RICHES FLORES RESEARCH

GLOBAL MACRO & THEMATIC INDEPENDENT RESEARCH

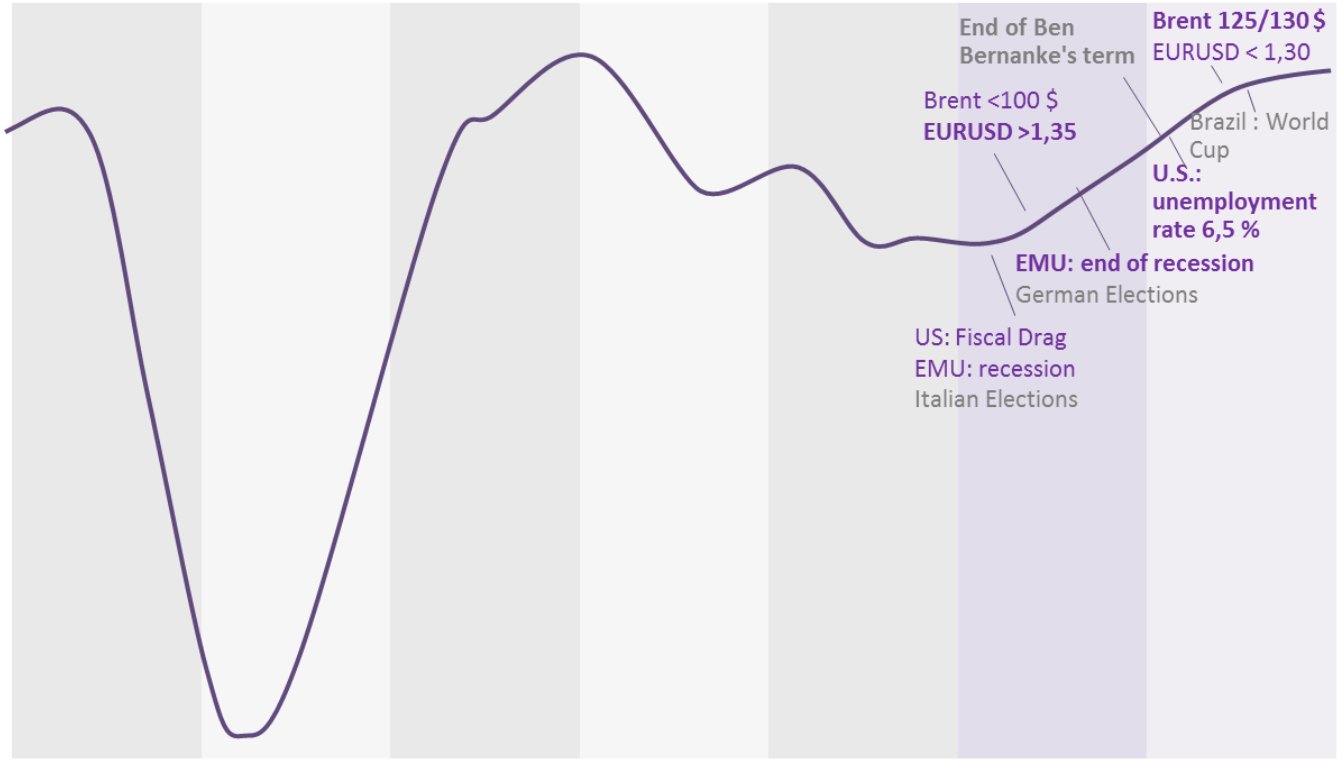
January 15th, 2013

FORECASTS

Our 2013–2014 Scenario: *A Situation Under Control*

- **Global GDP up 3.1 percent in 2013, 4.1 percent in 2014.** With difficult conditions prevailing through the first half of 2013, the world economy will not grow any faster than the 3.2 percent registered in 2012. **It will take until 2014 for global growth to exceed 4 percent—a level not seen since 2010.**
- **50–50.** Over the next two years, emerging economies will add $4 trillion to their combined GDP (at constant 2010 prices and exchange rates), contributing four times as much to global output as developed countries. **By 2014, global GDP should therefore be evenly distributed between the emerging and developed worlds.**
- **Inflation.** All quiet on this front in 2013, but will start to edge up in 2014. Weak growth and receding commodity prices in early 2013 should keep a lid on inflation throughout the year. However, more vigorous recovery in 2014 will push commodity prices up (with oil reaching $130) and accelerate inflation in emerging markets.
- **Sovereigns.** Budget deficits should ease slightly in 2013; public debt will continue to swell in 2013 and 2014. Countries that have structurally weakened and whose reform policies have yet to kick in will still be at risk. **Italy tops the list, followed by Spain; France is balanced on the razor's edge; and the future of Japan will depend on how successful the new prime minister's stimulus program is.**
- **The U.S. unemployment rate will diminish to 6.5 percent** in **the first half of 2014.** The Fed's quantitative easing program will be over. Expectations that interest rates will revert to normal levels will bring the period of low long-term rates in the Western world to an end.
- **10-year U.S. Treasury Note yields will hit 3.5 percent by end-2014.** The rise in U.S. long-term yields will go from gradual in the latter half of 2013 to more pronounced in 2014. Europe will follow suit, with a moderate widening of the T-Bond/Bund spread.
- **The euro will trade at $1.35 in 2013.** The Fed's vastly expanded balance sheet, combined with the elimination of extreme risk in the euro area, will keep the dollar low against the euro in 2013. But the trend will reverse in 2014 when the Fed abandons its unconventional policy tools.

