

Macro and Markets in 2012

Policy makers hold the key

Generali Investments Research

Large political uncertainty and skyrocketing price volatility over the last three years have left market participants wondering if any valid conclusions can be drawn for the outlook. We acknowledge that uncertainty is high but we believe that some predictions can be made which will stand the test of time.

In this paper, we focus on financial market developments in the euro area in 2012 but some of the conclusions we offer are likely to be valid beyond the coming year. This is above all true for the paradigm shift that we foresee for EMU governance in general and fiscal solidity in particular.

The main conclusions we offer are: i) growth in the industrialized world will be low for some years to come but ongoing expansion in the developing world will cushion the downturn ii) inflation will be very low during the forecast period iii) monetary policy will remain very accommodative to dampen the negative growth effects from fiscal austerity.

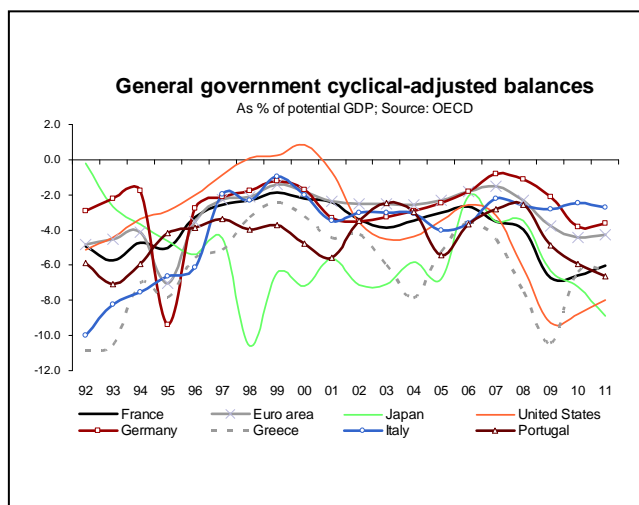
If true, we conclude the following for financial markets: First, key to higher core yields will be the solution of the credit crisis. However, since progress to reduce deficits will be slow and due to the low growth and inflation trade off we expect, yields will rise only gradually. Second, intra-EMU spreads will tighten but will remain wide by any historical comparison. Third, due to strong external growth we anticipate private sector assets to do better than public sector assets. Finally, tactical re-allocation will remain key in a high-volatility environment.

Admittedly, risks to this 'guardedly optimistic view' are plentiful, and they are mostly concentrated on the downside. The most important ones are sovereign debt crisis spiraling out of control, a credit crunch and thus deflation, as well as social unrest in the countries of high fiscal and structural adjustment needs. That said, strong efforts to tackle structural problems in the euro area could also unleash a virtuous circle of better financial conditions and, hence, stronger growth. In the end, we believe it is the policy makers which will make the difference between a positive or a negative year 2012.

As we approach the year-end 2011, we are trying to come to terms with the outlook for the next year. Needless to say, that recent developments make this look like a daunting task. Usually, we make inferences for financial markets based on fundamentals like the macro outlook.

Challenging outlook

Now, this time looks much more challenging. Progress in overcoming the current malaise in the euro area depends to a very large extent on the political will to do so. The euro crisis is in earnest a crisis of public sector finances and to a lesser extent the result of institutional shortcomings. The financial crisis and the measures to fight it may have pushed debt ratios higher but they have only brought to the fore a problem which has plagued the industrialized world for a very long time, namely persistent structural deficits (see chart).



We have now reached a point where the willingness of financial markets to finance these deficits is next to exhausted for most countries. Investors now want to see that the solidity of public sector finances is improved via reduced spending - for instance, by making pension systems demographic proof - but they also want to see that the problem of low structural growth is tackled. Only if highly indebted countries will be able to make it on a higher growth path there is a chance that current debt levels will

shrink meaningfully over time. Some argue that higher inflation could also be a solution but we are skeptical that we will see prices jumping much higher because the fundamental backdrop for high inflation is just not in place.¹

Unfortunately, predicting political outcomes is much more difficult than economic forecasting. This is especially true for the euro area, where 17 countries have to agree on a solution and national interests still play a considerable role. For the purpose of the 2012 outlook we work on the assumption that structural reform and large deficits will be tackled at the national level. Of course, it will take time before these measures will start to work² but we have confidence that forward-looking markets will honor attempts to reign in excessive deficits and to improve medium-term growth trends. We feel that we have reached a point where the 'sense of urgency' among policy makers has risen - but in the end we are far from certain if political roadblocks will continue to be in the way of better policies.

I) Conclusions which will pass the test of time

All this raises the question if conclusions can be drawn at all for the 2012 outlook which will pass the test of time. We believe yes. In the following pages we elaborate on the key points we feel fairly confident about. We then explain what their impact on the financial markets will be. Finally, we comment on the risks investors should have on their radar screen for 2012. We conclude on a positive note by describing a virtuous circle of improved governance, better financial conditions and, hence, stronger growth. While this outcome may not seem the most likely at present investors should not ignore it altogether.

a) Meager trend growth

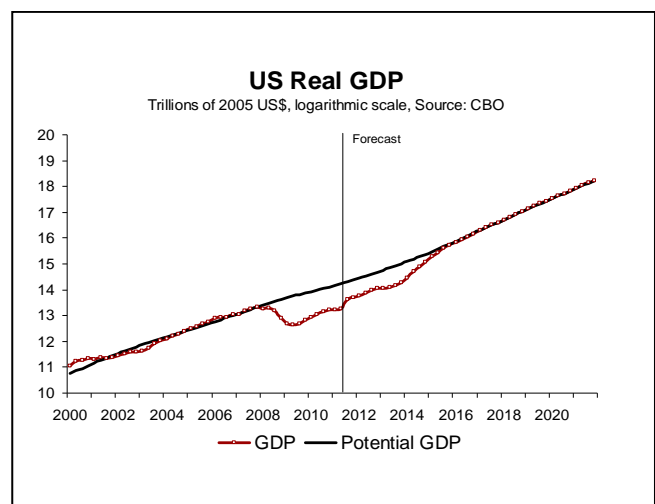
Growth will continue to be highly heterogeneous across regions. While the Asian economies will power ahead with solid speed, the US will experience positive but subpar growth and the euro area, the structurally weakest region at the moment, will undergo a technical recession at the outset of the coming year.

