

Brief Global Outlook

We expect a broad global expansion that should withstand North Africa turmoil, current oil prices and Europe's debt crisis. The environment is more favorable for equities than bonds or commodities as we pass from the cautious stage of the expansion to the growth stage.

U.S. Kicking the Can Hard

- We think the U.S. is growing at a 4% rate, enough to create jobs and gradually lower the unemployment. Corporate profits should remain relatively strong, despite the margin squeeze for commodity users. Growth in auto sales will slow as pent-up demand is met, but we expect pent-up small-business demand to begin adding to capital expenditures
- We expect the U.S. to continue its ultra-loose fiscal and monetary policies. The federal debt burden will rise rapidly above 70% of GDP, with the effective debt maturity shortening due to QE2 buybacks. However, given the global recovery and high levels of U.S. household assets, we don't expect a near-term debt or dollar crisis. The U.S. has succeeded in kicking the can down the road -- there will be some structural reforms at the state and local level but few at the federal level. We don't expect tax or entitlement reform or much reversal in Washington's spending and regulatory boom.
- The Fed will probably complete its QE2 asset purchases on schedule, building its assets to nearly \$3 trillion. We don't think it will start QE3 unless growth slows substantially. The fed funds rate will probably stay negative (i.e. below inflation). This undercuts the dollar, which will probably fall below its March 2008 record low (70.7 on DXY) as more U.S. capital flows to countries with stronger currencies.

Europe: Debt Problems Unresolved

- Europe should be able to grow moderately, while gradually converting its severe losses from the 2008 bubble into legacy costs (as the U.S. did with General Motors.) Some of the weaker European countries will see their debt burdens 'supra-nationalized', i.e. shared by euro-zone facilities, the IMF and creditor haircuts. If the net present value of the debt is reduced enough, economic growth will resume in the weaker countries, adding to ongoing growth in the stronger countries.

- The latest round of bank stress tests hasn't been tough enough to separate strong and weak banks or give confidence on consistent capital adequacy. We don't expect much progress in the March 24 euro-zone financial meetings either, leaving peripheral sovereigns and their banks under pressure.

Emerging Markets: Minor Slowdown

- China will probably slow to 8% from its 10% plus rate. There's a well-designed top-down effort to limit inflation, tighten bank lending and refocus on consumption growth. Though China still uses central planning, we think the overall economic program is improving the quality and sustainability of China's growth.
- Other emerging markets will also slow some as they tighten monetary policy and digest their burst of growth. Commodity inflation is forcing higher interest rates, but most of the countries have used the opportunity of plentiful capital to build infrastructure and make structural reforms aimed at competitiveness.

Oil and Commodities

The demand for oil is relatively inelastic in the short run, meaning a supply disruption beyond Libya would cause a further oil spike. Global growth would slow in the event of a supply-driven oil price increase. With oil supply stable for now, other factors provide downward pressure on commodities, leaving the possibility of a constructive decline.

- The Fed is not "printing money". Its asset purchases are financed by excess bank reserves (i.e. idle reserves not circulating through the private sector). If oil stabilizes and U.S. growth avoids a double dip, the safe haven value for gold and commodities should go down.
- Commodity ETFs have boomed, exaggerating the upswing in commodities. As we move into the growth leg of the expansion, investment flows are shifting to equities from bonds and should also shift away from momentum-driven commodities.
- This leaves commodities volatile over a wide range and dependent on Chairman Bernanke's signals on Fed dovishness. For example, any expression of Fed awareness of dollar weakness or rising headline CPI inflation (the Fed usually focuses on slow-moving core) would take commodity prices off boil.

Lots Can Go Wrong

There are many caveats in a constructive global outlook.

- Pakistan and Iran are unpredictable. The turmoil in Arab countries could turn catastrophic. Oil supplies could be disrupted in a number of scenarios. The European debt situation requires steady political leadership in spreading the losses, where mistakes or delays could cause a rapid deterioration. Illinois, California and other states will demand federal bailouts, creating a rolling debt crisis with broader social fights than the recent Wisconsin tensions. Warren Buffett's phrase -- you don't know who's swimming naked until the tide goes out -- applies to an unknown number of other submerged debtors (home mortgages, commercial real estate, European banks).
- On the positive side, we note the early stage in the expansion cycle, worldwide innovation, and the rapid improvement in opportunities for hundreds of millions of Chinese, Indians and Africans.

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