POLICY HITS OR MISSES TO DRIVE GLOBAL BOND MARKETS IN 2013 (PART I*)

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We believe the global economic recovery will remain on track in 2013 as the benefits of accommodative monetary policy continue to feed through to global demand.

Executive Summary

Standish Global Macro Strategist Tom Higgins expects global real GDP growth to average 3.3% in 2013, a slight uptick from the 3.1% growth in 2012. Global price pressures, he says, are likely to remain subdued, with inflation rates easing in every major region except Latin America and developing Asia. In Standish's view, political uncertainty in the developed markets represents the most significant risk to its global outlook, as the deleveraging process shifts from the private to the government sector. Tom foresees a modest increase in government bond yields in the U.S., Germany and the U.K. as monetary policy begins to gain traction. He also anticipates some strengthening in emerging market currencies as better economic fundamentals attract capital inflows to developing Asia and Latin America.

GLOBAL MACRO OUTLOOK FOR 2013

We believe the global economic recovery will remain on track in 2013 as the benefits of accommodative monetary policy continue to feed through to global demand. However, we are concerned that fiscal consolidation will weigh on economic activity in the developed markets (DM), particularly at the beginning of the year. We are more optimistic about the outlook in the latter half of 2013, when we hope to have greater clarity on key policy issues impacting the United States and Europe.

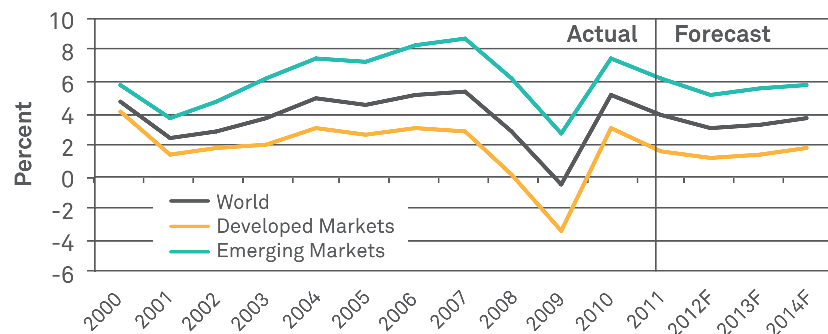
We continue to expect emerging market (EM) economies to fare better than their DM counterparts, given the absence of major macro imbalances and their ability to employ countercyclical policy to offset economic weakness. Soft external demand in the first half of 2013 will weigh on growth in some of the export-oriented economies in Asia, while healthy domestic demand should bolster several of the economies in Latin America. Eastern Europe probably faces the biggest challenges, given its ties to the euro area.

*Part II of Standish's outlook for 2013 will be released in the second half of January.

Overall, we are forecasting global real GDP growth to average 3.3% in 2013, which marks a slight uptick from 3.1% growth in 2012. Much of this growth will come from EM economies, where we expect growth to increase 5.2% in 2013 compared to only 1.2% for the DM economies. In our view, global price pressures are likely to remain subdued, with inflation rates easing in every major region except Latin America and developing Asia. Despite the absolute low levels of DM government bond yields, we foresee only a modest increase in interest rates in 2013 amid this macro environment. We also anticipate some strengthening in EM currencies as better economic fundamentals attract capital inflows from DM economies.

The negative effects of the policy uncertainty in Washington could be partially offset by positive developments in the U.S. housing market.

Exhibit 1 – Global Growth Remains Middling



Source: International Monetary Fund and Standish, as of December 2012.
F = Forecast

U.S. FISCAL AND MONETARY POLICIES AT ODDS

The key risks to our global economic outlook mostly lie on the policy front. Although the U.S. Congress and the Obama administration marked the first days of the New Year with an agreement to avoid the worst of the fiscal cliff effects, we assign a low probability to their achieving a grand bargain on tax and entitlement reform in 2013. Consequently, once the euphoria of avoiding the cliff subsides, the rhetoric in Washington is likely to heat up again, which will weigh on consumer spending and business investment in the first half of 2013. In the end, we expect legislators to approve a suboptimal long-term fiscal reform plan that fails to restore long-term solvency to Medicare and Social Security.

The negative effects of the policy uncertainty in Washington could be partially offset by positive developments in the U.S. housing market. Over the past year, there has been a steady improvement in housing sales and starts, along with some stabilization in prices. The positive wealth effect from increasing home valuations should bolster household balance sheets with some ancillary benefit to consumer spending. Separately, there appears to be some common ground between Democrats and Republicans on corporate tax reform, which could free pent-up demand from businesses that have been putting off capital expenditures because of uncertainty on fiscal issues.

