

FROM STIMULUS TO REBALANCING

Questions (and answers) on the global economic outlook for 2014



November 2013, Atlanta GA

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Overview

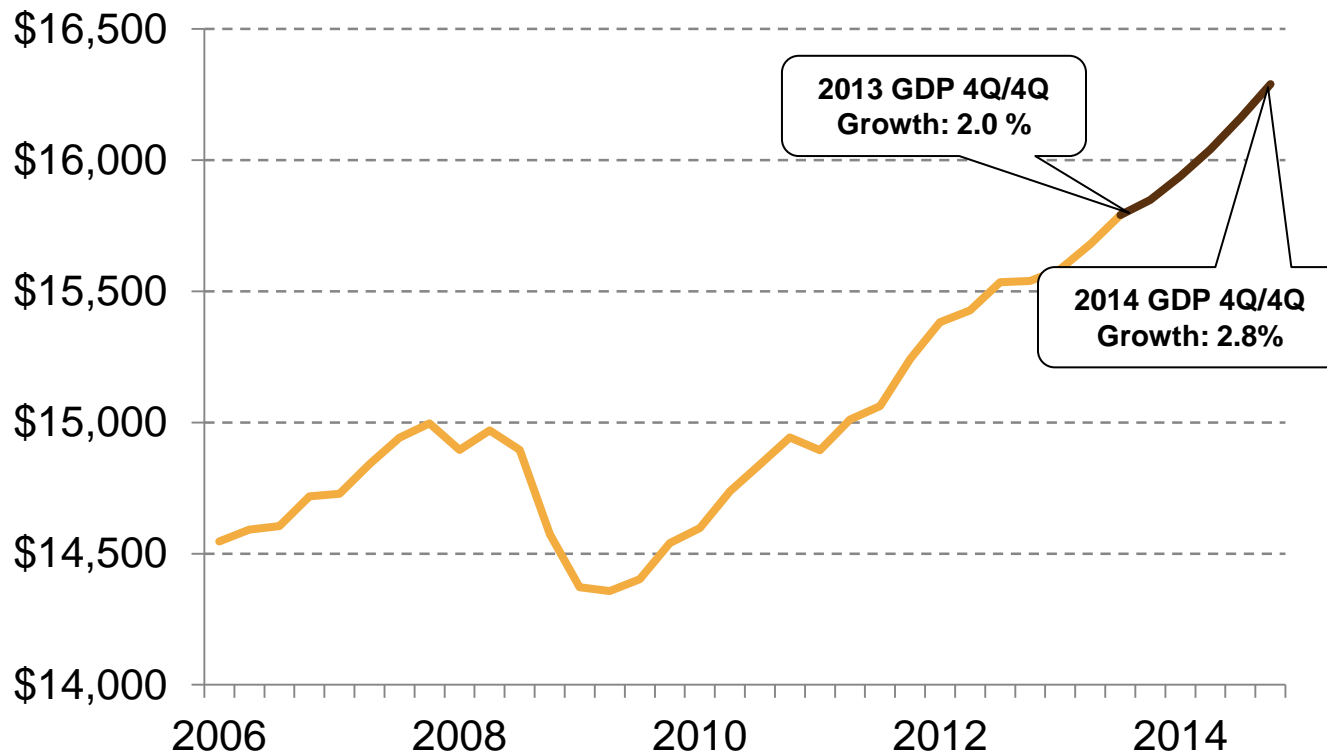
- I. A key assumption: slow progress in the U.S.
- II. Monetary policies: going out of synch?
- III. Financial markets: toward greater volatility
- IV. Europe: between stabilization and new risks
- V. China: the reacceleration that won't be
- VI. Japan: bolder policies in a compromised context
- VII. The Best of the Rest: strong fundamentals offer options
- VIII. The 2014 Watch List

Does the world still catches a cold when the U.S. sneezes?

Unfortunately, hopes for a steady progress to better growth have been dashed. While we don't anticipate much American sneezing for 2014, persisting uncertainty about fiscal policies, LSAP tapering, uneven labor market improvements and weak business spending will delay the much anticipated acceleration.

