Outlook 2012: Living In Interesting Times

December 22, 2011

With everything that has happened across the globe this year, we are reminded of the Chinese curse, “May you live in interesting times.” People may debate whether this is actually a curse or even of Chinese origin, but as we write the outlook for 2012 we wonder if these interesting times are indeed past us. The global outlook is far from stable two years after the global recession. In fact, this year was marked by some of the worst financial crises of recent history, with the possibility of more piling on. Indeed, it seems the global economy is at a tipping point. Will the tailwinds supporting economic activity prevail over the headwinds emanating from many regions? Sovereign debt woes and sharp fiscal tightening in the Euro-zone; the risk of a renewed credit crunch and housing market problems in the U.S.; signs of a potential slowdown in China – not surprisingly, some analysts are darkly comparing the coming year with the double-dip contraction between 1929 and 1938 that marked the Great Depression in the U.S. and a period of social and financial turmoil throughout Europe. If 2011 was the year of the Chinese curse, might 2012 be the year of a more USA-styled phrase – “You ain’t seen nothin’ yet”?

Setting aside the debate over the appropriateness of various policy directives, this Outlook considers which countries or regions are vulnerable as we head into 2012. Not surprisingly we start off with Europe, then go through the U.S., industrialized Asia, and Latin America, finishing with a brief discussion of the political powder keg that is the Middle East.

Europe – Muddling Through While Flirting With Disaster

Our base case is that the Euro-zone does not completely collapse within the next two years, largely because the political fallout would be so severe. The Euro-zone (and indeed the wider EU) is at heart a political creation – which means that it will continue to survive for as long as the various national politicians calculate that euro life support is less politically “expensive” than pulling the plug. Even so, there is a not-insignificant risk that Europe’s leaders will fail to find a way out of the past two years’ political and policy paralysis, plunging Europe into depression and possibly taking the global economy with it. Some event could cause the “muddle through” process to derail into chaos: perhaps the “failure” of a major bond auction from, say, Italy as the markets refuse to roll over Italian debt at any price; or the collapse of a major bank; or a national political upheaval that prevents a key government from meeting its policy objectives or promises.

A continuation of the “muddle through” approach to keeping the Euro-zone going will not be pretty, particularly given the current backdrop of heightened risk aversion and very close attention by headlines and markets to national budget policies. However, the problem facing the Euro-zone is not the size of some members’ fiscal deficits (on which Italy, for example, looked better than Germany just a few years ago). Rather, it is the mismatch in competitiveness between Germany (and a handful of smaller economies such as the Netherlands) and everyone else. This mismatch was apparent back in the 1990s when the ‘zone was being created, and was the reason why some commentators insisted that the common currency could never work. The political impetus behind the euro’s birth was strong enough to over-ride such pesky details – and indeed, for most of the ‘zone’s first decade, a combination of strong economic growth and market hubris caused
investors to ignore this fundamental mismatch. A decade on, the Euro-zone has “succeeded” in creating such close economic and financial sector linkages across its now-17 members that dissolution would impose staggering costs on all concerned. So member governments will feel they have little choice but to impose the kinds of fiscal austerity that normally would not be contemplated at a time when economic recovery is still so fragile. They would be better served by ignoring headline fiscal deficit ratios and instead concentrating on the kinds of macroeconomic structural reforms that will underpin growth going forward – deregulate labor, product and services markets; reform national pension and healthcare schemes; simplify tax codes, etc.

For now, our base case forecast is that the macroeconomic cost of keeping the Euro-zone going will be a recession across most of Europe through at least the first half of 2012 and a prolonged period of subdued growth after that. To varying degrees, the 27 members of the EU will be facing a powerful trio of negative headwinds: fiscal austerity; higher funding costs for sovereigns; and severely-constrained credit provision as banks struggling to boost their capital ratios do so largely by cutting back on lending. The latter will be particularly problematic for much of continental Europe, where corporations seeking funding are far more likely to turn to their banks than to the debt or equity markets. Indeed, there is a considerable risk that the credit crunch could become so severe that it exacerbates the recession – and makes it even harder for national governments to meet deficit:GDP ratios.

PMI data have been signaling a slowdown in recent months and the signals coming from the Belgian National Bank’s (BNB) business confidence indicator are even more disconcerting.

