covering retracement. Valuations appear low in many markets, but given necessary structural adjustments, they are likely to remain so.
- **Commodities:** The recent recovery in commodity prices is consistent with that of the equity markets. Agricultural commodities have lagged and are now looking attractive in relative terms.
- **Risks:** Worsening sovereign debt dynamics, a cyclical global downturn, and trade and currency disputes could continue to weigh on asset valuations.

Region	Weight in world GDP	Real GDP growth (%y-o-y)					Difference from consensus (pp)
		Actual (IMF)			Forecast		
		Average 1989-07	2009	2010	2011 ¹	2012	
	2010						
Europe	29	-	-4.1	2.0	1.9	0.5	0.4
Euro area	19	2.2	-4.0	1.7	1.5	0.2	0.4
Germany	5	1.9	-5.1	3.6	3.0	1.1	0.6
France	4	2.0	-2.6	1.4	1.6	0.5	0.5
UK	4	2.4	-4.9	1.4	0.9	0.5	0.0
Italy	3	1.4	-5.2	1.3	0.6	-1.0	0.3
Spain	2	3.1	-3.7	-0.1	0.7	0.0	0.4
North America	26	-	-2.5	2.8	1.8	1.6	-0.6
US	23	2.9	-3.5	2.8	1.7	1.6	-0.6
Canada	3	2.6	-2.8	3.2	2.3	1.7	-0.3
Asia	27	-	1.5	7.2	4.7	4.1	-1.3
Japan	9	1.6	-6.3	4.0	-0.6	1.9	0.0
China	9	10.0	9.2	10.3	9.2	6.0	-2.4
India	2	6.3	6.8	10.1	7.2	6.0	-1.3
Latin America	8	-	-2.0	6.0	4.1	3.3	-0.3
Brazil	3	2.5	-0.6	7.5	2.9	3.0	-0.3
Other	11	-	-2.0	3.8	4.1	3.7	-0.4
Global	100	-	-1.9	4.0	3.0	2.3	-0.4

FX rate	Policy rate	10y yield	Equities*
End 2012			
1.40	1.0%	2.0%	U
1.65	0.5%	2.4%	U
N/A	0.25%	2.2%	U
1.00	1.25%	2.5%	U
72	0.1%	1.0%	N
6.2	3.5%	N/A	U
48	6.0%	N/A	U
1.70	9.0%	N/A	N

* O = overweight, U = underweight, N = neutral

¹Consensus forecasts December 2011

Consensus, although now anticipating a slow and grudging Western recovery, continues its reluctance to factor in a material slowdown in Asia and the primary exporting economies.

The US

The recent data have been positive: the unemployment rate fell to a three-year low in January, and consumption and GDP accelerated in Q4.

The fundamentals however remain weak. Employment levels are still low, consumer confidence is still poor; and deficits and gross government debt, and on- and off-balance-sheet liabilities held by third parties, remain worryingly high. Household deleveraging has a long way to go.

Although corporations do not look overleveraged, and there is much liquidity available to invest, the myriad uncertainties, risks, and prospects of longer-lasting slow growth continue to amplify investment caution, and keep animal spirits subdued.

Necessary fiscal consolidation is still to come, and is unlikely to begin before the latter half of 2012 at the earliest. Meanwhile the downside risks from not implementing credible debt and deficit reduction policy continue to grow, and arguably are coming closer to the extent that the European crisis proceeds step-wise to resolution. Markets have a tendency to focus on one thing at a time.

We maintain our below Consensus forecast of 1.6% growth for 2012.

Europe

The Consensus forecast for euro area GDP growth in 2012 has fallen to -0.2pp.

The euro area has a range of problems and policymakers have been slow to address them. However, a path towards closer fiscal union is beginning to emerge, with outline new arrangements now worked out.

25 out of the 27 EU Members have now agreed to move towards a more fiscally conservative, more German, Europe, enshrined in a new Fiscal Compact that includes automatic corrective mechanisms. The ESM may now enter into operation this year.

This stands to pave the way for greater support from the ECB in the near-term, buying time to institutionalise the reforms that are needed. Meanwhile the ECB's efforts to

ease near-term pressures, including by buying Italian et al paper, while still keeping the pressure on the politicians/people to agree reforms, seem to be bearing fruit.