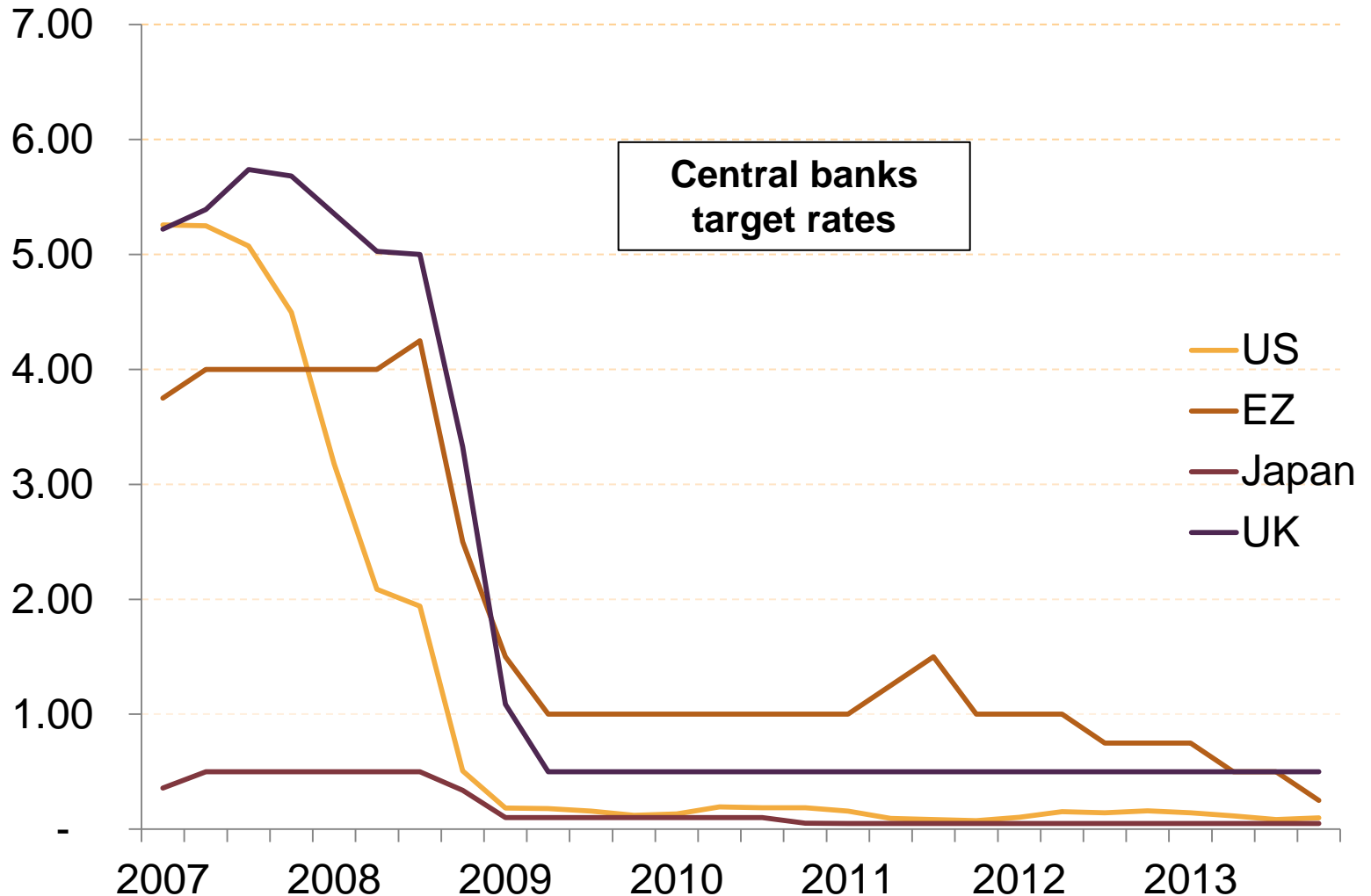
U.S. GDP and Forecast

\$ billions



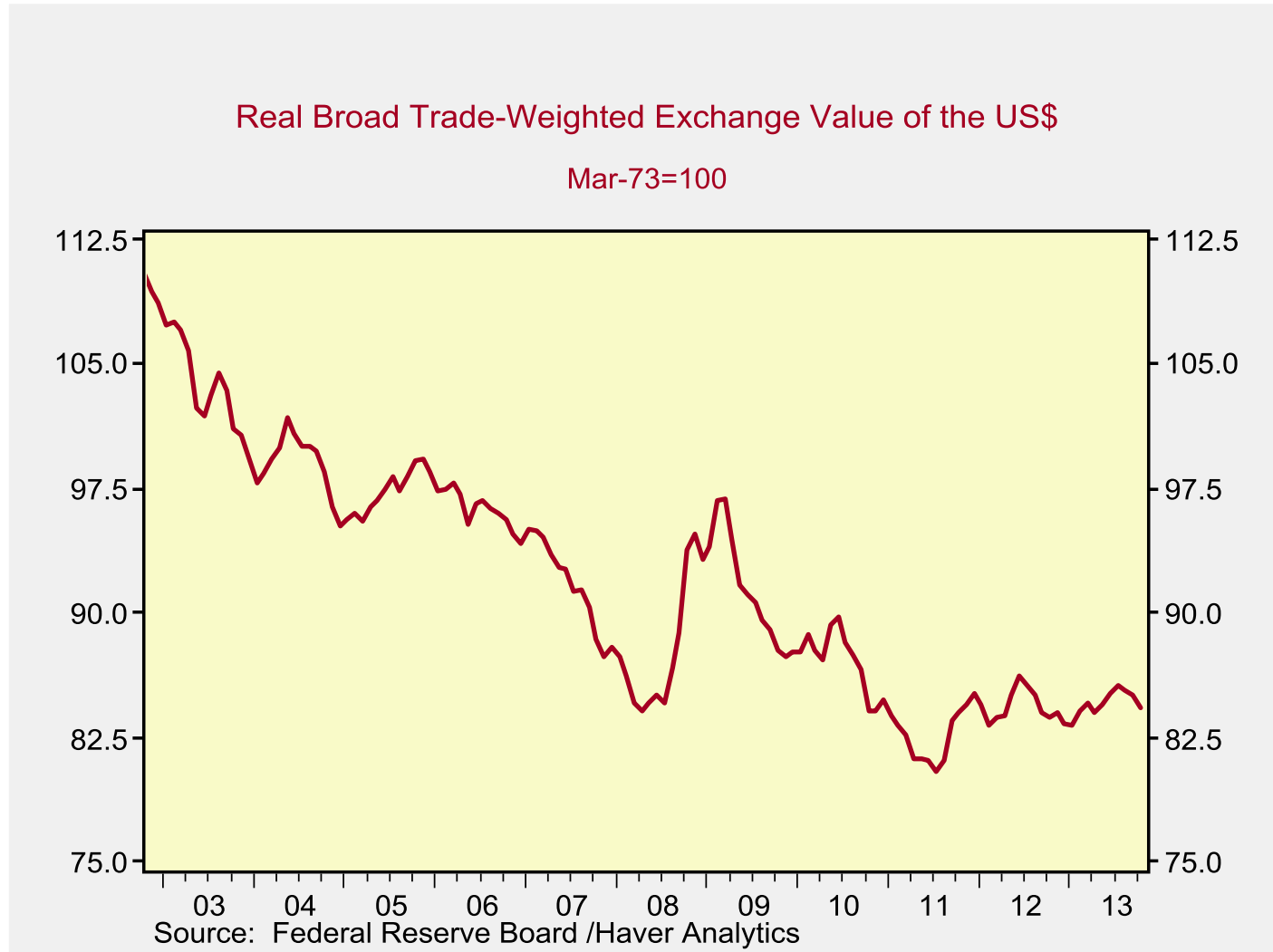
Monetary policy: global easing... for how long?

Since 2007, central banks around the world have remained pretty much in synch. With tapering at the horizon, are we entering a new stage of policy dissonance?



The dollar: at the end of the bear run?

The greenback has experienced many years of progressive weakening, only temporarily reversed by the flight to safety of 2008-2009. Is it time for a turnaround?



