

Central Banks are Reflating, Governments are Imposing Austerity: What this Means for the Economy and Financial Markets

Robert Spector, CFA | Multi-Asset Portfolio Manager

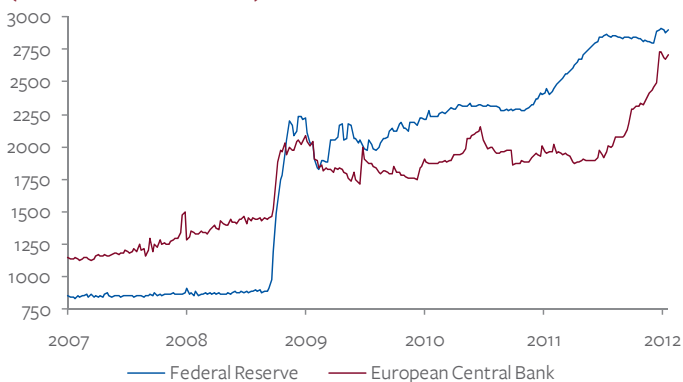
As 2012 begins, some major macro policy themes are falling into place. The European Central Bank (ECB) has cut interest rates and injected liquidity, the Federal Reserve signaled that U.S. rates are likely to be near zero percent until at least late 2014, and there have been signs of monetary easing from emerging market central banks. Why, after 2+ years of global economic expansion is monetary policy still easing? The world economy continues to require a buffer given ongoing de-leveraging in the private sector, governments which are imposing austerity, and fiscal drag that will become more intense in coming years. Below, we discuss our outlook for the global economy and review MFS McLean Budden's asset mix stance in this environment.

The Global Economy

Our long standing view on the global economy is that the recovery which has been in place since mid-2009 would be sub-par when compared to past cycles. Largely, this has played out. The headwinds to growth, particularly in the 'Advanced Economies' or 'Developed Economies (DEs)' include private sector de-leveraging, fragile banking systems, increased regulation and fiscal austerity. An additional headwind has recently emerged—Europe's sovereign debt crisis and in particular how policymakers navigate the tricky waters of the Eurozone's future. A disorderly financial market response to a possible Greek default (perhaps as soon as the end of Q1 2012), or any perceived pause in the pace of reform in Italy, Spain and France could lead to further debt ratings downgrades, a deeper regional recession and a global credit crunch which would lead to lower global growth. If both fiscal and monetary policy are pushed close to their limits, we could see enormous economic, political and social consequences.

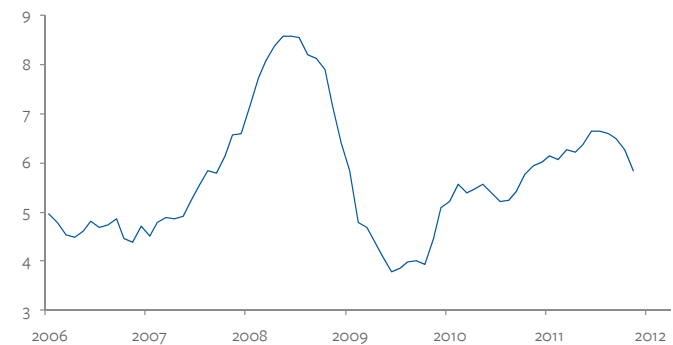
On a regional basis, it is noteworthy that not all areas of the world economy are the same. Some economies (US, UK and Japan) are showing signs of being in a classic liquidity trap where repeated doses of monetary and fiscal

Chart 1: ECB Joins the Money Printing Parade—Long Term Refinancing Operation (LTRO) Buys Time, Not a Long-Term Solution for Europe's Crisis (\$Bln - Fed, Bln euros - ECB)



Source: Haver Analytics, Bloomberg

Chart 2: Lower Emerging Market Inflation Will Pave the Way for Policy Easing (Consumer Prices: y/y % Chg)



Source: RBC Capital Markets

stimulus fail to produce a strong, self-sustained economic recovery. Interest rates are basically zero in these economies and central banks have ventured into the unknown world of quantitative easing (QE) in order to offset deflationary pressures. Government debt has surged as well. In the U.S., consumer spending has risen more than many expected, not because of strong income growth but because savings rates have declined more than what is warranted based on the housing market and household net worth. Assuming job growth continues, we are likely in for a period where income growth outpaces consumer spending, restoring savings to levels more reflective of underlying fundamentals.

As mentioned, Europe has a unique set of problems, where a sovereign debt crisis has combined with a banking crisis to produce a recession, bank de-leveraging and intense fiscal austerity and structural reform. This is likely to be deflationary, and the ECB has belatedly reversed ill-timed rate hikes (with more easing expected), provided virtually unlimited liquidity to the financial system and is buying peripheral government bonds in the secondary market to lower yields in order to help prevent a highly unsustainable trajectory in debt-to-GDP ratios in these countries. The ECB is engaging in 'stealth QE' and its balance sheet is rapidly expanding along with the Fed's (Chart 1).