The Federal Reserve will do its best to coax these green shoots into a sustainable recovery in private demand by providing ample liquidity. At the current pace, the Fed will purchase a combined $1 trillion in agency mortgage-backed securities and Treasuries in 2013 as part of its third round of quantitative easing (QE). The Fed has committed to maintaining QE until the outlook for the labor market improves "substantially."

Although the unemployment rate has fallen by a percentage point over the past year to 7.8% in December, the Fed has not viewed this as a substantial improvement because nearly half of the decline has been driven by workers dropping out of the labor force. We believe this will change in 2013, with the participation rate stabilizing and the unemployment rate gradually declining to 7.4% by year end. At that point, we believe the Fed will be more comfortable ending its balance sheet expansion, which will mark the first move toward tightening monetary policy and perhaps the beginning of a gradual rise in U.S. Treasury yields. By the end of 2013, we expect the yield on the 10-year U.S. Treasury bond to be around 2.5%.

Despite our expectation that Treasury yields will rise modestly in 2013, we do not foresee the Fed raising the federal funds rate until late 2014. At its December policy meeting, the Fed announced that the exceptionally low level of short-term interest rates will be appropriate "at least as long as the unemployment rate remains above 6.5%" and "inflation between one and two years ahead is projected to be no more than a half percentage point above the Committee's 2% longer-run goal."

Based on our projections, the U.S. economy will grow at an average rate of just 1.5% in 2013 because of the fiscal drag, but growth should accelerate back toward its trend rate of 2.2% in 2014. Assuming a gradual increase in labor force participation and steady employment gains, we believe the unemployment rate will fall to 6.5% by December 2014, which is roughly six months earlier than the Fed is forecasting. As the market begins to anticipate the eventual normalization of monetary policy, market volatility will likely begin to pick up the closer we get to the Fed's unemployment threshold.

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POLITICAL RISK AND REFORM FATIGUE IN THE EURO AREA

Though the issues are different, policy risk is also high in the euro area. Key events in 2013 include Spain applying for a memorandum of understanding with the European Stabilization Mechanism (ESM) authorities; the activation of the European Central Bank's (ECB) Outright Monetary Transactions (OMT) program; and both Italian and German elections.

We expect Spain to apply for a liquidity assistance program from the ESM in the first quarter due to, the large amount of debt the country must roll over in 2013. Once approved, the ECB will begin purchasing one- to three-year Spanish government debt under its OMT program in order to drive down the country's borrowing costs. There is an outside chance that Portugal or Ireland might request assistance before Spain, which could mitigate Spain's need for assistance if borrowing costs decline across the peripheral economies; but this is not our base case. There is also a risk that Spain's request for aid could be rejected by one or more member countries or that the ECB fails to be aggressive enough in its bond purchases to have a meaningful impact on peripheral borrowing costs. However, we believe the probability of such an outcome is currently relatively low.

Our forecast for euro area real GDP growth is flat for 2013, with a modest acceleration to 0.8% growth in 2014.

Italy's Prime Minister Mario Monte's resignation has added another layer of uncertainty in the euro area as new elections are scheduled for February. We anticipate that a new center-left coalition government will be formed, but it is unclear who will lead it. If a fractious government emerges, then the outlook for reform would dim. We are more hopeful about the results of the German elections in the fall, which are expected to produce a grand coalition. This could prove to be quite positive, since tough decisions will need to be agreed upon by all parties in government.

A smooth transition through these political risks would likely see an incremental improvement in risk assets, all else equal. However, we are sensitive to the risks of further bouts of volatility if unforeseen developments upset the expected trajectory of policy developments. As such, we believe high-quality developed sovereign bond markets could benefit amid outflows from riskier periphery markets. We think the biggest beneficiaries would be U.S. Treasuries, German bunds, and U.K. gilts. Over the course of the year, periphery spreads are likely to trade in a broad range, though we believe they will gradually trend lower as debt dynamics in these economies improve and the markets force policymakers into action. Our forecast for euro area real GDP growth is flat for 2013, with a modest acceleration to 0.8% growth in 2014. There is a large standard deviation risk around this growth forecast, linked to continued accommodative monetary policy and progress on reform as well as a pickup in global demand.

EMERGING MARKETS FARING BETTER

Emerging markets were once plagued by the same kind of political uncertainty now holding back developed markets, but they have moved beyond that. Instead, their primary concerns today revolve around the dampening effect of sputtering growth in developed economies on global demand. This is particularly worrisome for export-oriented economies in developing Asia. Recent purchasing managers' surveys in the region remain mixed and do not demonstrate a decisive recovery for output and exports in 2013.

Asian countries generally have the fiscal and monetary flexibility to employ counter-cyclical measures if necessary. Yet, barring a collapse in global economic activity, we do not foresee interest rate cuts in the region as a response to the possible inflation risk associated with abundant global liquidity and rising wages in these countries. We believe the outlook is positive for Indonesia and the Philippines and are more cautious on the near-term economic prospects for Vietnam. For the region as a whole, we are forecasting real GDP growth of 7.1% in 2013, a slight increase from the 6.9% growth rate in 2012.