Main Features of our 2013–2014 Scenario



Real GDP growth rate

	2008	2009	2010	2011	2012	2013	2014
World*	**2,8 %**	**-0,6 %**	**5,1 %**	**3,8 %**	**3,2 %**	**3,1%**	**4,1%**
U.S.	**-0,3 %**	**-3,1 %**	**2,4 %**	**1,8 %**	**2,1 %**	**1,8 %**	**2,7 %**
EMU	**0,4 %**	**-4,4 %**	**2,0 %**	**1,6 %**	**-0,5 %**	**-0,7 %**	**0,7 %**
- Germ.	0,8 %	-5,1 %	4,0 %	3,1 %	0,9 %	-0,2 %	0,9 %
- Fra.	-0,1 %	-3,1 %	1,7 %	1,7 %	0,1 %	-0,6 %	0,7 %
- Ita.	-1,2 %	-5,5 %	1,8 %	0,4 %	-2,1 %	-1,6 %	0,0 %
- Spa.	0,9 %	-3,7 %	-0,3 %	0,4 %	-1,4 %	-1,5 %	0,4 %
China	**9,6 %**	**9,1 %**	**10,4 %**	**9,2 %**	**7,9 %**	**8,1 %**	**7,7 %**
Brazil	**5,2 %**	**-0,3 %**	**7,5 %**	**2,7 %**	**1,0 %**	**3,5 %**	**4,0 %**

- PPP $2010 Exchange Rate
  Source: RichesFlores Research

A Situation Under Control

In 2013, government budget deficits will show little change compared with 2012, and national debt will once again increase substantially in the vast majority of developed countries. Real Eurozone GDP will shrink for the second year in a row, U.S. output should grow a bit more slowly than this past year, and the expansion of the Chinese economy—just over 8 percent—will be due entirely to the catch-up process under way. **From this standpoint, the new year will bear a strong resemblance to the previous one. In fact, global growth is unlikely to exceed the 3.2 percent figure forecast for 2012, and may even be slightly lower. But the sentiment arising from what are otherwise similar data is markedly different today than six months ago. There are two reasons for this.**

- The first one has to do with recent changes in **crisis management.** This applies most importantly to Europe, where the dogmatism reigning since 2010 has finally given way to a more pragmatic approach. But it also applies to the United States, where the Fed has worked doggedly to clean up the banking system and lessen the effect of deleveraging on growth. And it applies to international financial institutions, since the IMF—the former guardian of the fiscal discipline temple—has announced a major policy change in response to the extreme risk in the euro area.
- The second reason is that **the adjustments most deeply feared at the start of last summer are for the most part behind us.** Europe's worsening sovereign debt crisis, the impending fiscal cliff in the U.S., plummeting growth rates, and sharp downward revisions to consensus forecasts can now be seen in the rear-view mirror. We expected this fraught environment to prompt bolder policies, and it did. **The upshot is that extreme risks have been eliminated. The euro area hasn't come unstuck, the ECB will be acting as lender of last resort, and the fiscal adjustment in the U.S. will be gradual, and therefore more bearable.** Monetary policy convergence between the Fed and the ECB, at least on paper, is yet another significant change that prompts us to take a less bleak view of the future than last summer.

In and of themselves, of course, these bright spots lack the power to bring about a genuine rebound and set the stage for the kind of growth we saw before the financial crisis. But they are a crucial prerequisite to dealing more confidently with the global economic turbulence that will still be with us in the first half of 2013—and eventually to obtaining enough forward visibility to make risk-taking a reasonable proposition again. They have also gradually improved the investment outlook. We can expect growth in the developed economies to pick up steam over time and the constraints holding back emerging economies to diminish. **So while global economic growth will show little change—hovering at 3.1 percent in 2013—it should exceed the 4.0-percent mark in 2014, a high since the 5.1 percent registered in 2010.**

The scenario we put forward here is therefore reasonably upbeat—certainly our most upbeat one in the last several years. We aren't positing particularly high growth rates, but rather a world economy better able to address its own imbalances and whose growth will be powered increasingly by emerging markets. With growth estimated to average 5.6 percent this year and 6.4 percent the next, the emerging world alone could account for four fifths of the expected expansion in the global economy. This would put it on an equal footing with the developed world by 2014, producing exactly 50 percent of global GDP.

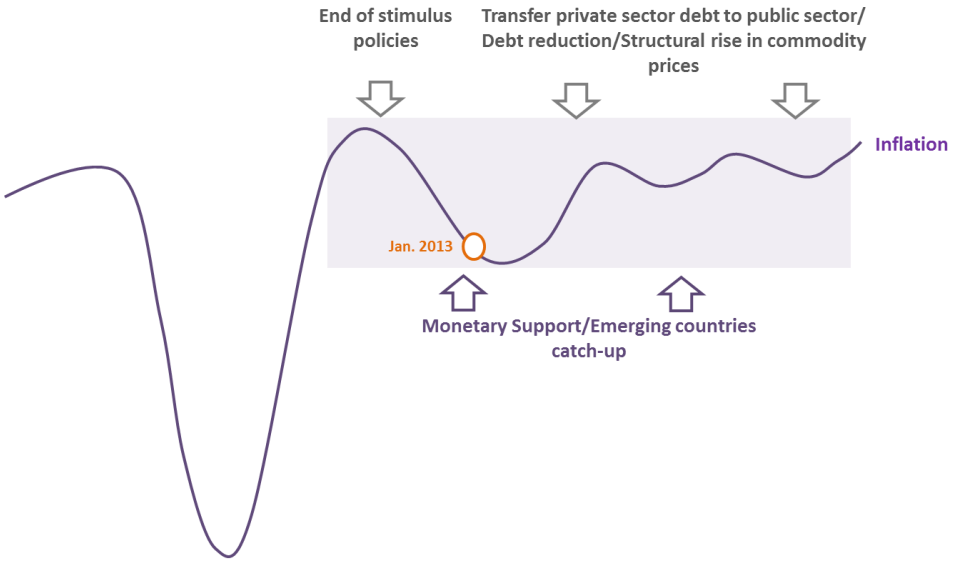
Global GDP Growth at Constant Prices, PPP

