# Review & Outlook 2011/2012: European Crisis Intensifies, Policy Makers Begin to Rewrite 'Fiscal Contract'; U.S. Economy Gains Momentum, Establishes Modest Growth Trajectory; Emerging Markets Slow, But Lead

After double-digit gains for the broad equity indices in 2009 and 2010, the markets proved to be more challenging in 2011 as external events including natural and nuclear disasters in Japan, a budget deficit impasse in the U.S., and the intensification of the sovereign debt crisis in Europe drove volatility to record highs, volumes lower and led to a bipolar, highly correlated market environment of either 'risk on' or 'risk off' headline driven extremes.

Investment markets overall continue to be fixated on macroeconomic policy. In this regard, the largest risks continue to be in Europe. One of that continent's greatest challenges lies with the fact that the 17-nation group that uses the common Euro currency is not a single country with a single fiscal mandate. Euro-zone members do not have the option of monetary policy loosening or individual currency depreciation, several tools that are typically used to offset economic weakness, at their disposal.

To counter economic weakness in the wake of 2007-2008 recession, several Euro zone peripheral countries, including Greece, Portugal and Ireland, embarked on a period of big spending, which involved fiscal expansion beyond levels that were sustainable. Over the course of the last two years, the sovereign debt issues have spread from the periphery of Europe to its core countries such as Spain, a G20 member, and Italy and France, which are both G7 members, and potentially most importantly in our view to Europe's banks, pressuring balance sheets, lending levels, and leading to a full blown credit crisis in wholesale funding markets.

Policy makers continue to move very slowly in their attempts to solve the sovereign debt crisis, however several recent developments could have a positive impact. Both the European Central Bank (ECB) and the International Monetary Fund experienced changes in leadership. Under Mario Draghi, the new head of the ECB, the central bank has lowered interest rates twice, entered the secondary market to purchase modest amounts of Spanish and Italian bonds in an effort to put a ceiling on yields, and provided additional liquidity to banks through a three-year, long-term refinancing operation. The ECB's willingness to lend freely to banks has reduced the risk of sudden bank failure due to a liquidity event, although banks will face constraints in how much they can borrow based on the quality of their available collateral.

Moreover, the governments in both Greece and Italy removed elected prime ministers and replaced them with technocratic leadership, backed by cross-party support, which is committed to implementing austerity measures to curb deficits and to promote growth-enhancing structural reforms. Last month, European finance ministers reached an agreement for a new 'fiscal contract', designed to ensure future fiscal discipline and backed by sanctions for nations that go astray. We view as the first major step toward addressing the core issue and one that has the potential to begin the process of stability. However, risk levels remain high as parliaments may reject the new fiscal rules, voters might refuse to accept austerity and restoring competitiveness across Europe's periphery will take years.

In Washington, the two political parties remain worlds apart on entitlement and tax reform and the situation continues to disappoint investors. The mid-year deficit debate that narrowly avoided default led to a credit rating downgrade for the U.S. by S&P, and to the formation of a Congressional committee which ultimately failed to reach a compromise. Given the political-policy stalemate, it appears that any attempts to drive real solutions, including on tax reform and entitlements, will be postponed until after the November elections, further delaying the inevitable in our view.

The election will undoubtedly drive the news flow this year and irrespective of the names on the actual ballot, what voters will more than likely be choosing between this fall are two competing visions of the role that government should play in a free society, the proper purpose and design of the social safety net, and the fundamentals of job creation and economic growth. The U.S. economy remains at risk of a prolonged period of policy uncertainty that could further erode business and consumer confidence, discouraging hiring and spending, and increased regulatory risk from Washington, such as the recent rulings favorable to labor unions and the tougher air quality standards.

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The U.S. economy gained momentum heading in 2012, reaching what appears to be a self-sustaining, albeit modest pace by historical standards, and avoiding the risk of a return to recession. The fourth quarter is anticipated to be the strongest since the second quarter of 2010 with an expected GDP growth rate of 3.0%, or higher. Holiday retail sales proved to be impressive and weekly jobless claims dropped to levels below 400,000 for eight of the last nine weeks of the year, with the four-week moving average marking its lowest level since June 2008. Multiple housing market indicators have ticked up recently as well, including housing starts to the highest level in 19 months, along with increases in both new and pending home sales. Moreover, durable goods orders, purchasing managers' activity and factory orders all improved in the fourth quarter pointing to continued growth in manufacturing.

The major source of global economic strength continues to be the rapid growth of markets abroad, including China India, Brazil, and a few dozen other emerging nations.

Many of these countries which had been tightening monetary policy in an effort to control inflation have recently shifted to easing interest rates and reserve requirements as they become more concerned about the level of global economic growth. As economies in Europe cool and exports level off, these countries will increasingly need to look to their own consumers, who are moving up the income ladder, and buying more in the way of automobiles, washing machines, smart phones and other discretionary items.