---

The opinions expressed herein are those of the author and do not necessarily represent the views of The Northern Trust Company. The Northern Trust Company does not warrant the accuracy or completeness of information contained herein, such information is subject to change and is not intended to influence your investment decisions.
Thanks to Belgium’s strong trade ties with its neighbors (about 80% of Belgium’s manufacturing output is sold abroad, mostly to fellow EU members), the BNB’s business confidence index is a reliable leading indicator – about six months out – for GDP growth in the Euro-zone as a whole. Although the survey nudged upward in December, this came after eight consecutive months of decline, and the overall reading remains firmly in negative territory. Our base case is that the ‘zone as a whole contracts in Q4 and through the first half of 2012, and sees only meager growth at best in H2, leaving real GDP for the year as a whole down by around 2.0%. Within this outlook, some economies have yet to return to growth from the ravages of 2009. Ireland, for example, is heading for a fifth straight year of declining consumer spending. Others such as France and Germany look set for a true “double-dip.”

Although not a member of the Euro-zone, the UK faces the same set of headwinds. The markets have not (yet?) started to impose markedly higher funding costs on the indebted sovereign, but the government is trying to impose its own sweeping fiscal reforms as the economy struggles to recover from the 2009 recession. History says that an economy takes 3-5 years to fully recover from a recession that was triggered by a major banking crisis. Given that the UK was hit particularly hard by the 2008-09 global financial crisis (thanks to the role of London as a major international financial center) and that the recession was exacerbated by a housing market collapse, the intense corporate and household deleveraging now underway implies no recovery until at least 2013. As in continental Europe, a slide back into recession through H1 2012 appears inevitable, followed by a slow and sluggish recovery that leaves GDP for the year as a whole down by about 1.5%.

The opinions expressed herein are those of the author and do not necessarily represent the views of The Northern Trust Company. The Northern Trust Company does not warrant the accuracy or completeness of information contained herein, such information is subject to change and is not intended to influence your investment decisions.
A new Euro-zone recession will certainly impact emerging Europe. The mostly small and open economies of central and eastern Europe are particularly dependent on exports to the likes of Germany, Italy and France. In addition, a new round of investor risk aversion will push their funding costs up sharply even though their own risk profiles have not deteriorated. Poland will likely fare better than its more export-dependent neighbors, and may once again manage to stay out of recession. The Czech Republic may be able to stay in positive territory for the year as a whole, although growth will remain below 0.5%, while export-dependent Slovakia’s recession will likely mirror that of the wider Euro-zone. The wild card of the region is Hungary, which has yet to come to terms with international lenders’ demands for more orthodox policy settings and has provoked a clash with the ECB over changes to its central bank law. Unless Budapest reverses course, the country could suffer a full-blown balance of payments crisis early in 2012. At best, the economy will likely suffer further contraction next year as fiscal austerity coincides with weaker export demand.

**Choppy Waters in 2012 – Will the U.S. Economy Show Resilience?**

U.S. economic performance has been better-than-anticipated as we close the curtain on 2011. A string of unexpected events – high oil prices stemming from the Arab uprising, an earthquake and tsunami in Japan, and the European sovereign debt crisis – slowed economic activity in the early part of the year. Growth should come in around 2.5% in the second-half of 2011 vs. less than
1.0% in the first six months of the year. The economic prospects for 2012 are more encouraging – barring catastrophic developments in Europe.

Real GDP is predicted to post an increase in the neighborhood of 2.5% in 2012. The drivers of economic growth should be a combination of small-to-moderate contributions from nearly all major components of GDP – consumer spending, capital investment, inventories, and residential investment expenditures. The notable exception is government spending, which is most likely to show significant setbacks owing to budgetary pressures and political gridlock in a presidential election year. Headwinds from Europe are predicted to stall exports in the first six months of 2012 followed by a small pickup in the latter part of the year. The turnaround in bank credit, seen in the third quarter and nearly all of the fourth quarter, remains an important development supportive of the forecast.

Consumer spending, supported partly by auto sales, should show a stronger performance in the fourth quarter compared with the 2.3% gain in Q3. The outlook for 2012 is moderate growth in consumer spending but this is marked with concerns. The projected growth path of the economy does not point to a robust gain in hiring in 2012. The drop in real disposable personal income in the second and third quarters of 2011 is worrisome. Household net worth fell in the second and third quarters of 2011. Households have reduced their debt as a percentage of disposable income to 114% in the third quarter from a record high of 130% in 2007. The severity of deleveraging is unprecedented and has a direct negative bearing on consumer spending. The combined impact of
soft employment conditions, tight credit conditions, and the deleveraging of household debt that is underway should prevent strong momentum in consumer spending during 2012.

