Macro and Market Outlook

January 2012

RGE Economic Research and Market Strategy Teams

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Roubini Global Economics

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2012 Market Themes and Outlook

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RGE Global Themes

- The credit crunch and slowdown has sent the eurozone (EZ) into recession, with a sharp contraction in most of the periphery and stagnation in the core. Our baseline includes recession in Europe, slowdown in China and below-trend growth in U.S. for global growth of less than 3%.

- In Europe, the immediate crisis response is likely to see an IMF bailout package for Italy and Spain while EU members (except the UK) start to implement the "fiscal compact." The latter will ensure the peripheral countries fall deeper into recession. We expect a number of weaker EZ countries, beginning with Greece to choose to exit the common currency over the next five years to regain competitiveness. A Greek exit could come as soon as 2012 and we expect more countries, including Italy, will require debt restructuring.

- The concurrent shocks from Europe and China, where a sharp property-related slowdown is underway, will weaken emerging market (EM) and global growth, while U.S. growth remains weak and subpar, despite the recent improvement in data.

- Policy makers have fewer policy bullets to get out of stall-speed, partly due to politics.

- In the medium term, our baseline scenario remains an anemic, subpar, U-shaped path in developed markets (DMs), hindered by ongoing balance-sheet repair, structural issues and the switch to policy drag. The risks are rising that a prolonged, severe recession with sharp deleveraging could be triggered.

Global Growth Forecasts

	Growth		Inflation	
	2012	2013	2012	2013
U.S.	1.4	1.5	2.6	2.0
EZ	-0.8	-1.8	1.5	1.3
Japan	1.6	0.8	-0.4	-0.2
China	7.4	7.1	3.2	3.0
G7	0.9	0.6	2.0	1.6
Advanced Economies 1	0.7	0.3	1.9	1.5
Emerging and Frontier Markets	5.0	5.0	4.7	4.6
Asia/Pacific 2	5.3	5.3	3.0	2.8
Emerging Asia 3	6.2	6.3	3.7	3.4
Latin America 5	3.3	2.5	6.7	7.3
Emerging Europe 6	2.6	2.6	6.2	5.7
Middle East and Africa 7	2.6	3.0	6.1	6.5
BRIC	6.3	6.2	4.3	4.0
World	2.8	2.7	3.3	3.0

1. U.S., Canada, Japan, UK, the eurozone, Sweden, Norway, Australia, Switzerland
2. Japan, Australia, China, India, Hong Kong, Indonesia, Malaysia, Philippines, Singapore, Vietnam, South Korea, Taiwan, Thailand
3. Asia/Pacific ex-Japan and Australia
4. Hong Kong, Korea, Malaysia, Philippines, Singapore, Taiwan, Thailand, Vietnam
5. Brazil, Argentina, Mexico, Chile, Peru, Colombia, Venezuela
6. Czech Republic, Hungary, Poland, Turkey, Russia
7. Israel, Egypt, Saudi Arabia, the United Arab Emirates, South Africa

Forecasts are current as of Dec 6, 2011

Based on IMF PPP Weights from April 2011 for 2011 and 2012

Global Scenario Analysis Flowchart

Present to mid-2012	2012	Probability	Policy Response	2013-15	Probability
DMs are close to stall speed (U.S., although the data momentum is positive) or in recession (EZ), while EMs are growing, but at a slower pace.	Some DMs are in recession through 2012 (notably the EZ) and others slow down or continue to grow well below potential. Austerity packages, a lack of resolution on the EZ crisis and policy mistakes (lack of or insufficient timely support) continue to weigh on growth contributing to a significant global slowdown. Chinese leaders respond only slowly to property correction.	**60%**	Adequate policy support (QE and fiscal stimulus across DMs and possibly some EMs, as well as deeper EZ integration) staves off the failure of systemic institutions.	EMs slow from 2010-11 growth, but stay far from recession, in some cases with policy support, especially China. EZ stabilizes and improves, U.S. and DMs in general moving toward normalization.	**~10%** (slow but steady recovery toward normalization)
				A weak, U-shaped recovery continues, with volatile growth in DMs (amid balance-sheet repair and possible remaining EZ uncertainty, despite orderly restructuring and exits) and EMs grow near potential. China's broken investment-led growth model gives out. Gradual rebalancing ensues.	**~55%** (slow and volatile growth environment)
	The growth environment is volatile, but the U.S. avoids technical recession and momentum remains positive. EZ peripherals remain in recession, but the crisis moves toward a resolution and the core stabilizes . EMs keep growing around potential.	**30%**	The policy response is totally inadequate (no QE or too-little, too-late QE; lack of adequate fiscal stimulus and possible fiscal drag). Failure to find a resolution to the EZ crisis.	Disorderly debt restructurings, default and exits from the EZ drive the global economy into a deep recession, which takes hold of DMs and possibly globally, requiring an aggressive, coordinated policy response. China hard landing.	**~35%** (deep and protracted recession)

What's New? Risks Still Point to the Downside

- The contagion has spread to **Europe's core,** while pushing Spain and Italy toward insolvency. A credit crunch, driven in part by bank deleveraging, is reinforcing weakness. A likely Greek exit in 2012 followed by Portugal in 2013 and a debt restructuring in Italy in late 2013 mean we will bounce from crisis to crisis in 2012-13. The recession that began in Q4 2011 will only deepen over the next two years.
- **Chinese** property prices are tipping over as anticipated, but the supply-side response looks set to come earlier and be more severe than we expected. Although the leadership will respond, we expect it to be too late to avoid a sharp slowdown in H1, and raises the risk of a hard landing in the medium term.
- In the **U.S.,** despite stronger numbers in H2 2011, the economy remains weak and mired in political gridlock, blocking much-needed stimulus. Policies will accentuate an unnecessary fiscal drag beginning in 2012, leaving the U.S. ill-prepared for tighter credit conditions from Europe. QE might be modest/not have the same reflationary effects.
- EMs will be affected through trade and financing channels. EMEA is most exposed to Europe due to trade links and weaker balance sheets, but weaker demand and financing will also hit Asia and Latin America, which are also exposed to the Chinese slowdown.

