Global Economic Outlook

US Muddling Through 2012 But Europe Remains in a Difficult Situation

Back in 2011, we highlighted that it would take a few years to resolve the debt issues in the West and things may get worse before getting better. About one month into the new 2012, things look seemingly much better than we initially expected. The US was still muddling through its economic and housing problems, but recent economic data from manufacturing, housing and labour markets suggested the economic recovery was improving further going into 2012. The key positive is that the situation in US has shifted from a financial shock towards an economic problem – which is more manageable at least from policy-makers' perspective.

And on the surface, Europe's problems seemed to have stabilized a lot in early 2012 since roiling the global financial markets in 2H 2011. But this belies the myriad of issues that needs to be cleanly resolved in the Euro-zone. Greece needs to reach a deal with its private creditors (to lower their "final offer" of the interest rate on the new Greek bonds) and avoid a disorderly default but time is running out and they may no longer able to "kick the can down the road". Leveraging up the EFSF has been challenging. The bank re-capitalization program of EUR106bn (to be completed by mid-2012) is contingent on the problems not spreading to Spain and Italy, which remain problematic although the lending costs for these two economies have greatly improved in early 2012. Policy-makers in EU over the past months have attempted to bring in the IMF with the objective of getting superpowers of the world, including US and China, to contribute more resources to help address the problems in Europe, but still without much success to show.

The start of 2012 may just be the calm before the onset of a choppy volatile season for the financial markets in 1H-2012. The resumption of uncertainty will put renewed downward pressure on the Euro currency. We continue to see scope for volatility amid sharp headline-driven price swings, and expect the EUR/USD pair to gradually depreciate as the fundamental outlook for the region turns increasingly bleak.

So, Can The European Problems Be Resolved?

Yes, if the ECB is willing to underwrite the mounting debt in Europe – as the US Fed did in 2008. Our primary view has not changed: the ECB is the only one institution capable of rescuing the Eurozone from its precipitous spiral into oblivion. Whilst the ECB is considered to be underleveraged and has more capacity to maneuver, so far it continues to decline assuming the saviour role and go along the line of large scale asset purchase operations. The ECB is unwilling to play this role directly, due to legal constraints and also philosophical difference, among other factors. We believe the ECB would eventually be forced into this role. But we suspect there would have to be much more pain before the ECB steps in – probably only when member countries are willing to surrender their fiscal independence to a central European authority.

Financial Markets Impact: Averting another Liquidity Shock?

Impact on the financial markets is clear risk of liquidity drying up. Central banks have tried to smooth the system with swap lines, in particular the coordinated global efforts on 30 November 2011 by 6 major central banks led by the US Federal Reserve to make it less costly for banks to get US dollar funding/borrowing. The willingness of the ECB to lend long term money to European banks at very cheap rates (i.e. LTRO facility) also helped shore up confidence. Thus, on this front, they looked to be successful with both the 3M Euro basis swap and the EURIBOR – OIS 3M / TED spread continuing to improve (as of 3 February 2012). However, the TED spread and basis swaps prices are still relatively elevated compared to the last 3-year average, suggesting that the market is still not fully convinced.

In the months ahead, the market is likely to continue to focus on the Euro-zone debt auction market as Spain and Italy seek to finance their budget gap. To underscore the likely intensity of market pressures in the next few months, just four Eurozone members alone have an estimated EUR1.1 trillion of refinancing in 2012, with bulk of it taking place in 1H-2012. Italy has about EUR382bln worth of redemptions (up from about EUR30bln in 2011); Spain has about EUR169bln; France has about EUR317bln; and

Germany has about EUR252bln.

Impact On Asia: Financial Or Economics?

So far, policy makers seemed to be successful in preventing a replay of another Lehman shock, whereby liquidity and credit dried up from the global system. However, the economic impact on Asian system seems unavoidable. To ensure that the global system continues to support European economies, fiscal austerity is a must. However, given the current economic conditions, further fiscal austerity will only push the system further south. Impact on Asian economies has been showing up. Various central banks have started to loosen monetary policy, and GDP growth for 2012 has been revised down significantly. For example, after recording growth of 4.8% in 2011, Singapore economy is expected to moderate towards 1-3%. For this reason, we are less positive on our general outlook for Asia in 2012, and have slashed our growth forecasts especially for the first half of the year.

Much has been spoken about Asian economies de-coupling from the West. However, we maintain that Asia is only less "coupled" – and not "de-coupled" – from the advance economies. We have included a piece on how intra-regional trade flows have changed over the last decade, pointing to a less coupled situation, rather than decoupling.

Impact On Asian FX

Despite the recent strengthening of Asian major currencies and equity market rally in early 2012, the expectation of more Europe-related volatility in first half of this year is likely to create bouts of risk aversion and cap any significant strength of Asian currencies. Policy bias towards easing monetary policy is likely to dampen further currency strength. In all, FX will continue to remain volatile in 2012 -- at least in the 1H2012. With this mind, we have downgraded our view on Asian currencies across the board for the first half of 2012, before improvements are seen in the second half, assuming Eurozone's debt situation continues to "muddle along".

