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Virginie Maisonneuve's Global Insight December 2012

By Virginie Maisonneuve, Head of Global and International Equities

In the third edition of this monthly series, Schroders' Virginie Maisonneuve provides an update on two key developments: progress on the Eurozone banking union and QE4 in the US.

Banking Union and political risk

"Europe today made progress by agreeing on the terms of a common bank supervisor – the first step towards a banking union and the most radical financial integration since the single currency. But political risk in Europe should still not be ignored. Inaction due to forthcoming elections is possible and could unnerve markets in the short term, against an otherwise positive background for 2013.

The steps made on the banking union are encouraging but we must remember that the measures will not be effective until March 2014, or after the German election of September 2013.

"Despite this positive step, we should not ignore that political risk in Europe remains and might feed bouts of market volatility. For example, Mario Monti's decision to step down and trigger an election in Italy this month, might be an open path for Berlusconi to come back and possibly shy away from reforms. The position of the UK in Europe is also a focus point as the potentially diverging views between the political and business voices in the country might fuel important discussions regarding future action and negotiations in the months ahead. The rights of non-Eurozone countries within the banking union may create some level of friction although the decision to allow a double majority decision for the European Banking Authority will help the UK coexist with a more integrated Eurozone.

"Nevertheless, while economic conditions will continue to be difficult with Europe now officially in recession, we are cautiously positive for 2013. Progress is being made on the debt crisis, and the well-received debt auctions in Spain and Italy in November highlight the growing confidence in the periphery, albeit from low levels. With most politicians now taking a more pragmatic approach between growth and austerity measures, 2013 might be the peak year for discretionary tightening in the region which bodes well for equity markets.

QE4

"The US Federal Reserve yesterday announced it intends to almost double its quantitative easing to \$85 billion a month – effectively amounting to QE4. This was largely unexpected and shows an all-out effort to boost the US economy. Linking quantitative easing to employment targets in our view makes official something that the Fed has been targeting for a while and confirms that in exceptional times, exceptional measures are warranted. It also possibly recognises that, with interest rates having been near zero for so long, central bankers must be open to innovative additional measures of support.

"Interestingly, QE4 may suggest that politicians will go over the fiscal cliff, even if only temporarily, before finding a "terrain d'entente" and finalising negotiations in January 2013. The Fed could be essentially providing a cushion for the US economy to offset any fiscal tightening that may be imposed on 1 January. Going off the cliff for a short while might help the political parties in the US to start with a clean slate and foster better negotiations in the end. While this might unnerve the markets, it should be taken as an opportunity to add to equities in 2013.

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