With respect to the US, we have in many of our writings highlighted two reasons why growth in the US economy will not be strong. The first is household deleveraging, the second meager credit growth. To be sure, private households in the US have reduced their debt burden by 11 pp from the 2009 peak of 99.4% in terms of GDP but the long-run norm is just 68%. Hence, more needs to be done. Since US consumption ac-

¹ To make a difference here, inflation would not just have to rise a bit. Only in case of large, double-digit inflation rates would debt levels in real terms shrink meaningfully. We will explain in a later section why we do not foresee inflation rates even close to this level.

² In Germany, Chancellor Schröder introduced the "Agenda 2010" (designed to revamp the social security system and the labor market) in early 2003 but it took more than five years for these measures to show up in higher trend growth and lower unemployment figures.

counts for about 70% of US GDP and roughly 17% of global production, this has severe implications for trend growth both domestically as well as globally. During the heydays of the US economy between 1992 and 2007, real consumption rose by 3.5% p.a. on average. We now look for trend growth closer to 1.5% to 2%. Likewise, credit growth will be less plentiful due to stiffer regulation, higher cost of capital and the breakdown of the securitization market. This will also dampen growth. That said, renewed recession in the US is not likely as well. Above all, despite all the talk about US debt, fiscal policy will largely remain neutral in 2012. What is more, we expect the Fed to remain on a very accommodative path. Apart from the commitment to keep the key rate at zero to 0.25% until mid 2013, the Fed will not hesitate to embark on further government purchases, if needed. Also, the residential housing market has sent signs of stabilization lately and company finances are extremely sound so that capex spending will remain a source of growth. All this implies that the US economy will not be able to serve its prior function as a global growth engine but it will not fall into recession either. We would only expect a big downturn if the sovereign credit crisis of the euro area were to spiral out of control with severe knock-on effects for financial conditions in the US.

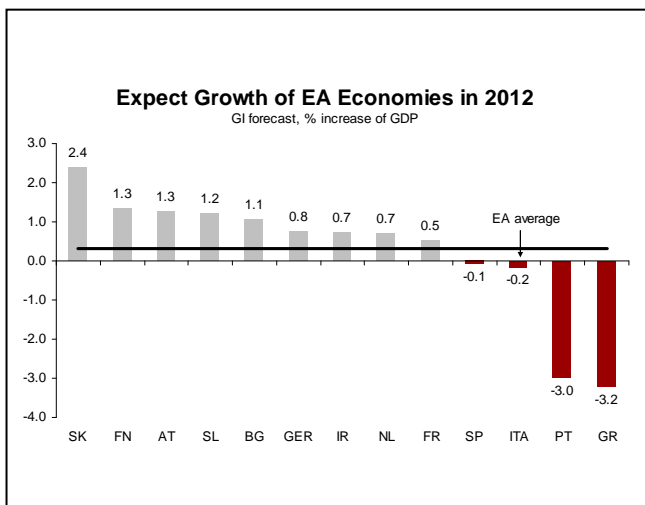


Sovereign credit crisis hurts euro area activity

After having shown some signs of improvement throughout the first half of 2011, economic activity in the euro area took a hit in the second half of the year. While there was a global downturn underway, the situation in the euro area was aggravated by the escalation of the euro crisis. As a result of the latter a vicious circle of deteriorating sentiment, increased fiscal consolidation, tightening lending standards and weaker economic perspectives emerged. Unlike to the other major economic regions, we therefore expect a mild recession over the winter months in the euro area. This makes a bad start into 2012. However, over the course of the coming year we forecast a slight improvement of the economic situation because of the following reasons: First, we are currently in a phase of destocking and the inventory cycle should turn around next year again. Second, we see headline inflation coming down strongly over the course of the

year which will boost real spending. Third, with the global economy overcoming its weak spot, export prospects should brighten somewhat again. However, in spite of these supportive factors growth should remain below potential for the following reasons: Above all, fiscal policy will continue to dampen activity as consolidation remains the name of the game in order to enhance the credibility of public finances. This is first of all true for the economies which are currently in the focus of the market. Moreover, in the wake of the euro crisis confidence took a severe hit. The future evolution of sentiment and hence also of the consumer and investment spending behaviour crucially depends on whether policymakers can turn expectations to the better again. While our forecast rests on some credit crisis easing, an unwinding appears utopian. As a result of the banking sector trouble and the need of banks to increase their core capital, the bank lending standards have been tightened as of late and could even tighten more. Banking behaviour is thus likely to dampen economic activity further.

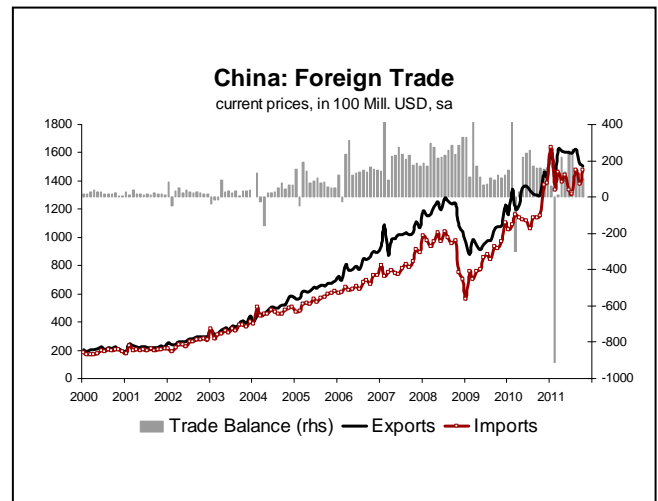
Summing up, over the course of the coming year economic activity should be able to recover from the winter recession. However, due to the dampening factors just mentioned growth should remain well below potential and average just 0.3% in 2012. At the same time, the strong heterogeneity among member countries should persist. Economic activity in the highly indebted countries should continue to shrink or be on the verge of shrinking over the coming year. The risks, however, are still tilted to the downside as we will discuss later on.



Soft landing expected for China

China's GDP growth moderated in the course of this year from 9.7% yoy in Q1 to 9.1% in Q3. So far, this moderation was to a large part the effect of a deliberate tightening of monetary and fiscal policy after the large stimulus package, rolled out at the end of 2008. Of late, however, exports started to slow more markedly as the result of a deteriorating international backdrop. Export dynamics are clearly negative. While this slowing process started with the US, now Europe and most interestingly Asia itself have become the main drivers. Asia as a whole is suffering from weak exports – PMIs dropped in part strongly

below the 50 points threshold – and this situation has started backfiring on intraregional trade as well. Looking forward, we expect the international backdrop to desynchronize. Thus, export dynamics will remain weak due to Europe but likely not fall off a cliff due to positive growth in the US. Parallel to the euro area, the deliveries will probably recover in the second half of next year. This should then, in turn, also result in higher growth rates around Asia.



