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Scenes From The Recovery

2013 Economic Outlook

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In a lot of ways, the current global economy feels like the beginning of the third act in a three-act story. In many movies, the filmmaker uses this three-act structure where the first act introduces the characters and puts the story into motion; conflicts are established, paths are determined, and sides are chosen. The second act is where the drama occurs and culminates with the greatest challenge for the protagonists. This sets up the third act for a resolution. That feels like where we are today.

The global economy's second act (in this story line) ended with the global financial crisis that decimated world economies and led to recessions across the developed world. Companies that once seemed like stalwarts of their industries disappeared in moments and entire business models – countries even – proved virtually incapable of coping with the volatile stresses of this new era.

So the third act begins, looking for resolution; however, the halting nature of this recovery and the continuing uncertainty around the world has made it a plot looking for direction. Several years in and there are still issues preventing the world's economies from achieving convincing, sustained growth. Fortunately, 2013 appears to have several plot devices that will ensure there's some action in this third act that will get the plot, and the global economy, moving again. We'll examine these scenarios and the actors they affect, and give some idea of where 2013 could take the global economy. The three principals we'll be looking at are the United States, Europe, and Asia. This isn't to minimize the importance of other economies around the world; it's just that these three regions hold the most sway over global economics.

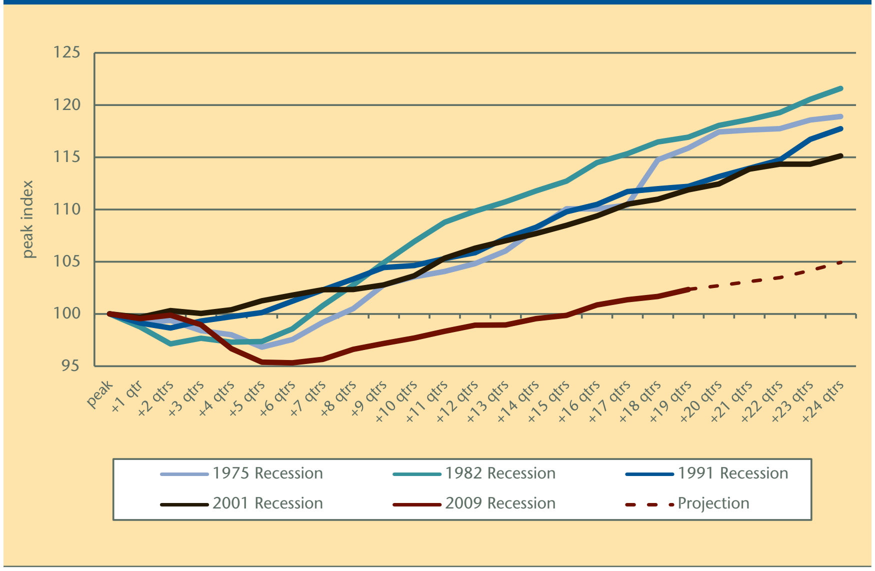
The United States and the MacGuffin

American films have long been known for their slavish insistence on a happy ending, or a resolution that works out in the best possible way for the protagonists. Americans in general also insist on a happy ending, and anything short of a perfect resolution is seen as unsatisfying. This helps describe some of the "America deserves better" rhetoric we heard during the presidential campaign. Even though U.S. GDP has been increasing – on average 2.25% annualized rate per quarter since the end of the Great Recession – this is widely seen as "not good enough." As shown in Exhibit 1 on the following page, this recovery has been painfully slow – the pace at which the U.S. economy has grown relative to the last peak is well below what is usually seen at this point in a business cycle. Many economists, business people, and politicians are used to a United States that roars out of recessions, and are finding the current halting recovery extremely unsatisfying. So the American story, to this point in the third act, has been one of a struggle between optimism and pessimism.

There is a term popularized by Alfred Hitchcock for a plot device that serves as the motivating element in a film used to drive the story; it's called a MacGuffin. A MacGuffin is the thing everybody wants or is talking about, and sets all the characters into motion. In Hitchcock's *North*

> *"The coming year seems to have several 'plot devices' that will help ensure that the global economy gets moving again."*

EXHIBIT 1: COMPARATIVE RECOVERY TRENDS IN REAL GROSS DOMESTIC PRODUCT (GDP)



Sources: Bureau of Economic Analysis, Principal Global Investors Economic Committee Forecasts

by Northwest, the MacGuffin is the microfilm containing government secrets. In *Casablanca*, the MacGuffin is the letters of transit that will allow their holders to leave for America. In James Cameron's blockbuster *Avatar*, the poorly disguised MacGuffin is the rare mineral the humans want called "unobtainium."

