

# Economist Insights

## *The tipping equilibrium*

The global economy is sitting at a tipping equilibrium that cannot persist indefinitely. If confidence about the Eurozone worsens it could send us on a downward spiral of ever worsening confidence and crisis. If confidence improves it could rapidly release pent-up demand. Stronger data in the US brought a low-conviction rally last week, but the prospects for 2012 will not be determined by small changes in the economy but rather by the perceived risks to the euro. We don't expect resolution before the second half of the year, when the cumulative effect of all the little moves finally creates enough momentum to tip us to the upside.

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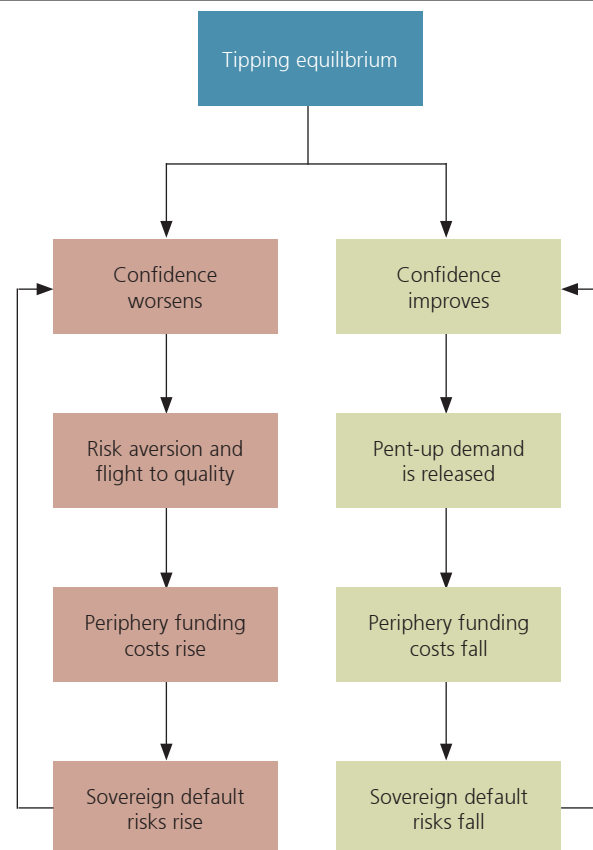
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Since Lehman Brothers went bust, economists' forecasts have increasingly been prefaced with the claim that uncertainty at the current juncture makes forecasts particularly difficult. This is in part cop-out, in part justified by the unprecedented nature of recent history and in part due to the central role of confidence in the current crisis. Confidence in particular is notoriously difficult to forecast, and a drop in confidence about the outlook can quickly become self-fulfilling.

It is not very useful for economists to give a central projection and then just claim that there is a very wide uncertainty around it. We prefer to characterize the current juncture as a tipping equilibrium. The 'central expectation' path that developed economies are on is one of low confidence and low growth outlook. We can stay on this path only if confidence does not take a turn either for the worse or for the better (see chart).

Should confidence about the Eurozone worsen, then things will not only turn bad, they will turn really bad. Lending to periphery governments and banks would dry up. Defaults would spread through the system, damaging confidence more and creating a vicious downward spiral. This could rapidly lead to first one and then many countries leaving the euro. As soon as you tip down into that spiral it is very hard to stop.

### The tipping equilibrium



In contrast, if the Eurozone finally starts to take enough steps to solve the sovereign crisis, confidence could start to improve. Low confidence has generated a lot of pent-up demand over the past few years, so a better outlook could lead to a rapid pickup in investment and consumption. This in turn would lead to more hiring, which generates more confidence and hence tips us over into a virtuous cycle. Crucially, improved risk appetite would make it easier for periphery governments to finance, bringing down the risk of contagion.

This is very much on the mind of investors. The start of the year brought with it what might be called a 'low-conviction' rally in risk assets. Perhaps it was just that the pessimistic trades are now so crowded that some investors are looking to take contrarian positions. Or perhaps after the continual downward reassessment of economic prospects in the second half of last year investors came back from their holidays to be surprised by the tone of the US data: improved purchasing manager indices, better job growth and falling unemployment.

This reinforces the ongoing theme of differentiation between the better prospects for the US and the gloomier prospects for the Eurozone. Indeed, the weaker Eurozone countries were left out of the rally in equity markets and periphery spreads against German bunds have widened further.

Unfortunately strength in the US, while nice to have, cannot really compensate for the fact that data still shows the Eurozone heading towards recession. More importantly, confidence about the US will not substitute for a lack of Eurozone action to deal with the tail risk that the single currency collapses.

The economic, and investment, outlook for 2012 is going to be dominated by that tail risk rather than by economic fundamentals. Who cares if Eurozone economic growth happens to be a bit below zero rather than a bit above zero if governments have done nothing more to prevent a sovereign collapse?

As long as both the fear of collapse and the hope of resolution persist side by side, we are likely to stay on the current subdued path. This situation cannot last indefinitely. Should the fear of collapse diminish the global economy could tip to the upside, but should the hope of resolution fade then the tip would be to the downside.

Our view is that the current balance between hope and fear for the Eurozone is likely to persist until the second half of 2012. In the meantime there will be more summits, more 'comprehensive' solutions that promise more than they deliver. However, as with the stabilization of the financial crisis in the US, it will be the accumulated impact of many individual measures that brings about the improvement rather than one single big solution.

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