Given this external outlook, the stability of domestic demand is of high importance. Latest PMI details have rekindled fears of a stronger slowdown. However, China's domestic expenditures have been rather stable so far. In fact, overall urban investment growth was more or less constant. Growth of real estate investment slowed limitedly, defying so far any worries of a property market crash. Local government investment even saw a slight acceleration. Data on new projects suggest that no severe change is imminent. Looking forward, however, domestic growth drivers like real estate and also local government investment are nevertheless expected to moderate. House prices and in its wake also land prices (which have become an important source of local governments' income) will likely start receding. In our main scenario, we do not forecast a bursting of a possible house price bubble and thus no abrupt slowing. High down-payments and comfortable loan to value ratios render it unlikely that the sector is overleveraged and accordingly, the exposure of banks does not appear to be stretched. Moreover, in case of a more severe slowing, social housing projects can be used as a buffer. A second reason for the expected slowing is the debt situation of local governments which shouldered to a large part the 2008 fiscal package. A debt restructuring seems necessary as the proceeds from infrastructure projects do not match the rather short-term bank credits. Thus overall, local government financing will become tighter and hence investment growth should weaken limitedly. In case the situation becomes more severe, the central government has viable policy options to prevent a downturn. Monetary policy could be further relaxed and fiscal policy has also room to respond. Given the weak exports, we reduced expected GDP growth rates in Asia, resulting in an overall outlook for the whole region of 7.1%. For China we expect GDP to advance by 8.6% in 2012.

Brazil and Russia to continue to grow

Regarding other major emerging markets, economic growth in Russia should continue to be driven by private domestic demand, but also fiscal generosity around the 2012 presidential elections should cushion the imminent slow-down from growth at around 4% in 2011. On balance, we expect Russia's growth to clearly outperform average growth in the advanced world, but we see mounting downside risks to this outlook for the second half of next year. In Brazil, growth stalled in the second half of 2011, despite continuing support from domestic demand. This weak growth should carry forward in the first months of 2012, thereby triggering two more rate cuts to 10.5% - despite the still elevated inflation rate. In combination with a moderate fiscal stimulus, this should contribute to an acceleration in the course of the year. All in, we expect both Russia and Brazil to grow at rates of more than 3% next year.

Bottom line

Just like in 2011, global growth will be around 3½ %. This is well below the 4.5% recorded between the years 2004 to 2007, and it is only ½ pp above the level seen as the dividing line between global growth and global recession. For investors in risky assets this implies that – while the global recovery will continue in our view - growth scares are likely to hurt markets periodically. Due to skittish markets, tactical re-allocation of portfolios will continue to be important next year.

b) Low inflation pressures

Ever since the beginning of the credit crisis markets have fretted about the inflationary impact of large budget deficits and unorthodox policy measures. We have always warned that scenarios of fast rising inflation appear greatly exaggerated in the current environment, and we stick to this call. There are many reasons to be sanguine about inflation threats.

First and foremost, Central Banks may have increased the size of their balance sheets strongly but this money is not making it into the real economy. In this respect, the US stands out. Since mid 2008, the Fed has increased its balance sheet by US\$ 1.9 tr. (12.6% in terms of GDP) but at the same time, commercial banks have increased their excess reserves at the Fed by US\$ 1.5 tr. Hence, the small sum of US\$ 400 bn (2.6% in terms of GDP) is not parked idly in the Fed accounts, an amount barely enough to trigger a price spiral. Moreover, demand conditions are not conducive to high inflation. According to the Congressional Budget Office, the US output gap will not be closed before the year 2016 (see chart, page 2), thus putting, if anything, structural downward pressure on prices. Moreover, the unemployment rate is way above its natural level (3.5 pp) so that wage pressures are low (1.6% yoy at present). Finally, there may be higher inflation in the emerging markets but this is mainly due to higher food and commodity prices although export prices are unlikely to rise much because lower global demand implies a stiffer competition for market share. All in, therefore, we anticipate US inflation to drop sharply from 3.1% in 2011 to less than 2% in 2012.

Euro area headline inflation spiked to 3.0% yoy as of late. Looking into the coming year, however, we expect it to come down strongly. First, the recent boost in inflation is due to some methodological changes in seasonal adjustment. Second, the contribution from energy inflation will significantly come down at the start of next year. With a reading of around 80 €/b Brent the oil price is ca. 30% up year-on-year but in January it will just be 10%. With economic activity muted, we hardly see any leeway for the oil price to inch dramatically higher over the course of 2012 so that headline inflation should be dampened by means of this base effect. Third, with the euro area undergoing a technical recession and growth remaining below potential thereafter, the output gap will widen next year thereby exerting structural downward pressure on inflation. All in all, we expect headline inflation to fall short off the 2% threshold over the course of the coming year. However, the risks are tilted towards somewhat higher inflation and related to the increase of indirect taxes or administered prices as a part of possible future consolidation packages. That said, the underlying pace of inflation should remain muted.

Bottom line

We deem current market concerns about rising inflation in the western industrialized world as overdone. If anything, we see a bigger risk that markets could become occupied again with the threat of disinflation or even deflation. In contrast, while inflation will also start to decline in the fast growing regions of the world, there are still bigger risks to price stability there.

c) Monetary policy to remain very accommodative

Whereas fiscal policy in many parts of the industrialized world is facing a prolonged period of contraction, monetary policy will remain extremely accommodative. This is true for both the Fed and the ECB. At the same time, we see room for monetary policy in the emerging markets to become less strict.

ZIRP with risk of additional Quantitative Easing in the US

The dual mandate of the Fed (price stability and maximum employment) has made US monetary policy more expansionary than in almost any other part of the world. Not only has the Fed committed itself to a zero-interest-rate-policy (ZIRP) for at least one and a half years more to come it has also massively extended the size of its balance sheet by investing about US\$ 900 bn in Treasuries. Also, to keep long-term rates low, the Fed has just adopted a program called 'Operation Twist'. Here, proceeds of maturing shorter-dated Treasury paper will be reinvested in longer maturities. The program has a size of US\$ 400 bn and it will extend into mid 2012. Finally, there are already strong signals that the Fed could resume purchases of MBS paper soon in order to stabilize the residential housing market more. Another round of outright Treasury purchase ('QE3') is unlikely in our view unless the economy falters again and inflation falls more than we currently predict. That said, the Fed stands ready to do more, if needed.

