Economics
2 January 2013

"…and another thing…"

2013 outlook and themes

Fiscal cliff has been ducked until later this quarter, but not totally evaded. Once that is resolved, we see a better US and global growth outlook, the waning of unconventional monetary policy, the reduction of some tail risks and a different outlook for energy prices. 2013 could look quite different to 2012. That would make a pleasant change.

Cautious optimism is not a sensation we are used to, following five or more years of unbridled gloom, but although the ten points we list below start on a mixed note with the inconclusive outcome for the fiscal cliff, the balance of our thoughts for the coming year are more optimistic than they have been for some time (see also our latest Global Economic Update – *Darkest before the dawn,* 6 December 2012).

1) Fiscal cliff – cliff hopping
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Fiscal cliff – Cliff hopping

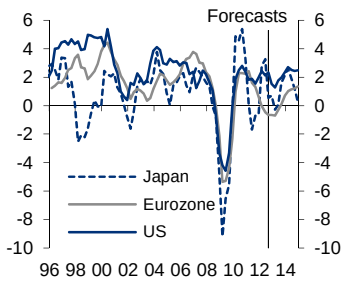
We start the year having avoided a Thelma and Louise style cliff experience. But the deal passed by both US houses deals with only the tax side of the problem. And it doesn't raise substantial amounts of revenue either. That means that the real work remains to be done with respect to spending cuts, and this is not going to be easy.

In many ways, what has been achieved is a very European style can-kicking exercise. If no deal on spending is reached by 1 March, then the automatic spending sequestering will go ahead as originally scheduled for 1 Jan this year. That gives the US two months to sort out this mess. A reprieve, not a pardon.

The agreement that has been reached is a pretty watered down version of President Obama's original request. Tax rises will occur, but only for those earning more than US$400,000 per year (US$450,000 for households). The payrolls tax cuts expire, hitting a much broader swathe of the earning public, adding 2% of tax take to the first US$13,700 of their incomes.

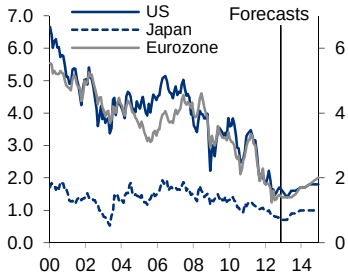
But there isn't much else. Some increase in taxes on dividend payments and capital gains, but again, limited to top tax earners, some increase in estate taxes, and the closure of some deductions for top earners. What this is not, is wholesale tax code revision. Many view this as a missed opportunity.

GDP growth (%YoY)



Source: EcoWin, ING

10Y bond yields (%)



Source: EcoWin, ING

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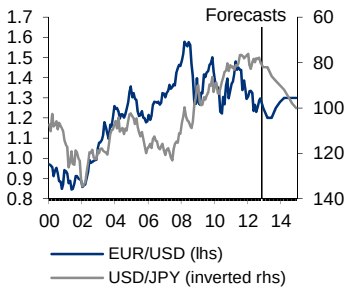

Source: EcoWin, ING

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Separating the fiscal cliff from the debt ceiling debate is not likely now

Furthermore, wrapped up with all of this is the debt ceiling debate. The US hit its debt ceiling of US$16.4tr on Monday, 31 December 2012. Treasury Secretary Tim Geithner can probably keep things together until after the 1 March deadline by shifting payments between state pensions and insurance schemes, juggling the money until such time as a resolution is reached. We still expect this to happen, and for the full sequestration to be avoided. Ratings agencies will probably give the US the benefit of the doubt until then.

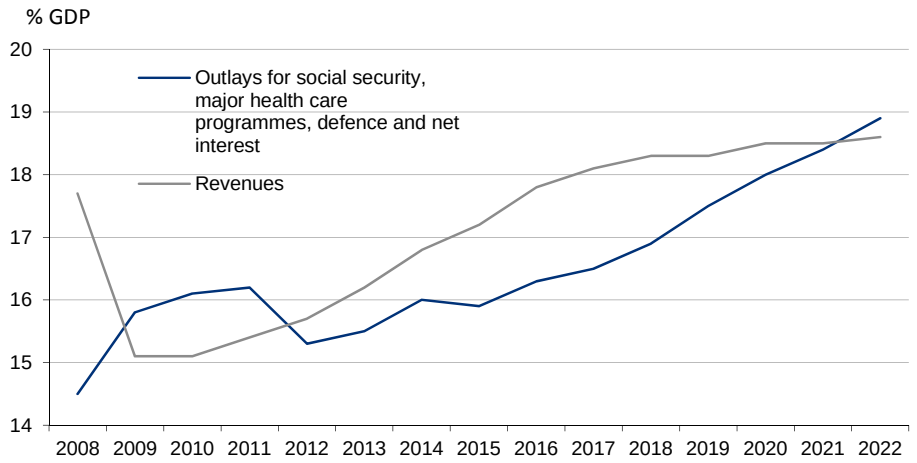
Finding the spending cuts necessary to avoid fiscal cliff by 1 March will not be easy

