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2012

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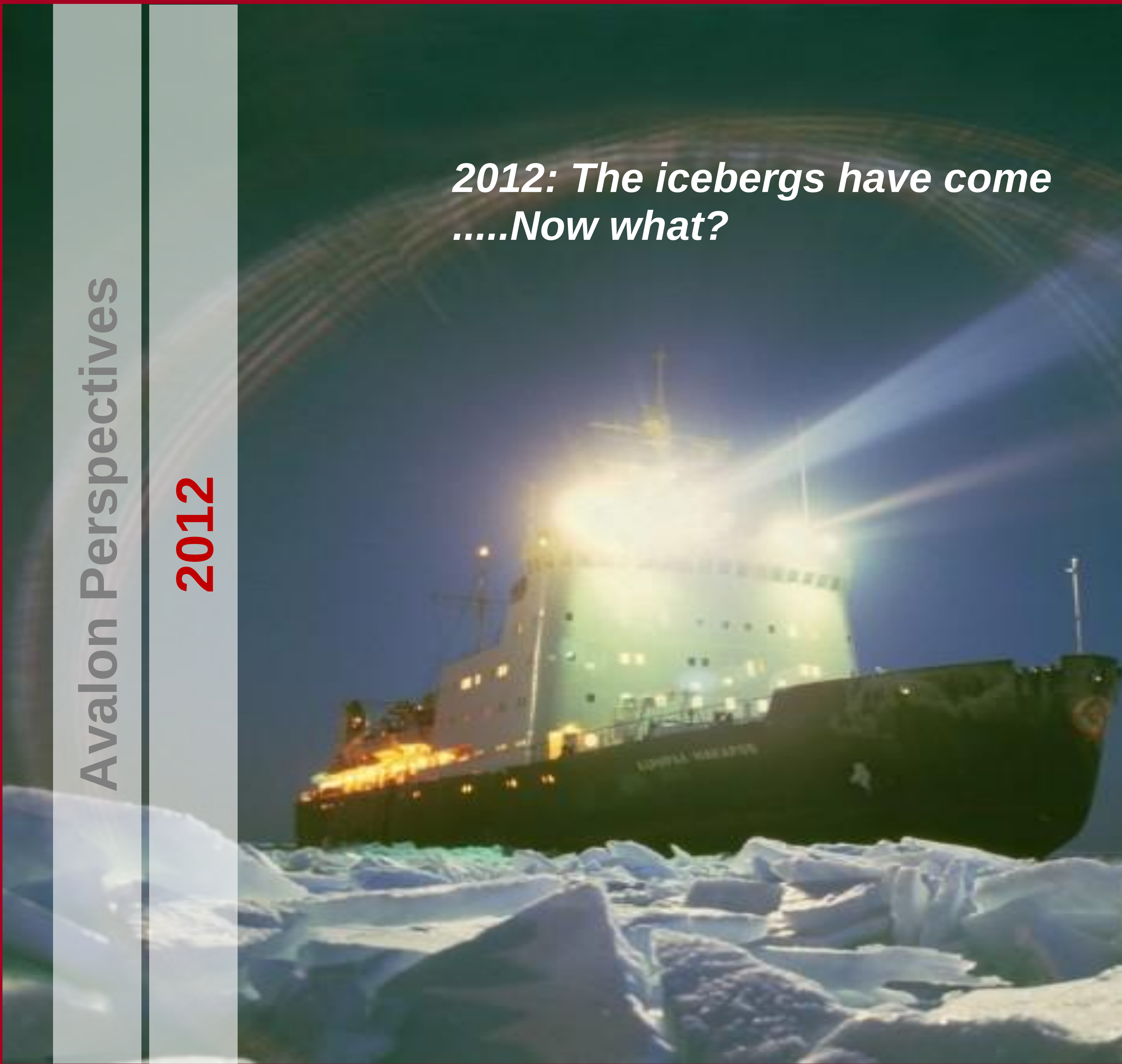

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2012: The Icebergs have come...... Now what?