ECB to play 'tit for tat'

The ECB has already responded to the deterioration of economic activity by means of a 25 bps key rate cut to 1.25% in November. Looking ahead, another key rate cut to 1.0% in

December seems highly likely to us. The ECB will take into account the significantly reduced growth outlook and the high degree of uncertainty by moving back to the key rate level low already seen during the financial crisis. However, the more interesting question is whether the ECB considers launching additional measures as – unlike to the times of the financial crisis – fiscal policy has this time no ammunition left. Past experience leads us to expect that the ECB is willing to stabilize the working of the financial system and hence economic activity through unconventional measures like longer term tenders.

ECB to act as lender of last resort?

Beyond that, the crucial question is whether the ECB will extend the purchasing of government bonds as part of its Security Market Program (SMP) in order to fight the euro crisis. So far the ECB bought roughly € 190 bn in order to stabilize government bond markets. This amount equals 8% of the ECB’s balance sheet. Even more important, the ECB at present sterilizes the effect from these bond purchases by means of repo operations at the short-end of the curve. Thereby the ECB behaved in a less decisive way to stimulate activity than for instance the Fed in the US. Here, the purchases of US treasuries sum up to US\$ 900 bn or roughly one third of the Fed’s balance sheet.

However, there are a number of differences which make a Fed like action by the ECB not the base case. First, the ECB’s objective is the achievement of price stability only. Second, the European Treaty explicitly forbids the direct purchase of government bonds by the ECB. Doing it indirectly on a large scale would get around this problem but would stand against the non-bailout principle of the Treaty. This is due to the fact that in case of a default the ECB losses would be distributed according to the share in the ECB’s equity capital among member states. Third, when it comes to the question of true Quantitative Easing (QE) there is a deep rift within the ECB Governing Council. The central bank presidents of Germany, the Netherlands, Spain but also ECB president Draghi were very reluctant on this issue in recent comments. It is questionable whether a majority on QE could be reached and there is a risk that the rift going among the Council intensifies in this case thereby damaging the reputation of the ECB further. Fourth, with the EFSF becoming effective soon there is less need for the ECB to intervene. Last and most importantly, the key question is whether unlimited government bond buying would really solve the euro crisis. Fixing the price of government bonds could only restore confidence of market participants if it goes hand in hand with structural reforms that enhance the sustainability of public finances. This in turn implies growth-boosting reforms combined with measures to improve the budgetary balance. In recent statements the ECB always demanded such kind of reforms from governments. In exchange for this it bought bonds of the country under consideration by means of the SMP. Looking ahead, we therefore find it most likely that the ECB continues to buy government bonds by means of its SMP, provided that governments do all what is necessary to improve the fundamental situation. It will most likely be a ‘tit for tat’ game with the governments. This is because if the ECB would just buy govern-

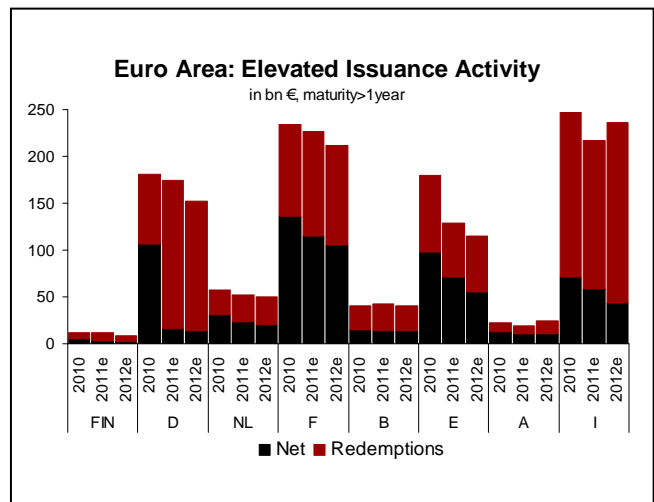
ments bonds the incentive to go ahead with reforms would fall dramatically.

However, in an extreme scenario where the pressure on euro area sovereign debt market reaches levels inconsistent with the existence of the monetary union, the ECB would in the end have no choice other than to take all kind of also drastically measures to keep EMU alive. In such a case, true QE should even become a realistic possibility. But the hurdle for this to happen is extremely high.

PBoC to relax monetary policy limitedly

Since October 2010, the People’s Bank of China (PBoC) has responded to rising inflation by hiking its benchmark interest rate by 125 bps and the reserve requirement ratio by 450 bps. Inflation has likely peaked in July 2011 with 6.5% yoy. Of late, food prices, which were the main culprit for these high rates, started to diminish. We expect this process to continue in 2012, leading to a drop in inflation from 5.6% this year to 3.6% in 2012. This gives the central bank more room for maneuver. The central bank has to find the right way between growth concerns amid weak exports and still high, but receding inflation. Given this still uncomfortably high inflation, we expect only limited moves of the PBoC. This is also true for most of Asia. In countries with stubbornly high inflation like India, monetary policy tightening likely has come to an end.

Bottom line: The policy mix in the advanced world will continue to be marked by tighter fiscal policy and unusually loose monetary policy. If anything, we expect central banks in the US and Europe to adopt even more measures to support the challenging road towards fiscal solidity which will keep long-term yields low. In the emerging markets, we see room for monetary policy to lighten up on the restrictive course which was adopted during the years of strongly rising inflation.



d) Sovereign debt crisis to continue

The euro area debt crisis has reached a level of escalation in 2011 not expected at the beginning of the year. Although several summits proposed far-reaching measures we do not ex-

pect the crisis to come to an end next year. In fact, politicians will not only be faced with the contagion to larger countries like Italy and Spain but also with the increased pressure on other core countries' sovereign bonds.

In the last two years, European politicians have started to reconstruct the EMU as the old structure did not prevent the emergence of significant imbalances. However, this is a multi-year task which is aggravated by the low growth environment and the turmoil on financial markets. Accordingly, the next year will be characterized by both further steps in the direction of deeper integration and a lingering of the debt crisis. Beyond the measures already taken (e.g. European Semester, Euro Plus Pact), we expect in particular a further transfer of competency from the national level to the EU. This will most likely happen without an explicit treaty change as this appears too cumbersome and markets do not appear to give politicians the time to act this way. Rather, we forecast an increase in power for European institutions. Whether this will be supranational bodies like the EU Commission or intergovernmental bodies like the EU Summit remains to be seen. Given the reluctance of Germany which had a major influence on the measures taken in 2011 and will probably continue to have next year, European institutions will be equipped with a strong monitoring arm and will have the power to supervise national budget consolidation. Moreover, imposing fines on countries which do not follow the rules will be a distinct possibility. While this development needs ample discussions, we regard it as the most likely outcome to maintain the viability of the EMU. The implementation of some sort of Eurobonds might also be part of the deeper integration as long as it is combined with strong rules regarding fiscal discipline.