Leading Indicators Stabilizing but Flashing Orange

Figure 1: Global Manufacturing PMIs Show Stall…and Contraction in EZ

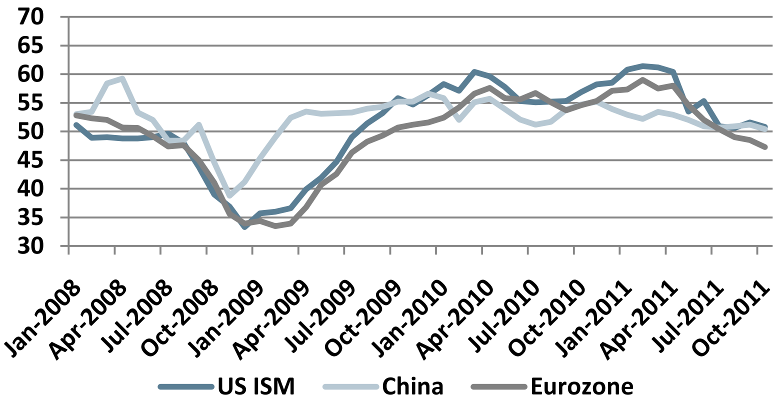


Figure 2: OECD leading Indicators Show Slowdown/Recession

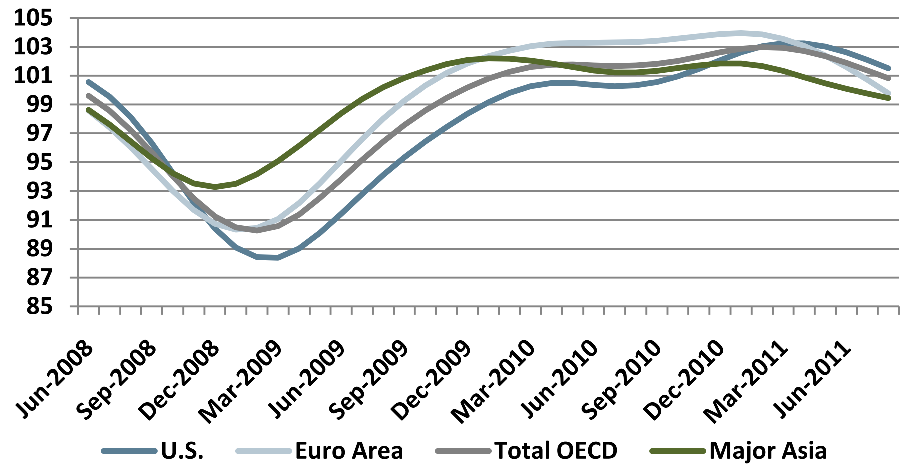


Figure 3: Output Stabilizing but New Orders Very Weak

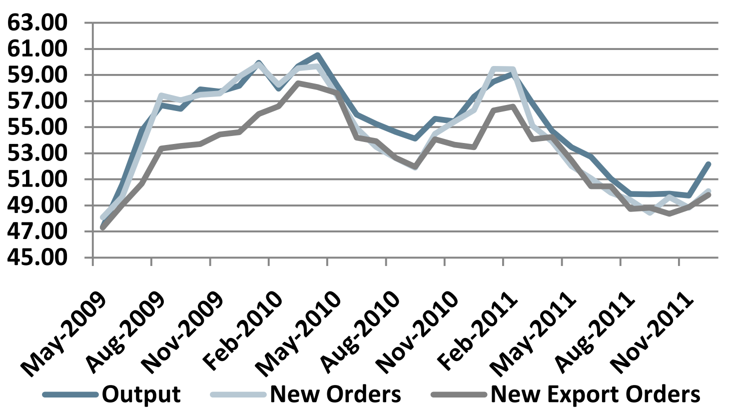
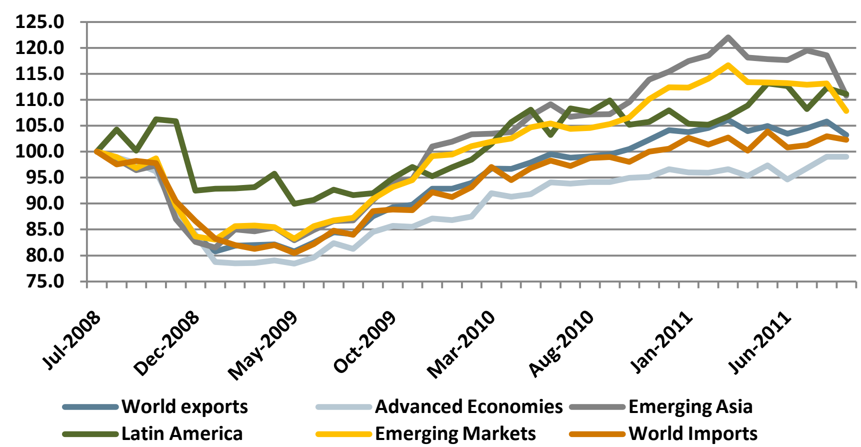


Figure 4: Global Trade Has Started to Slump in Asia



Source: Markit, OECD, Bloomberg, RGE (Figures 1-4)

Cross Asset Monthly

Overview of Cross Asset Monthly Themes

- ***Commodities: Real Demand Versus Synthetic*—We are flat/short the complex as a whole, but tactically long energy for geopolitical reasons, against industrial metals for global growth concerns.** Our bias still plays the up- and downside risks with relative value within the complex.
- ***Currencies: Stay Defensive*—We expect the dollar to be the main gainer from an intensifying EZ crisis in 2012.** Tactically, we capitalize on a short, sweet spot in risk appetite to go short USDCAD. In our new strategic FX portfolio, we short EUR and risky currencies vs. USD, JPY, but are flat CHF.
- ***Rates: You'll Take Your 1% and Like It!*—Zero nominal yields on cash will continue to drag down government bond yields in countries with monetary sovereignty and fiscal credibility as risk aversion will flare up.** In contrast to Treasurys, gilts, JGBs, bunds, we continue to worry about the EZ PIIGS and potentially more major issuers of public credit in the EZ.
- ***Credit: Spreads, Risks, Downgrades and Defaults*—We stay long U.S. investment grade, and short global HY and European credit; we prefer leveraged loans to bonds; and we re-initiate a long CEMBI position.** The logic is simple enough—EZ recession and eventual weakness in global growth as all cylinders fire a bit less—argue for being long quality names, sectors and geographies. We prefer the lower volatility and higher credit quality of EM corporates to DM HY.
- ***Global Equity: Reading the Road Signs*—We conceptually retain a long bias in defensive geographies, such as long the United States against most of the rest of the world. We capitalize on the prospect that U.S. recovery hopes will persist by taking on more risk in our sector bets,** with less defensive value and more growth/pro-cyclical plays in growth-geared regions. But we retain concerns that this growth hope may prove a blip by keeping the size of these bets moderate.
- ***Emerging Markets: Defensive Diversification:* We retain an EM local-currency rate/FX neutral exposure, but hold a number of relative-value trades in the interest rate and swaps space.** We look for further swap curve inversion in Hungary, given fraught relations with the IMF and EU, and advise selling short-dated domestic debt in Hungary and Turkey given policy confusion and concerns. We expect steeper interest-rate swap curves in Chile, Brazil and Israel. In the EM FX space, we expect EZ challenges to lead to EMEA underperformance relative to EM Asia as a net creditor region. We also underweight LatAm FX, particularly BRL, given aggressive easing ahead.