The good news is that the world will not end on December 21, 2012 as the Mayans thought it would; the better news is that a new world is likely to emerge from the financial holocaust of the past 3 years. It is going to significantly change the way we look at the world.The world will be a different place. The G7 has already given way to the G20. Banking and attitude towards risk will be different. There is more to come.

The title of this year's note takes off from that of the title of my note for 2011 (***The Icebergs are coming***), which was written when the economic confidence indices were merrily rising, especially in Europe. In fact, in early 2011, I had many readers asking me whether the Icebergs will really come, since nothing had happened till then. My answer was always, "wait till midyear".

The European ship, has since hit the icebergs. The peripheral European countries have suffered damage. Can the engine room say that it is not bothered about the hull? Not really, and that is why Merkel and Sarkozy are actively engaged in the matter. The problem is that water has started entering the engine room. Plugging those leaks will not solve the bigger problems. They hull has to be repaired and the ship stabilised to save the passengers. The problem is Titanic in size and has struck exactly 100 years after the Titanic's proud launch with assumptions of invincibility. What price will the people manning the engine room extract?

To understand, 'what next' in 2012, it is instructive to look at Europe and China,and less so at the US, unlike in the recent years. Some of USA's financial sector problems also lie in Europe and in the UK, as was clear in what we now know about Lehmann and about MF Global. But that's another story for another time.

Will the Eurozone collapse? Will EU split or the Euro die?

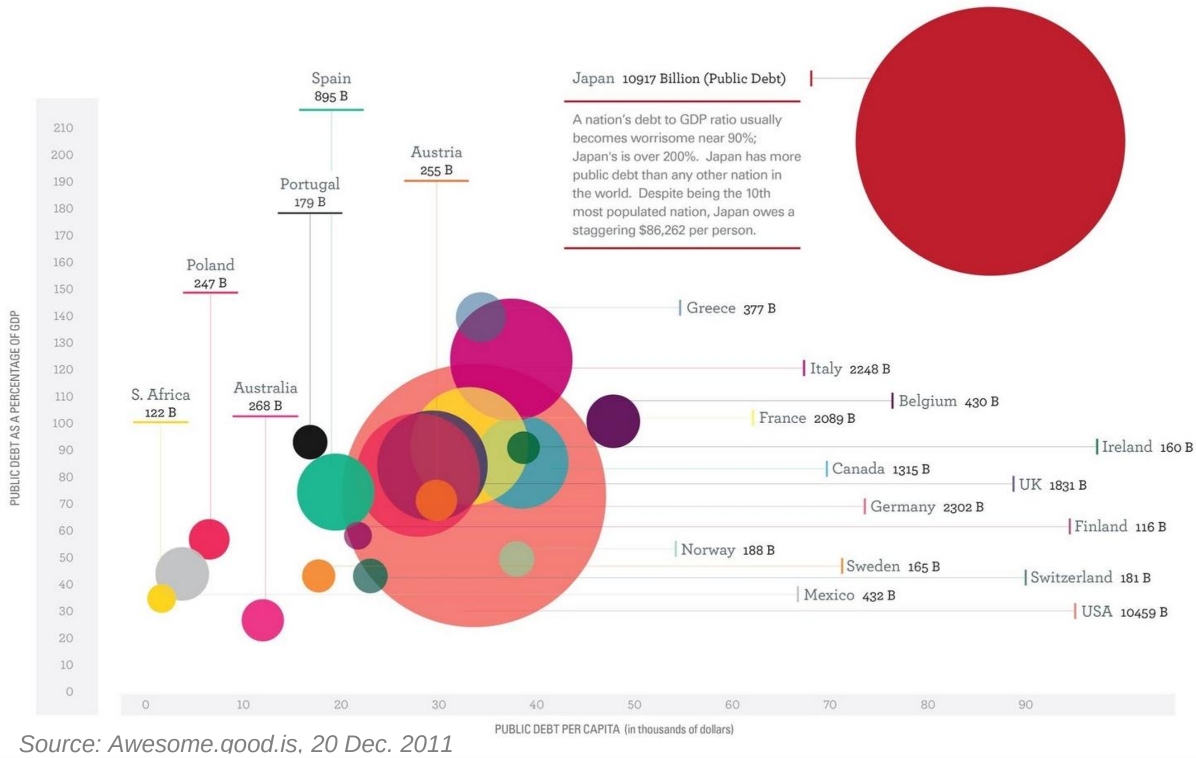
The European economic crisis has to be watched carefully because under the surface of the sovereign debt crisis lies a struggling European Banking system which received a $1 trillion dose of low cost 3 year funding from the EuropeanCentral Bank in December 2011, most of which was lapped up within a week but promptly deposited safely at slightly higher rate rather than lending. If the Euro collapses as a currency, the European Banking system will collapse and there are plenty of Euro critics around who have written off the Euro. Question is not whether it deserves to collapse for not observing some of the basic rules of economics but whether Europe can afford to let it collapse. That can kill the European banking system, which is the largest in the world, holding thrice the consolidated assets of the US system, and probably four times of the Japanese Banking system. Italso plays a huge role in connecting the economic system of the emerging markets, especially Asia, with those of the developed nations. Neither Europe nor the rest of the world can afford to let the European Banks collapse. Hence everything under the sun will be done to save the Banking system and the Euro, neither of which will be easy. A dark scenario is one in which some of the problem nations could be asked to leave the EU. For the Euro to be saved there needs to be a much tighter fiscal union in the EU that bonds the productive North and the delinquent South which today look like two economic zones, with different problems to which solutions are not merely economic. There could also be some Bank consolidations or nationalisation in the EU to save the weaker ones in the wake of Basel III.

