ECONOMIC SITUATION AND STRATEGY

World economy is growing, but debt ratios in industrialized countries continue to climb

The good news first. The world economy is growing. And if the International Monetary Fund is right, global growth will accelerate somewhat next year. These are the main points made in this week's World Economic Outlook[1]. However, there is also some bad (though expected) news. The growth forecasts for 2012 and 2013 have been revised downward. The IMF is now predicting global growth of 3.3% this year and a slight increase in momentum for a growth rate of 3.6% next year. This growth would match precisely the average trend from 1980 to 2012, although the regional influence on the global economy has shifted dramatically and will continue to shift. For example, the industrialized countries will again grow by only 1.5% next year (long-term average since 1980: 2.7%) while the emerging economies will be much stronger, growing by an expected 5.6% (long-term average since 1980: 4.6%).

IMF Estimates (World Economic Outlook / Fiscal Monitor, October 2012)

	GDP Growth				Deficit to GDP		Debt to GDP	
	2010	2011	2012	2013	2012	2013	2012	2013
World output	5,1	3,8	3,3	3,6				
Advanced countries	3,0	1,6	1,3	1,5	-5,9	-4,9	111	114
USA	2,4	1,8	2,2	2,1	-8,7	-7,3	107	112
Japan	4,5	-0,8	2,2	1,2	-10,0	-9,1	237	245
Euro area	2,0	1,4	-0,4	0,2	-3,3	-2,6	94	95
Germany	4,0	3,1	0,9	0,9	-0,4	-0,4	83	82
France	1,7	1,7	0,1	0,4	-4,7	-3,5	90	92
Italy	1,8	0,4	-2,3	-0,7	-2,7	-1,8	126	128
Spain	-0,3	0,4	-1,5	-1,3	-7,0	-5,7	91	97
UK	1,8	0,8	-0,4	1,1	-8,2	-7,3	89	93
Canada	3,2	2,4	1,9	2,0	-3,8	-3,0	88	88
Other advanced countr	5,9	3,2	2,1	3,0				
Africa	5,3	5,1	5,0	5,7				
CEE	4,6	5,3	2,0	2,6				
Russia	4,3	4,3	3,7	3,8	0,5	0,2	11	10
Asia	9,5	7,8	6,7	7,2				
China	10,4	9,2	7,8	8,2	-1,3	-1,0	22	20
India	10,1	6,8	4,9	6,0	-9,5	-9,1	68	67
ASEAN-5	7,0	4,5	5,4	5,8				
MiddleEast	5,0	3,3	5,3	3,6				
Latin America	6,2	4,5	3,2	3,9				
Brazil	7,5	2,7	1,5	4,0	-2,1	-1,6	64,1	61,2
World trade volume	12,6	5,8	3,2	4,5				

Source: IMF, World Economic Outlook, October 2012

It is explicitly stated here that the uncertainties surrounding these predictions are even greater than usual. The IMF is still assuming a nearly 20% probability that global growth next year will be less than 2% and the world economy will enter a recession (in earlier publications, the recession threshold was 3% global economic growth). The IMF is putting the risk of recession at 80% for the euro area, 25% for Japan, and 15% for the United States. The biggest downside risks for the world economy stem from a renewed escalation of the euro crisis and the "fiscal cliff" in the United States. That is, if the budget cuts and tax increases that have already been passed automatically take effect, the US will enter a new recession. Since the majority opinion on the markets has so far been that US policymakers will be able to agree on a moderate austerity program after the November 6 presidential elections, their failure to do so would have significant negative consequences for market confidence because a "tail risk" (extreme scenario) would occur. If that happens, we would have to expect a significant drop in share prices on the world's stock exchanges since a US recession would have a negative impact on the entire world economy.

