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INVESTMENT PUBLICATIONS HIGHLIGHTS

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Investment Publications Highlights

Summarized by the Published Research Team

"2012: Another Difficult Year" by Gregory Peters, et al., Morgan Stanley, December 6, 2011

In all likelihood, 2012 will be another difficult year marked by macro and political issues. The three main macro issues that could greatly affect asset classes are weak developed market growth and the risk that poses to emerging markets, developed world deleveraging and the related spillover effects to the emerging world, and European tail risk.

In all likelihood, 2012 will be another difficult year. The 2012 outlook is clouded by macro and political risks, all of which are impossible to predict. Asset classes could be driven by three main macro issues, weak developed market growth and the risk that poses to emerging markets, developed world deleveraging and the related spillover effects to the emerging world, and European tail risk. Deleveraging in the developed world is ongoing, and its impact will continue to reverberate across global economies and markets.

Emerging markets are expected to support global growth, but the developed world faces slower growth given necessary deleveraging. Recession risks are becoming the bearish case for the United States and Asia; it is already the base case in Europe. The risk of a recession in the United States is heightened by the political wrangling taking place in Washington. Fiscal tightening is needed in the developed world, but is likely to produce an aggregate slowdown that makes it tough for politicians to push. Against a starting point of anemic recovery, broad-based fiscal tightening may in fact lead to a broad-based developed world recession.

While emerging markets are counted on to support global growth in 2012, they have experienced slowing growth since mid-year, and this trend is likely to continue. In an effort to cushion the potential hard landing, a number of emerging markets central banks have eased policy rates and retain flexibility for further cuts. However, emerging markets policymakers do not have the same room to maneuver as they did in the past few years, with inflation at a higher starting point and capital flight a greater risk. China remains the focal point of emerging markets. Inflation pressures are higher now than in 2008, so it seems likely that any Chinese response will be slower and more muted relative to 2008–09. Nonetheless, a soft landing in the emerging markets world remains the base case, as policymakers have more tools to respond to an unacceptable slowdown in activity than their developed markets counterparts.

Deleveraging will be a central theme in the developed world during 2012, as it has been during 2011. The financial sector in Europe is more levered than the United States, and leverage remains near its peak. European banks are likely to accelerate their deleveraging by shrinking balance sheets. The increased price for lending and restriction of credit worsens the outlook for growth within Europe. In turn, EU bank deleveraging is likely to affect emerging markets, despite European bank lending to emerging markets having dropped 20%, or €500 billion, from March 2008 to June 2009. In 2012 it is likely that the banking world will continue to "de-globalize" as domestic preferences continue to drive decision making.

The third macro theme is the risk associated with the potential for the European end game to be in sight. Whereas other developed markets economies may continue to muddle through, this no longer seems an option in Europe. By this time next year, the Eurozone will likely either have partly stabilized the current situation—by moving closer toward fiscal integration and using the European Central Bank (ECB) as a sovereign backstop—or we will see disorderly defaults, either of financials, sovereigns, or both. These defaults could occur by the euro fracturing and denominating debt in a depreciated currency. Even if the European crisis is "resolved," it is only in the sense that Europe would look more like other highly leveraged regions—still facing a difficult end game, but without the fragilities that frustrated policymakers' ability to kick the can down the road, as has happened elsewhere. With markets now generally more alert to sovereign stress, and global growth slowing, it may be that the surprise of 2012 is that sovereign stress spreads beyond Europe to other developed economies.

This macro and investing environment is not conducive to taking on excessive risk, as reflected by asset allocation preferences for 2012. Specifically, developed markets credit remains a preferred asset class. Spreads are pricing in exceptionally high default rates, even in Europe, where a recession is closer to being priced in. Credit generally is also more attractive than developed markets equities, as the latter are not yet cheap based on a long-term valuation metrics and will be challenged by slow growth and the risks associated with deleveraging. Within credit, U.S. high yield and, by extension, collateralized loan obligations are our favorite asset classes as corporate fundamentals are also solid. Leverage levels are relatively low, cash balances are high, and debt maturities over the next year are very modest.

On the equity front, it is likely that emerging markets equities will outperform developed markets equities, largely supported by Asia. Within developed markets, the risk-reward on a 12-month view favors Europe over the United States, but price returns in both regions will be modest at best. The preference for Europe comes down to two factors: much cheaper valuations and expected progress on the debt crisis. Europe may yet go lower, but the outlook is more balanced than for the United States, in our view. In total, markets will remain volatile, so high-quality, dividend-paying stocks are particularly appealing. In a "carry and yield" environment with low interest rates for an extended period, dividends remain a stable alternative source of income.