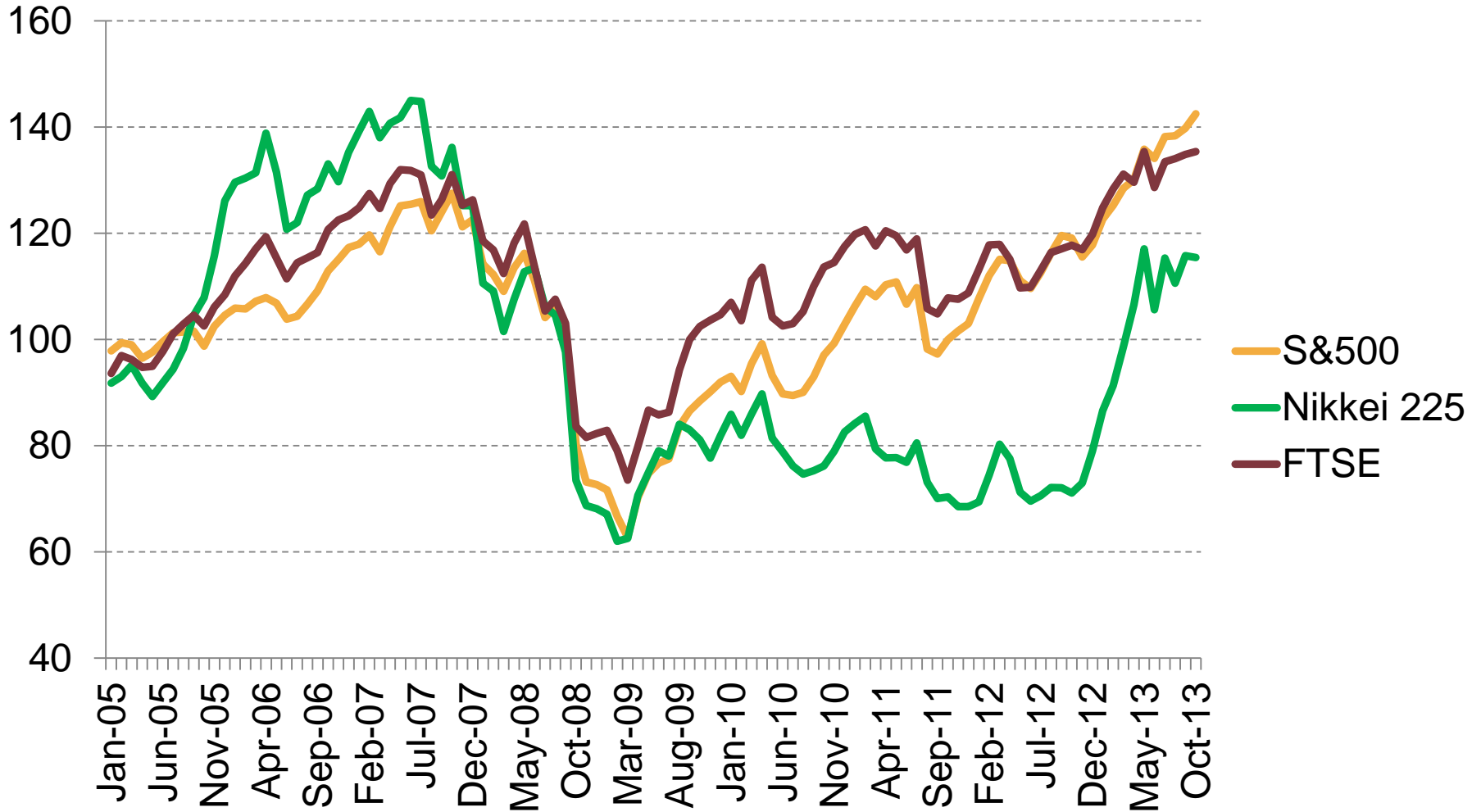
Emerging markets are losing their luster

As shown in the volatility of the MSCI Emerging Economies ETF, emerging markets appear to be quite vulnerable to the Federal Reserve's next move. A delay of tapering may have delayed the adjustment by just a few months.



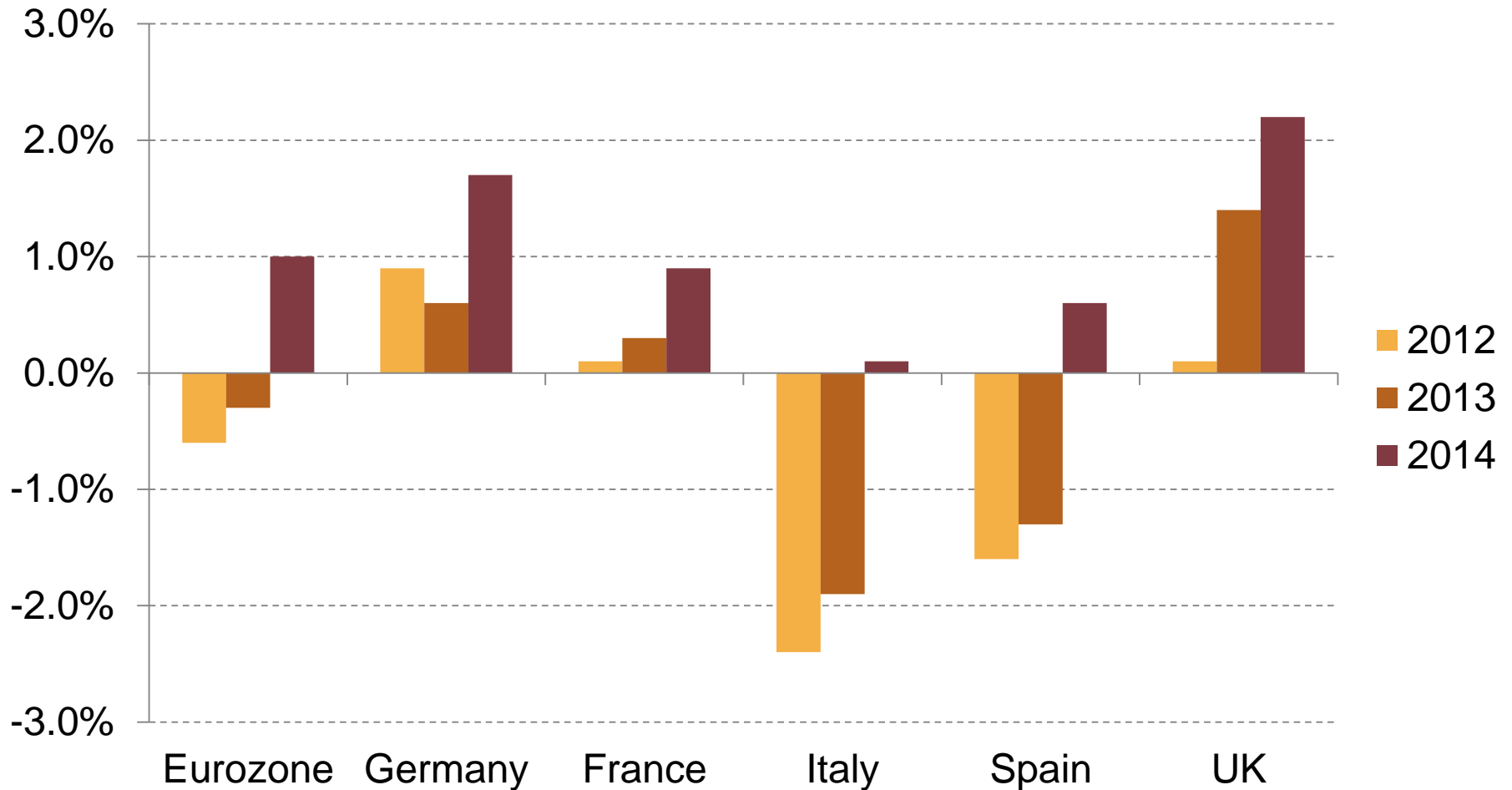
Equity market in advanced economies: the bulls keep riding

Monetary accommodation and economic stabilization are a powerful driver of higher equity prices. Are markets getting frothy?