Whilst markets should view recent developments as a welcome step forward, in truth, this deal has not achieved very much. And the hard work is yet to be done. The upbeat tone that marks the start of the year could well give way as the 1 March deadline approaches, if we do not see some signs of progress on spending cuts. And in the end, the outcome will be for a much tighter fiscal stance from the US than in 2012 – the only question is, how brutal this is going to be.

But fiscal cliff is a distraction – the underlying picture is looking better

Having said all of this, we view fiscal cliff as a distraction, a temporary aberration, and not the stuff on which investment decisions for the rest of the year will be based. The US will face a more restrictive fiscal policy next year. And this will expose it to many of the same headwinds that held the Eurozone back in 2012. Nevertheless, the US enters restrictive fiscal territory from a much better conjuncture than the Eurozone. And our forecast 2.0% growth rate is not bad in a G-7 context, given this fiscal drag.

Fig 1 Projections for current spending and revenues



Source: CBO

2013 GDP outlook – going in the right direction

The direction of revisions is up…

Although it is not readily apparent, our latest monthly economic forecast update was unusual. What makes it stand out from many recent forecasts is that the bulk of the forecasts moved up, not down.

…even if the magnitudes are small…

The amounts of upgrade at this stage are small. And 2013 growth is not startlingly stronger than that in 2012. Indeed, it is weaker for the US, though that is almost entirely due to the poor start to 2013 and the weak end to 2012 induced by the ongoing uncertainties of fiscal cliff – which the latest deal have not removed. Stripping this out, we have some reasonable quarters of growth in the second half of the year. Indeed, if we see fiscal cliff properly settled by 1Q13, there is no good reason why 2Q13 should not bounce back strongly on pent-up demand.

…and the Eurozone is still skirting recession

For the Eurozone, the growth outlook remains fairly poor, with zero growth – a higher forecast than the ECB's own forecasts (though they are notoriously late to the game, and in forecasting weak growth, they also give themselves more room for policy manoeuvre). But to the extent that the Eurozone is still tightening fiscal policy in 2013, it is doing so at

a slower pace than in recent years (having finally realised what damage it does to growth).

Fig 2 ING GDP growth forecasts (%)

	2012F	2013F	2014F
World	2.4	2.7	3.2
US	2.2	1.9	2.5
China	7.7	9.0	8.4
Eurozone	(0.5)	0.0	1.2
Japan	2.1	0.9	1.6
UK	0.0	1.3	2.2

Source: ING

Both the UK and Japan face a slightly brighter future…

It is a similar story in the UK, where fiscal targets are being allowed to slip and base effects drop out. A faster UK outturn looks like a reassuringly 'safe' forecast, absent external shocks. Japan too may benefit from a new government determined to step up its monetary stimulus through more aggressive money printing. This should help Japan to weaken its currency, though it falls short of the sort of currency war horror story recently told by outgoing BoE Governor Mervyn King. This was a feature of 2010, and with good reason, given the QE being undertaken by the US back then and the countervailing capital controls introduced in emerging markets to stem the inflows to their economies. We don't see the same parallels with 2013.