Asset Class Outlook: RGE Model Portfolio

- RGE's Cross Asset Model Portfolio returned 24 bps in 2011, surpassing market-portfolio benchmark by 8 bps. Overall defensive positioning and a quality bias supported outperformance in the volatile marketplace.
- The model portfolio advanced 17 bps in Dec., benefiting from overweight exposure to high-quality debt and underweight positions to growth-sensitive assets. The benchmark returned 12 bps in December, lagging the model portfolio by 5 bps.
- In line with our cautious risk positioning, we are modestly underweight equities vs. global governments as we begin 2012. This position performed well in December as DMs and EMs experienced modest losses. Though improvements in recent macroeconomic data prints could belie the underlying weakness of the recovery, we remain vigilant for indications that upside risks to our 2012 equity forecast are gaining traction and in fact merit a less bearish equity tilt.
- Favorable positioning in the capital structure and resilient corporate fundamentals underpin our longest-running portfolio theme: long quality via an overweight to IG corporates. This position, which is offset by global governments and collateralized debt, outperformed the benchmark in December, and we hold this trade.
- In line with our quality bias, we are underweight HY bonds, preferring to hold municipal bonds. The trade was flat for the month, but we expect it to outperform in the coming months as the global credit crunch pulls forward defaults of corporates looking to roll over HY debt in the near term. The model portfolio also is overweight S&P leveraged loans vs. IG credit—a position we hold.
- The long quality theme is also expressed across rates and equities as we favor U.S. assets, believing Europe will continue to be strangled by slowing growth, near-frozen credit markets and chronic debt problems, while U.S. will likely perform better on a relative basis.
- We have held a general underweight bias to the S&P GSCI vs. cash. In Dec., this position added to the outperformance of the benchmark. We still recommend a tactical short position in industrial metals and precious metals as lending restrictions and sentiment, respectively, pose risks to performance. We are neutral grains and softs, while holding overweight positions in livestock and energy.

Figure 1: Relative Performance Against Benchmark

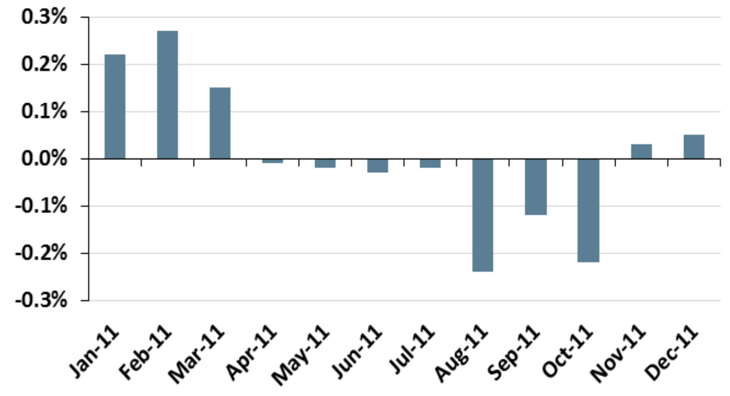
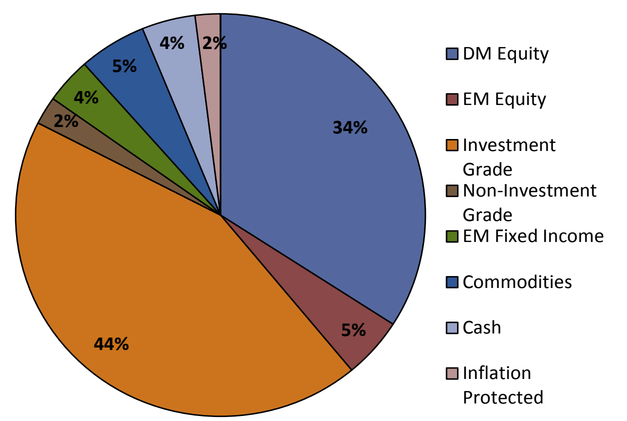


Figure 2: RGE's Asset Allocation (as of November 30)



Source: RGE, Bloomberg (Figures 1 & 2)

Current Model Portfolio

Recommended Tactical Allocation Relative to Benchmark Portfolio				
Asset Allocation	Bench WT	Model Wt	Recommendation	Effective Date
EQUITIES	**40.47%**	**38.97%**	Underweight	Oct 6 2011
Developed Markets				
S&P Developed BMI	35.42%	34.11%		
Emerging Markets				
S&P Emerging Market BMI	5.05%	4.86%		
FIXED INCOME	**49.74%**	**51.49%**		
Investment Grade	**42.09%**	**43.59%**		
BofAML Global Governments	24.30%	23.30%	Overweight	Oct 6 2011
BofAML Municipal Master	1.00%	1.50%	Overweight	Nov 7 2011
BofAML Global Market Corporate	8.42%	12.92%	Overweight	Jan 31 2011
BofAML Global Broad Market Collateralized	8.37%	5.87%	Underweight	Aug 2 2011
Non-Investment Grade	**2.24%**	**2.24%**		
BofAML Global High Yield	1.47%	0.97%	Underweight	Nov 7 2011
S&P US Leveraged Loan	0.56%	1.06%	Overweight	Sep 6 2011
S&P European Leveraged Loan	0.21%	0.21%		
Emerging Markets	**3.42%**	**3.67%**		
JPM EMBI Global	0.49%	0.49%		
JPM GBI-EM Global	0.96%	0.96%		
JPM ELMI+	1.56%	1.56%		
JPM Corporate EMBI Broad	0.41%	0.66%	Overweight	Jan 10 2012
Inflation Protected	**1.98%**	**1.98%**		
BofAML Global Gov't Inflation Linked	1.98%	1.98%		
Barclay EM Inflation Linked Unhedged	0.00%	0.00%		
CASH	**3.47%**	**4.22%**		
ML 3 Month T Bill	3.47%	4.22%	Overweight	Oct 6 2011
COMMODITIES	**6.33%**	**5.33%**		
S&P GSCI	6.33%	5.33%	Underweight	Oct 6 2011
INTERACTION				
TOTAL	**100.00%**	**100.00%**		

Asset Class Outlook: Global Equity

- The biggest upside risk we see is continued strength in U.S. data. While we maintain our fundamental view that demand cannot be strong in an environment of weak income growth, we are closely watching the data for signs of a real recovery.
- We continue to recommend U.S. versus Europe. Within Europe, we continue to be underweight Portugal, Italy, Greece, Spain, France and Belgium. However, we are reducing our Ireland underweight to neutral.
- We continue to be underweight South Korea and Hong Kong relative to the rest of Asia/Pacific ex-Japan (AXJ), and we hold our underweight in AXJ versus total DM equity.
- Within EMs, we are upgrading LatAm to an overweight, downgrading EM Asia to an underweight and maintaining an EM Europe underweight relative to total EMs. Within EM Asia, we are underweight China and India. Within EM Europe, we are underweight Hungary, Russia, Turkey and Czech Republic. Within LatAm, we are underweight Mexico and Brazil vs. Peru and Chile.
- On a sector basis, we are moving to an overweight in technology and discretionary while shifting materials and industrials to neutral. To be cautious, however, we continue to be underweight financials while maintaining overweights in consumer staples, telecom and utilities.

