



2012 Outlook

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European policy makers still appear intent on snatching defeat from the jaws of victory; successive 'crisis' summits promise comprehensive solutions but in reality are simply a further staging post towards a still uncertain destination. Therefore I see the outlook for 2012 - both in terms of economics and markets - as essentially binary, with equity markets' current middle path unsustainable.

Policy makers now talk of the grand plan for Europe as being a marathon and not a sprint, in part to implicitly criticise financial markets' impatience, as well as to highlight that the measures required to reduce deficits and improve competitiveness will take a long time. However, my view is that while trying to create the perfect outcome over the medium term, they fail to address the fractures apparent in the shorter term. To extend the marathon analogy, everyone understands that in order for athletes to complete the race they need to re-hydrate throughout it. Therefore to simply believe that economies will improve through fiscal reform and restructuring fails to recognise the reality currently faced. Without the ECB forcefully intervening in very significant size in sovereign debt markets to drive rates down to more sustainable levels, a growing number of countries will be unable to finish the marathon.

Despite the protestations of policymakers, the European banking sector is significantly undercapitalised and is precipitating a credit crunch through the region and beyond as it attempts to address its balance sheet problems. Furthermore, corporate confidence is leeching away, given that uncertainties are mounting and the economic recession, which has probably already started, will turn increasingly nasty into 2012. Before the crisis is over we are likely to see more banks nationalised as governments are the only place they can turn to for funding.

The reason why the prices of risk assets are not much lower is simply because market participants cannot believe that policymakers can continue to ignore the reality facing them and that they will have to dramatically shift tack. It seems incredible that it might take bank failures and a further recession before the policy change occurs. We've been frustrated for some time that the necessary steps have not been taken to allow the marathon to be safely completed but we still believe in the inevitability of the change. It was hoped that the recent move whereby the US Federal Reserve had to provide liquidity to the European banks to prevent a failure in Europe would have come with conditions attached, forcing the ECB to do far more. So far this has not been the case.

Unfortunately this intransigence is masking what is an improving story in the rest of the world. We've seen encouraging economic news out of the US and the start of policy easing in a number of other countries, including China, with more to come. I still believe that the necessary shifts will occur in Europe and that in combination with more supportive moves elsewhere, 2012 can turn out to be a decent year for credit and equities. However, without it the alternative could prove extremely challenging and almost certainly include a Euro breakup.

Source: rlam as at 22 December 2011 unless otherwise stated.

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