Europe: structural reform and reformed expectations

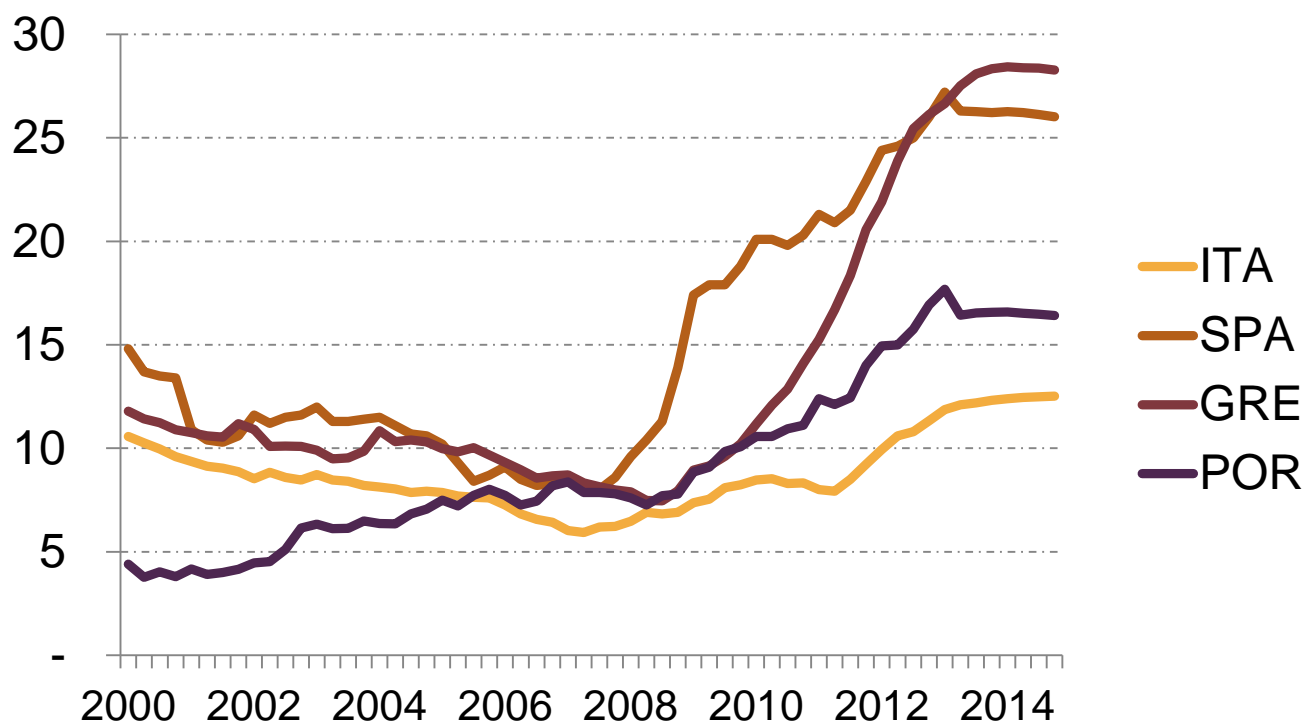
The Eurozone will experience a modest recovery (+1%), with growing divergence across countries: Germany will continue to expand, while France is stagnating, Spain improving, and Italy failing to fully recover.



Europe: unemployment peaking at the periphery

With financial markets stabilized (for the time being), and structural reform taking place at glacial pace, unemployment has possibly peaked in 2013 in most of the embattled countries at the periphery. But do not expect a quick turnaround.

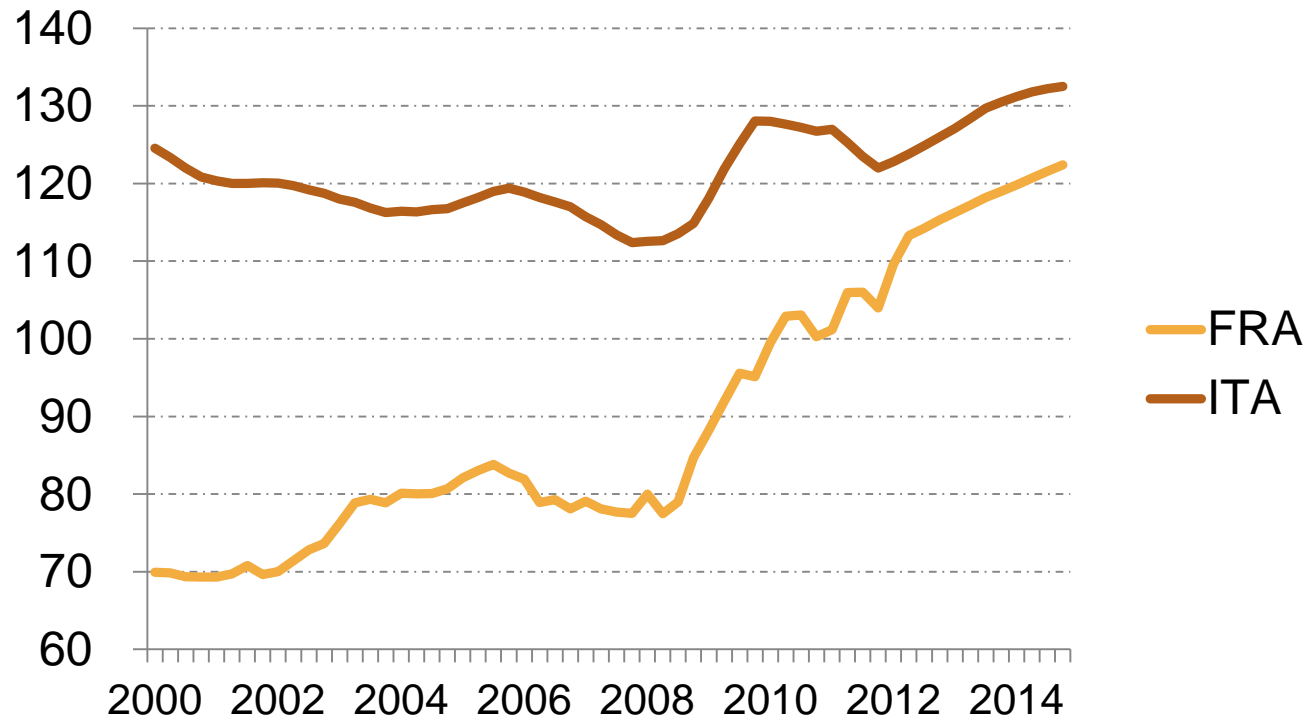
Unemployment in Selected Eurozone Countries



2013 – the year France moved from the core to the periphery

The crisis has temporarily subsided, but new challenges wait for the Eurozone and the European Central Bank. Is a fiscal crisis looming in France?

