SRI-KUMAR
GLOBAL STRATEGIES

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January 7, 2013

Five Developments That Could shape 2013

The twelfth hour resolution of the fiscal cliff in Washington may just be a wayside station rather than a watershed event. The U.S. Treasury has reached the debt ceiling of $16.4 trillion, and is continuing government operations through stop-gap measures. And since President Obama is thought to have won his objective of increasing taxation on the rich, Republicans will have to justify their existence by demanding more spending cuts as they negotiate raising the debt ceiling.

On the other side of the Atlantic, the situation is calmer than it has been in months. Greece did not default in 2012 or leave the Eurozone. Secondary market debt prices shot up during the final months of the year as Greece did get the funds it was seeking from the European Union. Spanish ten-year yields are just over 5% today, down from 7.5% last July. And despite a 75% taxation that the French government would like to impose on high-income earners, French ten-year yields are at 2.13%, about the same as those of the United Kingdom, and just 60 basis points higher than German bund yields. Is the European crisis over?

Global investors should prepare for fresh storms in 2013 rather than take comfort from the calm after the storm. Here are five things to watch for as the year progresses:

- **Watch the U.S. unemployment rate**: Despite rising home prices, U.S. consumer confidence will continue to be under pressure due to the still high unemployment rate. The U-6 unemployment rate, which includes discouraged workers and those working part-time because they cannot find full-time jobs, is still stuck at a relatively high 14.4% of the work force. And 4.8 million workers - - 39.1% of the unemployed - - have not had jobs for 27 weeks or longer. The negative impact on the economy stemming from fiscal cliff-related uncertainties, and from ongoing discussions to raise the debt ceiling, will likely raise the U-6 and U-3 unemployment rates in the current year.

- **President Obama: Won the battle but lost the war**? Despite having won the fiscal cliff contest with few cutbacks in spending or entitlements, the President may have missed his opportunity to promote economic growth and employment. What the latest issue of *The Economist* refers to as "America turns European" is a kick-the-can-down-the-road approach to problem solving. As Europe is discovering, such measures avoid a catastrophic fall in markets, but perpetuate slow growth or, worse, economic stagnation. Will the President adopt structural changes in his second term much as the then-German Chancellor Gerhard Schroeder did in 2003 with labor market reforms that put Germany in the strong position it is in today? Few signs of such measures yet.

- **Can German patch-work solutions prevent a renewed crisis**? Chancellor Angela Merkel's government has little appetite for radical solutions for Europe ahead of German parliamentary elections scheduled for September. Neither the repeated bailouts of Greece, nor the proposed recapitalization of the Spanish banking system, are going to resolve the European debt crisis. *Greece and Spain face a solvency crisis*, not a problem of liquidity to be solved by the ECB printing money, or by the EU repeatedly doling out bailout funds.

In addition, the austerity imposed on countries in exchange for bailouts will put the two countries in repeated bouts of recession, and increase political opposition to the measures. Expect the fraying social fabric to eventually force a debt reduction and massive haircuts to lenders. It is a fair bet that the crisis could arrive ahead of the September elections in Germany.

- **Emerging Markets: Safe Haven from Developed Country Crises**? Can investors hide in emerging markets? Will equity and fixed income investments continue to provide attractive returns above those in the United States and the Eurozone, and at *reduced risk*? If the ongoing Eurozone recession deepens, or if continued fiscal uncertainties push the United States back into recession, emerging markets are not going to remain unaffected. Equity markets in China, Brazil and Russia, in particular, will remain vulnerable to renewed downturns in the developed world.

- **Will central banks understand the limits of monetary policy**? It is a time-tested principle in monetary theory that shifts in central bank policy become ineffective at extremely low interest rates. The Fed's three quantitative easing operations, and the ECB's Outright Monetary Transactions, are intended to be alternatives to interest rate cuts. It is not surprising that neither the Fed has succeeded in significantly lowering unemployment, nor the ECB resolved the debt crisis. An end to further monetary easing - - unlikely in 2013, given the entrenched bureaucracies in Washington and Frankfurt - - and a shift in focus to flexible labor markets and worker training, would be precursors to renewed global growth.

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