## Economic Risks

- **Narrowing of cyclical underperformance of euro area growth relative to the US and UK**
- **China and India growth rates moderating further**
- **Continued weakness of primary exporters**
- **Deglobalisation gathers pace**
- **More financial repression in the US and beyond**

**Euro area**: conjunctural problems could still spiral out of control. However:

- Heads of state and government now seem committed to a three stage plan on banking union:
  1. Completion of the legislative framework by 31 December 2012;
  2. Establishment of the Single Supervisory Mechanism in the course of 2013; and
  3. Perhaps direct recapitalisation in 2014.
- Harmonisation of national resolution and deposit guarantee frameworks under European supervision will likely be matters for the future
- And Greece has now received its latest instalment

**Euro area in 2013**: euro area GDP underperformance relative to the US and the UK may narrow:

- Increasing fiscal consolidation and corporate sector retrenchment will come to an end
- Destocking no greater than in 2012 would add 1pp to GDP growth
- While disparities will persist in the region, France may do better than envisaged by Consensus
- French competitiveness is increasingly seen as the stick with which to beat the administration
- Calls for wage restraint/cuts are growing in the face of supply side adjustments in the periphery
- *A priori* it is hard to see anything particularly dire about the current French position
- Vis-à-vis non-euro countries, the recent (two-year) slide in the euro seems likely to impact favourably, offsetting any changes in relative costs/prices
- Vis-à-vis euro countries, France still seems in better shape than most of its partners

**Bottom line:** policymaker resolve will continue to hold the euro area together

**Watch for:** inventories supporting GDP, fiscal plans in the core economies, progress on banking union

**US in 2013:** we remain of the view that GDP will grow below the economy's potential rate:

- The most visible risk is fiscal, with a real chance of a large consolidation knocking 1-2pp off US growth
- The inventory cycle is unlikely to support US GDP in 2013 to the extent that it did in 2012
- More positively but longer term, lower hydrocarbon prices will boost both consumption and investment

**Bottom line:** expect below-consensus growth (-0.8pp)

**Watch for:** the inventory cycle becoming less supportive; and fiscal consolidation plans

**UK in 2013:** we doubt that GDP will grow as fast as the consensus expects:

- Consensus seems likely to be right on UK growth (1.3%) only if it is wrong on the euro area (-0.1%)
- Fiscal consolidation continues, household debt is up, animal spirits are weak, exports disappoint
- We see a 1 in 3 risk of UK exit from the EU, with the euro area the 'new European single market'
- With no strategic plan for its place in the world – particularly concerning the City – the UK faces increasing marginalisation

**Bottom line:** sub-consensus 2013 GDP growth (-0.6pp)

**Watch for:** realisation that the UK is in many ways – especially financial – in worse shape than the euro area

**Asia in 2013:** we continue to dispute the decoupling from the West still implied by the consensus:

- China's exports have slowed sharply
- China's GDP grew at an annual rate of 7.4% in Q3, the slowest rate in more than three years
- India continues to run sizeable deficits and its structural reforms are key to avoiding a return to the so-called 'Hindu' rates of growth
- India and China are unlikely to do as well in 2013 as envisaged by consensus. The recent sharp stock market underperformance is a warning sign

**Bottom line:** below-consensus growth in both China and India in 2013 (-2pp and -1.3pp respectively)

**Watch for:** policy stimulus, exchange rate adjustments

**Primary exporters:** we strongly doubt that growth in 2013 will rebound as strongly as consensus suggests:

- Brazil: we expect below-consensus growth (-1.4pp): 2012 is turning out considerably below consensus

**Watch for:** declining terms of trade; more domestic demand stimulus; and domestic inflation ■

## Financial Market Risks

- **Escalating deglobalisation pushing up risk premia to levels not seen in decades**
- **Falling corporate profit margins**
- **Recent bounce in industrial commodities becoming unsustainable amid slowing growth**