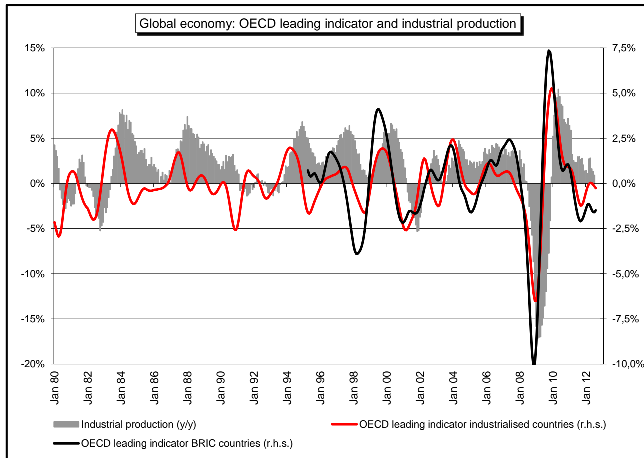
The IMF also points out that leading economic indicators have so far not suggested any significant global economic recovery in the year ahead. This is also in line with our estimate, although we have recently seen many economic data stabilize or even improve slightly from their very low baseline levels. Whether this trend will continue remains to be seen. However, many financial markets have improved considerably since the European Central Bank's announcement that it would buy up government bonds from crisis countries without limit under certain conditions (Outright Monetary Transactions, OMTs). However, not only the ECB's OMT program in conjunction with a further loosening of ECB collateral requirements, but also the conventional and unconventional monetary policy measures taken by other central banks have contributed to this improvement. For example, the US Federal Reserve Bank announced that it would buy mortgage-backed bonds for USD 40 bn each month in order to shore up the US housing market. The Fed also suggested the possibility of additional bond purchases if the US economy does not pick up considerably and the unemployment rate remains too high. The Bank of England and the Bank of Japan have also expanded their programs for quantitative easing of monetary policy by way of purchasing securities. Moreover, central banks that are still able to apply "normal" monetary policy have reduced interest rates in recent months. This was the case in Australia, Czech Republic, Israel, South Korea, Brazil, China, Hungary, and South Africa. Thus, hopes of economic recovery over the course of the next few months rest primarily on the expectation that monetary policy will remain expansionary or become even more so and that the effects of economic policy measures taken will also begin to emerge.

The IMF's forecast that the economy will recover somewhat in the coming year agrees with our own estimation. For, besides all the monetary and fiscal policy measures that should positively impact the trend, there is also an economic cycle that influences growth independently of such policies. However, the question arises whether the inherent cyclical forces will be strong enough to put the economy back on a stable growth track. One of the important problems remaining, in our view, is that potential growth has weakened. Even if there is a strong economic upswing, growth rates will turn out lower than they have been in the past.

Undoubtedly, fiscal adjustment has proceeded well in the euro zone, as the decline of budget deficits shows. The overall budget deficit for the euro zone has fallen from 4.1% last year to 3.3% this year. Another decline to 2.6% is forecast for 2013. On the other hand, the situation in the United States looks considerably worse. The IMF has actually raised its deficit forecasts again for both this year and next. It expects deficits of 8.7% in 2012 and 7.3% in 2013. Budget deficits in Japan and Great Britain are also consid-

[1] http://www.imf.org/external/pubs/ft/weo/2012/02/pdf/text.pdf

erably higher this year and next at about 7% to 10%. Against this background, it is surprising at least at first glance that the focus is always on the "crisis in the euro zone" and only the bond markets of the EU periphery countries are under pressure, while yields on government bonds of the United States, Great Britain, and Japan have actually fallen in the same period and are nearing record levels.



European politicians have repeatedly drawn attention to this state of affairs. However, it is definitely a good idea to be cautious when analyzing budget deficits. Churchill's advice to trust only statistics one has doctored oneself may not apply to these numbers, but it is the case that certain extraordinary one-off charges are not taken into account in the calculation of the budget deficits. That was true, for example, last year in the case of Portugal, where the government's assumption of major banks' pension obligations was not considered in the budget deficit, and this year in the case of Spain, where ESM loans for Spanish banks do not enter the calculation of the budget deficit.