…and China is also looking promising

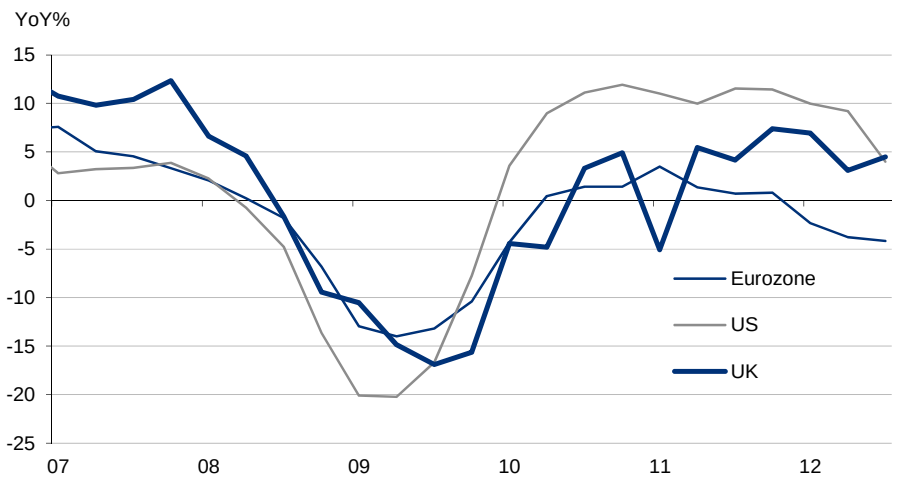
The other pivot factor for global growth outlook in recent years has been China. And here, the good news has also been outweighing the bad, with recent manufacturing PMIs adding to the sense that the economy has turned the corner. So overall, whilst 2013 can hardly be described as "full steam ahead", the direction is at least positive, and the revisions to consensus forecasts are also for the most part likely to be positive in the months ahead.

A return for capex?

Capex has been one of the weakest points for the G7 economies

One of the ongoing questions for economic analysts is to explain why global growth has been so weak in this recovery. A quick look at the sources of recent weakness reveals different answers. But one fairly common theme is the weakness in corporate investment. This is true whether coupled with a reasonable lending backdrop, as in the US, tight but recovering credit conditions, as in the UK, or still a downright awful borrowing environment, like the Eurozone.

Fig 3 Business fixed investment: EZ, US, UK



Source: EcoWin

…whilst corporate sectors remain flush with cash for the most part

Another common feature is that the corporate sectors of these economies are generally profitable, and with low debt-to-earnings ratios. What is missing, it seems, is not funds for investment, but simply a will to invest.

In the US, resolution of fiscal cliff could deliver some pent-up investment spending

In the US, corporate investment recently has been badly depressed by fiscal cliff. But this also builds up the potential for some pent-up demand from investment in 2H13 – depending on when the cliff problem is finally solved. UK corporate investment will likely pick up on the back of the better background for growth. Japanese investment may benefit from a more competitive yen and better regional demand. And in the Eurozone – well let's just say that it hopefully won't deteriorate any further, and might benefit from the improvement in sentiment overseas.

The consumer awakens?

There is less uniformity on consumption spending, reflecting national characteristics…

In contrast to capex, there is less uniformity about the consumer sector in the developed world. Consumer spending in the US has always been stronger than would be implied by sentiment or earnings data. Whilst in Europe, even strong-man Germany has always tended to disappoint when it comes to consumer spending, even if employment and wage fundamentals have been good. What we see in terms of consumer spending seems to reveal as much about the household characteristics of a nation, as about the economic backdrop.

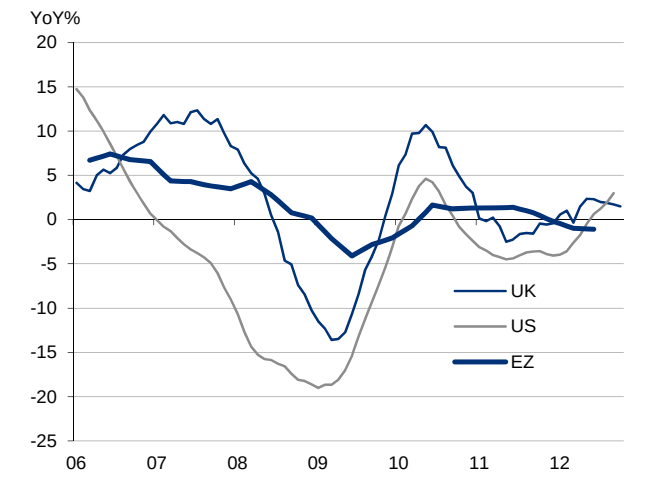
…but where housing markets are recovering, there is scope for better consumption

Saying this, there are some reasons for more optimism. US and UK employment is improving. In neither country is it being combined with much in the way of wage growth, but inflation is low, and the aggregate effect is for incomes and spending to rise.

