Global Economic and Market Outlook
UMB Investment & Wealth Management

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Outlook 2012: The Long Hard Slog Continues

2012 Outlook

- Accelerating growth in North America
- A recession in Europe
- Global political and economic anxiety
- A worldwide debt hangover

"The obscure we see eventually. The completely obvious, it seems, takes longer."

Edward R. Murrow

A Debt Supercycle Unwinds

The developed world is in turmoil, and has been for the better part of 10 years. Unsettling news concerning banking, currency and political messes make daily headlines. We are seeing the unwinding of a global debt supercycle whose origins date to the early 1970s, depending on the country.

Japan's economy has been in a no-growth mode for 25 years. Political leaders in the U.S. cannot seem to make any decisions as the nation continues to dissect our political needs from wants. The very structure of Europe's banking, currency and economic systems is in flux. The developed world seems to be coming apart at the seams. The Long, Hard Slog continues.

A Secular Slowing of Growth

We have long held the view that developed economies' dysfunction resides in a secular slowing in growth, coupled with a systemic rise in debt structure. This profile has been building for the better part of a quarter century. Last year, we outlined why the developed-world's long-term economic growth rate has been slowing. The slowing is due to many issues, including demographics and a secular shift from private sector dominance to economic systems which rely more heavily on government involvement. This has all been a reaction to the developing world's increased dominance of worldwide economic power.

Our thematic piece published in October 2010, *Black Swan Rising*, outlined in detail our thoughts as to why a slowing in systemic growth has led to a higher-than-normal level of uncertainty, which we believed would continue. The increased level of uncertainty towards the sustainability of economic growth led to a rise in secular volatility rates within the financial markets. We postulated that those trends would continue in 2011. Indeed, that call was accurate.

Has anything happened over the last year which changes our view of slower-than-historical growth rates coupled with higher volatility in the developed world, at least over the short-term?

In a word, no.

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Economic Growth and Inflation Forecasts

The following is our economic outlook, in numbers for the year 2012:

Real Economic Growth Projections		**Average 1990 – 2007**	**2011 estimate**	**2012 estimate**
World-Wide GDP		2.90%	2.60%	2.40%
Developed World GDP		2.40%	1.10%	0.70%
Emerging World GDP		6.50%	6.80%	5.50%
Projected Inflation Rates				
Developed World Inflation		2.40%	2.40%	1.10%
Emerging World Inflation		--	7.40%	5.80%
Forecasts for Individual Countries	**2011 GDP Growth**	**2012 GDP Growth**	**2011 Inflation**	**2012 Inflation**
U.S.	1.6%	1.8%	3.0%	2.0%
Euro-Zone	1.5%	-1.0%	2.8%	1.8%
Japan	-0.5%	1.5%	-0.4%	-0.5%
U.K.	0.8%	-0.5%	4.5%	2.5%
China	8.5%	7.0%	5.5%	3.0%

If we are correct in our overall view of pressures and opportunities, the world's economic environment may, for the majority of 2012, resemble an economy slowing in its overall growth profile, dragging inflation down.

In this environment interest rates, particularly high quality sovereigns, should remain low, and perhaps move lower still. We believe the world's investors will continue to scramble for sustainable income streams. This rather benign environment masks deep troubles that, at times, will surface.

Global Economic Outlook Highlights

Why No Worldwide Recession

What gives us heart that the world will escape an outright economic contraction? We believe a full 65% of the world's economies will experience some level of economic growth deceleration compared to 2011. Central banks have been very busy attempting to liquefy banking systems to provide ammunition to economies for expansion purposes. Central banks which have been lowering interest rates or taking other easing actions include:

United States	Euro Area	Japan
United Kingdom	Switzerland	Australia
New Zealand	Russia	Czech Republic
Romania	Turkey	Israel
South Africa	Hong Kong	Indonesia
Thailand	Brazil	Mexico

These 18 central banks represent economies which dominate worldwide economic power. Indeed, the only central banks which have continued tighter monetary policies include:

China	Canada	Sweden
Norway	Poland	Hungary
Nigeria	India	South Korea
Taiwan	Malaysia	Chile
Peru	Columbia	

The U.S., by itself, generates more GDP (in dollar terms) than all the countries mentioned in the second block combined. Consequently, it is easy to say the world's central banking system is very much aware of economic risks, and is concerned primarily about growth**.** *It is very rare for the world, in total, to enter a recession when the great bulk of central bank activity is concentrated on avoiding an economic contraction.*

Leading Economic Indicators

The majority of the world's Leading Economic Indicator (LEI) indexes are not pointing towards a recession. Of the 29 countries within the OECD (Organization for Economic Co-Operation and Development), 12 are currently showing LEI levels of 100 or better, indicating

(expansion). Importantly, one non-OECD country that is showing expansion is China. In fact, the world's three largest economies (individual countries) are showing LEI levels indicating continued expansion (U.S., China and Japan).