Figure 1: USD Global Sector Performance

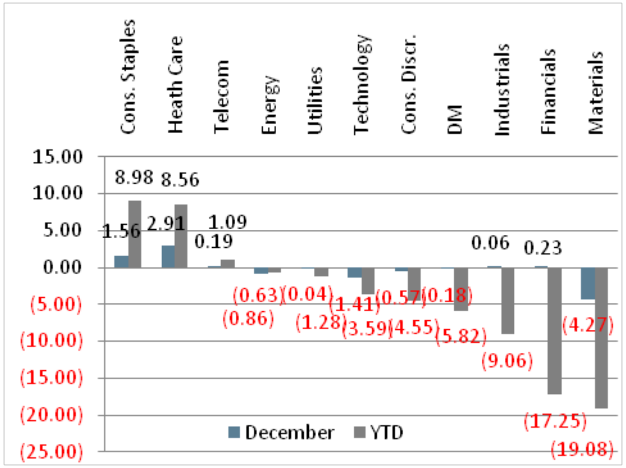
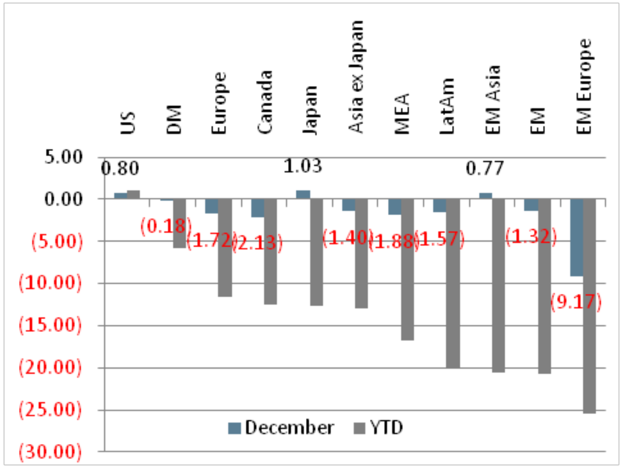


Figure 2: USD Global Market Performance

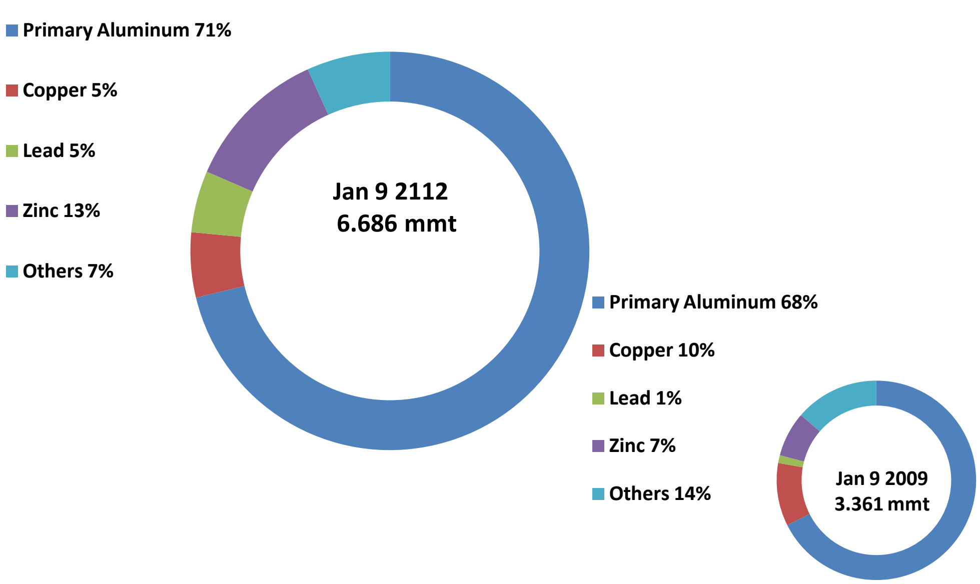


Source: Factset

Asset Class Outlook: Commodities

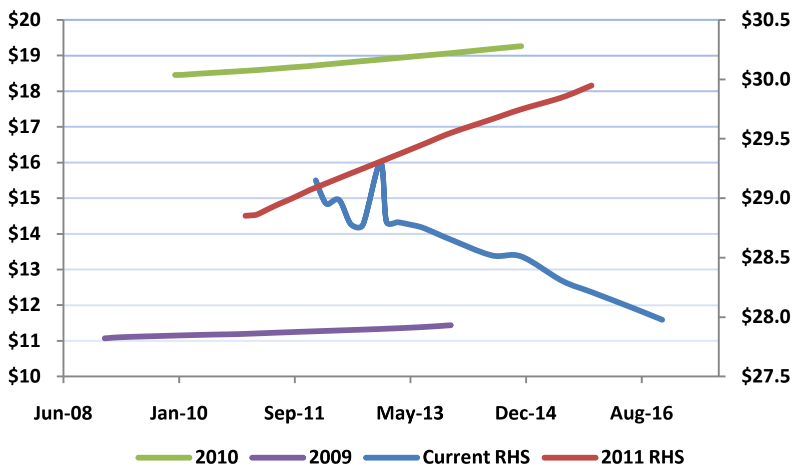
- We remain tactically short industrial as well as precious metals in light of gold's fall from grace as the safe haven. Silver calendar spreads show opportunity in light of a rare backwardated term structure.
- Geopolitical threats to crude oil and distillates lead us to be tactically long energy in light of Iranian and Persian Gulf threats to production, while being cognizant of the potential for weakening demand.
- We are neutral grains and softs, but still favor livestock despite toppy markets and suggest buying on dips inclusive of wheat, as growing short positions will require coverage. We await USDA corn data, which may favor the upside.

Figure 1: LME Warehouse Inventories Double in Three Years (million metric tons)



Source: Bloomberg, RGE ("Others" include aluminum alloy, N.A. specialty aluminum, nickel, tin,and steel billet)

Figure 2: Silver Flips Out—Forward Curve Comparisons



Source: Bloomberg, RGE

Asset Class Outlook: Currencies

Stay Defensive

- The world in 2012 abounds with risks. Market returns could underperform even 2011. We believe the intensification of the EZ crisis, with the first sovereign restructuring and EZ exit to be seen this year, will set the general tone for risk sentiment and thus impact other markets. Ongoing monetary accommodation will likely drag EUR down significantly, while USD is set to be the key beneficiary of safe-haven seeking. U.S. economic outperformance is unlikely to last and slowing emerging markets will limit gains for risk-related currencies.
- Despite this background, our tactical portfolio adds a short USDCAD position to take advantage of a short-term sweet spot in market sentiment. But we also introduce a new fully allocated portfolio that expresses our medium term views. It is short EUR and risk-related currencies, long USD, JPY and European currencies with strong fundamentals outside the EZ and neutral on CHF.