The house price - consumption link is especially strong in the US

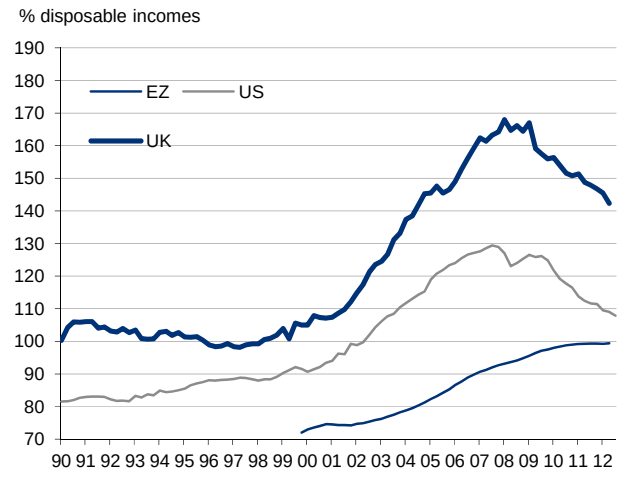
Furthermore, in both the UK and the US, housing is playing a more positive role. With household sentiment and house prices inextricably linked in these two economies, and household finance also linked to levels of negative equity in the US, and the Funding for Lending Scheme providing support to the UK mortgage market (though not much else at present), consumer spending in these countries may also see some recovery in 2013.

Fig 4 House price inflation



Source: EcoWin

Fig 5 Households and NPISH debt to disposable income (%)



Source: EcoWin

Deleveraging is not complete, but may be slowing, which will also help

There may also be some sign of a slowdown in household deleveraging in the US and UK, though it is early days and the levels of household debt still seem high relative to historical averages. But deleveraging as a ratio of disposable incomes does not require absolute cuts in debt, just that indebtedness increases slower than incomes, and that could provide another small boost to spending if savings rates begin to trend down.

Again, the Eurozone is a potential outlier here. Though in its case, as with capex, any incremental weakness is likely to be smaller than it was in 2012, and could be helped by a scaling back of the fiscal consolidation efforts mentioned earlier.

Commodities – finding some support

Better growth should help industrial commodities…

The earlier stories of increased economic growth, including a resurgence of capex, and a more modest pick-up in consumer spending are good news for industrial commodities. However, this general demand pick-up is, we believe, likely to be offset to some extent by the scaling back of incremental unconventional policy easing.

…but the effects here may be limited as QE effects wane…

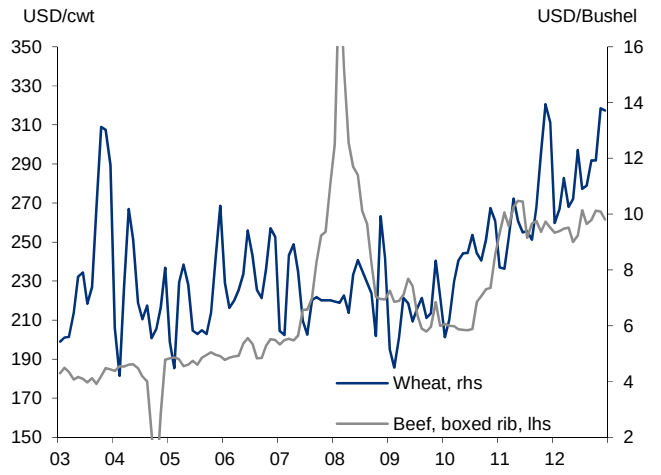
Although it is a bit too early to call for the death of US QE in 2013, we can see it beginning to play a smaller incremental role, taking pressure off the USD to depreciate against the majors. In dollar terms, this suggests that commodity prices need not rise too far in USD terms.

…as too may the effects on gold and other precious metals

We consider energy separately, but precious metals demand is, in simple terms, a combination of Asian consumer demand and reflections on the dollar. With Asia – in particular China – finding its feet again, this therefore delivers half-hearted support to gold and other precious metals, whilst the absence of substantial QE expansion will remove the demand for fiat currency substitutes from investors.

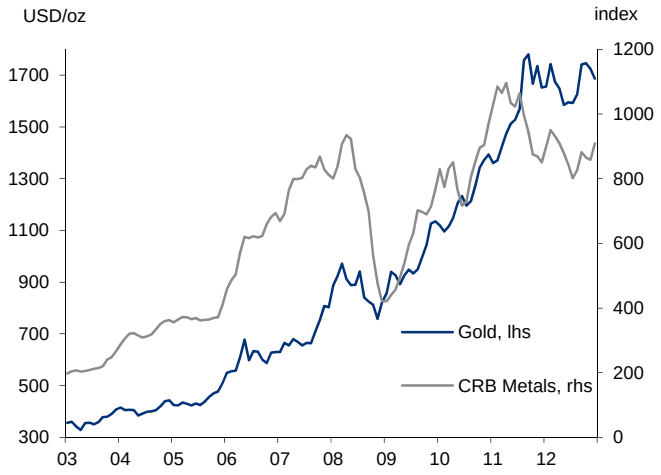
This does not suggest a rout in gold, far from it. But we can see a case for a flattish to somewhat lower gold price, though fiscal cliff may give gold prices a final boost before any softening.

