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Central Banks Are "All In" – Now It's Up To The Politicians

Over the past few weeks the central banks of the three major developed economies (the US, Europe, and Japan) have committed to unlimited monetary accommodation. The US Federal Reserve will purchase $40 billion of mortgage securities every month until unemployment drops to targeted levels. The European Central Bank (ECB) has pledged unlimited support for Italian and Spanish bond markets, provided they submit to budgetary and policy oversight from the rest of the Euro Bloc. Thus, the ECB has at long last assured a sufficient backstop for the funding needs of these highly indebted economies. Even the Bank of Japan, which has been too little and too late in its policy response for more than 20 years, has committed to aggressive Quantitative Easing (QE) asset purchases until Japanese inflation exceeds 1%.

These extraordinary open-ended policy commitments, combined with aggressive interest rate cuts in most emerging markets (see chart), suggest that the central bankers of the world have gone "all in" with the most powerful monetary tools remaining at their disposal. For the first time since 2009, almost every central bank in the world is united in easing monetary policy and encouraging economic growth.

With monetary policy firmly on their side, investors are likely to shift their focus to the success or failure of political processes in the major economies. We believe that resolution of three critical fiscal issues is likely to determine whether the global economy reaccelerates or lapses into recession in 2013:

1. The US election and resolution of the "fiscal cliff"
2. Specific conditions imposed on Spain and Italy in exchange for ECB support
3. Additional stimulus initiatives from China

We are reasonably confident that, despite predictions of continued gridlock by political pundits, the US will avoid falling off the fiscal cliff. We further believe that survival instincts will force the new Chinese leadership to provide far more fiscal stimulus as Chinese growth appears poised to drop below 5%. To complete the policy trifecta, the conditions placed on Spain and Italy in exchange for ECB debt purchases must switch from growth-inhibiting austerity measures to growth-promoting labor market and regulatory reforms. Rumors in the financial press suggest that just such a policy shift is being negotiated, but our experience with European decision making suggests we should wait to see what emerges from these negotiations before getting too optimistic.

If politicians in all three economies deliver hoped for policy responses, the global economy could reaccelerate in 2013 and equity markets could post another year of double-digit returns. Our current view is that the politicians will deliver on at least two of the three needed policy responses, which should be sufficient to keep the global economy out of recession in 2013 and allow equity markets to grind higher with modest gains. If, unlike global central bankers, politicians fail to understand the gravity of the economic risks and are unwilling to compromise on appropriate policy response, then the global economy could slump back into recession in 2013. In that scenario, which we do not anticipate, aggressive monetary policies can only soften the severity of the slump and the associated market declines.

The US: Significant Shift in Negotiating Leverage Suggests that Fiscal Cliff will be Avoided

Perhaps the most severe risk facing the global economy in 2013, in our view, is the potential that the tax increases and spending cuts scheduled to occur in the US actually take effect. In addition to the expiration of the Bush tax cuts, current legislation demands cuts of approximately $100 billion in defense and other discretionary expenditures and the end of emergency measures such as extended unemployment benefits and reduced social security taxes. These measures total nearly 4% of GDP, and simultaneous imposition of all of them would likely push the US economy back into recession, a policy outcome that Fed Chairman Ben Bernanke has described as “driving off a fiscal cliff.”

The 2011 debt ceiling fiasco created an indelible image of a dysfunctional political process and has elevated fears that political leaders will once again be unable to agree upon a specific solution. However, we believe that the gridlock of 2011 was a function of political factors that will be significantly altered in the fiscal cliff negotiations. Forecasting a specific resolution for the fiscal cliff is impossible given the impending presidential elections. However, we believe that the next president will have such overwhelming negotiating power over Congress that the partisan gridlock of the past two years will be avoided.

The 2011 debt ceiling deal mandates $100 billion in defense and discretionary spending cuts in 2013. As Commander in Chief, the next president will have tremendous power over whose congressional districts bear the brunt of those cuts. Congressmen may find that the President can make their districts pay a terrible price if they block his budgetary priorities.