In the third act of the U.S. economic story, the MacGuffin is "policy uncertainty." This is the single biggest driver (or dampener, depending on your viewpoint) of political and economic movement, and the subject that all others seem to depend on. It takes the form of uncertainty over the regulatory environment (e.g., Obama's health care legislation or the Dodd-Frank Act); however, it is most often seen in the debate over the so-called "fiscal cliff," a package of tax increases and spending cuts set to occur at the end of 2012. If all of the aspects of the fiscal cliff were allowed to occur, it would almost certainly send the U.S. economy back into recession. This has businesses spooked and hesitant to invest in jobs or capital expenditures until the issue is resolved. Consumers, on the other hand, are moving forward, apparently discounting any negative outcomes from the fiscal cliff. This has led, in recent months, to a divergence between business and consumer confidence. The former has remained moribund, but consumer measures have hit multi-year highs. America's broad middle class appears to believe the Bush-era tax cuts will be extended for them, regardless of what happens for wealthier Americans. Presumably, if the U.S. government could clear the way for some sort of compromise on the fiscal cliff issues, businesses would recognize clarity on the issue and move to capitalize on this swell in consumer positivity.

As of this writing, Democrats and Republicans have struggled to come to any sort of compromise. Any "grand bargain" will be difficult because Republicans are adamantly opposed to tax increases (or rather, increases in tax rates), while Democrats are equally adamant in their opposition to cuts to social safety net programs like Social Security and Medicare. Right now, initial offers are on the table, and each has flatly rejected the others' opening bids.

Luckily, the fiscal cliff isn't as steep a drop as the term would imply, or as the media would have you believe. Some effects will be immediate, but other impacts will not take place until later. The gradual phase-in of the tax increases and spending cuts is such that some have started referring to the situation as a "fiscal slope." The payroll tax cut, which for now looks to be off the table, would hit the first paycheck of the year. The 2012 AMT (alternative minimum tax) creep would likely hit in March or April. In addition, depending on withholding schedules, the expiration of some of the Bush era tax cuts won't start having an effect until people file their 2013 taxes – sometime between January and April of 2014. The spending cuts don't all come at once either; they're spaced throughout 2013. The fiscal slope gets steeper the longer it takes Congress and the President to address, but it would still probably lead the U.S. economy into recession. The idea of a fiscal slope, versus a cliff, does breed a certain amount of confidence that if a decision isn't reached by January 1, the economy won't lapse into free-fall.

Since both parties appear willing to let the country reach the edge of the cliff, or perhaps briefly slide over it, the most likely outcome is continued bickering until sometime in January. Some Republicans are already talking about concessions on higher taxes, while as of this writing, we have yet to hear conciliatory comments from Democrats. Our expectation for the most likely case is for the middle class tax cuts to be extended and some type of tax increases for the wealthy. Our base case calls for some sort of deal on spending cuts, or "sequestration" as policy wonks like to call it.

In either the base case or a more negative scenario, that uncertainty over fiscal policy and higher taxes will drag on consumer and business spending for a good bit of the first half of 2013. Oh, and after the fiscal cliff, we've got a debate over increasing the U.S. debt ceiling . . . again. Unless the wheels fall off completely, fiscal policy uncertainty should abate (even if this comes from a temporary patch) and we should see U.S. growth begin to accelerate in the second half of the year.

Once we move beyond the cliff, there are lots of reasons to be optimistic about the United States. The recovering housing market springs to mind first, but there are other sources of sunshine for the U.S. economy: profits have been terrific; corporate balance sheets are strong; bankruptcies and delinquencies are falling; private debt is not a problem; inflation is modest; payrolls are ultra-lean; interest rates are at record lows; inventories are under control; and the stock market is not yet collapsing.

In our minds, the only thing holding the U.S. economy back is policy uncertainty. The more credible the deal Congress and the President finalize, the larger the potential for acceleration in growth. If policymakers only postpone the big decisions on fiscal policy (i.e., no fundamental changes in entitlements, tax rates, and other spending), then growth would only return to the path it's set out so far in this recovery – about 2% and change. Washington would then be forced to revisit those fiscal issues sometime in the future, keeping uncertainty alive. If we get a more credible deal, growth potential may shift to the upside as confidence rises and investment comes back.