Fig 6 Agricultural prices



Source: EcoWin

Fig 7 Precious and industrial metals



Source: EcoWin

Agri prices are set for a rebound from last year's supply shocks – but the weather is a wildcard

As far as agricultural markets, the die for many of these markets was cast earlier in 2012, with the very unhelpful weather conditions in many parts of the world affecting the wheat and meat markets in particular. Prices here are likely to remain elevated through the early part of the year, but may fade in 2H13 as high farm incomes encourage overplanting and the rearing of livestock. What the weather does next year is a closed book to us. But on the highly risky assumption of a reversion to mean temperature and precipitation, prices of these agricultural commodities may also drift lower in 2013.

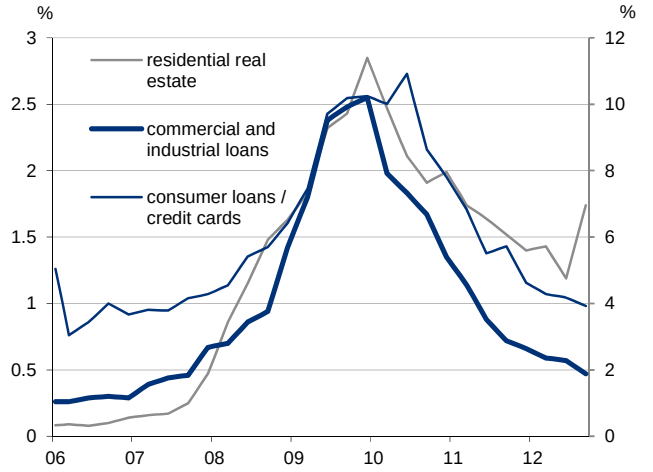
Financials finding their feet?

It is becoming harder to be negative on the financial sector

At the risk of being accused of 'talking our own book', there are some better reasons for assuming that the financial sector starts to deliver better results. Firstly, the improvement in the economy and capex resurgence is likely to enable, if not vastly higher lending volumes (which are still likely to be dictated by regulatory pressures), at least some wider lending margins. Adding to this is the creeping sense that tail risk in Europe is being

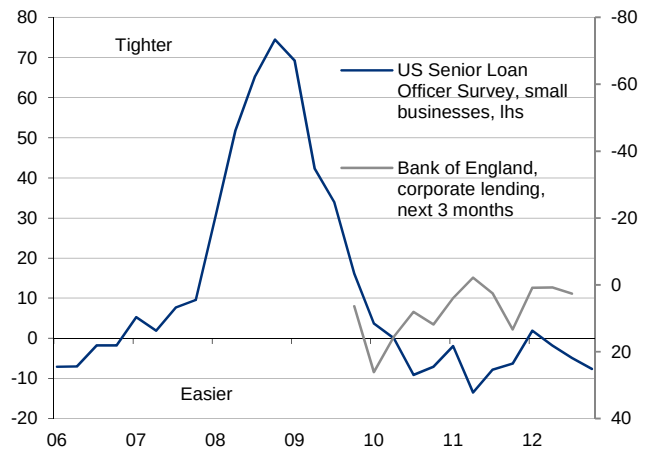
taken off, which may help lower borrowing costs. For example, cross currency basis swaps and continued recovery in the covered bond market. And whilst one can never say never, it looks as if an imminent exit of Greece from the Eurozone is not on the cards, and that the Spanish situation is also 'manageable', albeit without having unleashed a single euro of the OMT fund.

Fig 8 US bank charge-off rates



Source: EcoWin

Fig 9 US and UK lending conditions



Source: EcoWin

Lending conditions are still not exactly great…

Bank lending conditions are improving in some areas, notably in the UK (from a very low base). In contrast, earlier improvements in the US seem to have stalled around a neutral level. In the Eurozone, conditions still look tight, but may have stopped deteriorating.