Mohamed El-Erian sums it up very well, *"Right now, the continent is being buffeted by challenges on three separate fronts: economically, politically, and socially. It's clear that the ECB wants to see change from its national governments first.So next year will be characterized by de-levering, de-globalization and policy inconsistencies".* The ECB waited till December 2011 to see the political leaders of Italy, Spain and Greece out and till the new ones showed political resolve to tighten the belt.

One thing pretty clear is that European Banks will shrink their balance sheets significantly, the consequence will be lower lending by them not just in Europe but in the rest of the world as well, especially Asia.

Will there be apocalypse in the global economy? Will Japan compound the problem?

The global economy will not collapse in 2012 but there will be sluggishness and/or de-growth in the West. A quick look at the indebtedness chart below would suggest that the US with a huge debt over-hang can still hold on given that its debt as a % of GDP is still below 100 (excluding contingent liabilities which are not insignificant) and that it can expect to grow in 2012 albeit at only around 1.5% - a little less or a little more. The US Fed played a huge role in ECB's recent backdoor Quantitative Easing because what happens in Europe affects US GDP. Negative impact on the US economy had to be minimised with the US going to elections in 2012. Japan on the other hand would appear to be a basket case but given that its borrowings are largely from internal sources and that the average cost of that debt is still sub 1% pa, Japan may not face the wrath of global bond markets in 2012 unlike some peripheral European countries like Italy and Greece. Spain is iffy and Belgium does not look terribly safe. France could face a credit down grade or a rap on its knuckles at the least, whilst Germany looks relatively stable but stagnant, and will be under intense pressure to rescue Europe. The general reckoning is that European GDP will decline by about 0.7 % and Europe needs to de-lever sovereign debt at the same time.



Source: Awesome.good.is, 20 Dec. 2011

It is more than likely that Germany will extract something significant in lieu of bearing the cross for Southern Europe, reminiscent of the US support for Britain during World War II for which the Pound had to give up its prima donna position as the global reserve currency in favour of the dollar. Europe could look different as a result.

Will Europe or the US sit quietly,observing problems at home and the loss of global economic clout? What can they do and if they do that, what will the consequences be?

They will not but the solutions are complex. Every nation is governed by three forces: fundamentals, sentiment and ability of the Government to control them.

