PERSPECTIVE

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DAYS OF DECISION

As the relatively quiet summer draws to a close, the remainder of the year is shaping up to be a critical juncture for the global economy and financial markets. Many of the risks that investors and businesses have fretted about will experience defining moments over the next few months. Make no mistake, things could turn ugly. However, the more probable experience will be like white water rafting: lots of twists, lots of turns, lots of excitement, but hopefully relative calm on the other side. Of course, that is so long as the raft doesn't flip along the way. Let's quickly review some of the key risks and their prospects.

The European financial crisis remains risk number one. If Europe completely loses control of the situation, it could create a systemic banking crisis and a renewed global recession. The more likely path, however, is that the past is prologue. We expect more muddling through that creates gradual progress. There is now broad based acknowledgment that Europe must put in place policies to separate the banking crisis from the sovereign debt crisis. This requires moving towards a banking union, which would involve improved bank supervision, stronger bank balance sheets and perhaps a pan-euro deposit insurance system. Europe also needs to make concrete progress towards a fiscal union, with binding limits on fiscal behaviour. The political hurdles on both fronts should not be underestimated. The existing political system is simply not capable of moving quickly when governments are being asked to fundamentally change their relationships and sovereign obligations.

In the meantime, the European Central Bank is left to fill the gap and give the politicians some breathing room. This is why the ECB is widely expected to announce a new bond buying program in early September to constrain yields on the debt of fiscally distressed countries. However, the terms and extent of the ECB program are still unclear. Some clarity could come at the ECB meeting on September 6th.

Given its rapidly deteriorating economic situation, an IMF/EU/ECB bailout for Spain seems inevitable in the coming months. If this occurs, markets could start to fret that Italy is next. There will be large bond auctions for Italy, Spain and some of the other at-risk nations in September and October. Moreover, the German constitutional court will give a ruling in mid-September on the commitments made by Germany during this crisis – odds are that the court will bend over backwards to find a way to decide in favour of the government's actions.

Meanwhile, the economic crisis in Europe will proceed, with economic contractions in several countries and meagre growth in others, adding to their fiscal challenges. Many of the governments receiving financial aid are expected to continue to miss the agreed upon fiscal targets, which creates a political risk that bailout money will be withheld or delayed. In the case of Greece, such a result could lead to a messy exit from the euro that could create contagion financial pressures on other nations. Can you envision the raft starting to tip? The final assessment is that some progress on resolving the European fiscal crisis has to be made this fall or else the risks to the global economy are clearly to downside.

The fragility of the U.S. economy is risk number two. The economy once again experienced a mid-year slump in growth. The good news is that the activity data is now looking a bit better. However, growth prospects still appear to be relatively muted and progress on reducing the unemployment rate will continue to be painfully slow. There is widespread hope that the Federal Reserve will ride to the rescue once again, delivering additional monetary stimulus at the September 12/13 meeting. The sad fact is that any Fed actions will not materially boost either economic growth or job creation. Given current market sentiment, the greater risk is that investors could be disappointed if the Fed only changes its forward-looking language or takes other actions short of major bond buying. Nevertheless, the U.S. economy is healing from the legacy of the credit bubble. Progress is being made. Most importantly, housing markets are finally showing signs of stabilizing. The big risk now is the conduct of fiscal policy. The Congressional Budget Office recently presented an economic scenario showing that the U.S. economy will fall back into recession if it hits the fiscal cliff – a risk that TD Economics has been stressing for a long time. The fiscal cliff is a host of tax measures that expire at the end of this year combined with scheduled spending cuts that arose from the debt ceiling fiasco of 2011. If all of the cuts and tax hikes occur, we estimate it would knock 3.5 percentage points off of economic growth in 2013. This is simply unacceptable, so the political system will act to ensure it does not happen. However, it is not evident how well Washington will function after the November elections. This creates political uncertainty that makes assessing the future of the economy very difficult until the dust settles, but that could be early 2013.

Risk three is the slowdown in emerging markets. Due to the lagged effects of inflation-fighting policies and weakness in exports due to reduced demand growth in the advanced world, there has been a material slowing in the expansion of most developing nations. With the Chinese government shifting the policy levers towards growth, TD Economics continues to believe a soft-landing is in store, but the extent of the economic weakness could be more than first anticipated. Other emerging market economies are less centrally commanded, implying economic management may prove more difficult. Make no mistake, emerging economies will remain the drivers of global growth, but they may not fire on all cylinders. The soft-landing will need to be confirmed this fall. There is also a key political event in the form of a generational change in leadership in China, which will happen in November. China has gone through such transfers of power in the past, but never before has roughly 70% of the leadership changed hands. This could be transformational for China and is worth paying attention to.

A fourth risk is oil prices and geopolitical tension with Iran. The Iranian nuclear program, and potential responses by other nations to this program, is concerning. In a worst case scenario, there is a risk of an oil shock. High oil prices are already weighing on the minds of global leaders. The G7 finance ministers released a statement last week saying they are vigilant about the risks to the global economy, but then the rest of the statement was about the risks posed by elevated oil prices. One simply cannot predict how geopolitics will evolve, but given some of the acute vulnerabilities facing the global economy, the path of oil prices is a key input to the outlook.

The conclusion is that it remains a risk-filled environment. One of the challenges is that the bulk of the risks have a strong political dimension, making predicting their outcomes problematic. There was a financial crisis in 2008 and an economic crisis in 2009 that led to a fractured and weakened global economic and financial system heading into the 2010 and 2011 recovery. Over the past two years, we have been in the political/fiscal crisis stage of this story. One also should acknowledge that the legacy of the financial/economic/fiscal/political crisis also lays the seeds for social distress. Central banks do not have the capacity to resolve the root problems. So, the ball is in the court of the politicians. The coming months will see how well global leaders are capable of rising to the challenges that face them. The most likely scenario is doing just enough, just in time to avoid a dire economic calamity– but there is a risk that financial markets could deem this to be too little, too late. The best possible outcome is that we get bold decisive leadership. But, if the past is any indication – and we think it is – this is like betting on a leisurely paddle through a set of rapids.

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