Royal Alliance

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Global Economic Commentary

Our Top 12 for 2012

It's that time of the year for us to step up and take a stand on some of the primary themes underlying our forecasts for the rest of 2012. We have been floating some of these since last summer and our regular readers are familiar with many of them. We look forward to looking back and reviewing these thoughts on December 31, 2012.

1 **The growth economies in general — and Asia in particular — remain in the strongest position globally** to enact easing policy measures (both fiscal and monetary) during 2012, from both an external and internal macro perspective, as well as from a banking and sovereign leverage position. Though we expect greater emphasis on fiscal policy measures (i.e., China), we do expect to see monetary easings in the form of lower interest rates to be widely used (i.e., Thailand, Indonesia, and possibly India). With inflationary pressures beginning to ebb and employment trends still relatively strong, we expect domestic demand and investment to lead the way into stronger growth in 2012, with strong momentum carrying into 2013.

2 **The European Central Bank (ECB) will follow its actions of 2011 by further expanding the size of its balance sheet.** The ECB is not only the lender of last resort to the European banking system, but is also the lender of last resort to its sovereign members. In 2011 it effectively became the de facto only buyer of Italian and Spanish government bonds and thereby their primary lender. 2012 will only see an acceleration of those purchases be it direct (such as the Securities Markets Programme (SMP)), via low interest term financing to banking institutions, or even newly formed facilities.

3 Despite our optimism on the survival of the Euro, **we anticipate macroeconomic conditions will only deteriorate in the Euro-zone from here. We believe that the region will be in recession for much of the first half — and in some countries until well into the second half** — of the year. Progress is being made on the political and monetary fronts on fiscal and political union; however, austerity measures will remove significant short-term domestic demand and weaken the private sector such that the labor force will continue to be negatively impacted and job losses prevalent for the year and well into 2013 for most countries.

4 We believe that financial markets and consumer and business expectations regarding the future of the Euro-zone have sufficiently priced in the possibility of a break-up. Given that we remain optimistic that the disintegration of, or even departures from, the currency union are very unlikely, **we believe that the worst may have already been observed in the market**s.

5 Euro-zone troubles and the possibility of spillover into the U.S. banking system led many U.S. economists and forecasters last summer to substantially lower second half 2011 and overall 2012 growth estimates. Not only did growth not slow, it in fact accelerated in the second half. **We believe growth estimates remain too low for 2012. Even our own 2.6% real growth figure could prove to be too conservative.**

6 **Commodity prices have likely peaked for this economic cycle.** With the possibility of QE3 (a third round of quantitative easing by the U.S. Federal Reserve) diminishing in the U.S., we are not likely to see prices approaching their peaks of 2011 in USD terms. We will allow for an exception in the case of energy prices, given the rising tensions in the Middle East. **The upside in non-commodity inflation — especially in the G-7 economies — remains limited** given that very little progress has been made in the removal of excess slack in the system over the past several years. With home prices likely close to a trough in the U.S., rental price inflation is also likely peaking.

7 **Long-term interest rates have bottomed**, for the time being at least. With growth likely to surprise on the upside, and payroll employment continuing to expand at a pace that could bring down the unemployment rate further in 2012, bond market yields (especially the long end of the term structure), will likely rise in the second half of the year; moves above 3.0% should not be ruled out.

8 With our expectations that payrolls will expand by an average of 150K per month during 2012, and with household formations beginning to rise again, the continued drop in new home inventories, the easing of standards for home purchases, and home affordability at historic highs, **we expect the housing market to finally bottom in 2012 and begin to rebound.** We believe prices will bottom in Q3 2012 and begin to rise, albeit at a slower than historic pace.

9 Given changing demographics, slower immigration, and no significant improvement in productivity expected, we are doubtful that potential GDP growth in the U.S. is high enough that the 200K+ per month growth in payroll of prior years and decades will be necessary for the unemployment rate to drop. In fact if 2011 is any proof, a growth rate of 1.8% percent may be enough to drop the unemployment rate by over one percent. **We believe keeping our unemployment rate forecast for Q4 2012 at its present level of 8.5% and assuming a YE 2012 rate that is only slightly lower than today's rate is quite conservative.** In fact, if the labor force does not expand as fast as we think (we believe the improving economy and better jobs prospects will increase confidence enough to raise the labor force participation rate during the year), then the unemployment rate could be below 8.0% by the end of the year.

10 The flight to quality environment of the second half of 2011 which resulted from the uncertainty surrounding Europe substantially increased the value of the U.S. dollar and, in the end, more than unwound the entire weakness of the first half of the year. The dollar's strength against many of the growth economies took us by surprise. **We believe the dollar will continue to strengthen in 2012**, albeit with plenty of volatility (more so against developed economy currencies).

11 Socialist candidate **Francois Hollande has a huge wind of popular discontent filling his sails and is set to capture the French presidency on May 6.** French voters have turned decisively against the incumbent, Nicolas Sarkozy, blaming him for the economic crisis and associated austerity measures. It is even possible that in the second round Hollande could face the far-right Marine Le Pen, who is siphoning votes from Sarkozy.

12 With the U.S. jobs picture improving by the month, employment on the eve of the November elections could be higher by roughly 1.3MM over the fourth quarter of 2011. With sensitive, swing states such as Ohio, Pennsylvania, and Florida being big beneficiaries, w**e believe it will be very difficult to defeat President Obama.** On the other hand, the GOP is likely to take back its majority in the Senate and keep its majority in the House of Representatives. Divided government anyone?

As always stay tuned;

Regards,

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