Till last year, we were in a two track world in which there were trendsetters and the rest would follow fast or slowly depending upon the capability and degree of interconnectedness. By 2010 the fast trackers were in the East and the slower growth economies were in the West. The equilibrium was shifting towards the East. So we thought. The assumption of stability that is associated with the term, 'equilibrium', was misplaced. It is going to be a far from smooth transition. In actual practice, stagnation in the West has made it unstable socially and politically whilst high growth in the East has also made it unstable because both were in alien situations. The medication being administered by Governments in the West is different from that in the East because the problems are different. However, since these two economic clusters are interconnected and since money is fungible, we are witnessing some strange things.

The instability in the West was due to the efforts to stem the rot and regain growth by hook or by crook without which their heart would not get to pump enough blood required to keep the citizens happy and theirmarkets alive. Low blood pressure would cause decay leading to collapse in some cases, which was not acceptable. Businesses and banks were being forced to become viable through quantitative easing and there would be more of that in 2012.

The instability in the East was because of efforts to control the amount of blood to be pumped in the system through the channels available. The rising demand pressure was becoming too high for the existing economic system and infrastructure to handle. The system was getting overheated.Growth was to be sacrificed else the system could haemorrhage. Inflation was going out of control in emerging markets, especially in India. That was not acceptable. Citizens were being forced to manage with more expensive money and in some cases, scarce money so that the demand could be curbed. It is well known that this is a poor remedy. India's lost decades before 1991 are a standing testimony to the folly of trying to irrationally curb rising demand instead of expanding supply of goods and services.This time around, the Reserve Bank of India increased interest rates 13 times in 18 months while clearlystating that the Government will be happy to sacrifice growth to control inflation.

We are now in a bi-polar world in which two parts are pointing in opposite directions and are being administered almost diametrically opposite solutions. But the East and West are not patients in two insulated rooms who can be treated in isolation. It is a connected worldwhere the global economy is like one patient where the East and West are like two lungs which are independent to an extent but connected; lungs that can support each other and infect each other as well.Western Governments did and will keep pumping in more money at low interest rates whilst Eastern Governments did raise interest rates and curbed money supply. This has given rise to East-West arbitrage opportunities and derivatives positions. The global interest rate swaps outstanding was $ 442 trillion on June 30, 2011 up by $94 trillion from a year earlier after being more or less flat in the previous 12 months. According to UBS, currency traders lost 2.5% in 2010 due to the unexpected strength of the dollar, much more than ever in the past decade.One has no estimates for 2011. Hedge Funds have done their worst to exploit the difficult situation in Europe since August and that made the challenge for countries like Greece even tougher. It is another matter that MF Global made a suicidal bet of $6 billion on default by Greece.

Europe's problems are too severe to be solved without the 'lenders' taking a haircut.

It is very instructive to follow the comments of the outspoken Governor of the Bank of England, Sir Mervyn King on several issues. He is also reported to have said something to the effect that UK's economic revival will depend upon what China and other creditor nations who run surpluses will do to help. He said: *"One way or another, the losses that were built up in recent years will have to be shared between creditors and debtors; in the world economy between creditors in the east and debtors in the west, and within the euro area between creditors in the north and debtors in the south.*" This is an admission that those who lent money recklessly to the West may need to take a write off.

Unless there is holistic treatment, the remedies may be sub optimal and in some cases, detrimental to one or both parts of the global economy.Is a holistic solution in sight? 2012 could down in history as the year of negotiations. Will solutions come top down through G20, 'G whatever' or WTO….or bottom up through regional alliances talking to each other whilst tackling issues in their home ground?It is likely to be a bit of all the above but the key to understanding what will that happen in 2012 lies in China and not so much in Europe.

Will China and emerging markets save the world economy again?

It is now acknowledged that emerging markets saved the global economy a lot of blushes by accounting for 78% of the economic growth during the 3 bad years post 2007, with China alone accounting for 33% at a time when the traditional power houses US and the EU added 8% and subtracted 9% respectively. The story may unravel in 2012 along similar lines though the absolute numbers would be different. The EU crisis is hurting the growth of emerging countries like China and India.