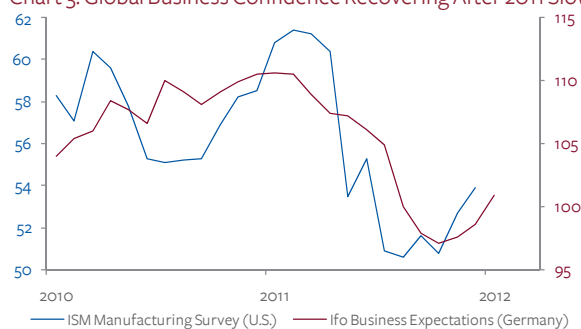
Smaller, export-oriented Developed Economies such as Canada and Australia have slowed alongside the global economy, and are vulnerable to a further decline in commodity prices. Meanwhile, strong domestic demand (owing to the past boom in resource prices), and relatively healthy banking systems have nurtured domestic housing and overly aggressive credit expansion. Central bankers here are caught in a box – higher rates may be required to slow down the aggressive credit growth, but tightening into a global slowdown is a bad idea when you are an exporting country. In addition, higher rates push up the currency, further dampening exports.

Central Banks are Reflating, Governments are Imposing Austerity: What this Means for the Economy and Financial Markets

Robert Spector, CFA | Multi-Asset Portfolio Manager

It is hard to treat all emerging economies as one, but by and large, the emerging world faced inflation pressures and tighter policy for much of 2010 and 2011. Slowing exports and falling inflation are now paving the way for easier monetary policy to support domestic activity (Chart 2). Unlike DEs, emerging market banking systems are functioning well, so growth should respond to rate cuts. Finally, less government and private sector leverage suggest scope for further actions if growth slows sharply. China is a bit unique in the emerging world. Housing has begun to slow and overall GDP is likely headed to around 8% from the 9%-10% range of recent years. This is still a soft landing, but any growth scares could impact commodity markets in 2012. Though we believe Chinese inflation will cool and monetary policy will ease this year, there is the potential for investor disappointment if easing is not seen as aggressive. Building wage pressures suggest inflation unlikely to fall as much as in prior slowdowns.

Chart 3: Global Business Confidence Recovering After 2011 Slowdown



Source: Bloomberg

On a near-term basis, there has been some encouraging news for the global economy. Global leading indicators such as the German Ifo and U.S. ISM have risen (Chart 3), credit spreads have narrowed from the 2011 highs and U.S. housing has shown signs of bottoming. Last year's imminent recession risks have faded and there is some positive momentum in the global economy right now (outside of many parts of Europe). Our bigger picture analysis described above suggests that this momentum may be short lived, in which case, we may remain constructive, but enjoy it while it lasts.

MFS McLean Budden (MB) Asset Mix

MFS MB's Asset Mix Team had anticipated a turn in global leading indicators, rebalancing equities to an overweight position as stock markets became oversold. The Team reduced target weights in fixed income as relative value favoured stocks over bonds and MFS MB's bond team saw less and less value in long-term bonds, particularly in the government sector.

This scenario has largely played out, but not entirely. Stocks have outperformed bonds since the start of Q4 2011 as US and global recession risks have faded, cyclical leading indicators have increased and the ECB's LTRO actions have been an important catalyst for this latest upmove. The

Fed's just-released statement that the Federal funds rate will likely be close to 0% until at least late 2014 will contribute to a positive liquidity backdrop for stocks. Moreover, even bad news, such as the recent downgrade to European countries debt ratings by Standard and Poors have had muted reactions, suggesting much of this negativity has been priced in for now. The surprise has been that government bonds remain near record lows despite improving global indicators and a rebound in risk appetite. Worries over tail risks and speculation over further central bank purchases have kept demand for 'risk-free' bonds very high. We anticipate a bond sell-off toward fair-value and recognize that in this unique environment, yields could trade below 'equilibrium' for an extended period.

Chart 4: Canadian Corporate Spreads Offer Good Value (bps)



Source: BAC-ML, Bloomberg

We retain a modestly optimistic view on stocks over bonds right now at the asset mix level. Though consensus earnings expectations have come down and could continue to grind lower, the improvement in leading indicators suggest the re-rating to profits may nearing an end for now. To be sure, profit growth is slowing. However, modest global growth suggests that a major downgrade to the earnings outlook is unlikely. With valuations neutral, equities should deliver total returns in 2012 that outpace the current level of bond yields. And if bond yields grind higher in the first half of 2012 as we expect as valuations normalize in the bond market, it will not take much for stocks to beat bonds on a total return basis.

Financial markets in 2012 are unlikely to go in a straight line, and one should expect volatility. Bottom-up stock picking, with an emphasis on high quality, companies that have the capacity to return cash to shareholders via dividends or buybacks, or generate cashflow for re-investment and future growth, will be critical for outperformance. Within bonds, high quality corporate bonds remain attractively valued versus expensive government issues (Chart 4).

Timing when this period of equity outperformance ends will be important, given the risks in the global economy. The asset mix team at MFS MB will rely on our proprietary fundamental, technical and quantitative top-down indicators as a guide, as well as dialogue with our investment and research colleagues around the world.