In addition to this structural change, the national governments will start/continue the way of fiscal consolidation and reforms. In particular, the recently appointed technocratic governments in Italy and Greece are forecast to kick-start the reform process and restore lost confidence. Moreover, the newly elected government in Spain has already announced tough measures. Nevertheless, the governments nearly have to square the circle as strong fiscal consolidation exerts a negative impact on the already weak growth environment. Accordingly, the reduction of fiscal deficits will continue next year but by historical standards the deficits will remain on a relatively high level. While the Italian deficit is expected to shrink further (well below the 3% threshold) other countries will not achieve the deficit criterion of the Maastricht treaty.

Accordingly, the net issuance of debt by EMU countries should come down in 2012 by around € 40 bn. However, given the unfavorable maturity profile gross issuance is expected to fall only from € 890 bn to € 870 bn. There is some relieve but not too much. Particularly, countries which are already in the focus of markets will continue to have a strong issuance pipeline.

Beyond that, the EMU will implement the measures already agreed on. This includes a stronger private sector involvement in Greece, the recapitalization of the banking sector and the

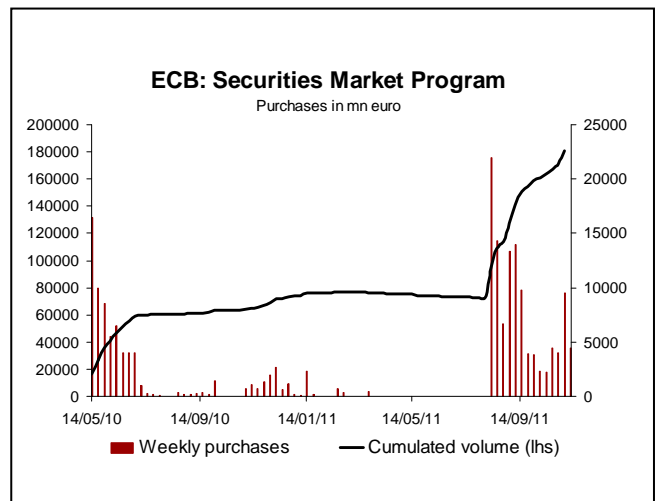
extension of the fire power of the EFSF. With support from the IMF the intervention power will be at least one trillion euro. In combination with an ECB which will most likely hesitantly continue its sovereign bond purchases this should provide an important backstop for markets.

Bottom line: The EMU will proceed on its path towards deeper fiscal integration. Although the growth environment remains challenging, fiscal consolidation will continue. In our base scenario we expect the EMU to persist and do not forecast a country to quit the common currency in 2012. Moreover, the situation is expected to improve only gradually and market participants' confidence should be restored slowly.

II) Risks

a) Escalating sovereign debt crisis

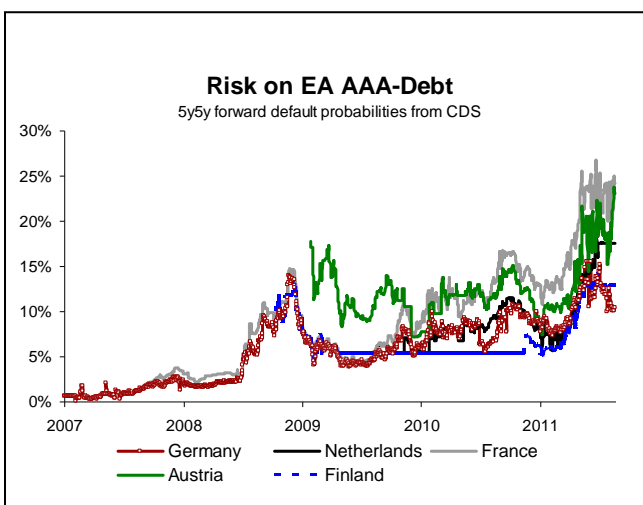
Probably the most important risk factor for the above described base scenario is a further escalation of the euro area debt crisis. We see numerous risks for the rather benign scenario of a lingering, but slowly improving debt crisis. The most obvious one which currently already keeps markets on their toes is a complete contagion of Italy (and maybe Spain). The most probable reason for this is a failure of the new government to implement reforms. But it could also be because international investors flee from the euro area bond markets as a whole. If Italy loses its markets access and cannot fund by issuing bonds anymore, another rescue package will become necessary. However, this package needs to be worth at least € 600 bn which appears politically infeasible.



Another problem area is Greece. We have repeatedly raised concerns about the sustainability of the Greek debt situation. Even if the haircut of 50% on notional Greek debt will be implemented (which is far from being sure), the aim to reduce the debt/GDP ratio to 120% by 2020 appears somewhat ambitious. Given that this ratio is still quite high (in line with the current Italian ratio) and the political risk that the new government cannot kick-start the necessary reforms, a failure of the EU/IMF rescue action in 2012 appears possible. In this case, a

'hard restructuring' followed by an exit of Greece from the EMU would be the likely outcome.

Moreover, core countries could be increasingly dragged into the debt crisis. Put differently, even the heart of the currency union, namely the AAA-rated economies, is increasingly affected by the euro crisis. There are various channels of contagion: The most important one is the banking sector resulting from the potential need to bail out banks which suffered losses in the periphery. Moreover, speculations about the need of further rescue packages to support Spain or Italy directly also imply higher liabilities and hence are a threat for public finances also in these economies. The whole situation is worsened by the fact that growth will be very meager in 2012 which increases the burden of public debt also for the core economies. As a result of these factors medium-term default probabilities (by we refer to the probability that a country defaults within the 5-year period starting in 5-years) rose of late for the core economies (see chart below). Before the financial crisis started in 2008 the core economies exhibited a very low and similar risk. Now with the crisis escalating the medium term default probability rose for all these countries but especially for France and Austria. The French banks are strongly exposed to Greece and Italy while the Austrian banks have huge risks related to the situation in Eastern Europe in their books. If these risks were to materialize France should be affected the most. It is the weakest economy among the AAA-rated euro area countries as its current year budget deficit (of 5.8%) as well as its debt-to-GDP ratio (of 85%) are the worst among these economies. Moreover, it is the only of these economies running a current account deficit (of around 3% in 2011). For the coming year we furthermore see the French deficit target into jeopardy but given that 2012 is an election there remains doubt whether the issue will really be tackled. In sum, if worse comes to worse a downgrading of France can occur. If France loses its triple A status, however, the borrowing costs for the EFSF increase and the fundamentally increased risk premium on government debt could have negative repercussions on the European banking sector again. The crisis should aggravate further.