US Economy: Lowered Growth Expectations In 2012 Due To US Politics And European Debt Worries

Even as the latest US economic data suggest that the US recovery remains intact going into 2012, the US economic outlook has turned more cautious due to US political deadlock and the uncertainty due to European debt concerns even as the constrained US consumer continues its slow recovery in 2012. The US recession scenario will only be possible if a financial crisis erupts from Euro-zone. US fiscal policy will continue to be one of the key risks for the US economic outlook in 2012 and it is likely to remain ineffective. In the first FOMC policy meeting of 2012, the Federal Open Market Committee (FOMC) surprised the markets as the Fed changed its forward expectations of the Fed Funds Target Rate (FFTR) unchanged at 0-0.25% "at least thorough late 2014" a significant extension from the previous "at least through mid-2013." The Fed reaffirmed the easing measures announced in the August and September 2011 FOMC statements, (including the Twist Operation), and did not add new easing measures even though reiterated its willingness to do more for the US economy. Even as the US economic and jobs outlook continued to show improvement going into 2012, the Fed remains concerned about the sustainability of the recovery and emphasized on the downside risks for the US due to the problems in Europe, weaker global growth and other factors. The significant key point was the Fed's downgrade of 2012 growth (to 2.2-2.7% from 2.5-2.9% previously) and 2012 inflation to be below the announced long-term target of 2% (core PCE inflation projected at 1.5-1.8% from 1.5-2.0% previously).

And with fiscal policy impotency set against the backdrop of weaker US growth (and very benign inflation outlook) leaves the Fed with little option but to announce more easing measures in 2012. We continue to expect the Fed to announce a QE3 programme as early as 1Q-2012 that is centred on purchasing mortgage-back securities because US housing market remains in the doldrums and the depressed US house prices remain a significant problem hampering for the US economic recovery. That said, if the US economic data continue to improve robustly while the European debt situation finds stability, then the bar will definitely be raised before the Fed can justify introducing more QE. Longer dated US Treasury yields could head lower in 1H-2012 due to renewed Europe-related risk aversion and Fed's action to extend the duration of its UST holding. We expect 10Y UST yield to head lower to 1.5% by end 2Q-2011. And while the USD strength faltered at the start of 2012, we believe that the USD is likely to stay supported 1H-2012 on safe haven flows as the Euro area debt crisis is far from resolved for now.

China: Last Man Standing, But Struggling With Domestic Issues

China's 4Q11 GDP report (17 Jan) showed continuation of deceleration in headline figure, but came in above expectations. Headline came in at 8.9%y/y, from 9.1%y/y in 3Q11. However, the pace in 4Q11 is the weakest in 2 ½ years, tracing back to near 2009 lows in the aftermath of the Global Financial Crisis. For the full year, China's economy expanded 9.2% in 2011, from a revised 10.4% in 2010. While "soft landing" is still our central scenario for China, risks of a harsher slowdown are bubbling below the surface, especially with worsening developments in the real estate market. We note several stress points in China: local government debt, property price and volume declines, and "informal" loan sector, among others.

Even with these factors straining China's system, it should be noted that resources are available internally in China should losses need to be socialized. In addition, 2012 will be a crucial year for China as its once-in-a-decade leadership transition takes place. With downside risks weighing both the global and domestic economy in the coming quarters, we look for headline GDP growth figures dipping below 8% in 1Q12-2Q12, and then rebounding in the second half. We are trimming China's headline growth forecast for 2012 to 8.0% (from our earlier projection of 8.2%), from 9.2% in 2011, but maintaining our 2013 forecast at 8.3%.

Asia's Intra-Regional Trade Flows To Cushion Impact Of European Debt Situation: Less-Coupled With The West?

There is high expectation for private consumption to help Asian economies cushion a global downturn. The growth of Asia's middle-income group in the past decade and improving household and corporate balance sheets will buffer the region in the event of a global recession. But, that is only true to a certain extent.

Intra-ASEAN trade and those with China and India has increased dramatically, compared with a declining share to EU 27 and the North America. However, the decline in ASEAN's direct exports to North America and EU has masked the fact that the region is still heavily dependent on the developed markets for its final exports. Intra-regional trade increase over the years was largely the result of the vertical specialization in the production cycle, which saw developing Asia's exports being channeled through China to the developed economies. In fact, around a third of the combined merchandise exports from ASEAN and China are still heading to EU and North America, despite some decline since 2000. This suggests that the increasing consumption within Asia would not be able to offset weakness in the developed markets yet.

Besides trade, Asia will also be affected via an expected drop in foreign direct investment (FDI) and the contagion risks in the financial markets causing the credit and liquidity conditions in the global markets to tighten. The impact of a global downturn on Asia will still be significant despite the improving economic fundamentals in the region.