However, there are a number of economically significant countries whose economies are slowing. The following are major countries that appears to us to be showing LEI levels at less than 100 (expectations of a slowdown in growth/contraction):

- Canada
- United Kingdom
- Germany
- France
- Switzerland
- Brazil
- India

The LEI data, while mixed, still points on balance to a continuation of growth, albeit on a choppier, non-systemic basis.

Slowing Industrial Activity

On the other hand, we are seeing evidence of economic stresses that are starting to occur due to the significant economic slowing occurring in Europe. *World-wide economic momentum, particularly in the industrial segment, seems to be slowing.* Indeed, the year-to-year percentage change in J.P. Morgan's Global Manufacturing PMI Index shows a contraction of 4.7%, as compared to expansion at the beginning of 2011. On a worldwide scale, the only major economies which are showing positive manufacturing readings are the U.S., Switzerland, Japan, India and Australia. All other major economies' manufacturing bases are showing weakness, on the margin, with particular current weakness observed in the Europe and China.

The Bottom Line for 2012

So where does this leave the world's economy? Looking specifically at the world's "income statement" items we paint a picture which is weak, on balance, but still positive. We expect the world to witness the following during 2012:

- **Weaker growth but no recession**. We expect to see slightly slower economic growth during 2012 vs. 2011. Worldwide economic growth (real) increased at roughly 2.6% during 2011. We expect a slower growth rate to emerge during 2012. However, the world should stay out of recession (defined here as growth less than 2.0%).
- **A shift in growth to favor the U.S.** In addition to a slightly slower economic growth rate, we believe the composition of that growth rate will change. Major geographic segments under growth pressure during 2012 as compared to 2011 include Europe, China and the rest of the emerging economies. Areas where growth may accelerate (in some cases only slightly) include North America and Japan.
- **Emerging market growth continues**. We believe China and many emerging markets will outgrow the vast majority of the world. However, we expect overall emerging market GDP growth to weaken.
- **European stagnation.** Although a global recession is unlikely, some of major geographic segments are likely to see economic contraction. The most notable of these will be Europe. We are calling for GDP growth in Europe to fall by 1% during 2012. This contraction may have a significant impact on worldwide economic performance during the year.
- **Age of austerity**. Consumer marginal demand will likely be slow, driven by higher-than-normal unemployment rates and existing high levels of outstanding debt. We are living through an age of deleveraging. This is true of both the U.S., and Europe. We feel consumers and governments will need to continue paying down debt to satisfy credit market demands.
- **Global inflation should decelerate**. This is not due to welcome reasons, slower final demand growth rates coupled with high levels of economic and political uncertainty. Businesses have been "sitting on their hand" over the last few years due to these trends, which may continue in 2012.
- **Commodity prices (industrial) may be weak**. Growth in major commodity-importing countries will be contracting, albeit from high levels.
- **Job scarcity continues**. Unemployment in major developed economies should remain elevated compared to historical norms.
- **Sovereign interest rates should remain subdued for "safe" countries**. We believe investors will pay a premium for sovereign debt that appears to be high quality (U.S., Switzerland, Germany and others) or is issued by countries which have a lack

of leverage on their sovereign balance sheets. Other governments which do not possess either of the above characteristics may need to "pay up" for capital during much of 2012.

- **Economic uncertainty, political anxiety**. Uncertainty will be accented due to monetary, banking and currency system dislocations. Politically-generated volatility may remain high on investors' source of anxiety. This is particularly true in the U.S. and the Euro area, especially France and Russia.

Balance Sheet Concerns and Our Longer Term View

While the world's economic environment seems rather benign, real issues still infect most people's view of risk taking and the sustainability of economic growth. We have written extensively on these issues since 2007. The problems have manifested themselves into levels of excessive debt that has been created due partially to a lack of strong economic growth rates to fund rising governmental and lifestyle activities. There are two ways of funding increasing spending by any economic unit; by earning the money or borrowing the money (or in the case of a central government, printing the money). If the economic unit borrows the money, the lender of this capital needs to be repaid when due.

A Final Word

With all that is happening in Europe, and Washington and the underlying issue of economic power transfer from the developed countries to the developing countries, why in the world would a U.S. investor consider raising their risk profile?

Complete risk aversion has never been a rewarding long-term strategy in investing or life. Being an investment Candide in this global environment also lacks credibility.

We feel the market is potentially at the start of a long-term process in which there could be more light than darkness. Given the background we have outlined, *it makes sense to us for equity investors to consider downside volatility, when it occurs, as an opportunity rather than a cost.* To do so, some candid, serious questions about the market should be asked. It is a healthy process that, in our opinion, needs to start. And why now?

We at Scout believe the next major secular bull market should start its upward move within the next 1- to 3- year period.

Look for more discussion about this topic in the near future. If we are correct on this call, then we believe investors should currently be proactive about seeking investment opportunities that have the potential to help them reach long-term goals.

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