Government Debt as Percent of GDP France vs. Italy

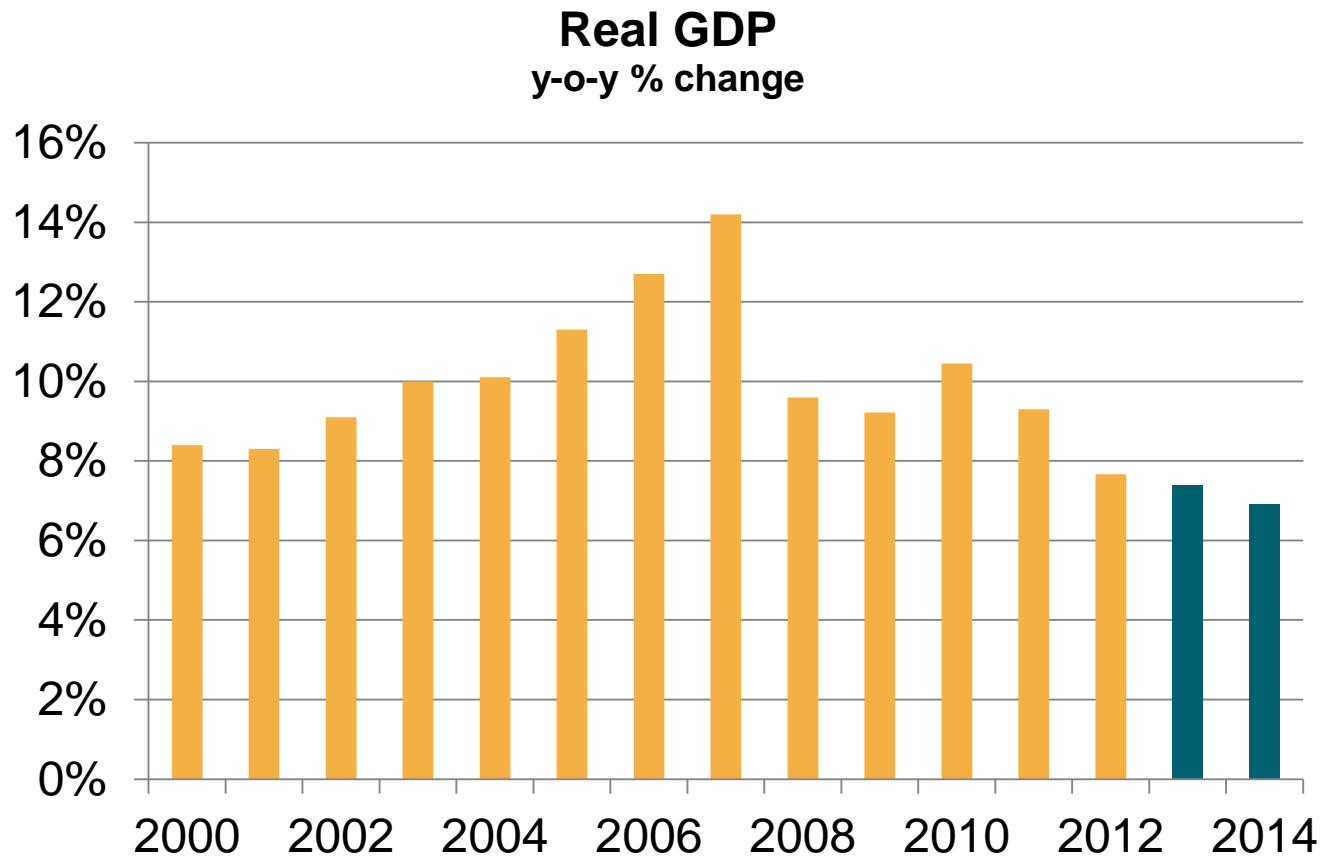


What to expect from Europe?

- Growth will underscore the divergence between stronger economies (the German “core”) and the lagging Southern periphery (maybe with an upside surprise in Spain.)
- The financial crisis is on “hold.” The European Central Bank has deployed a big bazooka, and no investor has much of an appetite to test it as a target.
- Yet, new tests wait for the Eurozone. Italy remains in uncertain political transition; Greece will inevitably default on its obligations toward international financial institutions such as IMF, ECB; policymakers are kicking the can down the road on fiscal consolidation and structural reform.
- The fiscal position in France is rapidly deteriorating, and will pose new threats to the stability of the common currency area.
- The political commitment to the euro remains very solid. A domestic weakening of Mrs. Merkel in Germany might in the end strengthen, rather than weaken, the cooperation between European partners.
- A referendum on the EU in the United Kingdom, and London’s eventual exit from the EU, would generate short-term financial instability but result in a stronger Eurozone (and a weaker England.)