Figure 1: EURUSD and 2yr Swap Spreads

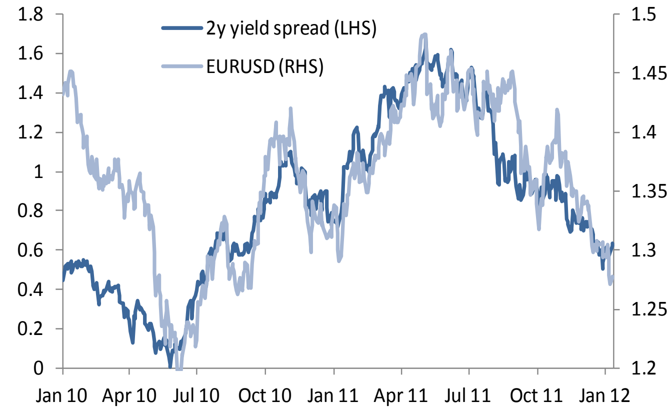
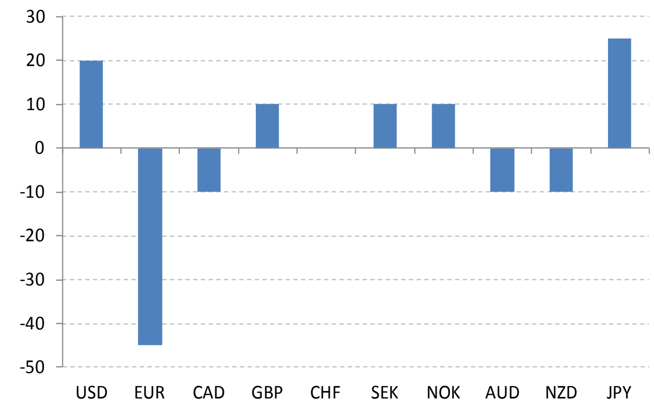


Figure 2: RGE FX Portfolio



Source: Bloomberg, RGE

Asset Class Outlook: Government Bonds/Rates

- Cash will return zero in major currencies for the next few years, as the global economy struggles with low growth or worse. This will continue to have a downward pull on yields of Treasurys, gilts, bunds and JGBs, which remain a good hedge for risk-aversion episodes, even as they give paltry returns in the medium term.
- The Fed is accepting the “new normal” by predicting no new normal, but will eventually do more QE to little effect or credit easing, which may work better. The ECB has doubled down, both expanding its balance sheet buying more risky sovereign debt and with a large medium-term loan to troubled banks to on-lend to overindebted sovereigns. The BoE will need to do more QE, as will the BoJ, to ward off declining inflation. The risk of higher inflation remains low.
- Central banks that have hiked since 2009 are cutting slowly, but housing bubbles loom large from Sweden to Australia—China is not the only one with a hangover from the 2008-09 response to the global recession.

Figure 1: G4 10y Bond Volatility (trailing 3 months)
(10y yield annualized vol—13-week trailing)

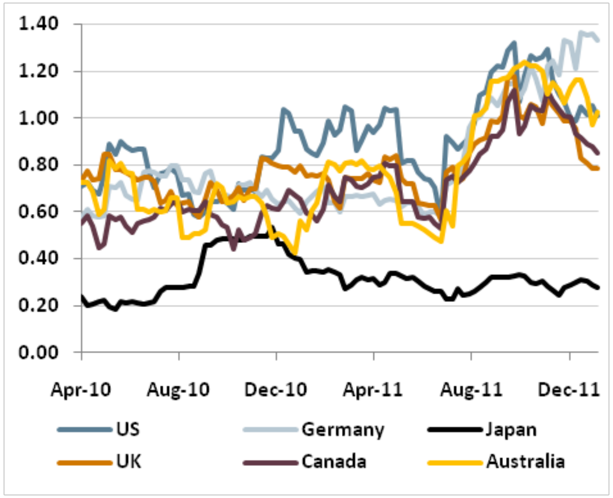
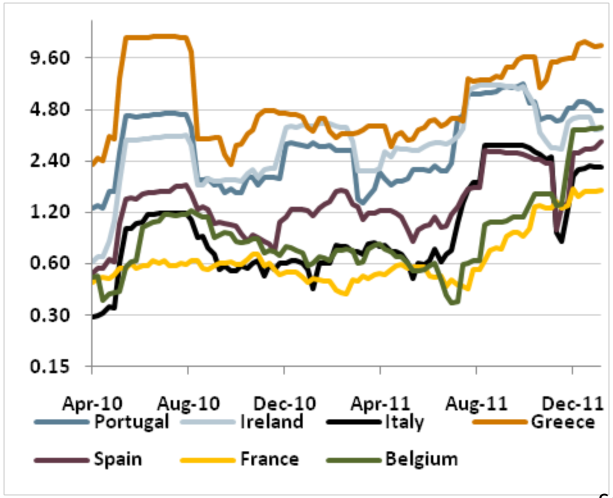


Figure 2: PIIGS+ 10y Volatility (trailing 3 months)
(10y yield annualized vol—13-week trailing)



Source: Bloomberg, RGE

Asset Class Outlook: Credit

- Weak growth, low yields and high spreads form a constructive outlook for IG bonds, as long as recession is avoided. Cashflows and debt metrics remain robust and deleveraging is taking place.
- Hold onto long IG with spreads already in recession range, expecting steadily contracting spreads. HY is much more vulnerable to weak growth and risk aversion, with the EZ and China the biggest risks for 2012; as such, we prefer leveraged loans to bonds. Stay short global HY and European IG.
- Re-initiate long CEMBI. Having been short EM corporates much of H2 2011, with spreads widening to 460 bps (a breakeven default rate of 8% per annum) the better credit quality and lower volatility compared to HY makes CEMBI attractive. We expect EM corporate fundamentals to buck macroeconomic and political factors, which may now favor sovereign underperformance.

Figure 1: Dramatic Corporate Deleveraging, in Real Terms…

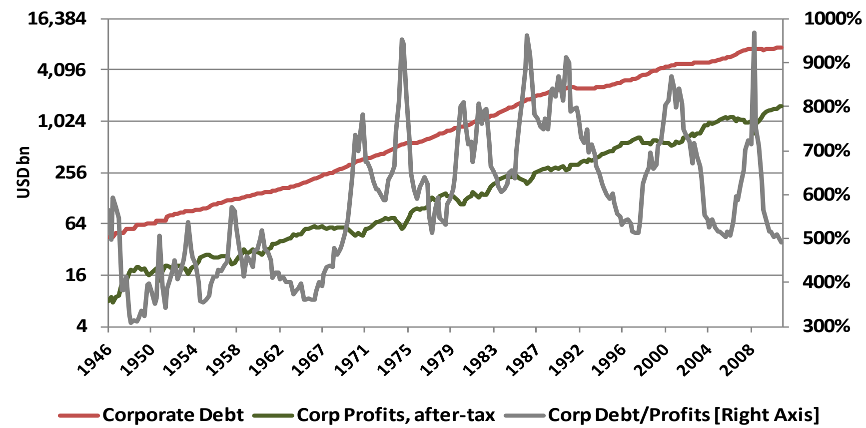
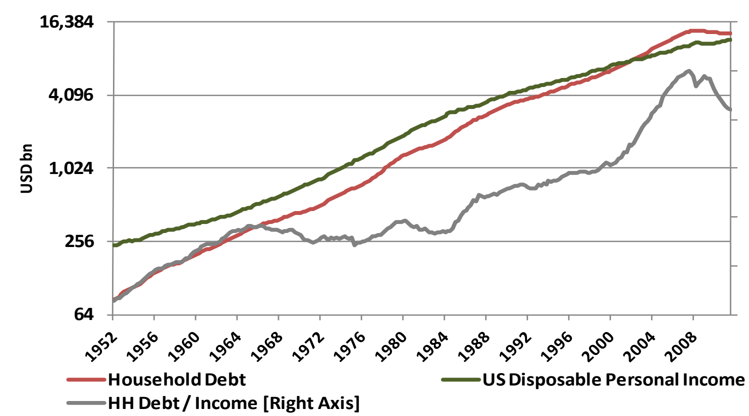