Beyond the risk that developments in single countries disappoint and cause another level of escalation, the overall situation can deteriorate. Triggered by a deeper than expected recession or more funds allocated to rescue the ailing banking sector, sovereign bonds can come under pressure thereby generating a situation which is unsustainable.

While politicians would surely not give in immediately and would even intensify the efforts to safeguard the EMU, it cannot be excluded that ultimately the vicious circle cannot be stopped. Moreover, if worst comes to worst the ECB is expected to ditch their principles and would intervene on a massive scale and would end up with large-scale bond purchases. However, if the fundamental situation deteriorates further or the political commitment falls short of what is demanded by markets, all rescue measures could turn out to be insufficient. In this case, the exit of one or more countries is likely which would send shock waves through financial markets.

b) Credit Crunch

Another significant risk for the macroeconomic development in the coming year is a possible credit crunch in the euro area. While this threat is not new, and in fact has been discussed from time to time since the outset of the financial crisis in 2007, the topic has shifted again into the focus of markets of late.

At the start of October, the latest ECB Bank Lending Survey unsettled markets as it showed a sizeable increase in the net tightening of credit standards in Q3 compared to Q2. While the overall tightening trend was by far not as pronounced as at the end of 2008, especially the reasoning and the outlook of the participating banks were concerning. One of the most important reasons for the tightening of credit standards was a deterioration of the access to market funding for banks, and regarding the outlook for Q4 the respondents even expected the tightening trend to aggravate. Looking at the latest market developments, the core of the banks' motivation for a more selective lending attitude – their refinancing difficulties – seem to have grown further. The spreads against Bunds of senior unsecured bonds issued by European banks have continued to rise in the current quarter and reached new year-to-date highs. And also the risk premium for 3-months loans between banks has climbed to the highest level since March 2009. But despite these high premiums, investors – including banks themselves – are still reluctant to lend money to banks, and more and more of the latter are complaining that their funding markets are virtually closed.

While the term-funding issue has been addressed by the EU Summit decision to introduce a guarantee scheme for bank bonds – similar to the ones seen in 2008 but on an European level this time – the other announced measure to stabilize the banking sector – the recapitalization plan – might even worsen the availability of credit for companies and households. This danger is imminent as the banks which according to this plan need to fulfill a higher capital target (Core Tier 1 ratio of 9%) until mid-2012 might prefer to meet this target by reducing their risk-weighted assets (RWA) instead of raising new capital in

the current market environment. Issuing new shares for example – if possible at all – would exert high dilution effects due to the very depressed levels of current bank valuations and the sizeable discounts needed to attract highly risk averse investors. The other alternative to really strengthen the capital base, to apply for governmental support, is surely also not very attractive for most banks, as it might be seen as a failing of the management board and might be accompanied by unalluring conditions like capped management gratifications.

Although EU leaders seem to be aware of this possible negative side effect and announced that national supervisors will be told to prevent banks from deleveraging excessively, the credibility of this threat is questionable as it would mean a deep interference in management decisions. Judging from the recent news flow, banks seem actually not to be impressed much, as several major institutions have already announced sizeable balance sheet reduction programs in connection with the higher capital threshold. To completely fulfill the new requirement by shrinking their asset base, European banks would have to cut their RWAs by around €1 trillion. Depending on the risk weights of the assets shed, this could lead to a deleveraging volume of between €1 and €2 trillion or 2.4% to 4.8% of total assets of European banks. While a part of this gap might be filled by cash rich lenders from Asia or the US – which has already been the case in some deals – a deleveraging of such a size would most likely have large negative consequences for the economic development in Europe. As in the euro area periphery the banks have the largest recapitalization needs and the countries the weakest growth outlook, these regions would probably suffer most in this scenario.

On the other hand, we deem it likely that banks are aware of the fact, that such a strategy also bears microeconomic risks. Selling assets aggressively and thus most likely with sizeable discounts for example leads to one-time losses and also diminishes the future income base. Furthermore, it endangers a lot of client relationships which are a valuable asset in the banking business itself. Therefore, and as not to further alienate policy makers, we expect deleveraging to be used with a sense of proportion and not excessively. But if worse comes to worse, a credit crunch is clearly a possible scenario.

c) Real estate crunch in Asia

Markets have feared for quite some time that housing prices in China have developed bubble like features. Indeed, risks to this sector could cumulate and lead to an abrupt drop of domestic demand. Like in other Asian countries, China relaxed policies for the real estate market during the 2008 crisis to help the economy recovering. As a result, the sector expanded again briskly. House prices as an average in 35 cities doubled between 2004 and 2009. Housing affordability – the relation of prices to income – in tier 1 cities reached extreme readings of about 20 in Beijing and 15 in Shanghai and other cities. On a nation wide scale, it hovered around 5. The housing bubble in the US burst with average levels of 6. The new floor space 'started' accelerated to growth rates of 70% yoy in 2010 and the share of the real estate sector in total investment expanded to

25%. In sum, while a house price bubble is unlikely in China as a whole, bubble like features can be detected in major cities. The government was well aware of the situation and reined in speculative demand with a slew of measures the most important of which were to raise down payments. This has reduced the need to deleverage on first price drops. The banking sector seems not overly exposed. However, real estate developers have resorted to other sources of funding, turning among other to the grey capital market when monetary policy started to tighten and credit become much scarcer. The combination of weaker property sales, potential price drops and possibly rising inventories could lead to more stress in the sector. This could be especially the case if risks cumulate with stronger than expected negative consequences of weak exports on employment, a failure of restructuring local debt and negative financial spillover effects from the European sovereign debt crisis. The IMF estimated that a price drop of 10% would lead to shrinking investment by 4%. Accordingly, a severe downturn of the sector would weigh strongly on GDP growth in China and the region.