…but charge offs are generally down

But perhaps just as important as lending volumes, which even if they improve will probably remain fairly soft, are charge-offs and write-downs. This is especially true in the US and UK, where mortgage markets seem to be in slow recovery mode. And the market value of some structured mortgage products on banks' balance sheets might improve to the overall benefit of the banks' solvency.

QE – running out of "puff"

Even if we see further QE expansion, we feel that the hey-day for QE is long past

Even though we might not yet have seen the end of QE in the US or UK, and Japan is about to embark on even more of this policy from the middle of next year (assuming a new BoJ Governor from April), we believe that the 'Golden age of QE', when we actually thought it might have more than a transitory impact on risk sentiment and the currency, is drawing to an end. And with the exception of Japan, for most countries already embarking on QE, we are probably drawing towards the end of the line for this policy – either in terms of the amounts of assets purchased, or the impact on markets that such purchases have.

Outgoing BoE Governor, Mervyn King, already seems to view QE as a policy that has done its bit, with marginal increases in QE having substantially diminishing returns.

A better economy and more reliance on forward guidance will likely relegate the importance of QE in the US

Fed Chairman Ben Bernanke has not yet made the same confession, partly, we believe, for fear that such an admission might unduly unsettle markets. The Fed increasingly seems to believe that its future lies in massaging market expectations, and so QE may play second fiddle to changes to forward guidance in the coming quarters. If we accept this proposition, then it has some important implications. Most notably, these include the USD, which will as a result be marginally more supported than it has been recently. In turn, USD-priced commodity materials will likely be softer relative to the counterfactual, and equities and other risk assets slightly less well supported too, though we believe that part of the reason we should expect QE to play a decreasing role is the broader-based

improvement in the backdrop for risk assets, so the equity outlook remains positive on balance.

Housing boomlets

Can housing strength become a new theme for growth in 2013? …

The housing issue is more of a story for the US and UK, where house prices have been rising on a trend basis. The outlook for housing in many parts of Europe remains badly challenged. Though perhaps there is scope for optimism that rates of decline may begin to level out this year. We wouldn't push this optimism too far though.

…probably yes, but don't hold your breath in the Eurozone

In the US, house prices are now rising consistently, and although they are only growing by 3.0% YoY, in line with disposable incomes, they are on an upward trend, whilst incomes so far are not.

A reduction of negative equity is an important feature of the US market…

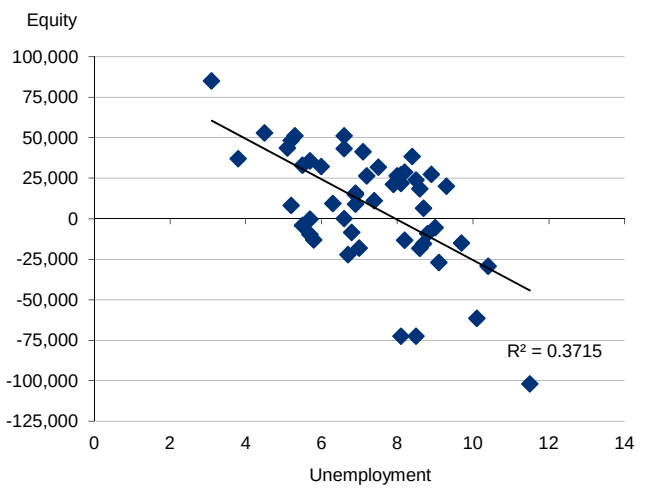
The upshot of rising house prices in the US is widespread. In the first place, this is supportive of household wealth, improving consumer sentiment and spending. But it is also important because it eliminates the overhang of negative equity that has weighed on labour mobility, and kept the long-term unemployment rate as high as it is. In Figure 11 below, we illustrate what the position for a theoretical household would be, having bought a property with a 95% loan to valuation at the peak of the housing market in 2006 using a 30Y fixed mortgage. Principal repayments, plus a recovery in process would leave such investors broadly flat – a marked improvement from recent years "underwater".

…but credit availability is also important there

But there is also a credit element to the US story. The elimination of negative equity in the US as mortgages are paid down and prices rise once again, will make refinancing increasingly available to households, unleashing spending power to augment the soggy income gains from employment.