Figure 2: A Longer Road Ahead for Households



Source: Fed, BEA, RGE, Bloomberg

Asset Class Outlook: Emerging Markets

- The weaker growth environment will continue to push most EM nominal yields lower in 2012. However, multiple risks are likely to keep EM debt range-bound and volatile. We therefore maintain an overall "neutral" stance in EM local currency and external debt for now. We choose to take directional views on a country level, where we recommend long positions in Brazil's NTN-F bonds while selling short-dated local currency debt in Hungary and Turkey. We expect steeper IRS curves in Chile, Brazil, Israel. However, we recommend paying short rates in Turkey, Hungary, Russia and see further swap curve inversion in Hungary.
- We maintain a defensive bias in EM FX. The EZ crisis and impact on capital flows to EMs points to EEMEA FX underperformance vs. AXJ FX. We recommend shorting KRW against SGD as a clean way to play potential instability on the Korean peninsula; opening RUB shorts on rallies against the EUR:USD basket, CAD and AUD as protection against greater political noise and larger capital outflows in Russia in the run-up to the elections; using rallies to open short RUB/MYR, long USD/CLP and long USD/ZAR as part of the commodity play; positioning to short TWD against THB later in 2012; and sell BRL into rallies in anticipation of additional monetary easing in 2012-13.

Figure 1: RGE EM Policy Rate Changes in 2012 (bps)

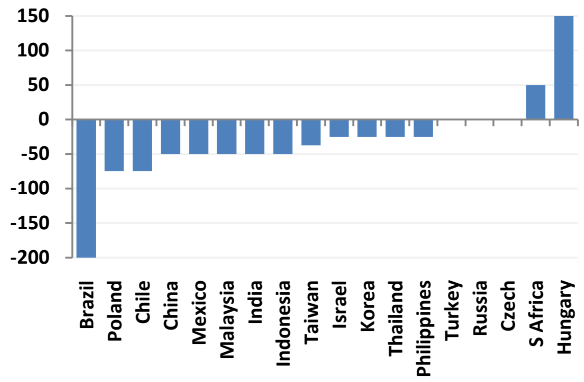


Figure 2: Brazil Policy Rate and 2y Nominal Yield (%)

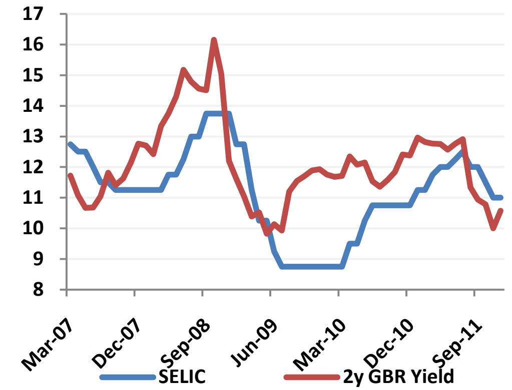


Figure 3: Correlations Between 2y-5y IRS Spreads in EM and G2 in 2011

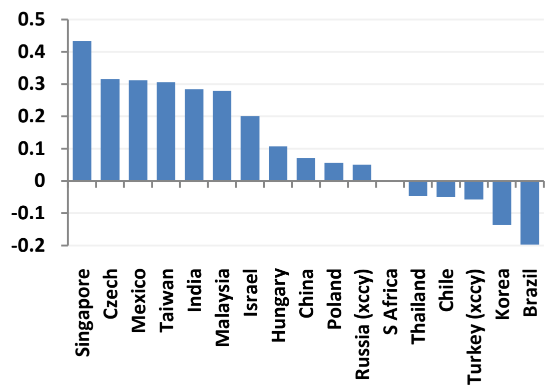
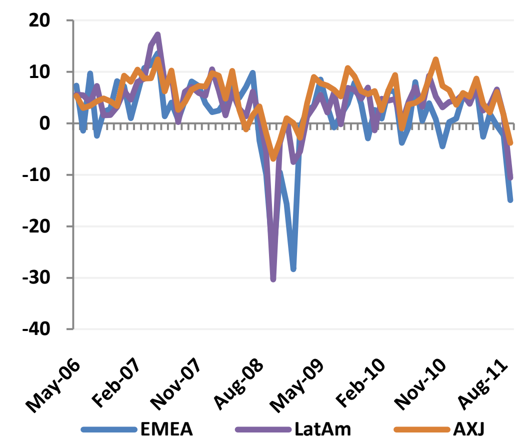


Figure 4: Changes in Appreciation Pressures in EMs (%)



Source: RGE, Bloomberg, IMF

Asset Class Outlook: Financials

- Current valuations better reflect fundamentals, but tail risks remain meaningful and we caution against focusing disproportionately on historical averages for future valuations and levels.
- Policy will continue to guide bank fundamentals; earnings are more likely to shrink than grow; regulation shifts to more complex issues of liquidity and derivatives; and deleveraging will be difficult to avoid.
- Equities have less room to fall than before. But estimates remain vulnerable and UniCredit demonstrates pent-up dilution risk.
- Sub debt reflects liability management and senior debt is cheap, *in the absence of crystallization of EZ tail risks*. Growth differentials and tail risks continue to favor non-EZ risk.