d) Deflation

As outlined above, there are numerous risks to the low growth profile that we envisage for the global economy. If business and consumer sentiment were to suffer more as a result of an escalating credit crisis, external financing were to dry up for firms because of a credit crunch or growth in the emerging markets were to falter, the global economy would relapse into a recession – and potentially into a quite severe one if the shocks were to occur at the same time both here and in the emerging markets. In this case, we have little doubt that our prediction of gradually easing inflation pressures would prove too sanguine. In this respect, we believe that the price developments in Japan are a good blue print for what could happen even in the face of massive fiscal spending (general government gross debt in terms of GDP has risen from 66% in 1990 to just over 230% now), zero interest rates (for basically twelve years now), and massive liquidity creation (just like the Fed, the Bank of Japan has engaged in massive government bond buying programs). Yet, during the same time, core CPI prices in Japan (ex food and energy) have fallen by 0.4% p.a. on average. This has led to a vicious circle of consumer retrenchment and even lower prices. Now, we believe that policy makers outside Japan have learned the lessons from this episode but unlike inflation, deflation is much harder to fight once it has started.

e) Social unrest and stiffer bank regulation

Last but not least, we see the risk that movements like 'Occupy Wall Street' could lead to an overly strict regulation of banks, which in turn would hit economic activity negatively.

Although these movements are rather small and thus will not have much influence on political decisions so far, the current economic environment in many western industrialized economies might fuel them going forward. Despite having no clear defined common aim, the people gathering on the streets of New York and numerous other cities seem to be driven by frustration and anger about the economic system and the power of big companies, not only but mainly out of the financial sector.

In view of persistently high unemployment rates, often especially hitting young people, weak growth perspectives, fiscal consolidation needs leading to less social spending or higher taxes, this discontent with the situation will most likely rather grow than recede in the coming year.

Against this background, it seems possible that politicians will increasingly try to win voters by adopting some ideas of 'Occupy'. The most likely target would currently be large banks. Thus the current trend to a tougher regulation of the sector, which in principle is a desirable aim, might get amplified too much and overshoot the target. A lot of measures have already been discussed since the outset of the financial crisis, and each of them might make sense individually, but implementing too many of them would lead from under-regulation to over-regulation and thus would have sizeable negative side-effects. As discussed in more detail in the section 'Credit Crunch', too high capital requirements for example bear the risk of under-supplying the economy with loans. And although excessive risk taking of banks surely has caused a lot of damage in the past – as for example the subprime crisis in 2007/2008 showed – it is also part of their function to take risks. If regulation were to discourage banks too much from taking risks, which could be the case if social unrest intensifies, it would thus have significant negative consequences for economic growth.

III) Implications for financial markets

Based on our guardedly optimistic base scenario, we expect 2012 to be characterized as a year of gradual healing of financial markets from heavily stressed levels. That said, this process will likely be subject to high volatility, not least owing to the ongoing high amount of political risk involved. The materialization of one of the mentioned risk scenarios would have the potential to noticeably change the outlook. We discuss the implications for bond, equity and currency markets subsequently in the following.

a) Bonds: Core bonds only attractive in adverse scenarios

We expect yields of core government bonds (i.e. Treasuries and Bunds) to trend moderately upwards, largely driven by recovering risk sentiment from the very depressed yield levels prevailing currently. What is more, the avoidance of another global recession has the potential to push investors back into other asset classes amid an urgent search for yield opportunities.

While highly stretched valuation levels even point at some stronger shift in yields, we caution against expecting too much of a rebound in core yields, though. Mounting disinflation concerns, a blurred outlook to long-term growth potential of the advanced economies and the continued extremely accommodative policy stance by the major central banks should keep the whole range of the yield curve at very low levels. While we do not anticipate a sharp sell-off in these markets, their total returns will likely be in moderately negative territory owing to

the depressed carry and negative shock return from moderately rising yields.

In our risk scenarios, however, core sovereign bonds should still offer decent returns. Strong safe haven demand, deflation fears and a deteriorating outlook for the global economy would have the potential to bring yields to even lower levels in these scenarios. The main virtue of core bonds is thus their quality as a hedge against the numerous risk scenarios for the year ahead.

b) Peripheral bonds: High returns in base case surrounded by political risks

The outlook for peripheral sovereign bonds is broadly the inverse mirror picture for core bonds. Progress in the European debt crisis and stabilizing risk sentiment should help peripheral bonds to recover parts of the steep losses experienced over the course of 2011. In our basic scenario, Italian sovereign bonds should yield returns in the upper single digit range, with the high carry being boosted by a positive returns from moderately declining yield levels.

Also on this front, however, we caution against expecting a rapid normalisation of risk premia. Confidence in politics has repeatedly been undermined by political brinkmanship. Moreover, with the euro area likely to dip into a mild recession over the winter months, governments of the GIIPS economies will face new fiscal consolidation challenges. Finally, trust can more easily be destroyed than rebuilt, and also the burden from higher margins required for sovereign repo deals are unlikely to be unwound quickly. So despite the expected moderation of risk premia, peripheral spreads are likely to remain stuck at historically high levels.

In the risk scenarios, peripheral sovereign bonds are likely to remain under strong market pressures, which can be only partly mitigated by ongoing ECB intervention and likely bond purchases by the leveraged EFSF. Thanks to the already very elevated carry and likely official intervention, however, the total return from peripheral sovereign bonds should stop short of falling into deep negative territory even in the risk scenarios.

c) Corporate bonds: Solid carry enhanced by tightening spreads

A similar picture holds for corporate bonds. In our basic scenario, corporate bonds should benefit from a recovering global risk appetite, enhancing the return from a solid carry. Many corporate issuers still can resort to a strong internal cash flow while global diversification of sales markets should dampen the impact from the expected recession in the euro area. At the same time, the overall leverage of the corporate sector is unlikely to increase by any significant amount, given the current funding stress and the uncertain economic outlook. Financial corporate bonds may also be supported by further political action aimed at easing the banks' funding squeeze. Also the prospective increase in capital ratios should be slightly positive for bond holders.

Owing to their strong exposure to the sovereign debt crisis, financial corporates should exhibit a higher sensitivity or beta to overall market sentiment than non-financials. This implies an outperformance of financials in our base scenario, but also noticeably stronger downside potentials in the risk scenarios.

d) Equities: Promising outlook, but surrounded by risks

Ongoing political risks will likely keep equity markets volatile going into 2012. That said, we expect a decent performance of stocks in 2012 in our base scenario. Helped by a moderation in concerns about the EMU, fundamental issues should come to the focus of investors again. In fact, valuations remain attractive, in particular for European stocks. This valuation case is further supported by the growing lack of risk-free investment alternatives, with central banks keeping interest rates at historically low levels. Finally, easing fears of a global recession also leave some scope for a recovery of equities after the sharp fall in 2011. We thus expect stocks to belong to the best performing asset classes next year.