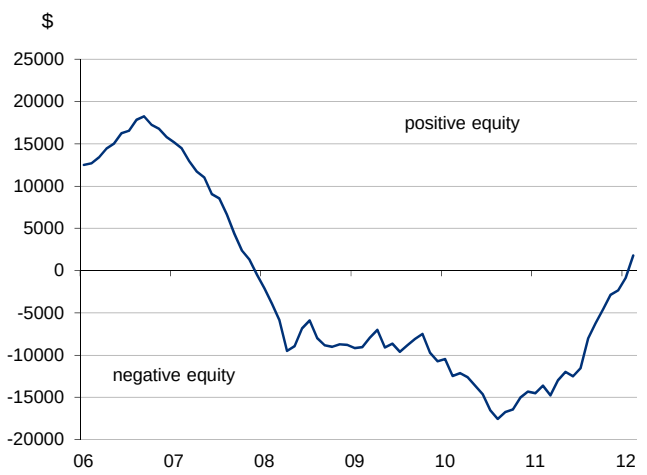
The story is similar in the UK, though the refinancing part is less important there, as mortgages tend to be variable rate in the first place, and only refinanced on the expiry of discounted rates. Nevertheless, with housing equity the single-largest component of household wealth, consumer spending is quite sensitive to improvements in this sector.

Fig 10 US unemployment rate by state and housing equity



Source: EcoWin, ING

Fig 11 US illustrative housing equity[1] (national basis)



Source: EcoWin

What is driving housing recoveries differs from place to place

Just why house prices are recovering differs. In the US, this simply looks like a market that has cleared, with price-to-rent and price-to-income ratios down to, or below, historical averages. In addition, the overhang of new and existing homes seems to have declined

[1] Assumes house bought in mid-2006 with 95% LTV and 30Y fixed mortgage

to a point where it is actually pushing prices higher, rather than being a drag. Trillions of dollars of QE will not have hurt the US housing market either.

In the UK, the structural undersupply of housing units means that without a strong negative backdrop, the natural tendency of housing is to rise against incomes, and this now seems to be happening again.

We worry that the US could be exhibiting early "bubble" signs

In both countries, central bank policy is supportive for house prices. Though in the US, the rest of the economy is looking sufficiently healthy (ex-fiscal cliff concerns) that further monetary pump priming of the housing market looks like the possible beginnings of the next asset price boom. Whereas in the UK, the backdrop remains sufficiently weak to see house price rises there as less ominous.

Tail risk in Europe ebbing

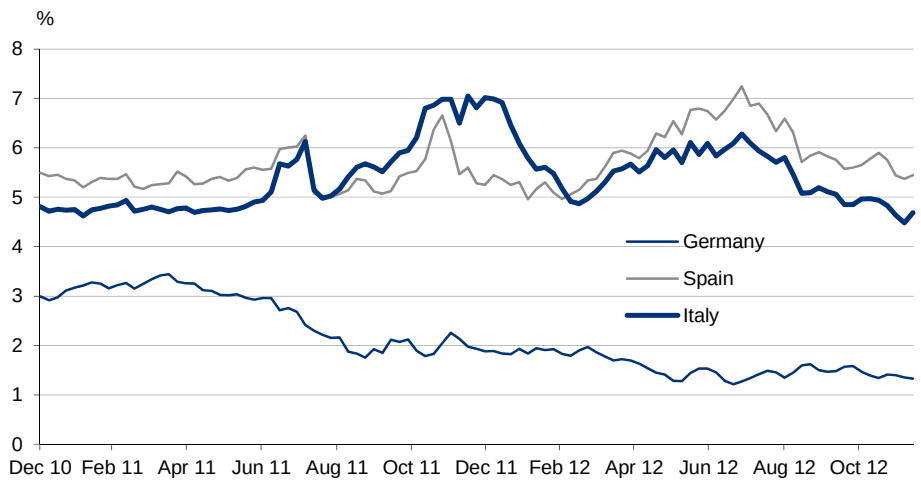
Greece is still a problem in Europe, but it is no longer an imminent problem…

At the risk of jinxing the future, it looks as if some of the biggest risks to the Eurozone project are abating. The recent agreement on the next tranche of bailout money for Greece, the revised terms and extended date of the bailout, and the well-received plan to buy back Greek bonds from the private sector seem to have taken Grexit and at worst, parked it sometime into the future.

…and Spain looks less of a clear and present danger than it did

Related risks, such as Spain's debt pressures, have also benefited from the inception of the OMT – the greatest policy that never was – with 10Y yields dropping. Of course, if the Spanish situation deteriorates again, we can always anticipate a request for OMT assistance, and in so doing mobilisation of the EMS. It seems wrong to say so, but finally, the Eurozone may have found a credible backstop to the region's problems – even if those problems still loom large in some peripheral countries.