If Governor Romney wins the elections, he is likely to use this negotiating leverage to defer all the tough budget cuts and tax increases while he pushes through a sweeping revision of the tax code. By contrast, if reelected, President Obama will likely use his substantial negotiating leverage to force Republicans to accept major tax increases – President Obama wants to maintain the Bush tax cuts only for families with incomes below $200,000. Economic forecasting firm ISI estimates that even this partial fiscal cliff could subtract about 1.6% from US growth and push the economy perilously close to recession. However, we are skeptical that a re-elected President Obama will have the backing of his own party for such large tax increases.

Democratic senators from California, New York, and Massachusetts, and even the Democratic senate candidate from Virginia have flatly stated that an income of $200,000 doesn’t make a family rich in their high income/high cost states. Should President Obama be reelected, these senators can be expected to align with Senate Republicans in pushing for an income threshold between $500,000 and $750,000 for the higher tax rates. Since most of the people, and therefore the economic damage, lie between incomes of $200,000 and $500,000, an Obama reelection is likely to result in a fiscal drag of about 0.8% in 2013. Under this scenario, the US economy would likely continue to experience painfully slow growth but avoid recession.

Europe – Will It Finally Abandon “Hoovernomics”?

One by one, European policy makers have abandoned the policy prescriptions we have described as “Hoovernomics.” The ECB’s long-term refinancing operations (LTRO) program and interest rate reductions have reversed the restrictive monetary policies of 2010 and 2011. The ECB has further agreed to provide unlimited financial support to Spain and Italy if they agree to policy oversight by the rest of Europe. The conditions of this policy oversight provide an opportunity for Europe to abandon Hoovernomics once and for all.

We believe that the debt problems of peripheral Europe are a symptom rather than the actual disease within these economies, and that the true source of the economic problems is uncompetitive labor costs. For much of the post WWII era, these economies have embraced labor and regulatory policies that tend to elevate labor costs relative to less restrictive economies, such as Germany. Until the advent of the euro, these countries tended to compensate for higher labor costs by periodically devaluing their currencies, essentially cutting worker pay through a lower currency and lower standard of living.

By entering a currency union, these countries abandoned their cost reduction mechanism (currency devaluation) but continued to embrace labor policies that elevated their costs relative to competitors. Thus, labor is more than 30% more expensive in Greece, Italy, Spain, etc. than in Germany, and few companies see these economies as attractive locations for new facilities. For example, Airbus is highly dependent upon support from the French government, yet it will locate its new production facility in Alabama.

Although labor costs are the primary problem in peripheral Europe, European policy makers have thus far focused most of their time and political capital on forcing bailout recipients to meet stringent budget deficit targets. Since political realities in these countries assure that deficit reduction packages rely predominately on tax increases, these austerity requirements have helped drive these economies into deep recessions/depressions (similar to the Hoover experience with tax increases in 1930 and 1931).

To complete the move away from Hoovernomics begun by the ECB, the conditions placed on Spain and Italy to receive ECB support for their debt should focus on labor and regulatory reforms instead of austerity and budget cutting. For the euro to survive another 10 years, labor costs in Italy and Spain have to fall into alignment with those of Germany, in our view. Instead of wasting precious political capital on austerity measures for two countries that have truly done their best to reduce budget deficits, all effort should be focused on labor market reforms that their leaders have attempted but have had difficulty in getting implemented. Market hopes for such a policy transition were fueled by a September 21 article in the *Financial Times,* which reported that:

> *…negotiations have been taking place with Spanish Finance Minister Luis de Guindos, and talks are surrounding structural reforms to the economy, but not new taxes or spending cuts…*