The outlook is particularly benign for equities in emerging markets (EM). A superior growth environment and the scope for easier monetary policy amid receding inflation rates make us expect EM equities to outperform the markets in the advanced economies. Also in Europe, we expect a more meaningful rebound than in the US: valuations are particularly attractive after the fears around the sovereign debt crisis have hit European equities particularly hard in 2011.

The good performance of equity markets is, however, subject to meaningful risks. In the downside scenarios, we expect equities to suffer another year of losses. This holds in particular for European markets, where financial securities would suffer even more if the sovereign debt crisis was to intensify further. A particular risk for emerging market equities would arise from an outright crunch of the real estate sector in Asia.

e) Currencies: Euro to recover vs. US dollar

We expect the weak spot of the euro to extend into the first months of next year. Adding to the pressures from the sovereign debt crisis, the looming recession in the euro area and the prospective further easing of monetary policy by the ECB will unlikely lend support to the single currency in the near term.

Later in 2012, however, we expect the euro to recover noticeably against the US dollar in our base scenario. The gradual normalisation of the sovereign debt crisis and easing concerns about EMU break-up are key triggers underpinning this view. This recovery of the euro should also be enhanced by genuine weakness of the US dollar. An unwinding of safe haven flows should encourage investment outside the US dollar universe. Moreover, given the US' own huge fiscal challenges and uncertainties, EM central banks will likely continue to diversify their forex reserves holding out of the US dollar into alternative currencies. At the same time, the further internationalisation and gradual revaluation of the Chinese yuan will predominantly come at the expense of the greenback. Finally,

the ongoing large external deficit of the US also lays the ground for further pressure on the US currency.

The risks, however, are tilted towards a stronger US dollar in the risk scenarios. Any escalation of strains on financial markets and the global economy would be most strongly felt in the euro area, adding to the existing downside pressures on the single currency. The strong grip of Japan and Switzerland on their currencies has given the safe haven status of the US dollar a new boost. This safe haven status of the greenback would become even more apparent in case of any renewed sharper spike in global risk aversion in our view.

IV) Conclusions

The macro and financial outlook for 2012 is highly uncertain. Political risks are unlikely to ebb fast and fiscal consolidation as well as structural reform will be a multi-year effort. Still we believe that some sound inferences in the macro space can be made: Above all, the global growth profile will be meager and underlying inflation pressures will fall. And while fiscal policy will be tight, monetary policy will remain extremely accommodative. In this respect, the year 2012 is unlikely to feel much different from 2011.

The financial market impact is straightforward: Improved EMU governance should lift core yields from their current lows but due to the growth and inflation trade off, the increase will remain muted. And while very low growth in the euro area will dampen domestic operating profits, large international companies should be able to perform well due to their earnings exposure in the fast(er) growing regions of the world, thus making equities and corporate bonds a better investment compared to core government bonds. Intra-EMU spreads should tighten from their current record highs, thus rendering government bonds from highly indebted countries potentially quite attractive. However, unlike in the past investors have to keep in mind that government bonds can not be considered as entirely 'risk-free' any longer.

We have highlighted numerous event risks and, unfortunately, all of them are on the downside. We would like to conclude the paper on a positive note by acknowledging that things can also work out much better than envisaged here. Ireland has in 2011 decisively tackled the crisis and it was able to quickly regain market trust. We see no reason why this should not be feasible elsewhere. In Spain, we have a new government which ran heavily on a ticket of structural reform. In Italy and Greece, we have now governments led by highly esteemed experts in the field of macroeconomics and financial markets. In our view, it is also feasible that strong signals from the political arena will lift market sentiment thus leading to a virtuous circle of stronger financial markets and higher growth. And we have little doubt that the ECB would support these efforts by appropriate monetary policy actions. When the crisis is deepest, the willingness to change is often highest. We do not rule out the possibility that Europe reforms itself both at the national level and in terms of improved governance at the European level.

	Growth			Inflation		
	2010	2011f	2012f	2010	2011f	2012f
US	3.0	1.8	2.1	1.7	3.2	2.0
Euro Area	1.8	1.6	0.3	1.6	2.7	1.7
- Germany	3.6	2.9	0.8	1.1	2.6	2.1
- France	1.4	1.7	0.5	1.7	2.2	1.7
- Italy	1.2	0.8	-0.2	1.6	2.5	1.9
Non-EMU	2.2	1.4	1.0	2.7	3.8	2.3
- UK	1.8	0.9	0.9	3.3	4.5	2.6
- Switzerland	2.7	2.0	1.1	0.7	0.4	0.4
Japan	4.1	-0.6	2.1	-0.7	-0.3	-0.2
Asia ex Japan	9.1	7.3	7.1	4.5	5.9	4.1
- China	10.2	9.2	8.6	3.3	5.6	3.6
Central/Eastern Europe	4.4	4.3	3.1	5.8	6.3	5.5
Latin America	6.1	4.3	3.8	7.1	7.1	6.9
World	4.7	3.4	3.3	2.1	3.1	2.2

Financial Market Forecasts			
Bonds	Current ¹⁾	2011*	2012*
10-Year Treasuries	1.97	2.20	2.70
10-Year Bunds	1.84	2.10	2.50
10-Year OATs	3.64	3.70	3.90
10-Year BTPs	6.86	6.70	5.70
10-Year Bonos	6.51	6.20	5.30
Forex	Current ¹⁾	2011*	2012*
USD/EUR	1.35	1.34	1.45
CNY/USD	6.35	6.30	6.00
Equities ²⁾	Current ¹⁾	2011*	2012*
S&P500	-1.5	1.0	10.0
MSCI EMU	-16.9	-14.0	10.0
MSCI BRIC	-18.5	-14.0	13.0
Corporate Bonds ³⁾	Current ¹⁾	2011*	2012*
IBOXX Corp Non Fin	286	270	190
IBOXX Corp Senior Fin	370	350	250

¹⁾ at year-end ²⁾ current values = 17.11.2011 ³⁾ Equities: total return ³⁾ Corporate Spreads: in bps

Imprint

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