China: the reacceleration that won't be

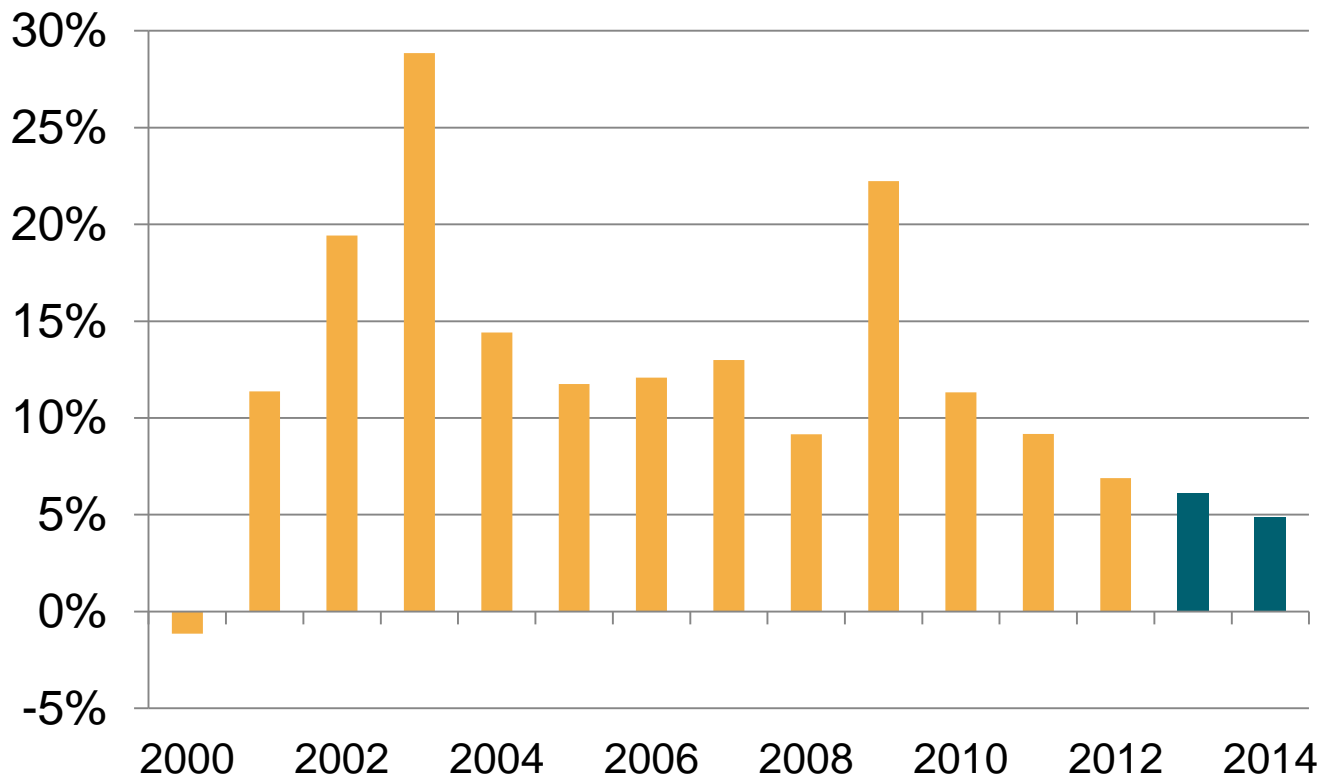
The landing was ultimately soft, but important imbalances persist in China. With a new leadership trying to strike a delicate policy mix balance, we anticipate a cautious approach to rebalancing the external position and the composition of internal demand.



China: when GDP does not create economic value

For a hybrid economy, where important command-and-control aspects coexist with market forces, the growth of GDP does not immediately imply the creation of economic value – especially when money is spent in large infrastructure investments.

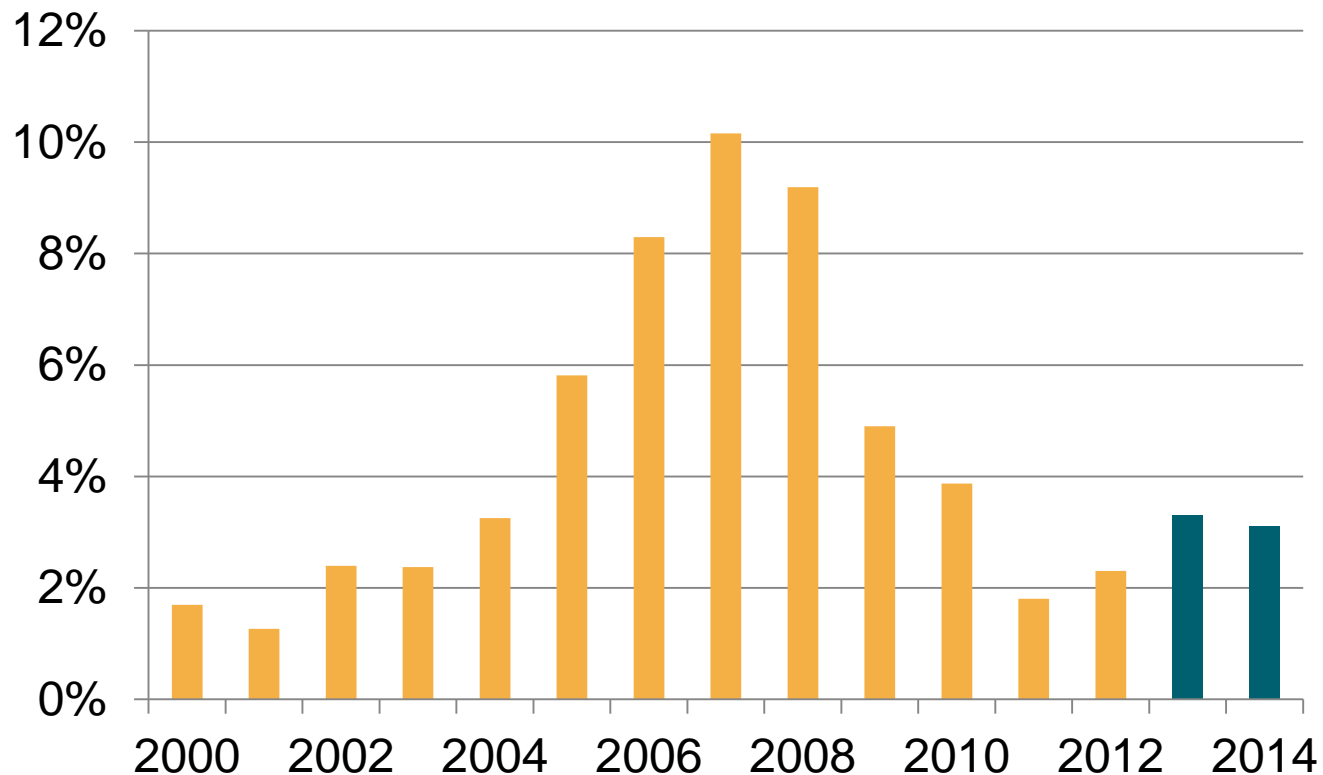
Total Fixed Investment



An export-led economy dealing with the global “new normal”

Exports have been a key ingredient in the Chinese development story. As major industrialized countries adjust to the “new normal”, can China adjust accordingly, and if so, then how? Will internal political factions allow for the much-needed rebalancing?