In this connection, frequent reference is also made to reducing so-called structural budget deficits. The structural deficit is a measurement of public finances after adjustment for cyclical and one-off factors and reflects a state's budget deficit irrespective of the economic cycle. In Germany, the structural deficit is a key measurement for budget policy. The "debt brake" in the German constitution provides, for example, that the structural deficit may not exceed 0.35% of gross domestic product. It is problematic, however, that the structural deficit is not a directly observable quantity, but rather must be estimated. However, the methods used to determine the structural deficit are demanding, lead to divergent results, and are therefore controversial.

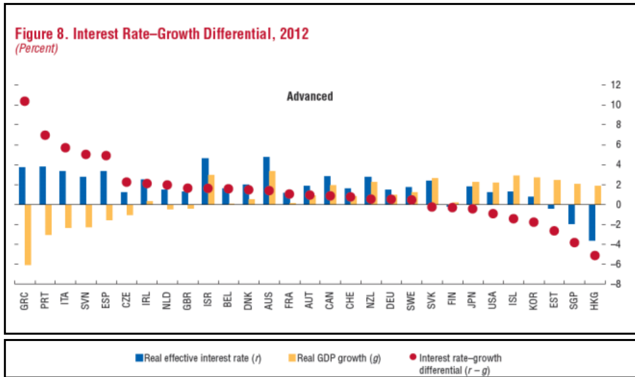
For these reasons, we believe that the budget deficit is only suitable to a limited extent as a key expression of the success and sustainability of state fiscal policy. One cannot conclude from declining deficits as such that a country's financial maneuvering room is improving. For that, one must take into account the entire national debt and concurrent economic growth. We therefore find the debt ratio, i.e., the national debt relative to gross domestic product, a much more meaningful fiscal measurement. For, when a national economy is growing, state revenues normally increase, e.g., due to higher taxes, and government spending tends to decline, e.g., due to lower outlays for social programs. In that case, a state may well afford to run higher debts, because servicing and repaying them is economically feasible. Conversely, this does not apply to a national economy that is in recession and therefore contracting. Revenues are decreasing then, and expenditures rising. The interest load, i.e., the share of total government spending attributable to interest, normally increases significantly and causes budgetary leeway to narrow. To prevent that from happening, a country whose gross domestic product is falling would actually have to achieve budget surpluses, and not just reduce its deficit.

However, the IMF has bad news to report about the development of debt ratios. They will continue to rise in almost all industrialized countries in the years ahead. At the moment, the debt ratio of the industrialized countries is almost 111% of GDP and is expected to increase to almost 114% in 2013. The situation looks quite different for the emerging markets. Their debt ratio will fall from just under 35% on average this year to only 33% next year. Now, there is no economic certainty about the point at which a country's actual debt ratio becomes critical and should be reduced or at least stabilized. Here, one can only say "the higher it is, the worse it is." The debt ceiling of 60% relative to GDP agreed in the Maastricht Treaty, for example, may not be economically justified, and theoretically one might have set the ceiling at 50% or 70%. Presumably, the 60% limit was chosen because it corresponded to the average debt ratio of the euro zone observed at that time. However, various studies[2,3] have concluded that lasting negative economic consequences of national debt begin to set in at a debt ratio of about 85%.

Reducing their debt ratios is therefore an urgent matter for most industrialized countries. Probably the most important factor for debt momentum is the difference between the interest to be paid and growth. The greater this difference is, the more likely it is that the debt ratio will continue to increase. Stabilization or reduction of the debt ratio is most likely when this difference is as low as possible, and it should optimally be negative. This effect may be brought about by different mechanisms, which individually or collectively lead to more tenable budgets. They include saving (austerity), lower interest rates, more real growth, and higher inflation. Saving alone, however, usually has the result that the debt problem initially becomes greater because government spending cuts lead not only to a lower deficit, but also to slower economic growth. This problem is made worse by the fact that the so-called fiscal multiplier is now greater than one. The IMF concludes in its latest studies, for example, that the fiscal multiplier has been between 0.9 and 1.7 in many countries since the Great Recession, and not 0.5% as previously assumed.

