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A Macroeconomic Risk and Credit Markets Outlook

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Global Credit Markets – Past, Present & Future

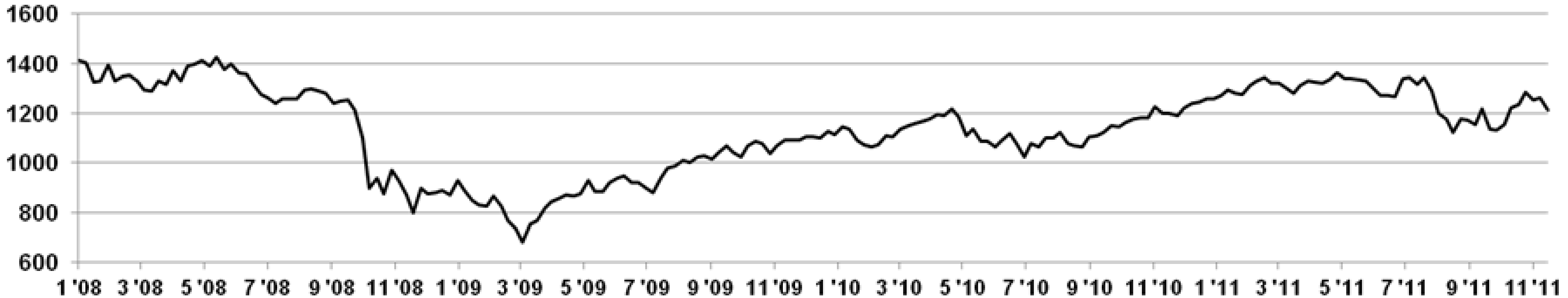
2002-2006	It's a wonderful life.
2007	The tide changes.
2008	A year of reckoning (lots of black swans).
2009	The tide lifted all boats.
2010	Rising risks – Europe.
2011	Investor fatigue, caution and jaded.
2012-13	Jabberwocks and turning points.

Main Drivers, 2011-2013

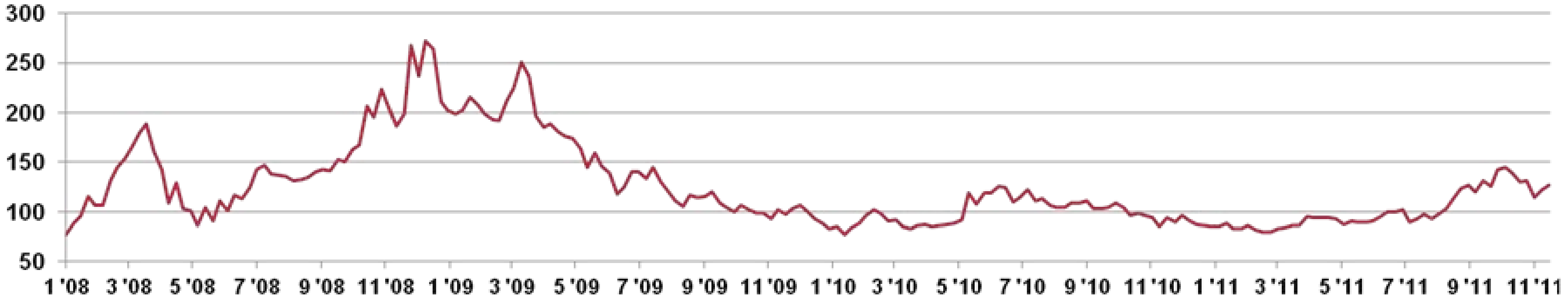
- Deleveraging in the Advanced Economies.
- Structural adjustment in the Advanced Economies and Emerging Markets.
- Geo-political tectonic changes (Middle East/Asia loom large).
- Market correlations remain high.
- It will get worse before it gets better.

Spot the Patterns…

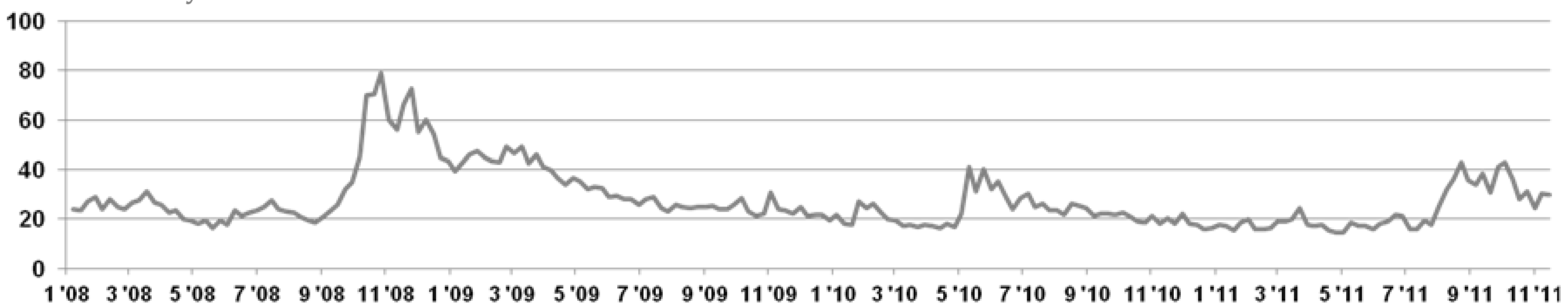
S&P 500 (index value)



CDX North America Investment Grade (bps)