Current Account Balance as % of GDP

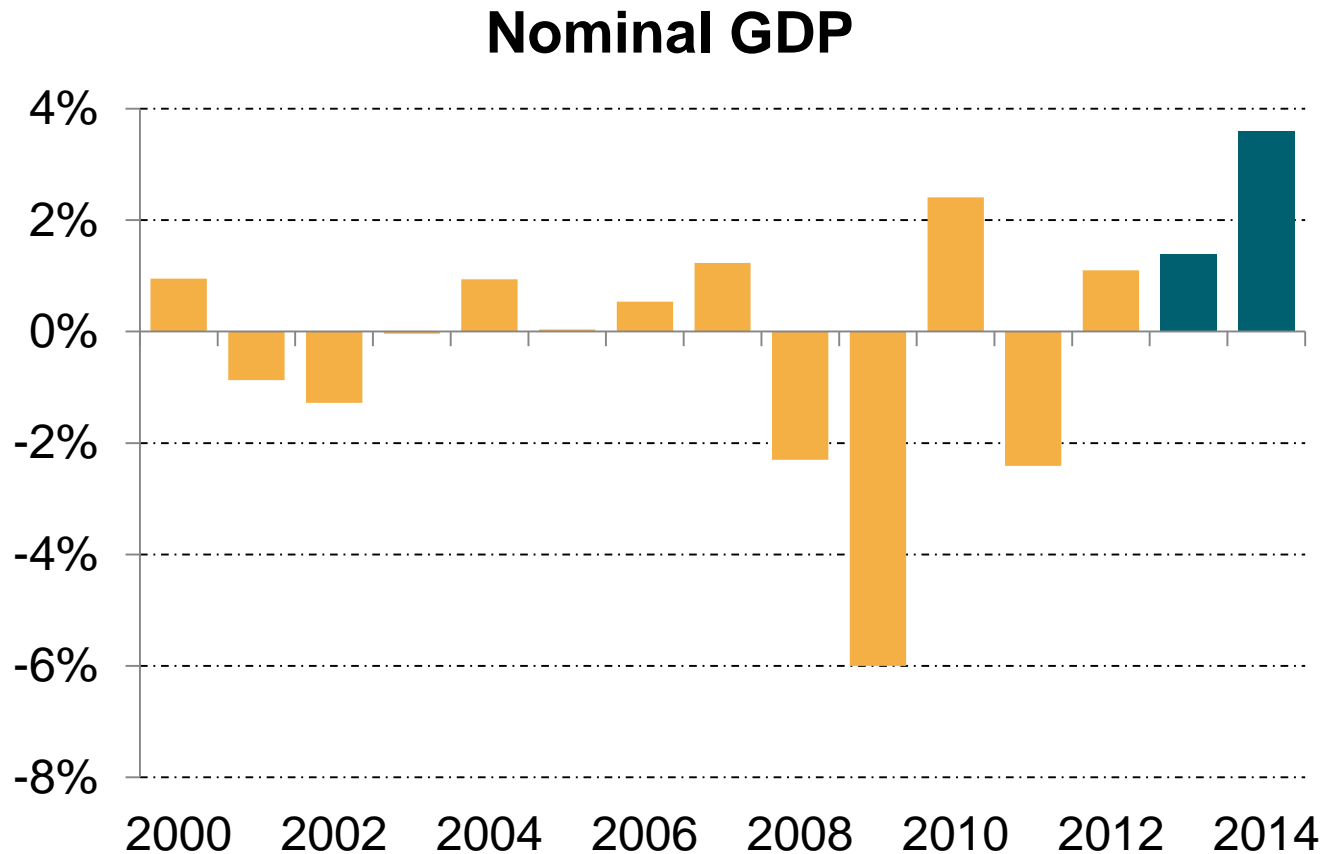


What to expect from China?

- China has been a phenomenal story of economic growth and development: but past performance is not an indication of future results.
- The Chinese model was – and still is – based on export-led growth, and large investment in infrastructure. The former appears hardly sustainable at the same pace of the recent past, and the latter may contribute to GDP arithmetic, but less clearly to the generation of economic value.
- The political transition is a major variable in the economic outlook, as the role of the party's factions and lobbies is reassessed.
- We expect China to continue on a path of solid, but not exceptional growth (around 7%), but we wonder where the future lies for the country: will it become a functional autocracy with a thriving market-based economy (think South Korea in the 1970s and 1980s), or will follow Russia along the path of a dysfunctional oligarchy ruling over a dysfunctional economy?

Japan and the disinflationary plague

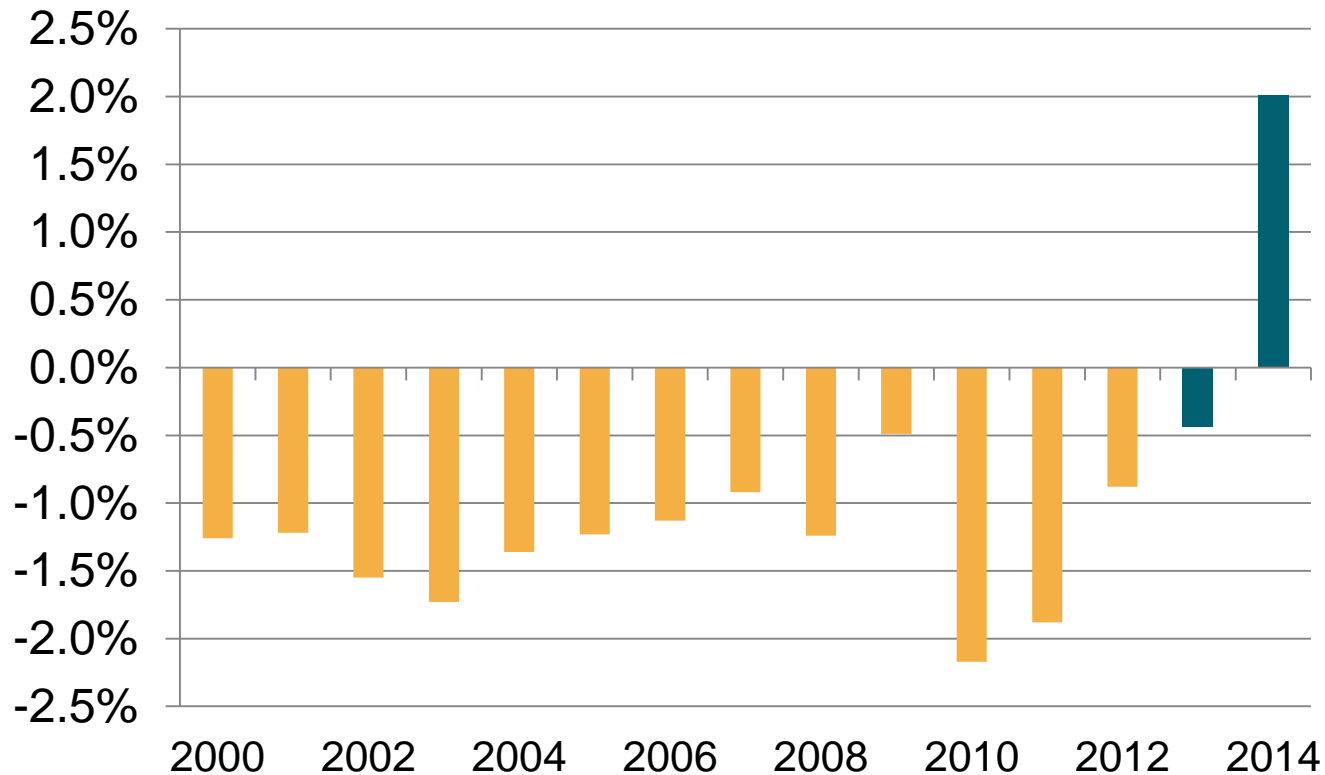
Japan has lost almost two decades in fighting, mostly unsuccessfully, persistent disinflation. Economic performance has been spotty in the recent past, but Abenomics is a real game changer – in the short term. Will it succeed in the long term?