[2] "The real effects of debt," Stephen G. Cecchetti, September 2011, http://www.bis.org/publ/othp16.pdf

[3] "Debt and growth: New evidence for the Euro Area," Anja Baum, July 2012, http://www.ecb.int/pub/pdf/scpwps/ecbwp1450.pdf

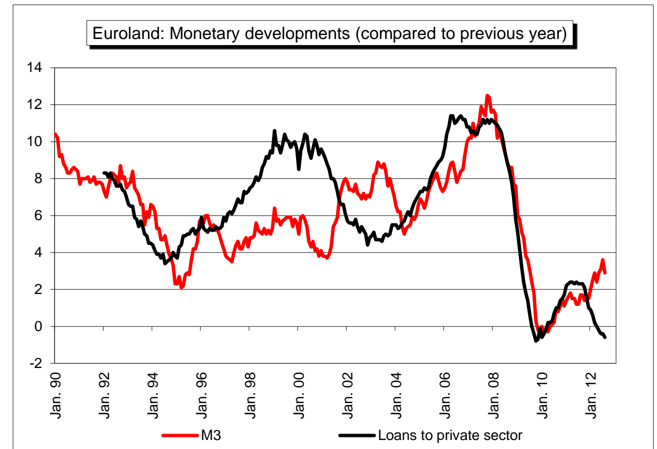


Source: IMF, Fiscal Monitor, October 2012

Lower interest rates and higher inflation are the two mechanisms that can be directly influenced by central banks. Interest rate cuts and unconventional measures are explicitly designed to lower the interest rate level for government bonds to stabilize or even reduce the interest load despite rising overall indebtedness. This is a necessary condition for keeping sovereign debt from going completely out of control. In order to ensure more or less the sustainability of public finances in industrialized countries with high debt ratios, interest rates will have to remain very low for many years. We therefore assume that the current phase of low interest rates is not a temporary phenomenon. This poses very special challenges for many investors such as life insurance companies and pension funds, since real value preservation with "safe" government bonds will scarcely be attainable in the future – not to mention the income that these investors need because of the returns that have been promised.

In view of the strong expansion of central bank balance sheets, potential inflation risks are also increasing. We do not expect a significant rise of inflation rates in the foreseeable future because money and credit supply growth is still too low for that. But the seeds of inflation have been sown by many central banks. Most of them emphasize that they have both the will and the instruments to counteract a foreseeable rise of prices with monetary policy, but we doubt the seriousness of such statements. It would probably suit not only many politicians, but also some central bankers quite well if one could "inflate away" the sovereign debt problem. For, the debt ratio will also decrease when the deficits in the denominator grow more slowly than the economic output in the numerator. But the latter expresses not only real growth, but also the change of the price level. Since we consider it unlikely that real growth in the industrialized countries will recover significantly in the foreseeable future (that would require significant increases of productivity or positive demographic effects), a higher inflation rate is thus the only hope left for strong nominal growth.

If one expects the inflation rate or inflation expectations to rise soon, it would make sense to invest in inflation-protected bonds. But we consider it still too soon for that now. Instead, we advise investors who focus on fixed-income securities to keep betting on corporate bonds and seek more exposure in emerging markets and EU periphery bonds. Spain is likely to file its application soon for financial aid from the ESM, which will then allow the ECB to purchase Spanish government bonds. Although we continue to doubt the long-term sustainability of the debt and solvency of many European states, a default in the near future has become unlikely. Consequently, our recommendation is to trade more opportunistically than in the past and not to look solely at the poor economic data. Investors with high risk tolerance may also buy convertible bonds, for example, in order to benefit from the expected positive performance of corporate bonds and the stock market or may immediately increase their stock ratio.