**Risk premia:** set to rise as deglobalisation gathers pace:

- Financial markets struggle to price in qualitative risks, due in part to the quantitative nature of modern finance
- This practically ensures that the myriad risks associated with deglobalisation are not yet priced
- The global slowdown implies a further sharp deterioration in government finances
- However, this is unlikely to lead to sharply higher bond yields as policymakers stand ready, through 'financial repression', to limit market discipline
- There is no free lunch: primary exporters and other trade surplus countries will nevertheless seek to de-risk reserve portfolios
- This implies general currency weakness in most developed importing economies
- Japan's transition from trade surplus to deficit is important: yet another sovereign debt mountain is becoming dependent on external financing
- Many commentators argue that reserve currency status confers unique, ever-lasting privilege on the US; we doubt that

**Currencies:** recent dollar weakness is likely to continue:

- US dollar fundamentals are deteriorating. Safe-haven demand provides support, but it is likely to prove only temporary
- China and other developing economies will likely continue to intervene to slow their currencies' appreciation
- However, we doubt that this will reverse the trend: this is contributing importantly to global de-leveraging and a re-balancing process
- Both have considerably further to run

**Equity markets:** recent QE-related gains are unlikely to be sustained as global growth disappoints:

- Much supportive action on the policy front has already been anticipated
- Oil and other commodity prices have risen strongly from recent lows, eating into margins
- A handful of earnings surprises have already cited rising input costs as an issue. This seems likely to spread across more industries
- Trade and currency disputes are increasing, and may become damaging to corporate profitability

**Commodities:** the recent range trade in commodities is likely to continue:

- Commodity prices are now consolidating gains from the cheap levels seen over the summer
- That said, being real assets, commodities cannot be 'devalued' as currencies can: indeed, deglobalisation implies growing supply constraints
- Gold and other 'safe-haven' commodities appear to have re-commenced a more sustainable uptrend

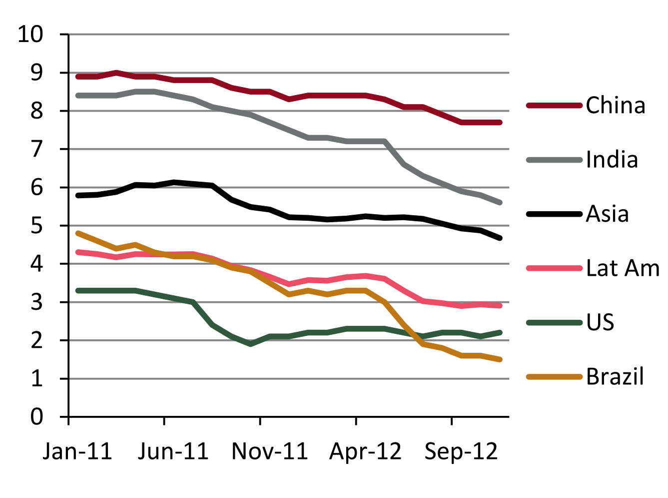
**Asset valuations:** increased downside risk:

- Deglobalisation is gathering pace, but asset prices have yet to price in these risks properly
- Public debt dynamics and strong global GDP headwinds are persisting longer, and are more obdurate, than consensus had been expecting
- More negative surprises may lie ahead for corporate profits, due to slower growth and margin pressures
- Worsening sovereign debt dynamics could also spill over into other markets as confidence wanes
- Moreover, the risks of trade and currency disputes are rising. Brazil is a notable example.
- Sanctions on Iranian oil exports could ignite other tensions – note the BRIC 'Delhi Declaration'

Trade wars are significantly negative for productivity and corporate profitability ■