% per annum	2011	2012 (est.)	2013 (fcst.)	2014 (fcst.)
World	3.6	3.2	3.1	4.1
Industrialized countries	1.3	1.1	0.8	1.
Emerging countries	6.4	5.6	5.6	6.4

Source: RichesFlores Research

In 2014, the world economy is unlikely to break out of the low-growth cycle it has been stuck in since the 2008 crisis. At this stage, we are maintaining the "square root" scenario we have been putting forward since 2009. As before, our long-term bet is on a return to inflation, with the first effects perceptible by the second half of 2014.

Medium-Term Inflation Scenario



Source: RichesFlores Research

In any event, with global GDP expanding by 4 percent, 2014 will be a year of radical change in monetary policy. The Fed's unconventional policies will come to an end, and long-term interest-rate expectations will probably start heading back to normal. The rise in long-term interest rates should go from gradual in the latter half of 2013 to much more pronounced in 2014. Even before the end of 2013, the risk of this happening will unquestionably be a major concern to both the Fed and the international financial markets.

2013 Off to a Chaotic Start

Recession in Europe, fiscal retrenchment in the U.S., and low levels of investment worldwide will ensure a gloomy global economic outlook in the first half of 2013.

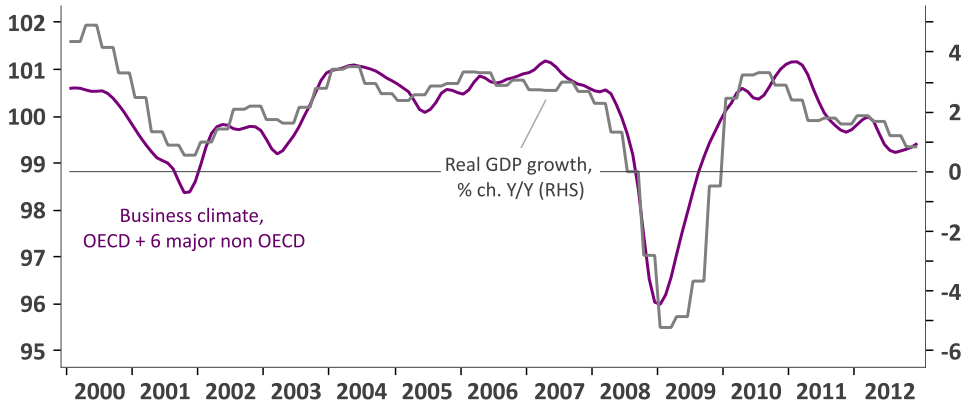
Although things should start looking up in the spring, a deteriorating global economy in the latter portion of 2012 and persistent instability at the beginning of the new year will clearly leave their mark on the outlook for 2013.

A Sharp Slowdown in Q4 2012

Despite a broad-based upturn in early autumn, the fourth quarter of 2012 will go on record as one of the worst the industrialized countries have known in the past two years.

- Growth in the U.S. is unlikely to have exceeded 1.5 percent at an annualized rate.
- With Italy, Spain, and now France sliding further into recession, Germany's industrial output is also falling. The country's GDP probably contracted by half a percentage point in Q4 2012—or by two percentage points on an annualized basis.
- Although the emerging economies have for the most part performed better in Q4 2012 than during the prior two quarters, they are still not growing fast enough to be able to spearhead a worldwide upswing.

Global business climate in manufacturing industry and OECD's GDP Growth



Sources: RichesFlores Research, OECD, Macrobond

Persistently Low Growth in Early 2013

Economic conditions will remain shaky in early 2013, even with the slightly improved business climate seen at the close of last year. Mediocre performance can by and large be expected in the first months of 2013.

U.S. Growth Stuck Below 2 Percent in H1 2013

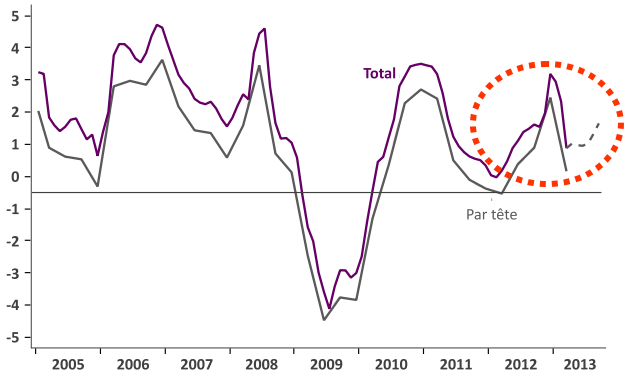
Although confidence has picked up since the January 1 budget deal, the U.S. economy is unlikely to get back to strong, sustainable growth for a fair amount of time.

For one thing, this compromise agreement will at the very least take a sizable bite out of household income. All American wage and salary earners will be hit by a two percentage-point increase in payroll tax at the start of this year—worth an estimated total of $100 billion per annum. And while the resulting decline in disposable income will probably be offset in part by a tendency to dip into savings, it will necessarily push down consumer spending in early 2013.