Sales of new and existing homes and construction of new homes show a small improvement but the level of activity continues to hold close to recession lows. The continued sluggish conditions of the housing sector and the shaky status of consumer spending are factors building a case for new policy support. The political gridlock in Washington in an election year rules out a new expansionary fiscal policy. The Fed is most likely to announce a large purchase of mortgage-backed securities in the first quarter of 2012 to not only correct the imbalance in the housing sector but also provide overall support for economic growth.

This baseline scenario for the U.S. in 2012 is fraught with risks. The first that comes to mind is the direct and indirect impact of the recession in the Euro-zone. Early signs of a slowing impact on US exports are visible. US exports to the Euro-zone have hovered around 20% of total exports during the three years ended 2010, followed by a gradual slowing to 18% in October 2011. Exports to Brazil, India, and China account for roughly 11% of US exports; this share could show a reduction if their respective exports take a hit from the Euro-zone crisis. Therefore, the overall impact is a decelerating trend of US exports. It is quite likely that we may be underestimating the headwinds from Europe, given the reach of the sovereign debt and banking crisis that is currently unfolding.

Second, China, a significant player in global economic activity in addition to the European Union and United States, is being watched closely because a hard-landing would have large adverse ripple effects across the world. So far, Chinese authorities have managed to steer the economy...
toward soft-landing by tightening monetary policy as inflation advanced and deftly lowering reserve requirements in early-December as signs of weakness emerged. The Purchasing Manager’ Index has dropped below 50.0 in November, the first such reading since early-2009. November inflation data show a decelerating trend, justifying the recent monetary policy easing. It is entirely conceivable that economic growth in China could slow to an 8.0% trajectory in 2012 vs. the 9%-10% pace of recent years. If such a soft-landing scenario comes to fruition, it would not imply a major setback to economic growth in the rest of world but the likely adverse implications may not be negligible.

Third, the sources of risk from within the United States are issues that have persisted since the recovery commenced in mid-2009 – lackluster consumer spending, a housing sector slump, and a severe contraction in bank credit. A markedly soft pace of consumer spending, for all the reasons cited earlier, could result in weaker-than-projected economic growth that would translate into a stubbornly high unemployment rate. If this scenario emerges, the housing sector’s problems could escalate to a deeper and more protracted challenge as the number of distressed properties increases and homes prices drop, exacerbating the already problematic underwater mortgage situation. Bank credit has advanced in the third quarter and most of the fourth quarter. This driver of economic activity has to maintain the recent positive trajectory, at the least, if economic momentum is to continue in 2012. Additional loan defaults and delinquencies in the residential and commercial real estate sectors could destabilize the banking sector even as banks struggle to meet capital requirements.

Pulling all these strings together, we return to our earlier question: Will the tailwinds supporting economic activity prevail over the headwinds from outside and within the United States? The short answer, derived from the baseline scenario, is yes. The ingredients of continued expansion are in place, but the risks presented suggest that there is a more than trivial chance of a disappointing performance.

**Industrialized Asia – Economies Diverging and Imbalances Developing**

When the global economy stalled in autumn 2008, Asia’s export-driven economies were hit particularly hard, some witnessing annualized drops in GDP of 15-20%, but the correction was also equally pronounced. Throughout the global recession, the Asian economies were supported by the triangular relationship within the region – commodity-producers supplying the low value-added manufacturers, which provided inputs for major capital exports, which made goods that were quickly consumed by the capital-hungry commodity economies. The parallel adjustments of exchange rates and trade flows throughout Southeast Asia was partly responsible for the region’s quick rebound, and it was able to maintain its incomes and competitiveness while not aggravating its debt stocks while the rest of the world struggled through. But now that the bust and recovery of the 2008 crisis has passed, individual countries are beginning to differentiate their economic cycles from the larger triangular relationship. While this is expected to some degree, it becomes worrisome if it creates imbalances within pivotal countries. In this case, the countries that are
experiencing individual problems happen to be some of the biggest players in the region, and their issues will not just recalibrate without some disruption.

At the beginning of this year, China’s attention was on containing rapid credit expansion and a real estate market most people felt was overheating. India’s problem was inflation, aggravated by supply bottlenecks and an unpredictable monsoon season. Neither economy placed a high priority on events in the Euro-zone at the time. But 2011 has been a prime example of just how much things can change over the course of a year, and economically, this applies for China and India.