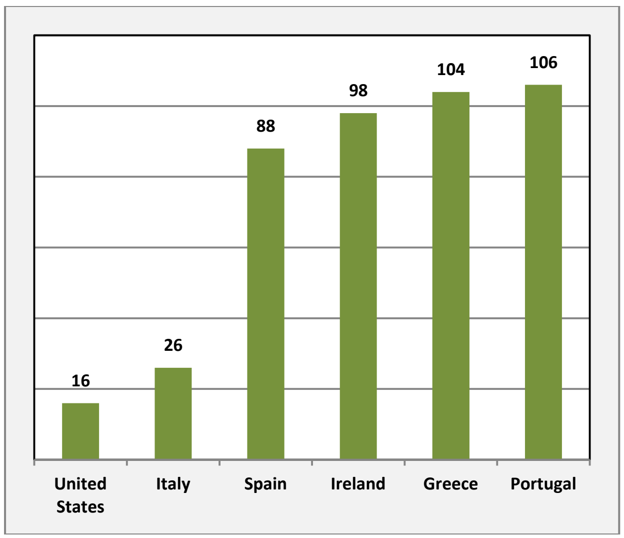
In 2012, Europe appears headed into at least a mild recession, followed by anemic levels of growth as it works to get its fiscal consolidation in place and deal with issues surrounding the excesses of the past and a modification to the 'welfare state' model. In addition, Europe's financial institutions and governments will face large refinancing requirements. Time will be needed to implement the rules regarding fiscal union and to execute on a credible plan to decrease tension. We will be watching closely for clarity on progress.

The U.S. economy appears to be gaining strength, potentially due to a higher level of flexibility and relative stability, and aided by an aggressive Federal Reserve. The November election will be the dominant story in the U.S. in 2012 and the market could 'vote' prior to the fall.

The secular growth story in emerging markets should continue to support global economic growth in 2012 in our analysis. Strong fiscal positions along with policy easing in the emerging markets should allow these economies to maintain the lead in terms of economic output, although they should experience a modest slowdown relative to the robust levels of growth of the recent past.

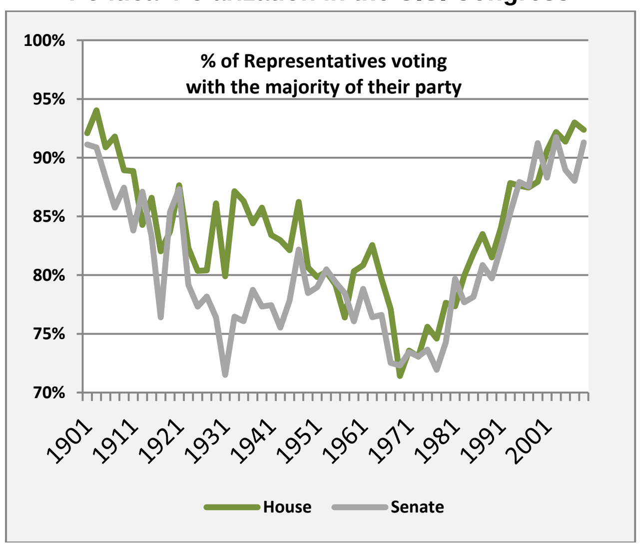
Given the volatile market environment and heightened global macroeconomic risk and policy uncertainty, we continue to favor non-cyclical, defensive industry sectors over cyclical ones, and to continue to focus on multinational, primarily U.S. based companies with the strongest balance sheets, the capacity to increase dividends, which stand to benefit from emerging market consumer demand.

**Total Economy Net External Liabilities (% of GDP)**



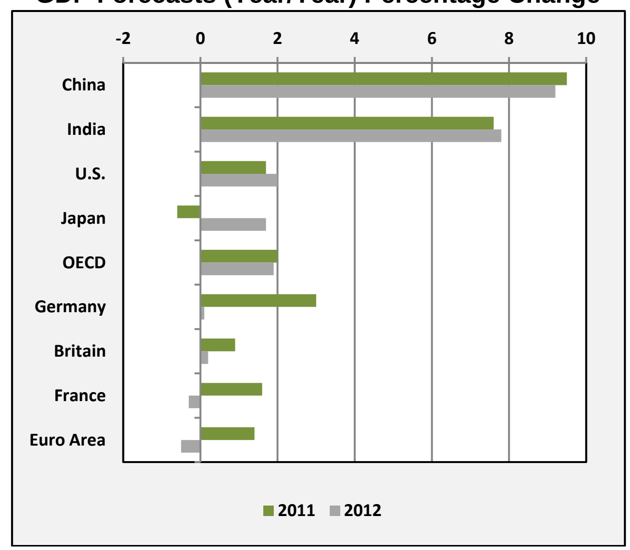

Source: IMF Global Stability Report, Lazard Asset Management

**Political Polarization in the U.S. Congress**




Source: www.voteview.com (McCarty, Poole and Rosenthal)

**GDP Forecasts (Year/Year) Percentage Change**




Source: The Economist