Japan: setting an inflation target

The BOJ has set an ambitious inflation target of 2%, following years of price declines. The target is achievable – doubling the monetary base over an 18-month period will indeed reflate the economy. But it will not fix what Japanese need most: better demographics and more competitive domestic markets.

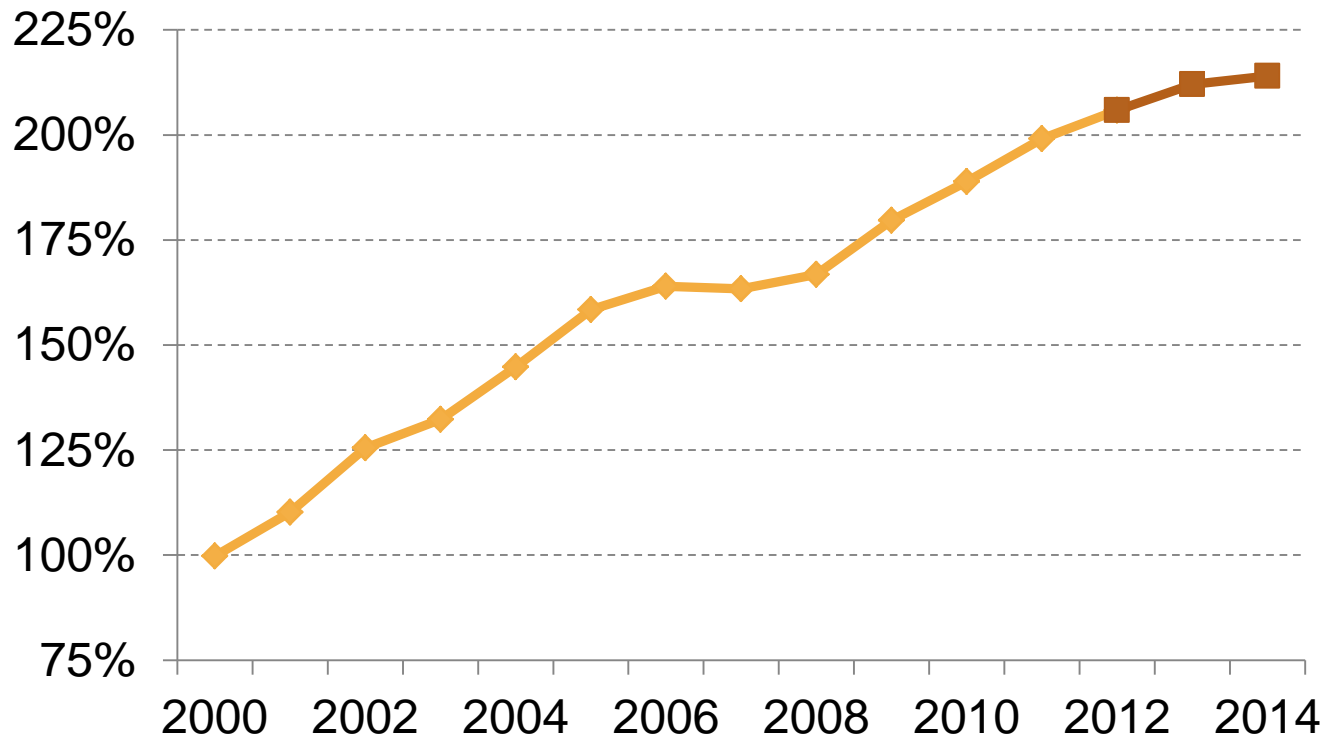
GDP Deflator



Japan: financial imbalances loom

A major risk for the country's financial stability is the ever-rising size of the government debt. Up to now, the internal market has been capable of absorbing most of debt, but going forward we anticipate aggressive sales of Japanese bonds on global markets, with likely consequences for interest rates around the globe.

Gross government debt
as % of GDP



The Best of the Rest

There is a selected group of small developed countries and large emerging economies that inspire confidence, in part because of strong macro and micro fundamentals, in part because of solid market institutions:

- In the Northern hemisphere, Canada and the European Nordic countries (e.g. Sweden).
- In Central Europe, Poland and the Czech Republic.
- In Latin America, Brazil and especially Chile.
- Australia and New Zealand.

Many of these countries have been beneficiaries of the commodity boom in the past few years, but all of them appear to have diversified economies, with a relatively established middle class and the capacity to generate demand and supply beyond the space of raw materials markets.

The 2014 Watch List

- Russia – the BRIC failure story. Despite its position in the energy market, we do not see much strength in the economy, we doubt its rule of law, and we question how attractive the country can be to foreign investors.
- India – it has yet to find a consistent way to create sustainable growth momentum and generate the same thrill that China achieved for the last 15 years. Institutional weakness and inadequate infrastructure are holding back what may soon become a center of global excellence in research and technology.
- Indonesia – any country with a population of 230 million and strategic position along the global trade routes should become a case study in what is working or not working in economic development. We are just not sure whether Indonesia will become a good example, or a bad one.
- Turkey – it undertook unprecedented efforts to become a junior partner of the European Union, but to no avail (mostly because of the short-sightedness of its Western partners.) In the process, the country built a robust and resilient economy. Now Turkey is launching a bid to become a regional superpower in the Middle East, following the disruptions of the Arab Spring. It is a tough neighborhood, and the gamble can pay off handsomely – or fail miserably.



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