Monetary policy will likely stay on it's current path. With President Obama re-elected, Federal Reserve (the Fed) Chairman Ben Bernanke has permission to continue his easy-money policy. We can probably expect that nominal interest rates will stay very low, and real rates will continue to be near zero or negative. If the economy sticks to our base case, rates could go up modestly by year-end 2013. However, if we see a cliff-induced recession, then we might expect to see rates go down. For example, the 10-year Treasury could fall to 1.25% or lower. If that occurs, the Fed's quantitative easing may wind down by 2014. If the downside scenario occurs, unemployment would rise and the Fed's asset purchases might continue at an even faster rate.

Europe and Plot Vouchers

European cinema has long been differentiated from typical American "Hollywood" fare by its acceptance of narratives with an apparent lack of resolution or with an "unhappy ending." European filmmakers haven't historically had a problem ending a film in a manner that leaves it up to the audience to determine the fate of the characters. This "lack of resolution" scenario is also playing itself out on the stage of the European economy right now.

There is a widely used device applicable to Europe called the plot voucher. A plot voucher is a relatively new term; it's an object given to the protagonist earlier in the story that, usually at the last minute, allows them to escape harm. It's a voucher because it is "valid for one awkward scrape" and is "not transferrable." Think about every gadget Q ever handed to James Bond. Somehow, a wristwatch with a laser cutter and remote detonator always seemed to come in handy.

Repeatedly over the last several years, the European Union (EU) has brought itself back from the edge of disaster with just this sort of a last-minute solution that patches everything together for just a bit longer and keeps the region plodding along. The phrases "European Union" and "muddle through" have been used together so often that they've almost become synonymous. Many outside Europe have a hard time with this sort of "right to the edge" diplomacy, though Europeans remain broadly confident that the process is working as it's intended, even if that means there is some amount of heartburn for all parties involved. There have been some positive steps. The European Central Bank (ECB) moved to implement unlimited secondary-market bond purchases to help keep sovereign rates down for at-risk members. The permanent bailout mechanism has been approved and has begun funding. The European Stability Mechanism (ESM) is operational and is already being used to recapitalize Spanish banks. Greece continues, at least for now, to meet deadlines and gain concessions to keep its own bailout capital flowing. These steps have reduced financial turbulence for now, and that may be a good start.

In 2013, this prolonged stasis will likely continue, with plot vouchers keeping the region out of the deepest dangers. Expect to see some movement (perhaps barely perceptible) in the direction of a deeper European fiscal union. Next year, there will be a phase-in of the banking supervisor; however, big movements toward fiscal consolidation like Eurozone-wide (A geographic and economic region that consists of all the European Union countries that have fully incorporated the euro as their national currency.) deposit insurance or jointly issued Eurobonds (A bond issued in a currency other than the currency of the country or market in which it is issued.) are further in the future. Policy makers will come to the realization that deeper integration is the path to follow if the single currency is to stay viable. The Eurozone has slunk back into recession, with economic slowdown now even making an appearance in Germany. Next year should see the economy stabilize and return to at least a little growth by mid-year.

A couple of big events to look out for in 2013 will be elections in Italy and Germany. The political arena in Italy is being upended by a sudden lack of support for the technocrat prime minister Mario Monti, and a return to politics by billionaire Silvio Berlusconi, who is currently free on bond after facing fraud charges. The danger, as in Greece's elections during 2012, is that anti-euro parties gain a foothold and push the country, at least philosophically, away from the EU.

Germany too has elections set for 2013. In September, Chancellor Angela Merkel will have to guide her Christian Democrat party through a parliamentary election. Merkel walks a fine line between being pro-Europe and trying to make sure that her citizens aren't forced to pick up the tab for every pitfall the EU stumbles into. Chancellor Merkel is unlikely to be unseated, as has happened to so many incumbents across Europe in the last few years; however, she faces a slowing economy that could tip into recession in 2013. Unemployment is beginning to tick upwards, so perhaps the German electorate will be more open to non-austerity options in the coming year.

Spain will continue to struggle on two fronts. Besides fighting to remain a part of the euro, Spain's government faces a succession movement in Catalonia. Catalonia is Spain's biggest economic region, and has taken on the role of "the Germany of Spain" – contributing more to the whole than it is receiving, and taking umbrage at the fact. After the ECB's Mario Draghi announced the Outright Monetary Transactions (OMT) program (a plan to deal with the region's debt crisis), Spanish yields came in enough to help Spain's Prime Minister Rajoy push off his request for a "dreaded" enhanced credit line. We also expect Rajoy to finally turn to the OMT for bond purchases to sop up the debt his government needs to issue in 2013.