Figure 1: Global Financial Credit Spreads, by Currency (OAS, bps)

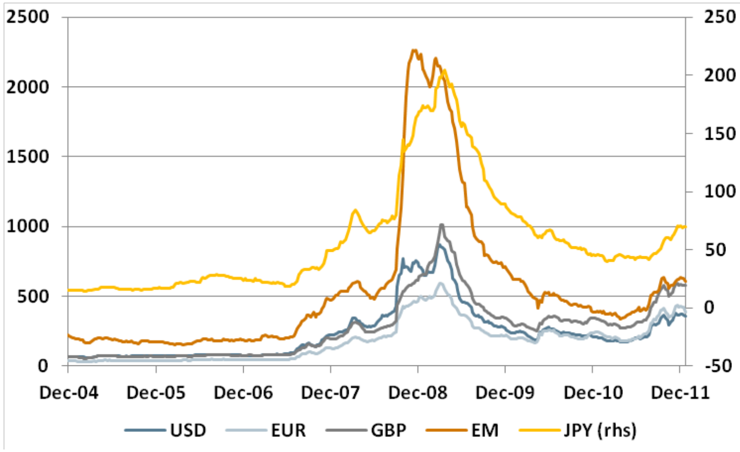
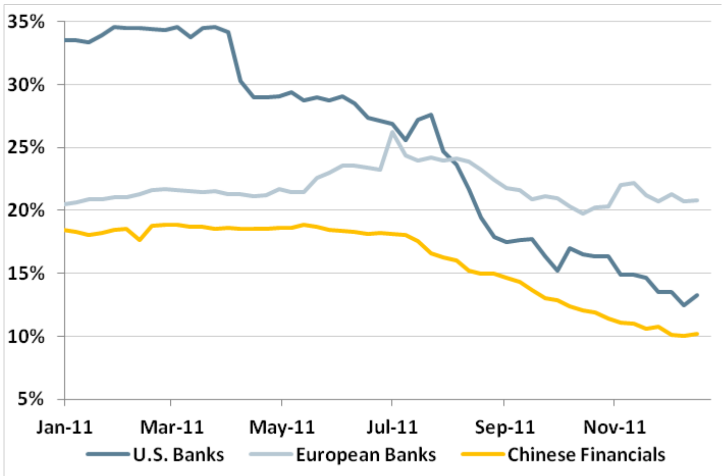


Figure 2: 2012/11 Expected EPS Growth



Source: Bloomberg, RGE

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Appendix: Global and Regional Risks

Global Downside and Upside Risks

Upside Risks

1. **More aggressive and coordinated response to the EZ debt crisis.** ECB steps in as a more aggressive LOLR, through a compromise in which IMF and European funds help take the periphery out of the market and more extensive steps toward fiscal union are taken to increase EZ sustainability in the long term. Aggressive policy easing, combined with a fall in the value of the euro toward parity with the U.S. dollar; and fiscal expansion in the countries that can credibly afford it.

2. **U.S. (and global) high-grade corporates put their strong balance sheets to work** and do more capex and hiring than expected, a positive for labor income and consumer confidence, although capacity utilization remains low and has recently flattened out.

3. **Moderation of oil prices provides a reprieve to global consumers,** offsetting other negative wealth effects. This requires that supply shocks be averted and supply, including that from the U.S. and Canada, continue to climb. Given the political risks (Iran) this seems unlikely.

4. **Implementation of more stimulus in EMs** (which need less balance-sheet repair and have stronger macro frameworks), supporting income growth and consumption. China and others do more stimulus and more quickly than we are expecting, focused on rebalancing their economies, supporting domestic and global aggregate demand growth.

5. **Asset reflation from accommodative policy (QE, credit easing) creates positive wealth effects** and balance-sheet repair (this has not worked very well in the past, though).

Global Downside and Upside Risks

Downside Risks

1. **Deepening of EZ crisis, financing strains, inadequate policy weighs on European and global growth**
   - Risk aversion exacerbates the cyclical slowdown by weakening consumer/investor confidence.
   - Fiscal austerity reduces growth, leaving debt sustainability far off.
   - The credit channel (the primary source of corporate finance) becomes even more blocked, threatening trade finance. A Lehman-like shock is triggered by insufficient policy responses and possibly disorderly default.
2. **Spillovers from Europe and fiscal weigh on U.S. growth**
   - Financial stress and negative feedback loops weaken consumption.
   - Negative wealth effects from housing are exacerbated by an equity selloff.
   - Labor market conditions stay weak, with expiration of benefits looming.
   - Fiscal retrenchment (states and local governments) is followed by federal fiscal drag in 2012-13.
3. **Chinese property-driven slowdown raises hard-landing risk especially in 2013+**
   - Chinese political cycle may delay stimulus efforts, leading to a greater correction in property prices and activity, bringing forward the risks of a hard landing in China.
   - Potential investment projects are lower performing, and effective debt levels are already high.
4. **EMs are also slowing and will face trade and financial spillovers from the EZ**
   - Risk aversion and withdrawal of capital undermines domestic investment. Reduction in trade finance from EZ banks exacerbates demand decline.
   - Even EMs have less policy space than in 2008, given costs of past stimulus.
5. **Lack of policy space (and less willingness to use the space that exists)**
   - Even countries that have fiscal space (market-access countries like the U.S.) are restrained by politics.
   - Currency tensions remain as deficit countries need real depreciation, which surplus countries prevent.
   - Risk of trade wars exacerbates the push for market share.
6. **Geopolitical risk**
   - Tensions with Iran and risk of renewed protest increase vulnerability to oil spikes. Election cycle in Asia in 2012 increases tensions in North Korea, etc. Piracy adds to shipping costs.

U.S. Outlook

- Some positive momentum in U.S. growth in H2 2011 will drive a modest upward revision to the outlook, but elevated financial stress, fiscal drag and ongoing deleveraging in a low-income environment will pin growth well below potential.
- Downside risks dominate: Sharper fiscal drag, the spillover of an exacerbation of the EZ crisis via the credit conditions and net worth channel still portend an elevated recession probability of 50%.
- The Fed will counter a slowdown in growth by additional QE by mid-2012; a shock from the EZ will prompt a more aggressive response.

	Risk	Probability	Impact
Upside	Payroll tax cuts are enlarged and expanded to employers; unemployment benefits are extended.	Low	Medium
	Financial conditions ease back significantly due to developments in the EZ.	Low	Medium
	Pent-up demand reinforces positive momentum, global growth remains supportive for trade.	High	HIgh
Downside	There is a Greek default and exit or a disorderly debt restructuring in the EZ	Medium	High
	Fed fails to counter tightening credit conditions and stress from the EZ until well into H2.	Low	Medium
	Both unemployment benefits and the payroll tax cuts expire at the end of 2011.	Low	High

Western Europe Outlook

- After growing by 1.4% in 2011, the EZ will slip into recession, contracting by 0.8% in 2012 and a further 1.8% in 2013. This forecast entails a Greek default and orderly EZ exit by end-2012 and orderly debt restructuring in Italy by end-2013.
- Domestic demand will exert significant drag on performance over the next two years as governments implement austerity, confidence plummets, unemployment rises and a credit crunch occurs.
- Immediate crisis response likely sees EZ leaders cobble together “Big Bazooka II” while taking small steps toward eventual fiscal union. This is unlikely to prevent a debt restructuring and eventual EZ exit for Italy/Spain in the short to medium term.