The People’s Bank of China (PBoC) began its monetary tightening phase in January 2010 but accelerated it in the beginning of this year, ramping up the reserve requirement ratio to a record 21.5% for large institutions and raising the more sensitive prime lending rate by 95 basis points – all in the first half of the year. This was supposedly a containment of inflation and credit growth and not a response to a growing asset bubble, and this was generally accepted once price increases moderated. However, as the Euro-zone economies slowed and China’s exports to that region tapered off, the PBoC changed its bias and eased reserve ratios. This was a response to events outside the Asia triangle, which introduced an element of differentiation into the relationship that could expand if Europe’s problems do not soon resolve.

Contrary to popular belief, the European Union imports more Chinese goods than the US does (19.7% of the total versus 18.0%), and therefore China is particularly concerned about events in the EU. It has not been a coincidence that Beijing officials have offered widely-publicized financial support since 2009 to troubled EU economies and purchased significant amounts of...
debt. Now it appears that PBoC policy is becoming accommodative to offset an expected Eurozone recession in 2012. As the situation in the EU progresses, and possibly worsens, policy measures from Beijing will reflect its increased concern.

India, however, is another story. The world’s largest democracy had been posting growth figures around 8% at the beginning of the year with inflation coming down from the 16% high at the beginning of 2010. However, price pressures were building as a poor agricultural season fed into supply shortages. Furthermore, a deceleration of money supply growth suggested the economy would be slowing down as the year went on. The Reserve Bank of India (RBI) was caught between fighting inflation or promoting economic growth, and while it opted to pursue price stability, its approach was insufficient. The economy slowed down, but prices rose back above 10% and the RBI had little enthusiasm for cutting rates. Going into 2012, India needs some outside help to promote growth, and a shortage of support will be India’s contribution to unbalancing the dynamic.

Even in the best of times, exports only account for 25% of India’s GDP, versus the 50%+ seen in the more export-oriented regional economies. India is not a major trading partner with Europe, but relies more on the US and Indian Ocean neighbors. This steers India’s trade clear of the Eurozone’s problems, but domestic growth and price stability both depend on domestic balance, particularly with regard to food. This year’s monsoon season fell below expectations, so combining this with slow money supply growth and rising prices, we believe that the economy will struggle to post 4% growth through the first half of 2012. And if inflation does not come under control during that time, that below-potential growth rate could last the entire year.

The opinions expressed herein are those of the author and do not necessarily represent the views of The Northern Trust Company. The Northern Trust Company does not warrant the accuracy or completeness of information contained herein, such information is subject to change and is not intended to influence your investment decisions.
Also important to the outlooks of both countries but far more difficult to forecast are their exchange rates – also heading in opposite directions. The Chinese yuan closed out last year at 6.62/US$ and has appreciated slowly throughout the year, though its strengthening is far from what its trade partners would prefer. The Indian rupee, however, has lost ground throughout the year, and dove precipitously since the beginning of November. For both countries, 2012 will need to be a year where their currencies move more in line with fundamentals. This suggests the yuan should appreciate more rapidly and the rupee should rebound assuming inflation is contained. Without these corrections, both economies will be vulnerable to problems in the global economy.

Japan spent the first half of 2011 firmly focused on domestic woes, but it is the headwinds from the Euro-zone and China that could derail the economy in 2102. The Japanese government’s primary focus will continue to be on reconstruction efforts following the devastating earthquake and tsunami which hit the country in Q1 2011. Following the passage of the supplementary budget for reconstruction totaling 2% of GDP, construction in the Tohoku disaster area will ramp up in 2012. Spurred in large part by rebuilding efforts, Japanese GDP should expand by 2.2% next year. Without the boost reconstruction will provide the pace of growth would be markedly slower as the nation battles fickle consumer demand, sluggish private investment, and softening demand from its trading partners.

After contending with supply chain disruptions arising from the Tohoku disaster and flooding in Thailand, Japanese exporters remain dependent on external factors. Not only do they face weakening demand from the impact of the Euro-zone crisis, but they must also contend with
concerns about the economic health of China, which took a combined 29% of Japan’s exports in 2011. The persistent strength of the yen will also take its toll on exporters. The Bank of Japan intervened in the currency markets numerous times this year with various levels of success in weakening the yen; however, as investors seek a safe haven, it appears the currency will only come down as confidence in the global outlook improves.

Meanwhile, domestic political concerns remain. As is customary in Japan, there is a chance that the current Prime Minister Yoshihiko Noda will face a leadership challenge next year. Noda is intent on beginning to tackle Japan’s fiscal difficulties, beginning with a hike in the consumption tax from 5% to 10% by the middle of the decade. The PM is also expected to introduce a plan which includes pension and social security reform and permanent income tax hikes for Diet approval in March. Due to tension within his own ruling Democratic Party of Japan, especially regarding tax hikes, and concerns from the opposition Liberal Democratic Party, Noda will face considerable difficulty in pushing thru any fiscal reform. The parties had agreed to work together in passing the three supplementary budgets for disaster recovery; however, any further cooperation will be heavy going, especially in regards to heated subjects such as tax hikes. Noda is likely to dissolve the Lower House and call for general elections next year in an attempt to gain a popular mandate, even though a vote is not due until 2013.