Asia

China and the Deus ex Machina

There was a time when double-digit GDP growth in China seemed as if it could last forever. Then economies around the world began to sputter and China found itself in a new era, when it would have to content itself with growth closer to 8%. Granted, GDP growth near 8% is impressive, but nowhere near what the world, and China, had come to expect. Throughout 2012, when leadership of the Communist party was beginning to transition, the country's stimulative efforts slackened somewhat as the new leadership was cemented. China's economy continued to grow, but at an increasingly slower pace. What could stop the slowdown?

The ancient Greeks developed a plot device that could seemingly solve a complex problem. A deus ex machina (literally "god from a machine") is an abrupt, somewhat unexpected solution that appears as if from nowhere. It's an easy and quick way of moving the plot along. In China, the complex problem is "how to get the economy restarted," and the deus ex machina is a man named Xi Jinping. In November, Xi took over as party chief from Hu Jintao. In May, the transition will be complete when Xi is selected as China's president by the National People's Congress.

China's economic and political fortunes have been tightly meshed, and their economic recovery has been waiting for this transition to continue the push forward. With the transition complete, 2013 will probably see new (and long-awaited) stimulus measures kick in; there are still plenty of infrastructure projects, and the government appears to be speeding up the approval process.

Because of an emphasis on exports to the United States and Europe, China will remain vulnerable to weakness in those regions. If Europe's shambling turns into stumble, or the United States slips back into recession, faster growth in China would be endangered. There is also a chance that 2013 is the year that the Chinese consumer begins to be a force to be reckoned with. Economic data has already indicated that the slowdown in China ended in July or August. Retail sales, industrial production, real estate investment, and electricity production and consumption have all been improving for two to four months. Several factors will provide the basis for a few more years of growth in the 6% to 8% range: policy easing, fast wage growth that is supporting strong domestic demand, a return to house-price increases, and continued infrastructure investment. The new leadership will also be supportive to growth; Xi's first actions have been to discuss urbanization, discourage ostentatious displays of officialdom, and attack corruption. In 2013, economic growth in China will still be impressive, just not the super-human variety of a previous decade. Focus will shift from pacing to sustainability.

Japan and Chekhov's Gun

The plot device that will seemingly throw some action into the third act of Japan's economic recovery is something often referred to as Chekhov's gun. Merely a concept of foreshadowing, the "gun" is named after Russian playwright Anton Chekhov. It's the idea that if you focus the audience's attention at a pistol on the wall, then later in the story someone had better fire the gun; otherwise, why was it there? This foreshadowing is currently on display in Japan in a peculiar political drama between Shinzo Abe, Yoshihiko Noda's probable successor as prime minister of Japan, and the governor of the Bank of Japan, Masaaki Shirakawa. Abe, leader of the Liberal Democratic Party (LDP), is ahead in current opinion polls and could likely become the next prime minister. Abe also has some pretty bold ideas on monetary policy; bold enough that he's been getting jabs from Shirakawa, whose term as Japan's head central banker expires in April 2013.

Abe is pushing for aggressive action to combat deflation and weaken the yen, which will benefit Japan's export-driven economy. The Chekhov's gun in this act will be Abe's ideas on what the Bank of Japan would be doing when he is prime minister. Abe has been overheard saying that he would support forcing the Bank of Japan to buy construction bonds directly from the government as a method of taming deflation. Statements like this may just be pre-election bolster, but it's prudent to remember Chekhov's gun so we aren't surprised when it goes off. Outright debt monetization, which is what Abe is calling for, could cause yields on Japanese government bonds (JGBs) to spike and would add to the already-crushing Japanese public debt. So, if Abe and the LDP come to power,we wouldn't be surprised to see Shirakawa replaced as head of the central bank. Should that come to pass, expect a weaker yen, increased competitiveness of Japanese exports, and a tick-up in inflation.

So will 2013 see a solution to all of these issues? No, but that's why they invented sequels. Our base case is for a limited solution to U.S. fiscal issues that would provide persistent slow growth in the first half of 2013, but a mild acceleration in the second half. If a long-term and credible resolution is found, the U.S. economy could be on a course for above-trend 3% to 4% growth in 2014, but the odds for that are daunting. The EU is likely to stay on the muddle-through path unless political problems confound the ability to implement needed reforms and spending cuts. China's economy is already mildly accelerating, but is not far from trend growth; it's not likely China can see double-digit growth again, since its labor force will start to shrink by the end of this decade. The Japanese economy seems trapped in deflation, but has some opportunity to gain ground. Overall, global growth is likely moving up and out of the doldrums we saw in late spring and summer, but will remain modest at least over the next year.

Karen Van Hamme also contributed to this article.

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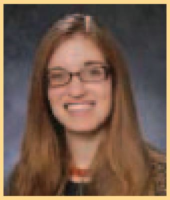

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