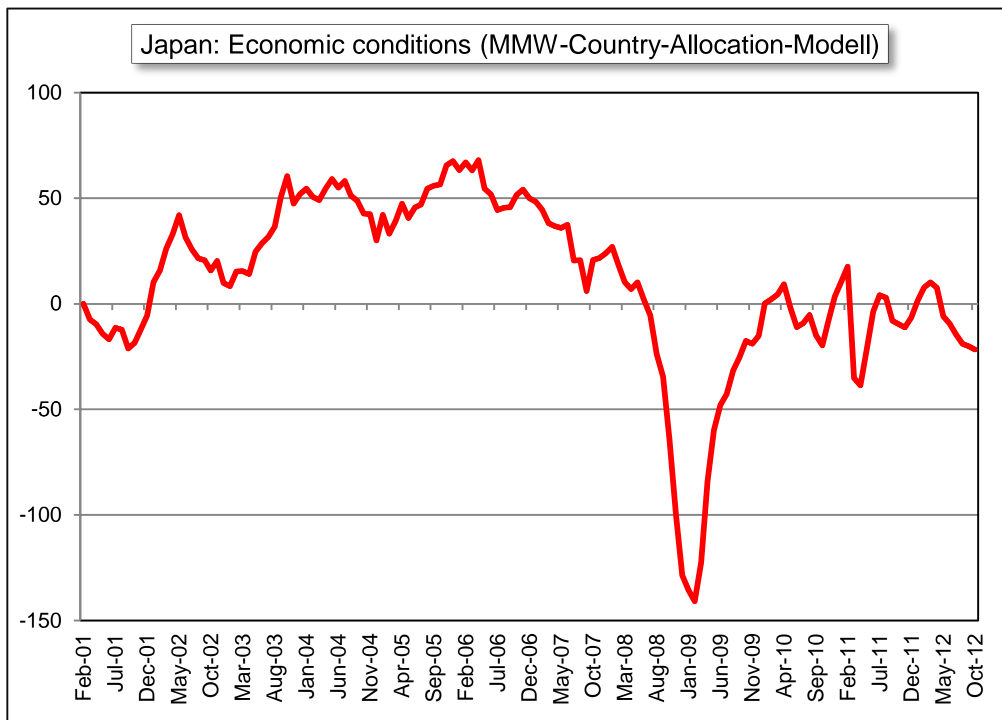


Weekly outlook for October 15-19, 2012

	May	June	July	Aug.	Sept.	Oct.	Release
DE: ZEW economic expectations	10.8	-16.9	-19.6	-25.5	-18.2	-9.7	October 16
DE: Producer prices, m/m	-0.3%	-0.4%	0.0%	0.5%	0.2%		October 19
DE: Producer prices, y/y	2.1%	1.6%	0.9%	1.6%	1.6%		October 19
EUR17: Consumer prices, m/m	-0.1%	-0.1%	-0.5%	0.4%	0.8%		October 16
EUR17: Consumer prices, y/y	2.4%	2.4%	2.4%	2.6%	2.7%		October 16
EUR17: Core inflation, m/m	0.0%	0.1%	-0.7%	0.2%	0.8%		October 16
EUR17: Core inflation, y/y	1.8%	1.8%	1.9%	1.7%	1.7%		October 16