China is clearly gearing to grow their domestic market to counter he expected slowdown in exports and more reforms are in store over the next 24 months as the country makes leadership transition; all this, notwithstanding the bad debts in their banking system, over heated real estate, and the poor financial logic for some of their infrastructuralprojects. They have the financial reserves to absorb them. Their incumbent leadership will also do its best to go out in a blaze of glory as it negotiates rules, deals and compromises that will include easier access for their exports to the EU and US, withdrawal of anti-dumping cases, easier access to acquisitions or strategic stakes in high tech areas like bio-technology , space technology, non-conventional energy and other relevant companies in return for greater access for growth hungry Western companies to China's home market and for financially supporting the peripheral nations in Europe, directly or through some institutions like the ECB. China's influence in world bodies will be significantly higher than today when I pen my note next year, a price for China's support.

China will be under pressure to revalue the Renminbi which has already risen (RMB 6.3 to a Dollar on Dec 31, 2011) in order to rebalance world trade. While making some concessions,China will argue that they have allowed labour wages to rise in 2011 and may believe that allowing increased wages in a low per capita income may be better for them politically than increase the value of the Renminbi.

2011 took its toll on India's growth bringing it to below 7%. In 2012, the GDP growth may slow down to somewhere between 6.4 and 6.8%, with a worst case scenario of 5.6% if all the negatives conspire to work together. India, which will grow faster than most global economies in 2012, has neither the clout which China has nor will it be able to engage in a well-targeted action plan orchestrated by the Government which is caught up in its own cobweb. Instead what we are witnessing is and will see more of in 2012, is action byprivate enterprise to exploit domestic opportunities and by cash rich corporate enterprises to acquire assets in the developed world to gain access to consumers in those markets and to technology. Most experts view the current dip in valuations in the West and Africa, asan opportunity because they look cheap when compared to those in India. Every day, investment bankers line up with a bag full of lower cost opportunities in the West. This is hardly surprising given that most of the cash rich enterprises have clocked double digit growth rates, often above 20% pa, over the past 8 years (and want to continue to do so), in a country that has grown at about 7 to 8% pa.(Note that India hardly accounts for 2% of the global GDP.) If their growth in their respective industries depends upon their global or regional positions, they will not hesitate to invest overseas. Two factors hindering it would be the weakening Rupee and significant slowdown in access to foreign capital because of the crisis that European Banking is in. In some sense the two are related.The big worry for India is the oil price. Just when the global slowdown was paving the way for lower oil prices, the situation vis-a-visIran is threatening to mess up the oil prices again. It is impossible to predict political events and skirmishes which will rock the oil market in 2012 but I repeat what I said last year, the days of cheap oil are over.

Hence India will run a large current account deficit. Unwillingness to reduce fuel and food subsidies with general elections coming in 2014 will reduce policy flexibility. In my review of the Indian situation in mid Aug 2011, I had pointed out that India could get away without too much damage in the financial year ending Mar 31, 2012 and that the biggest risk factor is the Government's ineptitude. In the next 4 months, the Government has indeed under-performed on the economic and political front, and has been rather non-functional on the policy front due to corruption scams, poor management of civil society's concerns and poor floor management in the parliament. The policy freeze and curbs on growth due to high interest rates (industries dependent on availability of affordable consumer finance like the auto sector and housing have been virtually brought to a grinding halt and that in turn has affected cement, steel, plastics, textiles and large swathes of the business sector) have combined to ensure that the growth in the financial year ending Mar 31, 2012 would be of the order of 7% or thereabouts and even lower in dollar terms because of the weakening Rupee. If the Government had not muddled things, growth would have been between 7.5 to 8%.

Will 2012 be very bad for India?

I would think not, but slower than 2011. One could see certain favourable things in the coming months:

- The Europeans bring about some semblance of stability in their banking system by some means, despite negative growth of the economy.
- The US economy being primed up for some growth in the election year, despite increased sound and action between the GOP and the Dems.
- China being able to negotiate their desired geo-political and economic terms, in return for helping Europe.
- Repeat of the annual return of FII funds into India's capital market in January after the flight out in December. The drop in the stock market along with the sharp decline in the value of the Rupee have provided head room for value creation
- Interest rates in India start declining in 2012 resulting in the revival of Indian manufacturing and related business. This and the return of the FII could potentially revive the stock market and in turn, improve the business and public sentiment
- Already, there is talk of likely 7-8% increased hiring in 2012

- Food inflation has already dropped significantly although the overall inflation is still high and commodity prices may remain low at least till mid-year. Oil is a big imponderable.
- The Government is showing the will to re-invigorate infrastructure projects which slowed down in 2011, and may indeed succeed.

