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World Outlook Remains Resilient But Not Without Risk, Say Deutsche Bank Economists

According to the *Deutsche Bank Global Markets Research* team, the macro-economic outlook for the world remains resilient — thanks to stronger data from China and an ease of eurozone tensions — though some challenges remain. Overall, global growth — bottoming out over the New Year period — is likely to accelerate in the second half of 2013, if central banks continue to maintain their accommodative policies and the US finds a solution to its potential fiscal difficulties.

New stimulus from the European Central Bank and the US Federal Reserve underpinned equity and commodity prices in September. That said, a disappointing recovery in Japan and fears around the upcoming "fiscal cliff" in the United States constitute the main risk to the team's forecasts for global growth.

They now expect the world economy to grow by 2.9% this year and 3.1% in 2013, down almost half a percent from previous estimates. They are also pencilling in a 2014 forecast of 3.8%.

Their forecast downgrade is mainly due to the slow rate of recovery in the US, which — although displaying moderate growth at 2.1% this year — is heading towards an "ugly" "fiscal cliff" at the end of 2012. The cliff will increase taxes and reduce government spending, which is likely to depress growth. Partly due to this, they now forecast US growth of just 1.9% for 2013, but with an expected pick-up in the second half of the year if fiscal issues are resolved.

They have also marked down their predictions for Japan due to a drop in reconstruction spending and a weaker export outlook — the economy is expected to enter its fifth recession in 15 years. The team has left its eurozone forecasts steady and expects the bloc's economy to bottom out in the first quarter of next year. But with a poor economic outlook, still considerable political uncertainty and Germany's loss of momentum, they see a high risk of a return of serious tensions within the European Monetary Union (EMU) area in the coming months (see below).

Meanwhile, most emerging economies — particularly India and Brazil — are also likely to struggle because of weaker exports to developed economies. Some emerging market central banks, however, may be tempted to tighten policy next year if food price inflation picks up significantly. And China's leadership change will act as a catalyst for economic reforms. Indeed, short-term indicators suggest China's growth will recover in 2012's fourth quarter, accelerate during the early months of 2013 and reach full potential in the second half of the year.

Commodities Outlook Remains Strong

The team believes the macro environment remains constructive for commodities heading into next year given their assumptions that world growth accelerates to 3.1% in 2013, as well as the likelihood of the US dollar remaining weak and the S&P 500 moving higher (subject to the resolution of the US fiscal cliff).

In addition, ECB action has reduced downside tail event risk for the euro area, while the Fed's liquidity injections should also help to sustain investor appetite for risky assets such as commodities.

The team is therefore maintaining a bullish outlook for precious metals and target gold prices rising to USD2200/oz next year. The sector will continue to benefit from negative real interest rates, they expect, as well as a weaker US dollar, central bank buying and the prospect of further rounds of Quantitative Easing (QE) by the Fed.

Meanwhile, industrial metal prices struggled in 2012 until the Fed announced in September a third round of QE. The team suspects the strengthening this caused may be difficult to sustain in an environment where Chinese growth falters. A more sustained rally in industrial metals is therefore probably more dependent on stabilisation of the Chinese growth outlook, but China's leadership change should help this materialise over the New Year period.

While they expect geopolitical risk will sustain price spike risk across the energy complex, this is dampened by the fact high gasoline prices will maintain speculation of a strategic petroleum reserve (SPR) release prior to year end.

And finally food — where strong gains in prices over the summer months are beginning to fade, although fundamentals in some markets remain tight: for example, corn. Moreover a developing *El Niño* threatens drought conditions in Australia and with it downgrades to the country's wheat production.

Eurozone Woes Continue

Outright Monetary Transactions (OMT) — the unlimited buying of an indebted country's short-term bonds — was a reminder of the ECB capacity for big policy innovations. As a "lender of last resort" — even if conditional on austerity and reform — the ECB is aligning itself with the likes of the US Fed and the Bank of England, and the markets were impressed.

However, the "conditionality" applied to the OMT, added to concerns around economic growth, which — along with the implicit political constraints on the ECB — will likely deflate much of the optimism.

Spain and Italy are likely to come under European Stability Mechanism (ESM) and OMT funding programmes in the coming months, and their reviews will be significant risk events next year. Furthermore, Germany — which had remained relatively resilient — is showing increasing signs of weakness, with 2012's fourth quarter growth likely to be -0.3%, the lowest since early 2009.

These factors mean the team remains cautious — expecting eurozone GDP to contract 0.4% in 2012, to recover only mildly in 2013, and to rise by 1% in 2014 as peak-austerity passes, purchasing power improves and global demand accelerates (though only gradually). However, the next 12 months — and the management of the Spanish and the Italian crises — will be crucial to ensuring that these predictions bear out.

Eurozone headline inflation forecasts for 2012 and 2013 have gone up a little compared to last quarter, but core inflation expectations have eased. That said, medium-term inflation expectations have risen: For instance, 5Y ahead inflation is at the high end of its historic range, according to the ECB Survey of Professional Forecasters. Worrying for the hawks, this forecast predates Mario Draghi hinting at the OMT.

In aggregate, the economists estimate the euro area fiscal stance to tighten a little less in 2013 (1.1% of GDP) than in 2011 and 2012 (1.5% of GDP in both years). Only in 2014 is there expected to be a significant softening of austerity. The euro area fiscal balance should fall from 3.2% of GDP this year to 2.4% of GDP in 2013. Within that, perhaps only Germany, Finland, Austria and Italy will record sub-3% deficits. Otherwise, the Commission will likely have to grant additional time to some non-programme countries to hit targets (e.g., the Netherlands).

On monetary policy, the ECB neither cut rates nor eased general collateral rules at the September meeting — opining that the OMT and associated conditionality ought to help prevent the downside risks to growth and inflation from materialising.

Fed QE3 and the subsequent jump in the EUR is likely to increase pressure for an ECB rate easing. However, OMT purchases, rising inflation expectations and a weaker EUR might be a toxic combination for German politics so that a pre-emptive move would be a hard sell to the Governing Council. We see the ECB waiting until Q1 2013 before delivering one 25 bps refi cut and only cutting the deposit rate into negative territory in the event of a substantial further deterioration in economic conditions.

Meanwhile, potential EU political gridlock on banking union, the emergence of populist political parties — for example, in Italy's 2013 election — and the US fiscal cliff all present significant risks for the eurozone in the months ahead.