MMWB estimates in red

Chart of the week: Economic outlook for Japan worsening



The bad news outweighs the good. As expected, economic momentum in Japan has diminished further, and that for various reasons. Foreign demand has continued to decline lately, and especially trade with China has slowed. Domestic demand is becoming increasingly weaker. After the Fukushima disaster, there was a surge in demand that the government additionally fuelled with subsidies for, e.g., hybrid automobiles. But the subsidies and catch-up effects are increasingly fading. The latest published leading indicators likewise show no positive trend reversal. On the contrary, consumer confidence has worsened further, falling from 40.5 to 40.1 points in September. Index values below 50 points indicate that consumers are pessimistic about the future. The September survey is therefore disappointing not only because consumer confidence declined on the preceding month, but also because consumers had already expressed only very subdued opinions of the economy and their situation before. Weak figures have also come from the business sector. Orders received by Japanese machinery firms ("core machinery orders") fell in August by 3.3% on the preceding month and were thus significantly lower than analysts had expected. Order intake in August was also 6.1% lower than in the year-earlier period. In our opinion, these figures indicate that Japanese companies have continued to hold back on capital investment. Our country allocation model, which evaluates important economic and financial market data from 34 countries, indicates a worsening of the economic environment in Japan. The pace of Japanese economic growth is therefore likely to slow further in the coming months.

Stock markets	Today 12.10.2012 13:09	Change versus 04.10.2012 -1 week	10.09.2012 -1 month	10.07.2012 -3 months	30.12.2011 YTD
Dow Jones	13326	-1,8%	0,5%	5,3%	9,1%
S&P 500	1433	-2,0%	0,3%	6,8%	13,9%
Nasdaq	3049	-3,2%	-1,8%	5,1%	17,1%
Wilshire 5000	14994	-1,4%	0,6%	7,0%	14,4%
DAX	7273	-0,4%	0,8%	13,0%	23,3%
MDAX	11281	0,4%	1,1%	6,8%	26,8%
TecDAX	813	-1,0%	1,2%	7,0%	18,7%
EuroStoxx 50	2487	0,1%	-1,6%	11,0%	7,4%
Stoxx 50	2537	-0,1%	-0,2%	4,6%	7,1%
SMI (Swiss Market Index)	6652	0,3%	2,2%	7,4%	12,1%
Nikkei 225	8534	-3,3%	-3,8%	-3,7%	0,9%
Topix	718	-2,3%	-2,6%	-5,3%	-1,4%
Bond markets					
Bund-Future	141,39	-28	107	-272	235
Bobl-Future	125,66	-4	45	-188	55
Schatz-Future	110,68	0	-1	-9	33
3 months Euribor	0,21	-1	-5	-31	-115
3M Euribor Future, Dec 2012	0,20	1	-2	-23	-1
3 months Treasury Bill	0,33	-2	-7	-12	-25
Fed Funds Future, Dec 2012	0,14	0	2	-2	0
10 year US Treasuries	1,70	3	1	20	-18
10 year Bunds	1,49	4	-3	16	-34
10 year JGB	0,78	1	0	-2	-21
US mortgage rate	3,36	0	-19	-26	-59
IBOXX AAA, €	1,72	1	-9	-24	-155
IBOXX BBB, €	3,63	1	-28	-89	-249
ML US High Yield	7,09	3	-11	-65	-157
JPM EMBI+, Index	692	-0,3%	0,7%	5,9%	14,9%
Convertible Bonds, Exane 25	5212	0,2%	0,6%	4,4%	14,8%
Commodities					
CRB Index	581,95	-0,7%	-0,2%	5,9%	3,4%
MG Base Metal Index	361,29	-2,9%	1,9%	8,7%	8,1%
Crude oil Brent	115,69	5,4%	1,5%	16,6%	7,5%
Gold	1767,45	-1,4%	2,0%	11,5%	12,2%
Freight rates Baltic Dry Index	903,00	6,9%	35,6%	-22,2%	-48,0%
Currencies					
EUR/ USD	1,2968	0,1%	1,5%	5,6%	0,2%
EUR/ GBP	0,8072	0,3%	1,1%	2,1%	-3,4%
EUR/ JPY	101,70	-0,2%	1,7%	4,2%	1,5%
EUR/ CHF	1,2089	-0,3%	0,0%	0,7%	-0,6%
USD/JPY	78,43	-0,1%	0,2%	-1,3%	1,9%

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