	Risk	Probability	Impact
Upside	The ECB steps in as a LOLR, providing quantitative and credit easing and alleviating the liquidity crisis in the EZ.	Low	High
	ECB cuts rates aggressively towards zero and talks down the euro so it depreciates significantly, with the EZ recession bottoming out in 2012 and growth returning in 2013.	Low	High
	The recapitalization of weak EZ banks boosts investor confidence and major asset sales are avoided.	Low	Medium
	Swift implementation of structural reform measures in the peripheral countries reassure investors, Spain and Italy regain market access when the bailout fun runs out of cash in 2013.	Low	High
Downside	Bailout fatigue in the core and in Greece causes the latter to default unilaterally and abandon the euro.	Medium	High
	Debt restructuring in Greece/Italy turns from orderly to disorderly. Possible triggers include social unrest, a government falling, holdouts, bank runs.	Medium	High
	Banks seeking to raise sufficient capital sell assets, adding to deleveraging pressures and credit crunch in EZ and globally, affecting also trade finance.	High	Medium
	EZ leaders rely on treaty changes and small, incremental steps toward fiscal union to reinstill confidence in the markets, but the markets are too skeptical for signaling to succeed without real action to back it up.	Low	High

Emerging Asia Outlook

- We have again lowered our 2012 forecast on expectations for a deepening crisis in the EZ and a sharp slowdown in China alongside a correction in its property market. Asian growth looks set to slip to 5.3% in 2012 after a 6% gain in 2011.
- Whereas we expect the rest of the global economy to expand at a faster pace in 2012 than in 2009, emerging Asia looks set to be an exception, with the slowdown in China entirely to blame.
- The policy space to offset an external shock is smaller than it was in late 2008, but most countries will be able to offer sufficient monetary and fiscal stimulus to ensure Asia remains the fastest-growing region in the global economy.

	Risk	Probability	Impact
Upside	Pent-up demand in the U.S. reinforces positive momentum, pulling up global growth and resulting in a more supportive environment for trade.	High	High
	EZ leaders find a comprehensive solution to the sovereign debt crisis.	Low	High
	Chinese policy makers abruptly reverse course on the property sector and offer massive credit easing and monetary stimulus, boosting 2012 growth while raising the risk of a much harder landing down the road.	Low	High
Downside	Chinese policy makers maintain restrictive property market policies beyond Q2 2012, resulting in a hard landing for the economy.	High	High
	EZ bank deleveraging leads to higher trade finance costs, weighing on export margins in Asia.	High	Medium
	Bailout fatigue in the core and in Greece cause the latter to default unilaterally and abandon the euro.	Medium	High

Latin America Outlook

- The correlation with global growth has increased substantially in LatAm over the past five years and the main transmission channels for stagnation and recession in the U.S. and EZ will be trade links, sentiment and FDI.
- A comprehensive policy mix will be implemented to balance the effects of a downturn in global economic activity.
- A Chinese hard landing in 2013 is the main threat to LatAm's medium-term growth prospects, with Peru, Chile and Brazil heavily reliant on Chinese demand for commodities (as well as through investment in oil and mining projects).

	Risk	Probability	Impact
Upside	The EZ develops a swift solution for its debt problems, lowering uncertainty levels and downside risks to the global economy.	Low	High
	Chinese policy makers promptly address structural problems that are a risk to short- and medium-term growth.	Medium	High
	Domestic demand shows resilience to global downturn aided by expansionary policies, sustaining elevated growth rates.	Low	High
Downside	China's growth slips below 5%, dragging global growth down.	High	High
	EZ debt problems have a disorderly resolution, affecting U.S. and global growth.	High	High
	FDI fails to arrive due to uncertainty about the health of the global economy.	Low	Medium
	Risk aversion causes volatility in EM asset classes, creating challenges for policy makers.	High	Medium

Emerging Europe/CIS Outlook

- Sluggish domestic demand and balance-sheet vulnerabilities leave regional economies particularly vulnerable to the EZ crisis as the region has the greatest trade and financial linkages to the EZ (esp. CEE). Several countries (Czech Republic, Hungary) may re-enter recession or at best stagnate.
- Even domestic demand-driven countries (Turkey, Russia and Poland) will slow sharply from the 2010-11 pace, very sharply in Turkey's case.
- FX depreciation not only undermines financial stability but poses stagflation risk, limiting easing. Nonoil exporters (especially Turkey) are starting to run out of ammunition to defend currencies.
- Hungary stands out as vulnerable due to policy mix and, in the absence of an IMF/EC cushion, the central bank will have to hike rates.

	Risk	Probability	Impact
Upside	Policy makers that can afford to defer fiscal consolidation, provide fiscal support for growth in the short term (increasing long-term financing risks).	Medium	High
	More aggressive approach in reaching a sustainable solution to the EZ crisis eases financial strains and supports growth.	Low	High
	Vienna Initiative-like measures to maintain funding to EE lenders avoids a severe credit crunch and/or parent banks' withdrawals.	Low	Medium
Downside	Slower growth puts fiscal targets at risk, forcing additional austerity measures.	High	High
	A severe dry-out in capital flows further pressures local currencies, triggering emergency rate hikes and boosting debt burdens to unsustainable levels.	High	Medium
	A disorderly event in the EZ exacerbates the financial crisis, causing fire-sale bank events in the region and creating systemic financial instability.	Medium	Medium

Middle East/GCC Outlook

- Regional growth will converge as oil cuts temper GCC output and financing shortages bring a weak recovery in oil importers. The region will grow at about 3% in 2012-13 from 4% in 2011 and 4.8% in 2010.
- Iran's saber-rattling will keep oil prices elevated, and any cuts in output would keep Saudi Arabia from trimming production. A conflict involving Iran remains a low probability but high-risk event for the region—and the global economy. A supply cut would spike prices, but bring demand destruction.
- Government-influenced consumption will be the primary growth driver, investment will be delayed due to politics and implementation risk, and lower returns will dampen property development.

	Risk	Probability	Impact
Upside	GCC government stimulus, external financing for MENA oil importers and multilateral bank support, offsets the lack of other capital.	Medium	High
	Higher oil prices, boost revenue, facilitating investment as well as consumption and facilitating more aid to other MENA countries.	Medium	Medium
	A solution to the EZ debt crisis prevents a slump in external demand and finances.	Low	High
	EU ban on Iranian oil boosts demand for Saudi crude, supporting hydrocarbon sector.	Medium	Medium
	A smooth political transition in Egypt and other countries hit by protests restores confidence, fueling growth and attracting investment.	Low	Medium
Downside	Implementation of employment nationalization policies in the GCC adds to private-sector costs and reduces remittances to other Arab countries.	High	low
	Unrest reignites MENA, hitting tourism and FDI and industrial output, pressuring global oil prices.	Medium	Medium
	Government spending adds to inflationary pressures, weighing on consumption, weakening purchasing power.	Medium	High
	Capital flight and government finance requirements choke off credit as banks are reluctant to lend to households and small businesses.	Medium	High
	Conflict between Israel and Iran knocks out oil supply temporarily, causing oil price spike and flight to safety and then massive demand destruction.	Low	High

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