For another thing, there is little reason to assume that the worsening investment outlook throughout much of 2012 will get any better in the near future. Despite an end to fiscal uncertainty, the fragile state of small businesses in the U.S. will continue to hold down corporate investment spending, especially now that companies are finding it much harder to export.

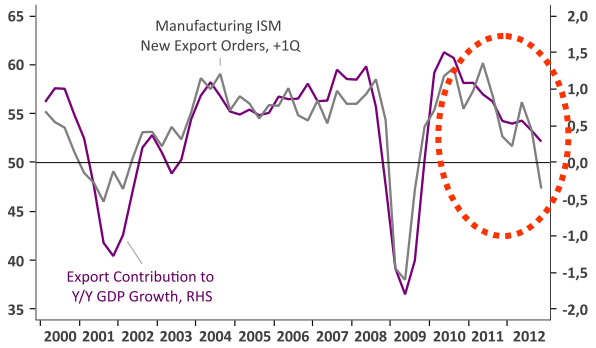
This means that the U.S. housing market revival will be unable to work miracles. In all likelihood, the country's GDP will rise by less than 2 percent in the first half of the year.

Real disposable income growth of US households, % ch. y/y



Sources: RichesFlores Research, Macrobond

US New Export Orders vs. Contribution of Exports of Goods to annual GDP Growth



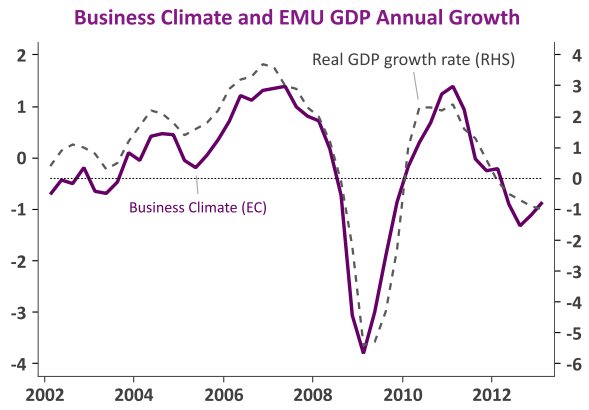
Sources: RichesFlores Research, Macrobond

From Bad to Worse in the Core Eurozone Countries

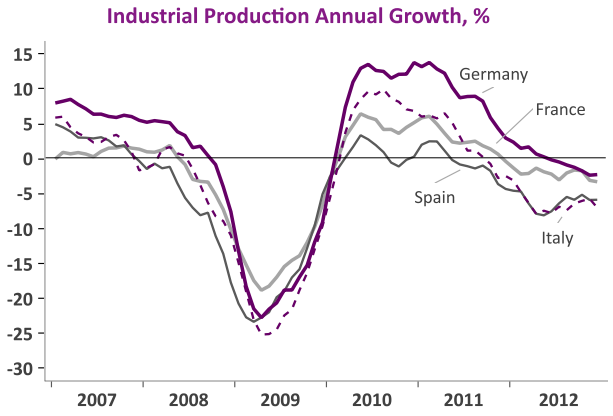
Circumstances in the euro area have gone from bad to worse in the past few months, putting such core countries as France, Germany, and the Netherlands in an increasingly vulnerable position. The downturn in France—the number-one outlet for German exports—spells trouble for the Eurozone's strongest economy, and for France in return.

Meanwhile, Southern European countries have been grappling with mounting domestic troubles in the past few months, suggesting that the recent, slight pickup in manufacturing will soon peter out. Their exports to the rest of the world, particularly to the U.S., did indeed bounce back in October and November, but it's hard to believe they can export their way out of the slump affecting the region.

The euro area has unquestionably entered a recession, and if Germany somehow manages to avoid two consecutive quarters of falling output (as recession is commonly defined in Europe), this will probably be due to statistical quirks rather than to any real immunity to negative growth.



Sources: RichesFlores Research, Macrobond



Sources: RichesFlores Research, Macrobond

In such an environment, the recent lull in fiscal tightening measures is bound to be short-lived. By springtime, Spain, France, and Italy will almost certainly find themselves incapable of honoring their deficit reduction commitments—and equally at a loss as to what additional adjustments could conceivably help them meet the targets they have set. So the most likely outcome by far is a rescheduling of deficit reduction timetables, given the dangers that a fresh round of austerity would entail. But that will by no means take fiscal uncertainty off the agenda.

It follows that the ECB will probably have to offer more than just promises. In fact, it's hard to see how the central bank can avoid cutting its key rates during the first half of 2013 and engaging in Outright Monetary Transactions (OMT).

Fiscal tightening required to meet 2013 deficit targets, based on our growth forecasts

% of GDP	2012 budget deficit (target at autumn 2012)	2013 target	Tightening needed in 2013 to meet target*
France	4.4 (4.4)	3.0	2.0
Italy	2.8 (1.7)	0.5	2.8
Spain	8.0 (6.3)	4.5	3.2

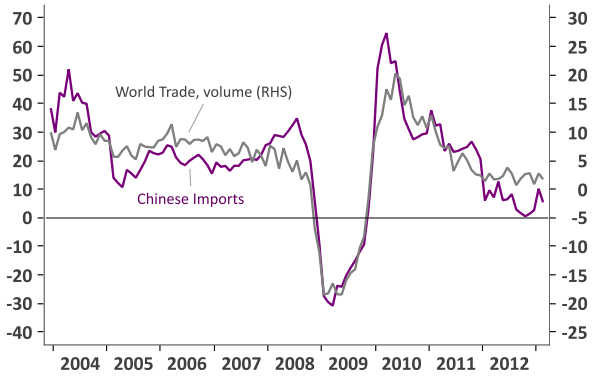
Source: RichesFlores Research, European Commission
* Given the delays in 2012 and those we forecast for 2013

Emerging Economies: An End to the Slide, but Not Enough Traction Yet to Tow the Rest of the World

Conditions in the emerging economies have stabilized in the past few months, thanks to a combination of lower inflation, accommodative monetary policies, and stimulus programs adopted in several countries. So far, this improvement has mainly been confined to the domestic scene, most notably to consumer spending (see our Global Consumer Spending Monitor), while business activity and earnings continue to suffer from weak exports.