"Credit Outlook 2012: Think the (Even More) Unthinkable … ?" by Jim Reid, Mahesh Bhimalingam, and Nick Burns, Deutsche Bank, December 12, 2011

After a volatile and unpredictable year in 2011, the outlook for 2012 is increasingly cloudy as many things that investors once took to be certain are no longer so. However, by looking back at some of the lessons of the 1930s, investors can gain some insight into what may play out in 2012 and beyond. Specifically, the crisis unfolding in Europe is similar to what happened when countries left the gold standard in the 1930s. Additionally, for the United States, 2012 could be similar to 1937, when tight fiscal and monetary conditions led to a deep recession. Further complicating the outlook is the increased probability of a slow-

down in China or emerging markets broadly, as well as the risk of a sovereign debt crisis in a developed country outside Europe.

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As the global economy went through a period of great economic contraction in the 1930s, it became increasingly difficult for countries—particularly in Europe, with its currencies fixed to gold—to remain competitive. Similarly today, countries in both the periphery and core of the Eurozone are facing structural issues largely due to their currency. Real wages rose faster than productivity for much of the last decade, and Eurozone countries ran increasingly large deficits. Many, including Greece, Ireland, Italy, Portugal, and Spain, are now in a position of being structurally uncompetitive and at the mercy of the markets to continue to fund their profligate government operations. Under the current euro structure, individual countries cannot devalue their currencies in order to regain their competitiveness and help rebalance their economies. This was also the case in the 1930s under the gold standard.

Faced with difficult choices such as remaining uncompetitive within the euro and imposing drastic fiscal austerity, many European countries may consider the best way out an exit from the Eurozone and a dramatic devaluation of their new currencies. Many countries did just that in the 1930s, and the experience for the most part was positive. Nominal GDP was able to expand, and eventually, the countries were able to rebalance, regain competitiveness, and, in many cases, thrive for years afterward. However, the impact of this type of large-scale devaluation and effective breakup of the Eurozone and its effect on the markets remains to be seen. What is clear from the 1930s analogy is that as countries began to leave the gold standard, economic activity increased and equity markets moved higher.

The United States is currently not going through the same issues as much of the Eurozone; however, the U.S. economy still faces many obstacles. Following the most recent recession, an unprecedented amount of monetary stimulus, complete with a healthy dose of fiscal stimulus, is largely believed to have "saved" the United States from a depression. There is a fear, however, that with little room for further monetary stimulus and little political will for additional fiscal stimulus, the United States could tip back into recession in 2012 as the underlying economy is much weaker than many realize and will falter without continued government support. In 1937, having largely recovered from the great depression, the United States sank back into recession following a tightening of both fiscal and monetary policy. While the most recent recession was not as severe as the Great Depression, the precedent of removing economic stabilizers and stimulus too soon can clearly prove to be dangerous.

Making the outlook for 2012 even cloudier is the potential for a disruptive event that shakes world markets. High on most investors watch lists is the increased probability of a slowdown in China or emerging markets broadly, as well as the risk of a sovereign debt crisis in a developed country outside Europe. China's incredible growth over the last decade is largely responsible for keeping the global economy afloat, especially over the last three years. As investors finally start questioning what has been driving China's growth and the bill starts coming due, there is increased scrutiny placed upon China and its ability to continue to expand rapidly. Any slowdown or growth scare in China or the emerging world at large could have an outsized impact on the already-fragile global economy.

With sovereign debt issues in Europe consuming all the headlines, it is easy to forget the weak position Japan, the United States, and the United Kingdom find themselves in. Japan is likely the highest risk in the near term for a sovereign debt crisis as it has recently been under the biggest microscope given its poor demographics and rigid economy. However, the United States and United Kingdom are both likely to undergo significant rounds of austerity if they are to regain their competitiveness and get their fiscal houses in order.

After an unbelievably eventful and wild 2011, 2012 could amazingly be even crazier.

"The Euro Crisis and the World: Lessons Learned from Asia 1998" by Dominic Wilson, Kamakshya Trivedi, et al., Goldman Sachs, December 14, 2011

The global economic outlook depends upon how the situation unfolds in Europe and how the crisis is transmitted to the rest of the world. The Asian financial crisis offers some useful lessons. If the banking transmission is minimized, other non-euro economies may suffer less from a Eurozone recession than feared. However, already-low interest rates may limit one potential positive transmission mechanism and make it less likely that the global economy will witness the resilience seen in the wake of the Asian crisis.

How the European sovereign debt crisis unfolds is key to the global economic outlook. However, the question of how bad the Eurozone outlook becomes is distinct from how the Eurozone crisis will affect the rest of the world, as the links are less straightforward than many assume. The Asian financial crisis in 1998—the last major regional crisis for the world economy—offers some useful lessons. During that crisis, investors substantially underestimated the breadth and depth of the hit to Asian demand, but overestimated its impact on the major non-Asian economies.