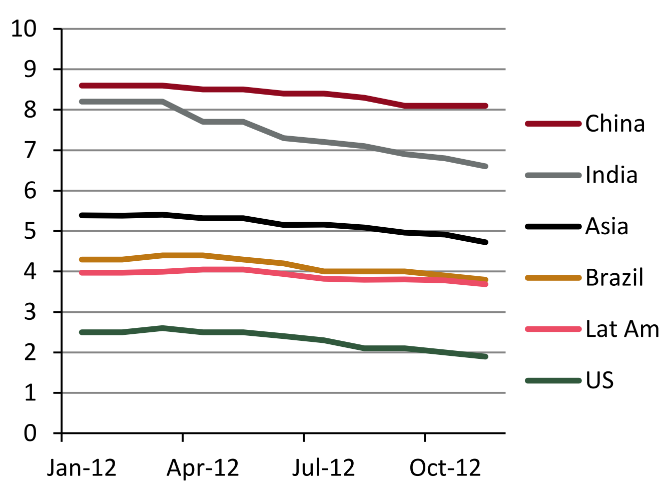
## Charts of the month

**Figure 1: Evolving consensus forecasts, 2012 real GDP growth**




*Source: Consensus economics*

**Figure 2: Evolving consensus forecasts, 2013 real GDP growth**




*Source: Consensus economics*

## Table: Real GDP growth and financial market rates

| Region | Weight in world GDP | Real GDP growth (% y-o-y) | | | | | | LLC Difference from Consensus (pp) | | FX rate | Policy rate | 10yr yield | Equities |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | Average | Actual | | | Consensus | | | | | | | |
| | 2010 | 1989-07 | 2009 | 2010 | 2011 | 2012 | 2013 | 2012 | 2013 | Mid-2013 | | | |
| **Europe** | **29** | - | **-4.1** | **2.0** | **1.9** | **-0.1** | **0.6** | **0.0** | **-0.1** | | | | |
| **Euro area** | 19 | 2.2 | **-4.0** | **1.7** | **1.5** | -0.6 | -0.1 | 0.0 | 0.0 | 1.35 | 0.25% | N/A | N |
| Germany | 5 | 1.9 | -5.0 | 3.6 | 3.0 | 0.8 | 0.8 | 0.0 | 0.0 | | | 1.6% | |
| France | 4 | 2.0 | -2.2 | 1.5 | 1.6 | 0.1 | 0.2 | 0.0 | 0.2 | | | | |
| UK | 4 | 2.4 | -4.9 | 1.3 | 0.9 | -0.1 | 1.3 | 0.0 | -0.6 | 1.65 | 0.5% | 2.0% | N |
| Italy | 3 | 1.4 | -5.0 | 1.1 | 0.6 | -2.4 | -0.7 | 0.0 | 0.0 | | | | |
| Spain | 2 | 3.1 | -3.7 | -0.1 | 0.7 | -1.5 | -1.6 | 0.0 | 0.0 | | | | |
| **North America** | **26** | - | **-2.5** | **2.8** | **1.8** | **2.2** | **1.9** | **-0.3** | **-0.8** | | | | |
| US | 23 | 2.9 | -2.4 | 2.8 | 1.7 | 2.2 | 1.9 | -0.3 | -0.8 | N/A | 0.25% | 2.0% | U |
| Canada | 3 | 2.6 | -2.6 | 3.1 | 2.3 | 2.0 | 2.0 | 0.0 | -0.5 | 0.96 | 1.0% | 1.9% | U |
| **Asia** | **27** | - | **1.5** | **7.2** | **4.7** | **4.7↓** | **4.7↓** | **-0.2** | **-1.1** | | | | |
| Japan | 9 | 1.6 | -5.2 | 3.9 | -0.6 | 1.8↓ | 0.8↓ | 0.0 | 0.0 | 80 | 0.1% | 1.0% | N |
| China | 9 | 10.0 | 8.7 | 10.3 | 9.2 | 7.7 | 8.1 | -0.5 | -2.0 | 6.3 | 2.5% | N/A | U |
| India | 2 | 6.3 | 5.7 | 8.6 | 7.2 | 5.6↓ | 6.6↓ | 0.0 | -1.3 | 54 | 6.0% | N/A | U |
| **Latin America** | **8** | - | **-2.0** | **6.0** | **4.1** | **2.9** | **3.7** | **0.0** | **-0.9** | | | | |
| Brazil | 3 | 2.5 | -0.2 | 7.5 | 2.9 | 1.6 | 3.8 | 0.0 | -1.4 | 1.85 | 7.0% | N/A | N |
| **Other** | **11** | - | -2.0 | 3.8 | 4.1 | **4.0** | **3.8** | **-0.1** | **-0.7** | | | | |
| **Global** | **100** | - | **-1.9** | **4.0** | **3.0** | **2.5** | **2.6** | **-0.1** | **-0.7** | | | | |

Note: Regional weights may not sum to 100 due to rounding. Arrows indicate a revision of at least 0.2pp since last month.

O=overweight, U=underweight, N=neutral