Fig 12 Core and peripheral European bond markets



Source: EcoWin

Bond markets have shown some convergence of the periphery with the core…but no sell off from the core yet

In conjunction with an improving backdrop elsewhere and a pick-up in risk sentiment, the need to keep running for the safety of Bunds and other core European bond markets seems less pressing. Indeed, were these trends to continue, we could see a two-way narrowing of core-peripheral bond spreads, accompanying an overall increase in Eurozone average bond yields. So far, any improvement in outlook has been one way only, stemming from lower peripheral yields, not rising core yields. There is scope for this to change.

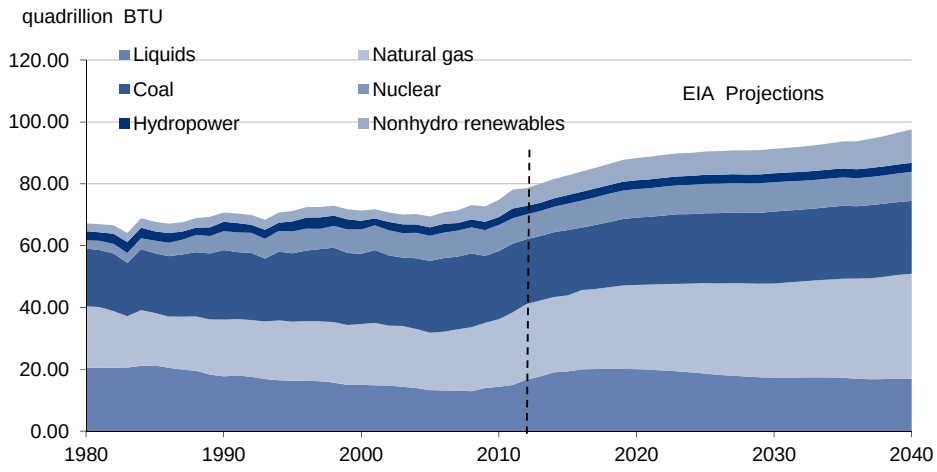
A more supportive energy backdrop

Love it or hate it, shale gas is here to stay…

Not everyone shares a love for shale gas. But the Energy Information Administration now speaks of shale gas as turning the US into an energy self-sufficient nation and a net

exporter of natural gas. Current production trends are impressive, though extrapolation of these may lead to as inaccurate overestimations as the earlier underestimates.

Fig 13 EIA projections of US energy production



Source: EIA

That said, a couple of things are clear: firstly, the US is now awash with energy, oil and gas. Secondly, substituting existing fossil fuel technology for gas can result in both cost and carbon savings. The US already exhibits a massive cost advantage in energy in terms of its manufacturing industries. The rest of the world seems destined to try to follow or to lose market share to the US. The UK government has just granted drilling rights for shale gas, though environmental concerns are holding back the Eurozone from doing the same just yet. Furthermore, Asian attempts to plug into this new source of energy have so far not been very fruitful.

Environmental concerns remain…

It took the US only five years from moving from 'experimental' fracking (hydraulic fracturing) to making this a substantial industrial operation. Europe may take longer. Property rights are less supportive for fracking on private land, and the geology is less helpful than in the US. The environmental judgement is also still being assessed, though we sense a growing consensus that fracking need not be environmentally damaging, even though it can be if done badly. In this, fracking is no different to anything else.

…but cheap energy prices will create their own demand for this fuel

Turning shale gas into a 'revolutionary' phenomenon might require something like the re-engineering of the US auto fleet to run on LPG, and associated infrastructure development. To many, this sounds like a pie in the sky dream. But it could at a sweep cut US greenhouse emissions, whilst providing US households with a huge running cost saving for their transport. Public transport and road haulage are increasingly making this switch. We cannot see any reason to rule out a more ambitious lower energy cost future, with the US in the vanguard.

Summary

So whilst the near term is still likely to be dominated by the fiscal cliff and debt ceiling debates in the US, we suspect an eventual compromise is reached, unleashing a better economic environment – in spite of tightened fiscal policies. The global outlook is shaping up too, and though Europe remains a fly in the ointment, at least it doesn't seem to be getting markedly worse – these days, that is as good as a "positive" for Europe. After wallowing in recession and market weakness for years, could 2013 pave the way for a brighter future, buoyed by restrained energy and commodity costs? We dare to hope so.

Good luck, and happy New Year.

Disclosures Appendix

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