

## Outlook 2012: proceed with caution



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### AT A GLANCE

- We enter 2012 as defensively positioned as we were in 2008.
- Global growth is slowing, but inflation is also easing, which will allow central banks to ease monetary policy.
- Fiscal austerity, bank recapitalisations and threats of expulsion to member states are having unintended negative effects that will worsen the economic situation in Europe.
- Assuming European policy makers can deal with what is essentially a political crisis, there is the potential for 2012 to be 'V-shaped' in terms of risk asset performance.
- Forceful ECB intervention could ease the crisis but policies that inflate the core of the Eurozone are the best bet to restore competitiveness to the periphery.
- We favour bonds over equities and commodities. Within equities, we favour the US and Swiss markets, which have relatively defensive attributes.

**2012 is likely to start off a challenging year for investors as Europe moves into outright recession and pulls down broader global economic growth. A recession in Europe will exacerbate the financing problems of peripheral economies and introduce contagion to the core banking systems as the eurozone crisis enters into a final, painful phase. Other developed economies are also struggling to grow under high consumer and government debt burdens and are hampered by fragile banking systems. All in all, things look bleak in the near term but 2012 does have the potential to be a 'V' shaped year for risk assets if Europe can deal with its political crisis and the US economy responds to stimulus.**

We are experiencing a second round of the global financial crisis. The first round was caused when banks and other highly leveraged financial institutions could not be certain of the value of complex financial instruments linked to sub-prime US housing obligations. This second round is based on uncertainty surrounding the value of eurozone sovereign debt, a far more widespread asset with a critical role as a "risk-free" asset in the global banking system. In 2008, the threat of bank runs was stopped by government intervention; now we are seeing a crisis of confidence in European sovereigns that will require equally forceful action.

A bullish case can be made for 2012. It rests on a US-led economic upswing strong enough to offset anticipated weakness in the European economy and it assumes the worst-case scenario of a messy euro break-up can be avoided. US data has been resilient, but as things stand I am doubtful financial contagion from Europe can be avoided.

Global growth is slowing and a peak in inflation will enable central banks to ease policy with force. However, it will be hard to offset a synchronised slowdown in the European Union, an economic area in aggregate larger than either the US or Chinese economies. Meanwhile, the ability of the US to underpin global activity is constrained by political deadlock over fiscal policy and China is unlikely to fill the gap. Its exports to the developed world are slowing and monetary easing is likely to be incremental with inflation still uncomfortably high.

We enter 2012 with our portfolios as defensively positioned as we were throughout 2008. One of the key reasons for my caution is I believe policy responses are making the European debt crisis worse. US investors have become used to a sequence of events that sees a market panic elicit a policy response that rapidly triggers a reversal in the business cycle and in stock prices. In earlier times, people called this the Greenspan put. But what if the policy response is the wrong policy response?

Europe's problems stem from a chronic lack of competitiveness in the peripheral economies resulting in large trade deficits with the core that markets are no longer willing to finance. Policy makers are addressing the crisis by insisting on ever deeper austerity, by threatening banks with injections of public capital and by hinting that countries that don't follow the rules can leave the euro. These policies may do more harm than good.

Austerity is exacerbating the economic slowdown in peripheral economies, causing their fiscal dynamics to deteriorate in a vicious and unstable circle. The peripheral European sovereign bond markets behave like corporate bonds. These states cannot print money to repay debts and they cannot devalue their exchange rates to restore competitiveness. When economic growth slows, bond yields rise as investors factor in a higher likelihood they won't get all of their money back. This rise in the cost of government finance itself makes fiscal sustainability more difficult. A move into recession will certainly test the commitment to cut spending and it will test the resolve of Germany to supply further funding to what it sees as errant member states.

Offering banks additional capital sounds sensible but it is causing a credit crunch. Banks do not want to dilute their shareholders so they are making every effort to improve their capital position by calling in loans. Meanwhile, talk of Greece or other countries leaving the euro creates uncertainty about the integrity of the entire single currency area and causes investors to factor in a risk premium for possible foreign exchange losses even to bonds in the eurozone core.

A solution to the problem could come from a policy to rebalance the European economies with the European Central Bank intervening to maintain market discipline in the meantime. Trying to restore

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competitiveness by deflating wages and asset prices in the periphery is doomed to failure when debt levels are so high. It is far better to inflate the core. If policy makers are unwilling to do this, for example by easing fiscal policy in Germany, then a much weaker euro exchange rate could do the trick by boosting German exports to the rest of the world.

The ECB could help such a transition by providing unlimited support to cap yield spreads in eurozone sovereign bond markets. Much depends on Germany's preparedness to agree to a policy that could involve a large transfer of wealth from the core to the periphery. The German Bundesbank claims that buying bonds in an unlimited manner would be illegal, amounting to central bank funding of member states. The greater impediment may be fear of moral hazard: that the signal ECB intervention would send to political leaders in the periphery is that fiscal irresponsibility will not be punished.

For Germany's opposition to this policy to become exhausted, we may need to see contagion spread to its financial sector and real economy. At present, this still seems some way off. The German unemployment rate is at a post-unification low of less than 7%; compare this to 23% unemployment in Spain and it is clear the German economy is simply not feeling the pain of its neighbours. Indeed, for now, Germany seems quite happy to live with or even engender a sense of crisis, as it allows them to push for structural reforms among their eurozone partners.

Once the crisis reaches Germany, the choices could become binary. A eurozone break-up is something that Europe's premier manufacturing export base wants to avoid at almost all costs. There would be huge damage to Germany's export and banking sectors from the appreciation of new Deutschmark. Quantitative and fiscal easing to inflate the German economy and make it less competitive relative to the periphery may, ultimately, be a solution that Germany is prepared to stomach. The alternative would be full political union, perhaps with a smaller group of states, allowing for large fiscal transfers and coordinated economic policy. If and when we get bold policies like this, it could be time to become more positive on risk assets.

A recession in Europe will have an impact on emerging markets through trade and financial channels. European banks are the dominant lenders into Asia where credit growth has been a key driver of economic activity. Emerging markets will probably not be spared from volatility but a weak global economy in 2012 could provide a good long-term buying opportunity in much the same way as it did in 2008/9. When global growth starts to recover, emerging markets are likely to outperform developed markets by some margin.

Moving into 2012, we continue to favour bonds over equities. We remain underweight in commodities, albeit overweight in gold. Within equity markets, we favour the US; the market has relatively defensive attributes and, despite the fiscal deadlock, it is still the most likely to stimulate its economy to protect economic growth and jobs. Economic policy is more pro-growth than in other developed markets, with the Fed willing to take aggressive action when required and the Democratic administration likely to table fiscal stimulus and housing support programs. Swiss equities are also attractive for their defensive qualities, with the currency hedged. We expect a period of euro and Swiss franc weakness and dollar appreciation.

In summary, investment conditions remain difficult. We expect short violent economic cycles driven by bouts of unprecedented fiscal and monetary stimulus. Diversification across a range of asset classes will remain an attractive proposition and there will be lots of opportunities to add value through a sensible tactical asset allocation policy.

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