

Three Key Questions

Randy Befumo, director of research at Legg Mason Capital Management, assesses the prospects for Europe, the US economy and global growth.

October was driven by three key questions: one, will Europe avoid disaster?; two, will the US recovery continue?; and three, will the rest of the world continue to grow?

In Europe, the umpteenth European Union summit delivered the closest thing to a workable solution we have seen. But contrary to conventional wisdom, we do not think immediate implementation of a specific plan is required for Europe to avoid disaster. The point is not whether this particular plan will work, but whether the financial system gets more time to adjust to inevitabilities. European authorities may never actually fix everything, but as long as they buy their highly leveraged banks time to repair their balance sheets, they have decreased the odds of a devastating sovereign debt crisis in Europe.

Even though headlines trumpet the policy twists and turns of attempting a European "fix," that isn't what the market is focused on. The market doesn't bet on specific outcomes, but rather reflects a probability distribution that includes all possibilities. It discounts new information incrementally, updating the distribution of outcomes to reflect incoming evidence and changing uncertainties. The market only needs signs of progress to assume that European banks have more time, the most critical factor, and to therefore reduce the chance of a devastating European scenario.

Escaping the black hole

Far from tripping stall speeds for the US economy, October displayed escape velocity from the black hole of a double dip. While not resplendent, third-quarter US real gross domestic product (GDP) of +2.5% annualised was above the 1% reading that is a key warning sign of an impending recession. While labour reports were similarly not robust, they were strong enough to prevent the average US employment rate from rising more than 35 basis points over the past three months, another recession precursor identified by Goldman Sachs economists.

While these alone were enough to reduce the odds of a second recession, there is more that gets missed in the daily angst over the economy. Real GDP, nominal GDP and consumer spending are all at all-time highs, driving US corporate results to a new all-time high based on annualised Q3 S&P 500 earnings of \$102 per share. This was more than enough for markets to reduce the odds of a double dip.

As for the rest of the world, a wave of central bank easing and new, unconventional monetary policies promise continued growth. Brazil, Russia, Israel, Indonesia, Pakistan, Denmark and Romania all lowered interest rates over the last two months. The Bank of England initiated its second round of quantitative easing. China announced plans to use its sovereign wealth fund to buy shares of local banks and help private enterprises. While the right bet since February has been to be "No" on the three key questions, October showed the other side of this trade.

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