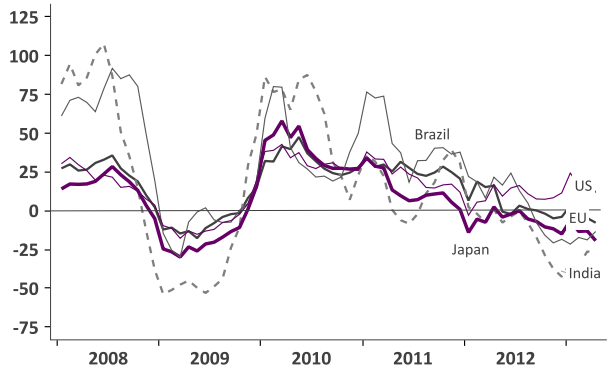
In light of today's anemic growth rates, the demand in emerging markets for goods and services from the rest of the world is still too weak to enable these economies to power world trade, as is widely hoped for.

Chinese Imports and World Trade Annual Growth, in %



Sources: RichesFlores Research, CPB, Macrobond

Chinese imports annual growth according to the country of origin



Sources: RichesFlores Research, Macrobond

Key Economic Factors Turn Increasingly Favorable in H2 2013

The economic policy ramparts set up by industrialized countries in the last two years, coupled with a gradual stabilization in the most influential emerging economies (China and Brazil), point to a more encouraging outlook in the latter half of the year.

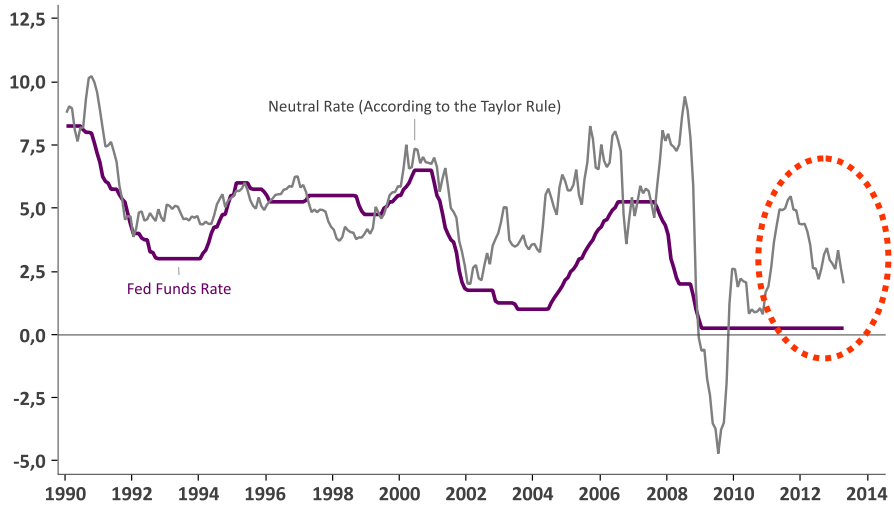
A More and More Accommodative Monetary Policy

Prolonged monetary policy easing in the United States is unquestionably a crucial component of the scenario for a gradually brightening economic outlook articulated in this paper. The Fed's current policies—although in some ways extreme and worrisome from a long-term perspective—indisputably support U.S. growth. **Once the impact of the recent fiscal cliff agreement has been digested, the macroeconomic benefits of those policies should become increasingly apparent.**

The entire range of monetary policy indicators bears witness to the central bank's unusually accommodative stance.

- The steady decline in the output gap over the last few quarters has rendered the Fed's zero interest-rate policy increasingly accommodative (see graph below).
- By end-2012, real interest rates were negative: short-term rates stood at –1.9 percent, long-term rates at –0.3 percent. The Fed's program of MBS purchases has been accompanied by shrinking bank margins and record decreases in mortgage lending rates.
- The M2 monetary aggregate shows persistently strong growth, exceeding 5 percent a year in real terms.

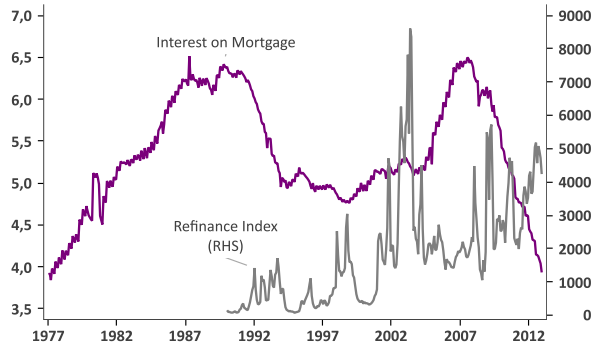
Neutral Rates According to the Taylor Rule versus Fed Funds Rate