Australia was the only G-10 economy to avoid recession during the global crisis and its string of growth will continue in 2012. Following sub-trend growth in 2011, largely attributable to flooding in Queensland earlier in the year, GDP will grow by 3.5% in 2012. The Aussie economy has benefited immensely from commodity demand in Asia—its top four trading partners are in the region—and the biggest threat to this forecast would be a rapid slowdown, as opposed to a soft landing, in China. The Reserve Bank of Australia has already noted evidence that Asia is seeing some effects from the downturn in Europe. Yet, as we expect commodity prices to remain level next year, the Australian economy should still experience robust growth, with the downside forecast coming in at 3.0%. While commodities and associated capital expenditures will buoy the economy, Canberra will need to make strides towards addressing its two-speed economy as domestic demand remains sluggish and housing prices continue their downward trajectory.

**Brazil – Bellwether For Latin America**

In late August, Brazil’s Comitê de Política Monetária (Copom, Monetary Policy Committee) surprised the markets with a 50-basis point cut in the Selic policy rate, followed by a second cut in late October that took the Selic to 11.50%. What looked like an imprudent monetary loosening back in August now looks like a prescient move. Brazil’s real GDP growth rate stalled in Q3, in part as global demand for its mostly commodity-based exports started to slide. The country is the world’s largest exporter of beef, coffee, sugar, ethanol and orange juice and the second-largest of iron ore and soybeans. The strong currency has not had a negative impact on the nation’s commodity exporters as their products are priced in US$. However, most of the slowdown has been the result of domestic developments. The manufacturing sector is struggling after a
prolonged period during which the real has gone from strength to strength, and now over-extended consumers have started to take a breather.

With both domestic and external demand set for a contraction, Brazil’s economy is likely to see negative GDP growth in Q4 and again in Q1 2012. However, infrastructure investment is starting to ramp up as the country prepares to host the 2014 football World Cup and the 2016 Olympics. And, Brazil’s export markets are well diversified between the US, Latin America, Europe, and Asia. These factors should help to ensure that, as in 2009, the recession will be relatively mild and Brazil will see positive growth for 2012 as a whole at around 2.5%. A similar pattern is likely to prevail in most of the rest of Latin America.

Middle East and North Africa – Growing Concerns About the Arab Spring

In contrast with the rest of the world, the pressing issues in the Middle East/North Africa (MENA) are almost exclusively political. The events of 2011 throughout MENA brought about the ouster of no less than four heads of state, triggered widespread social unrest in countries once considered stable, and showcased the political clout held by common people. While a couple of countries are transitioning to new, elected governments, it would be hasty to suggest the worst was over with regard to the Arab Spring. In fact, there is reason to believe that more is yet to come.
In Tunisia, a newly-elected government took charge in early December, just shy of the one-year anniversary of the events that would change the region. For all the worries of a chaotic campaigning period, an erratic and corrupt voting process and the fear of Islamist extremists seizing power, the high-turnout election was relatively free and fair, with the results widely accepted and a Constituent Assembly now working on a new constitution. Worries from the international world about a region falling into chaos now seemed wildly exaggerated, and everyone breathed a sigh of relief. However, we posit that Tunisia, far from being the prime example for transition, was rather the exception. The growing violence in Egypt even as voters go to the polls supports our concerns, and leads us to wonder what lies ahead for those states bringing together a new leadership and those where the problems are as yet unresolved.

The uprising in the MENA countries took hold where an educated youth demographic was being increasingly disappointed by the lack of opportunity and income. These protests were demands to reshape the relationship between the government and the people, as the former had failed to live up to its most basic expectations. As this movement grew – with Egypt being catalytic in raising it from isolated events to regional movements – other countries witnessed their locally-grown imbalances turn into national issues. This ranged from low standards of living to the widespread degree of government corruption to the Sunni/Shia divide. While each government handled its situation differently, most protests were placated but the issue not corrected.

Now that the people have found a voice, we believe that further protests and greater demands will be placed on states throughout the region, with the ultimate but unspoken goal being a new relationship between the people and their government. This will not resolve in a year or two, but be a potential hotspot of instability for years to come.