In Latin America, growth has continued to exceed expectations in countries such as Mexico, Peru and Chile. Although growth in Colombia has slowed, the country's economy is still expected to grow close to potential over the next year. We think Peru will be the top performer, with growth expected to surpass 6%. Meanwhile, we believe Mexico, Peru and Chile should each register growth above 4%. Domestic demand continues to be the main growth driver, supported by net exports. We continue to favor Mexico, because of its fiscal health, credible monetary policy, and reform momentum under the new administration. By contrast, we remain cautious on Brazil because of what we consider to be a poor policy mix. Recent data suggest that Brazil's economy might have touched bottom in 2012, so some acceleration might be expected in the first half of the 2013. Argentina and Venezuela remain laggards in our view because of policy and institutional setbacks.

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As for East European economies, we believe they are probably the most exposed to euro area risks. The sharp deceleration in trade with the euro area has already negatively affected regional growth. Moreover, the deleveraging of West European banks has resulted in declining capital flows and reduced credit growth in many of these countries. That lack of access to credit comes at an especially inopportune time as governments such as Hungary's face severe fiscal shortfalls and debt management challenges. Consequently, we believe Eastern Europe is likely to be the worst performing EM region in 2013, with growth of just 2.4%. Meanwhile, we think the Commonwealth of Independent States, which includes Russia and other former republics of the Soviet Union, should perform better, with growth of 4.3% thanks to the region's large reserves of oil and natural gas.

Exhibit 2 – Global Growth Forecast

Jan 2013	Standish						IMF					
	Real GDP			CPI			Real GDP			CPI		
Survey	2012F	2013F	2014F	2012F	2013F	2014F	2012F	2013F	2014F	2012F	2013F	2014F
United States	2.1	1.5	2.2	2.0	1.8	1.7	2.2	2.1	2.9	2.2	1.8	1.7
Japan	1.7	1.0	0.6	-0.1	0.0	2.2	2.4	1.2	1.1	-0.2	0.3	2.6
United Kingdom	-0.1	1.1	1.5	2.2	2.0	2.0	-0.4	1.1	2.2	2.2	1.7	1.7
Euro zone	-0.5	0.0	0.8	2.0	1.5	1.0	-0.4	0.2	1.2	2.1	1.7	1.4
Developing Asia	6.9	7.1	7.4	4.6	5.0	5.0	6.7	7.2	7.5	5.5	4.8	4.2
Eastern Europe & CIS	3.1	3.4	4.0	5.7	5.3	4.9	3.1	3.4	3.7	6.2	5.9	5.6
Latin America	2.5	3.8	4.1	5.7	6.1	5.7	3.2	3.9	4.1	5.8	5.9	5.6
Global	**3.1**	**3.3**	**3.7**	**3.7**	**3.6**	**3.5**	**3.3**	**3.6**	**4.6**	**4.0**	**3.6**	**3.4**

Source: Standish and The International Monetary Fund forecasts as of October 2012 based on purchasing power parity.
F = Forecast

We are more skeptical than others that removing the worst of the political uncertainty in the U.S. and Europe and unleashing pent-up demand from consumers and businesses will spur a significant revival in global growth.

MORE OF THE SAME IN 2013

During the past four years of post-financial-crisis recovery, the global economy has struggled to consistently achieve the 5% plus growth rates experienced prior to the crisis. Instead, global growth has been hovered in the 3% to 3.5% range. We expect this pattern to continue in 2013, as developed economy governments seek to repair their balance sheets through deleveraging, as the private sector did in the immediate aftermath of the financial crisis. However, in contrast to the last three years of interest rates trending lower, we foresee a modest increase in government bond yields in the U.S., Germany and the U.K., as accommodative monetary policy begins to bear fruit.

We are more skeptical than others that removing the worst of the political uncertainty in the U.S. and Europe and unleashing pent-up demand from consumers and businesses will spur a significant revival in global growth. Indeed, the most significant downside risk to our forecast is that uncertainty might actually increase in 2013 because of the combined challenges of long-term fiscal reform in the U.S. and the implementation risks associated with economic reform and central bank policy in the euro area.

Despite these risks, as Standish CIO David Leduc will describe in the forthcoming second installment of our 2013 outlook, we continue to see attractive opportunities in certain segments of the fixed income markets around the world. Although valuations are more challenging than they were a year ago, we believe high yield and emerging market local currency debt should benefit, as investors move down the capital structure in their search for yield. We also anticipate a strengthening in EM currencies versus their DM counterparts as global growth and interest rate differentials attract capital inflows to fiscally stronger economies and their currencies.

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