Sources: RichesFlores Research, Macrobond

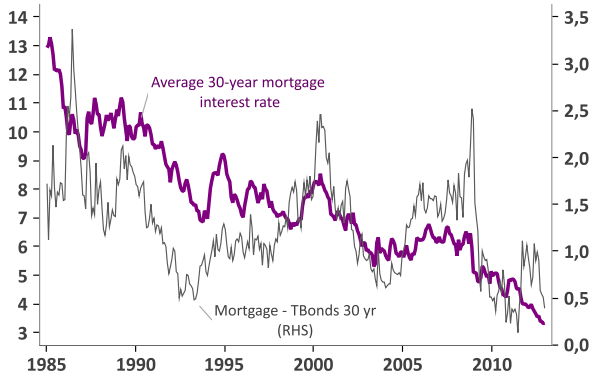
The Fed's purchases of MBS and T-Bonds—to the tune of $85 billion a month—will ensure the availability of easy financing for the bulk of 2013, almost certainly with greater and greater impact as the business cycle advances

Refinance Index and Interests on Mortgage (in % of Household Disposable Income)



Sources: RichesFlores Research, Macrobond

Average mortgage interest rate and Bank Margins

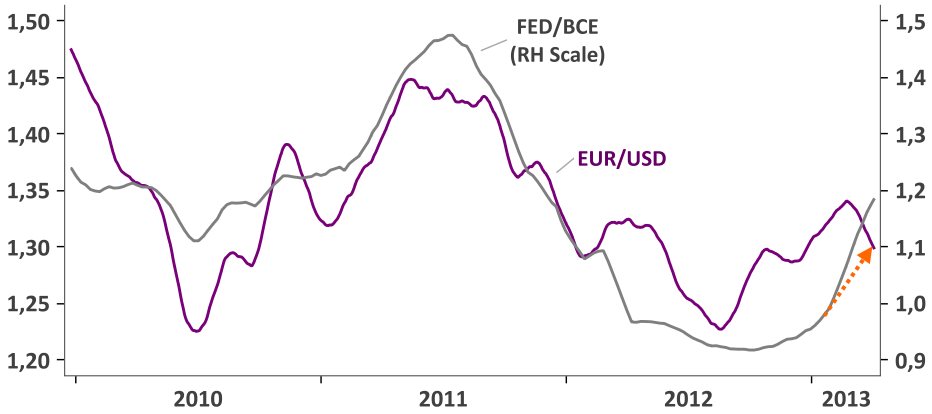


Sources: RichesFlores Research, Macrobond

A Depreciating Dollar and Reoriented Exports Will Push U.S. Growth Over the 2.5-Percent Threshold in 2014

By hugely expanding its balance sheet in an effort to buttress U.S. monetary policy, the Fed has greatly weakened the dollar over the past few quarters. This balance-sheet expansion is likely to drive the U.S. currency down further against the euro in the months ahead. **Our estimate is that the euro–dollar exchange rate will average 1.35 in 2013.** The euro rally in the first half of the year may temporarily push the greenback even lower once the effects of the divergence between the ECB's balance sheet (which is shrinking after the repayment of the first LTRO tranches) and the Fed's (which is ballooning further) fully kick in.

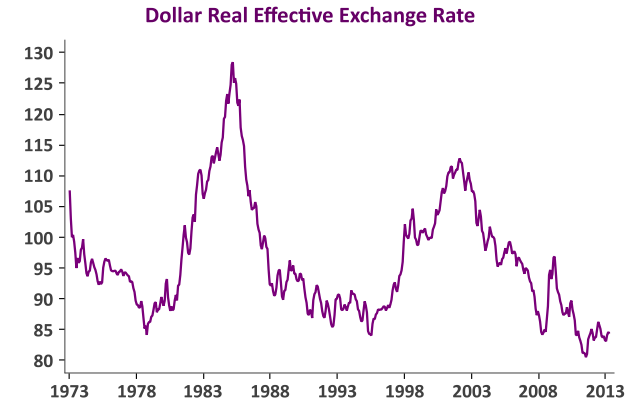
Relative Evolution of Fed's to EBC's Balance Sheet and EUR/USD Exchange Rate



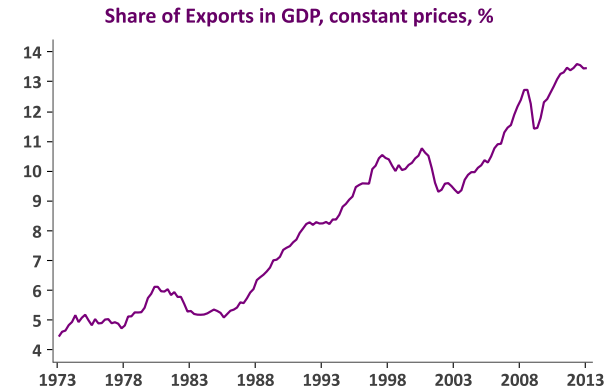
Sources: RichesFlores Research, Macrobond

With the real dollar exchange rate back to historic lows, American exporters hold a clear competitive advantage. And this advantage will eventually become even more pronounced as exports are reoriented toward China and Brazil—the world's fastest-

growing markets. The U.S. economy's increasing openness to the outside world has a short-term downside, but it gives the country a structural advantage that will pay off in earnest once the global economy picks up.



Sources: RichesFlores Research, Macrobond



Sources: RichesFlores Research, Macrobond

Despite the constraints imposed by the private and public-sector deleveraging under way, the Fed's policy choices will ultimately produce results. In particular, more sustained investment in the latter half of the year should pave the way to higher productivity—a prerequisite for better job figures.

Although GDP is expected to rise by less than 2 percent this year, a more favorable economic climate in 2014 should give U.S. economic growth a hefty boost to an average of 2.7 percent, according to our estimate.