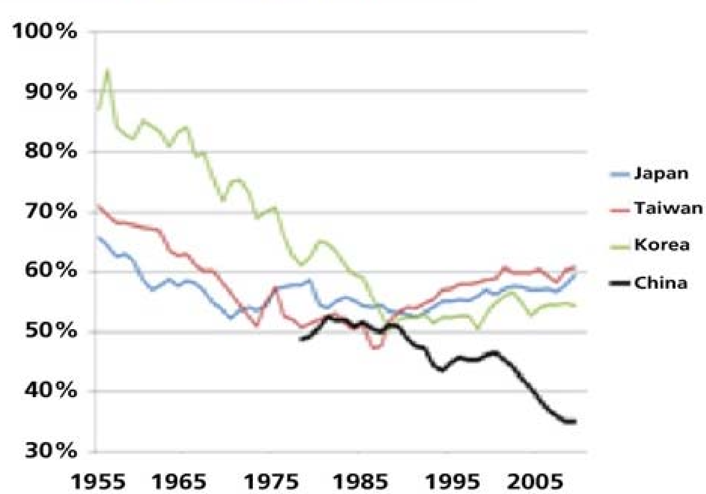
If European leaders truly make such a policy shift, we believe that low-cost ECB funding and improved growth spurred by more flexible labor markets, when combined with austerity plans already in place, should be sufficient to bring their deficits under control.

China – More stimulus spending needed, now!

The China economic “miracle” of the past 20 years has been driven predominantly by investment spending, chiefly the infrastructure investments necessary to allow more than 300 million Chinese to migrate from farms into the rapidly expanding Chinese cities. Chinese policy makers hope to transition the economy from such heavy dependence on investment spending to a more balanced economy in which consumer spending plays a larger role. They have supported this vision by allowing double-digit wage gains for much of the past five years and enhancing the social safety net.

Despite these policy changes, consumer spending as a percentage of the overall Chinese economy has continued to fall (see chart at right). We believe this strategy will

Chart 1. Household Consumption as a Percent of GDP



Source: CEIC

continue to fail until Chinese policy makers make far more sweeping economic reforms, dismantling the extensive policies and economic structures that depress domestic consumption in favor of exports.

As evidence continues to mount that consumption is not accelerating fast enough to offset decelerating export growth, China is faced with allowing growth to dip below the potentially politically explosive level of 5% or looking for alternative sources of growth. With the political will for sweeping reforms thus far lacking, we believe that China will opt for the same old script of investment driven growth. Ample opportunity remains for productive infrastructure investment (Shanghai hotels are among the most technologically advanced in the world, but guests must brush their teeth with bottled water), and we expect that many more infrastructure packages will follow the recently announced $150 billion initiative.

Market Implications

US equity markets have had a great run and will likely be further supported by extraordinarily aggressive global monetary policy. If we are correct and politicians deliver at least two of the three needed fiscal changes, the S&P 500 should be able to climb past 1500 over the coming months. However, current polling suggests that President Obama is highly likely to win reelection and therefore US fiscal policy will become more restrictive in 2012. This means that the best "change in the rate of change" for economic policy is likely to be in Europe with ECB support for Spain and in emerging markets with continued stimulus announcements from China. Both of these markets have so underperformed the US that they could continue running long after higher relative valuation causes the US to lose upward momentum.

Additional support for overseas market may come from a renewed decline in the dollar. While both the Fed and the ECB have committed to potentially unlimited asset purchases, the Fed intends to print new dollars to finance its mortgage backed securities (MBS) purchases. By contrast, the ECB plans to fund any Spanish or Italian bond purchases by essentially borrowing existing euros from German banks rather than printing new ones. Thus, markets will have to absorb $40 billion more dollars relative to euros every month and continue absorbing these excess dollars even if/when the ECB begins its bond purchases. Thus, US markets will enjoy additional liquidity to fuel further market gains, but only at the expense of potential downward pressure on the dollar.

For the past year, interest rates in the US, German and UK bond markets have dropped dramatically as investors priced in a potential disaster scenario for the euro. The disaster premium built into these “safe haven” bond markets is likely to reverse as the implications of unlimited central bank support for the US economy and the euro is reflected in market prices. For the US bond market, that will probably mean that 10-year Treasury yields will increase to between 2.0–2.5% while the 30-year could trade in a range of 3.5–4.0%. If our forecast is correct, yield increases of that magnitude would translate into price declines of approximately 3–6% for the 10-year, while the long bond could fall as much as 18%.

We continue to believe that European equity markets will provide the best early signal about the appropriateness of global economic policy. If European markets break through the resistance levels indicated by the green line on the graph below, then market confidence is building that the fiscal issues outlined in this report are being resolved in favor of global economic growth.

Source: RiverFront Investment Group, FactSet Research Systems; Past performance is no guarantee of future results

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