These factors could offset the political impasse that will continue in 2012 and heighten in preparation for the showdown at the ballots in 2014.

What are the implications for Indian businesses and for those dealing with India?

The fundamentals like growing per capita income and spending, high levels of private savings, higher export competitiveness due to the weaker Rupee, improved productivity of the Indian manufacturing sector in absolute terms, liquidity levels in the economy, etc. are strong points.

Policy for foreign investments into India will be further liberalised in many sectors because of the need for Foreign Direct Investment at a time when global liquidity will be stretched more than ever. For the Foreign Direct Investors this is a good time to invest when the dollar parity is most favourable. The sense is that the Rupee could strengthen from 54 to 50 to a Dollar.

Pending legislations aimed at rationalising the structure and processes for collecting indirect taxes, like GST, could be pushed through albeit after a lot of push and pull.

All this could improve the sentiment for primary issues of equity in the stock market and thus speed up pending capital investments.

Indian and global companies may find 2012 to be the year to cherry pick acquisitions in India before valuations go up again.

Treat these as lead indicators and look out for them in the volatile 2012 global economy, in order to adjust your outlook on India. There are reasons for optimism on two of the 3 forces but the Government's ability on the 3rd one (to control things) remains a question mark. Another issue is cross border terrorism from Pakistan, if the current internal turmoil in that country worsens. China is getting more allied to Pakistan as if to offset US influence, but will, by and large, posture against India but not venture beyond that because India and China need each other economically more than ever before in the coming decade.

Finally as usual, no discussion on the real world of business is complete without getting social- social media, I mean. It is changing what we thought of as the real world. In 2012, social media will become more integral to our commercial and personal lives. Let us just take one small aspect of business, advertising. That world is going to change beyond imagination. Internet advertising which is growing silently (already 16% of the global advertising pie) is expected to beat newspaper advertising in 2013. The game is different on the internet and the players are different and 2012 is expected to be the defining year. At stake is $ 84 billion advertising cake in 2012. Social networks are becoming the platform taking share from other properties on the internet. Google is the 800 pound gorilla in the internet advertising space with a share of over 40% but it cannot afford to let Facebook, the leader in social networks get too much of that. 2011 is the year when Goggle got socially right after earlier failed attempts (Orkut, Buzz and Wave), and 2012 will be a defining year for Google +, the new social networking site launched in mid- 2011. There is a lot of buzz about who will be the winner, Facebook or Google+. There are clearly at least 3 features which make the Google+ experience superior to that on Facebook, but that alone is not enough to declare the winner in the high stakes race for billions of dollars of advertising revenue.

Facebook has over 800 million people on it already, whilst Google+ is expected to cross 100 million in the first half of 2012 and they have a huge budget. Facebook's IPO in 2012 could give them enough money to add many new features to fight it out. Finally, you will choose the winner. Who will it be? Who wins does not matter to newspapers. Their world will change by this time next year. It will also change for a lot of other business folks as well across industries and continents. Ask yourself, why your industry or sector will not. Bankers can tell you a thing or two.

The Mayans were right after all.

The author - Raj Nair - is the Chairman of Avalon Consulting (a strategy consulting firm), Avalon Global Research, Ugam Solutions (a leading global Marketing analytics firm), Germinait Solutions (a start-up in digital unstructured text analytics offering solutions to business verticals) and Director of OC&C Strategy Consultants. This publication is intended for general guidance only. It is not intended to be a substitute for detailed research or the exercise of professional judgment. Avalon Consulting cannot accept any responsibility for loss occasioned to any person acting or refraining from action as a result of any material in this publication. Moreover, they should be seen in the context of the time they were made in. The objective of the paper is to cover the subject at a high level but readers who are interested in discussing any issue in greater depth are welcome to contact the author on raj.nair@consultavalon.com

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