Emerging Economies Still in Catch-Up Mode

In the absence of export support, overall trends in emerging economies are shaped to a great extent by commodity prices and by sporadic economic policy initiatives. However, those countries have considerably less leeway to implement such initiatives than they did a few years ago, and they are unquestionably less well-positioned to return to pre-crisis growth rates. In China, the transition to a more endogenous form of growth, driven by domestic demand, has been accompanied by more modest productivity gains. This—in combination with the sharp appreciation of the yuan over the past few years—has proved particularly damaging to the country's exporters. And because domestic consumption is still too weak to make up for the fall in exports, China necessarily finds itself with reduced growth potential. Most of the other major emerging economies suffer from chronic under-investment, whose effect on growth stands out starkly as soon as export support is no longer forthcoming.

Even so, the factors behind the substantial slowdown in emerging economies in 2012 represent less of a handicap today than in the past several quarters, because:

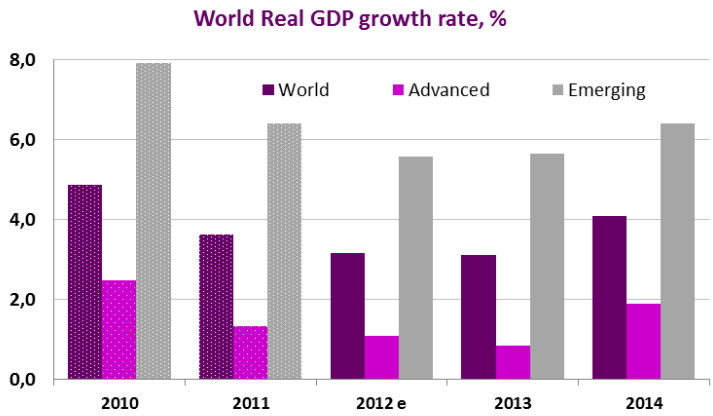
- commodity prices have stabilized, and weak global demand may even push them down in the first few months;
- international trade growth has also stabilized;
- Stimulus programs have been on the rise since last autumn.

Once the vulnerabilities referred to above have been overcome, the structural catch-up process under way should gradually enable emerging economies to leverage more favorable trends and achieve more vigorous growth from 2014 onward.

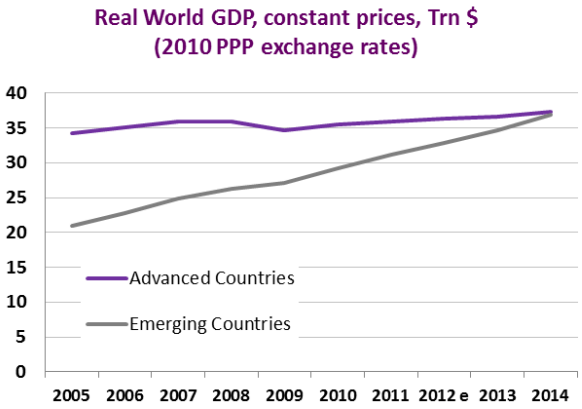
- In China, where consumer demand is perking up just when the government has started investing more heavily, growth should reach a more comfortable level this year than in 2012, most likely in the vicinity of 8 percent.
- In Brazil, government policy is gradually beginning to pay off. After sliding to 1 percent in 2012, GDP growth should bounce back into the 3.5–4 percent range in 2013 and 2014 as public investment programs and measures to support consumer spending gain traction.
- The Indian economy is too bogged down in structural rigidities to produce much in the way of fireworks in 2013, but in the less punishing international environment of 2014, it should be able to expand once again by more than 6 percent a year.
- In contrast, the Central and Eastern European countries will take longer to recover, since they are much more exposed to Eurozone turmoil.

Growth in the emerging world should therefore average somewhere around 5.5 percent this year, before rising to about 6.5 percent in 2014.

Given the increasing weight of emerging economies in the past several years, their combined GDP can be expected to expand by over $4 trillion at constant prices—thus contributing four times as much to global growth as developed countries on the basis of our forecasts. This will bring the emerging world's share of global output to exactly 50 percent by 2014.