We judge that, provided the requisite reforms are made, G20 'big guns' stand to be brought to bear if needed, in a demonstration of international resolve and commitment to maintain confidence.

The 'new Europe', if it does eventuate as we expect, is likely to be stronger as a result of its crises. The UK, however risks becoming somewhat more peripheral.

Taking everything together, our view is that domestic demand this year will be less weak than current expectations, and that the Consensus GDP forecast for the euro area's largest economies has now come down too far.

Asia

The high growth rates of the past decade stand to be difficult to maintain in the face of a sluggish West. If the double-digit year-on-year growth in investment were to slow, consequences for GDP would be significant. A slowdown in investment will come, the only questions are when, and how sharp it will be.

China does not have a labour constraint, and so has a high potential growth rate, and ample fiscal space that could be used to support domestic demand. But nevertheless policymakers have to keep fiscal policy on a sustainable path; longer-term, consumption would have to take over the running.

The restructurings and economic diversification required to re-balance economies towards greater reliance on domestic demand take time. Historically, few countries have managed this well, certainly Japan did not.

GDP growth risks being significantly below Consensus.

Primary exporters

There is now further evidence of a mounting slowdown in the primary exporting economies, and OECD composite leading indicators continue down.

Consensus forecasts have come in our direction over the past six months. We remain slightly weaker.

Policy rates moved lower in the developed economies in late 2011. In 2012, those in the major developing economies will follow. Bond yields have already priced in the global slowdown.

Although the recent deterioration in leading indicators is abating, a global slowdown is clearly underway. Developed economies have already loosened policy. Developing economies will soon follow as inflation rates begin to decline. Global bond yields have already priced in the slowdown, including recent policy actions, and are thus unlikely to decline materially from here.

At the margin, the decline in Japan's trade surplus is likely to place some upward pressure on global bond yields as Japan's net savings position declines.

Financial markets continue to give the UK government the benefit of the doubt when it comes to fiscal consolidation. Gilt yields are not only low in historical terms, but also relative to German Bund yields. Any signs that the government is backing away from planned cost-cutting measures would be clearly gilt negative.

Additional dollar weakness is likely, vis-à-vis most currencies.

Q4 dollar strength was the result of a rush into dollar liquidity, rather than global recognition of US economic strength. As risk assets have recovered, the dollar has declined anew.

Further dollar weakness is likely alongside accelerating dollar money and credit growth. This is because the US is more dependent on external financing than other developed economies.

However, China and other Asian economies will continue to intervene as required to slow their currencies' appreciation, although we do not believe that they will reverse the trend.

The recent rally in equities appears to be a short-covering retracement. Valuations appear low in many markets, but given necessary structural adjustments, they are likely to remain so.

Equity markets have recovered much ground in recent weeks. In our view, this appears to be largely a short-covering rally amid a stabilisation in many key leading indicators.

While valuations appear low, they should given the structural global economic headwinds and necessary de-

leveraging. In particular, expectations for profit margins remain unreasonably high. Wage growth in emerging markets is beginning to erode some of the one-off benefits of outsourcing and globalisation.

The recent recovery in commodity prices is consistent with that of the equity markets. Agricultural commodities have lagged and are now looking attractive in relative terms.

Commodity prices have recovered alongside equity markets. Metals have performed particularly well, both industrial and precious. The former are unlikely to continue to rise further amid a global slowdown, while the latter could rise if there are signs that major central banks are going to ease policy further in the coming months.

Agricultural commodities are significantly less correlated to equity markets and have lagged in the recent recovery. On some measures, they look cheaper vis-à-vis metals and energy than they have in years. Given low stocks, any signs of tight supplies or poor weather could push agricultural commodity prices sharply higher.

Worsening sovereign debt dynamics, a cyclical global downturn, and trade and currency disputes could continue to weigh on asset valuations generally.

Recent developments reinforce our concern that a potential 'perfect storm' of negative factors, the combination of which has yet to be priced into financial markets, could materialise in 2012.

Unlike in 2008, when fiscal and monetary policies were both able to address the immediate issues, this is not going to be the case over the coming year.

The risks of trade and currency disputes remain elevated. Indeed, the flash point of sanctions on Iranian oil exports could ignite tensions in other areas. As trade wars are significantly negative for productivity and corporate profitability, this is a key area to watch.■

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