The Asian crisis highlights two important insights for understanding the transmission of any regional financial shock. First, the current account shock (and the corresponding hit to the exports of trading partners in the wake of plummeting Asian domestic demand) was accompanied by a capital account shock, which helped lower yields and ease financial conditions in other markets. While the first was clearly negative for growth outside Asia, the second was positive. On net, the impact was eventually neutral. The second insight is that it matters where perceptions of risk rise, and how broad that rise in risk premia is. Ultimately, the Asian crisis saw risk premia rise only on a regional basis. As a result, capital flowed away from those viewed as risky into those viewed as safe.

While the origins of the Eurozone crisis differ in many respects from the Asian financial crisis, there are some important similarities. For much of the period since early 2010, capital has flowed out of the "periphery" into the stronger "core," easing German financial conditions in particular. As a result, German growth accelerated into early 2011. While that picture has been changing over the last six months, the echoes of the story clearly remain. The impact on the broader Eurozone looks similar, or less threatening on some dimensions. The trade shock, for instance, will likely be significantly smaller. While the Eurozone represents a larger share of global GDP than was the case in Asia, the potential trade shock to the rest of the world is a function of both the share in global demand and the size of the hit to domestic spending. In the Asian crisis, the compression in domestic demand was much more dramatic than is likely for Europe, given that the Eurozone has supported member countries and the weaker banking systems can fund themselves cheaply through the ECB. The flipside is that capital inflows to the rest of the world are also likely to be smaller, and bond yields in the non-crisis economies (e.g., Germany, the United Kingdom, and the United States) have fallen by comparable amounts.

At the same time, there are important differences. The Asian crisis occurred against the backdrop of a strong recovery in domestic demand in the major developed countries. In contrast, the current global economy is a good deal more fragile, as evidenced by weak economic recoveries in the United States and the United Kingdom. Furthermore, lower yields are less helpful for demand in many places and monetary policy more constrained. A key part of global resilience in the Asian crisis is that as capital flowed toward the developed markets, the resulting drop in yields and monetary easing provided a powerful stimulus to domestic spending. With monetary policy constrained in many economies and the banking channel clogged, the impact from lower yields is likely to be a lot smaller. More precisely, the impact of easing financial conditions—mostly driven by falling long-term rates in the "safe haven" economies—on actual spending is likely to be less effective. Alongside deleveraging pressures, the scope for higher private demand in those countries is worse than in 1998. Finally, and perhaps most importantly, banking linkages to the rest of the world are much larger for Europe. Outside the Long-Term Capital Management crisis, which calmed quickly, the damage in the banking systems of the Asian crisis economies had only a limited impact on banks outside the region (with the partial exception of Japan). The banking systems of the affected Eurozone economies represent a much larger share of global banking assets (roughly 20% using banking sector credit as a proxy). Direct exposure from other countries' banks to the Eurozone is also much higher, as is the overlap in Eurozone bank assets with other banks and their role in lending to other markets. Consequently, the risk that funding stresses or deleveraging pressure here could affect other countries' banks looks much greater.

Pulling all this together, there are a couple of key messages from the Asian comparison. First, *where* the market sees a rise in risk is key. If the Eurozone crisis remains primarily about risk perceptions of the crisis economies themselves, then some of the offsets that limited transmission in the Asian crisis (e.g., lower yields in other countries) will remain important, even within the Eurozone itself. The difference between 2008 and 1998 can largely be framed in these terms. Ultimately, the 2008 crisis saw risk premia rise across a broad range of countries, and capital flowed out of all risky assets, rather than moving from "risky" countries to "safer" countries as it did in 1998. For that reason, the broadening of the group of countries in the Eurozone that are viewed as "risky" is an important marker in expanding the scope of the crisis. If the market begins to raise risk premia across the Eurozone as a whole (as it has started to do in the past few months), it widens the implications of the crisis for the Eurozone and for the transmission to the rest of the world.

The second message is that banking is the most important (i.e., presents the greatest risk) channel for transmission. The export channel does not look large enough globally to precipitate a major problem for the rest of the world, and lower yields or policy easing in many other economies will provide some offset. Funding pressures in a broader range of economies, however, will be a sign that the shock from Europe is truly "going global" and provide the most obvious mechanism by which it could have a more damaging effect on the rest of the world.

Despite many important differences, the Asian financial crisis is a good reminder that the 2008 template of full global transmission—which many implicitly apply to the current Eurozone crisis—is not the only path. There may be larger forces at work that explain why the damage from the Eurozone to others has so far been less intense than feared. In particular, the Asian financial crisis highlights that there can be important offsets to the trade shock to the rest of the world as long as the change in risk perceptions is mostly concentrated in the affected region. Those lessons reinforce the notion that a major banking shock poses the biggest risk now. If banking transmission can be minimized, other parts of the world may suffer less from a Eurozone recession than feared. However, comparisons with 1998 also suggest that the impairment to interest rate transmission in the post-bust developed world make it less likely that we will witness the extent of resilience seen in the face of the Asian crisis. ■