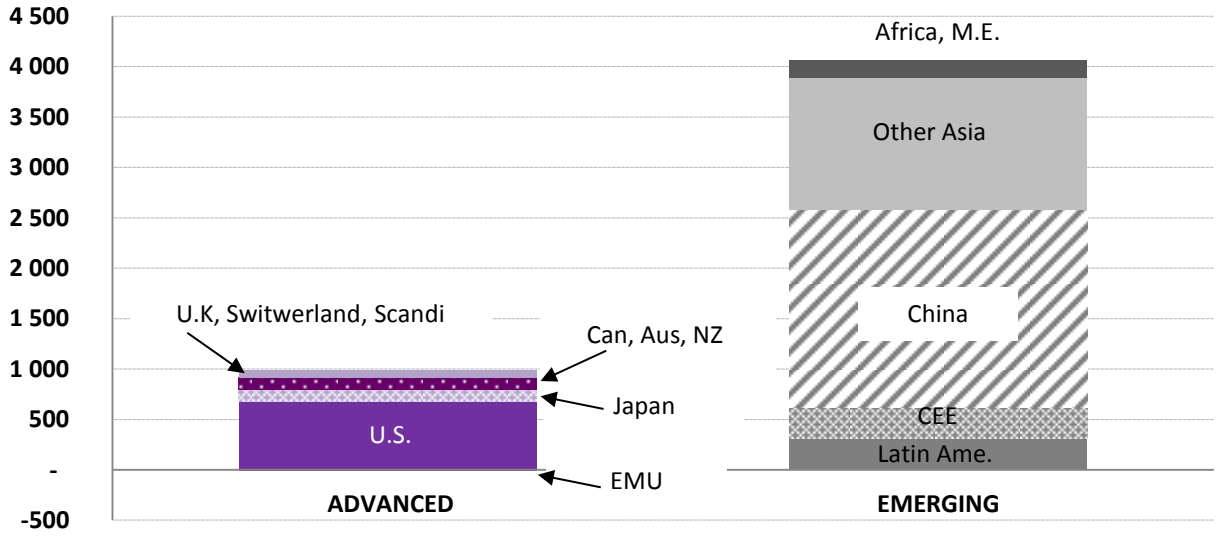


Source: RichesFlores Research



Source: RichesFlores Research

2012-2014 Real GDP growth, bln $, constant prices (PPP $2010)



Source: RichesFlores Research

Europe: Belatedly Joining the Global Recovery Party

Any scenario for the Eurozone's gradual emergence from recession rests entirely on the prospects for a healthier global economy. But even if those prospects come to pass, Europe's restrictive economic policies, together with the appreciation of the common currency, have created powerful headwinds. It will take several quarters for things to settle down and for the euro area to stand a chance of pulling out of the slump. We estimate that Eurozone GDP will shrink by 0.7 percent in 2013, falling by 0.2 percent in Germany, 0.5 percent in France, and 1.5 percent in Spain and Italy.

In addition, the gradual turnaround we are predicting for the second half of 2013 is unlikely to produce growth of more than 0.7 percent in 2014, which is clearly not enough to spark a discernible recovery or make much of a dent in budget deficits. **So the realization of our scenario will depend primarily on how pragmatic Europe's economic policy-makers are.**

In other words, the possibility of sovereign bond yields creeping back up again can't be ruled out, although its impact should be limited now that the ECB has the means (via OMT) to assist the most beleaguered Member States.

- There is still serious concern about the increasingly dramatic conditions in Spain, including a budget deficit likely to exceed 6 percent of GDP this year—a far cry from the 3 percent forecast by the European Commission last spring! And whatever the Rajoy government may assert, it's hard to imagine how the country can pull through without an ECB bailout.
- In Italy, meanwhile, the longer the recession lasts, the more the risks build up. With debt topping 120 percent of GDP, the economic slump is deep enough to dash any hope of a lasting reduction in the structural deficit. Not only have the government's recent reforms yet to produce results; Italy's competitive position—unlike Spain's—is still eroding. The positive productivity shock the Italian economy needs to get back on the road to recovery is simply unattainable in a country suffering from short-term recession and secular economic decline. All these factors will put whoever wins the upcoming elections in a very uncomfortable position.

So the euro area is by no means out of the woods, and the medium- to long-term outlook is far from clear. In the five-year period from 2010 to 2014, average annual GDP growth will probably not exceed half a percentage point—a rate that is much too low for public and private debt levels to be brought even moderately under control. Such poor performance is also incompatible with the objectives in the recently revamped European Treaty. In fact, the plain truth is that the giant steps achieved in the past few years can't possibly pay off without some serious rethinking of economic policy in Europe. It took Japan fifteen years to reach the same conclusion. The monetary union may not be able to hold out that long

.

Quantitative Easing Inevitably on the Way Out in 2014

A brighter economic outlook and lower unemployment will rapidly raise the question of how the Fed should exit its unconventional monetary policy. Long-term T-Bond yields could start heading upward in the second half of 2013.

The euro area apart, our scenario for 2014 points to a substantially improved international economic outlook. **In 2014, global GDP should expand by slightly over 4 percent, a pace that no longer squares with the monetary policies pursued by many developed countries today**—first and foremost the United States. If this happens and the American economy starts creating jobs again, declining labor-force participation could drive unemployment down faster than commonly anticipated. Our estimate is that as early as Q1 2014, the U.S. jobless rate could hit the 6.5 percent threshold set by the Fed as a prerequisite for ending quantitative easing. Furthermore, as the global economy picks up, commodity prices are likely to rise—thus adding extra fuel to inflationary trends. **All the ingredients for phasing out quantitative easing should therefore be at hand by early 2014, which just happens to mark the end of Ben Bernanke's term as Fed chairman.**

But since the current environment is hardly conducive to levelheaded decision-making, the Fed probably won't wait until then to shift gears. Gradual adjustments that herald an end to unconventional monetary policy are clearly to be expected. The transition, however, may well turn into a perilous balancing-act: long-term U.S. bond yields have strayed so far from what the fundamentals suggest that at times they could spike surprisingly sharply. Under the best-case scenario, ten-year yields will gradually inch up to between 2.50 percent and 2.75 percent at end-2013. But the upward trend could prove harder to stem in 2014. According to our scenario, yields should reach or exceed 3.50 percent by year-end.

If they do, the euro area will probably be unable to avoid a similar correction, even though its economic cycle is not synchronized with that of the U.S. The debt-pooling process assumed in our scenario will leave the German economy increasingly prone to higher long-term yields. Starting in the second half of 2013, ten-year Bund yields could gradually rise, likely exceeding 2.5 percent by end-2014.

Key Scenario Assumptions

	End-2012	End-2013	End-2014
Fed funds rate	0.25	0.25	0.25
ECB repo rate	0.75	0.50	0.50
10-year T-Bonds	1.70	2.50	3.50
10-year Bunds	1.50	2.00	2.75
EUR/USD	1.32	1.35	1.25
Oil (Brent), USD/bbl.)	111	100	130

Source: RichesFlores Research

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