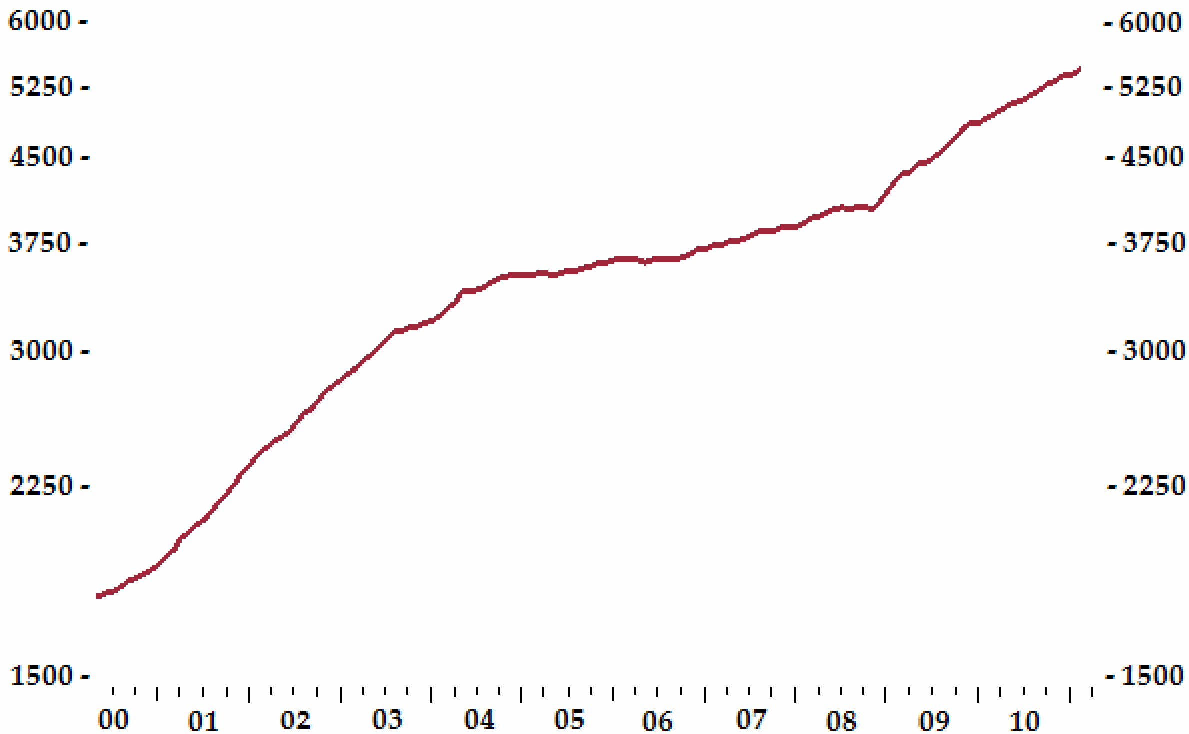


VIX Volatility Index (index value)



U.S. Investors Holding Tight to Cash at Low Interest Rates

Money Stock: Savings Deposits, including Money Market Deposit Accounts (SA, bn USD, log scale)



Source: Federal Reserve Board/Haver Analytics

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European Outlook

- Europe's sovereign debt crisis is the biggest threat to global economic recovery.
- The nature of the crisis is one of liquidity as well as structural inadequacies, probably the most glaring problem is having a currency union without a functioning fiscal union.
- What was a sovereign crisis has morphed into a banking crisis.
- The economic crisis is complicated by the rise of "new politics" that question the value of the European Union's grand experiment.
- Deleveraging is only just beginning and exit options are complicated and painful.
- The € is not going to survive in its current shape.

European Crystal Ball – Gazing into 2012

- Greece will default/ debt is too high.
- The EU will slip into recession.
- Italy will go to the IMF for help.
- A two-track Europe will become more institutionalized as German standards dominate.
- European banks will see government bailouts and will not hit capitalization targets by mid-2012.
- Europe's multi-year deleveraging/structural adjustment will translate into ongoing volatility and low interest rates.
- Europe could come out of this period with a stronger, more competitive economy.

U.S. Outlook

- U.S. economic recovery remains fragile/growth is sub-normal for a recovery.
- Fiscal discipline continues to be questionable.
- Ratings remain under pressure because of fiscal mess.
- Downsizing the financial sector part of a multi-year structural adjustment.
- Unemployment will continue to be structurally high.
- Strong risk of paralysis in economic policymaking until after 2012 elections.
- With high risk of European recession, interest rates likely to remain at lows and QE3 could be used.
- Corporate sector creditworthiness remains strong.

Canadian Outlook – "Lucky to be Canadian"

- Canada is benefitting from painful fiscal reforms enacted in the early-to-mid 1990s.
- Bank of Canada has a high degree of credibility.
- Economic policymaking is pragmatic.
- Housing market slowing, but never exposed to the excesses of sub-prime lending.
- Big challenge ahead is managing an open economy in a world of structural adjustment, deleveraging and enhanced geo-political risks. Key risks:
    - If the U.S. economy slips into recession
    - If Europe goes into recession and causes international contagion
    - If Asia catches a cold from Europe
    - Bottom line: slower growth, a watchful central bank, low rates, availability of fiscal stimulus and ratings stability.

Conclusion

- All markets are "challenged" by deleveraging and structural adjustment in the advanced economies.
- Europe is the biggest risk factor to fixed income and other markets.
- The U.S. has problems, but left alone will probably growth at 1.5%-2.0% range in 2012. A severe European downturn most likely causes a U.S. recession. Chances of a U.S. recession (40%).
- Interest rates in U.S. and Europe remain low.
- China will continue to grow, but at lower pace heading into a soft landing (for now).
- Canada is a safe harbor, but even safe harbors get rocked by big storms.
- Investors will face volatility, tougher economic conditions, and an ongoing quest for safe harbors.

Biography

DR. SCOTT MACDONALD, Senior Managing Director, Head of Credit and Economics Research: Dr. MacDonald had served as the Chief Economist and Director at KWR International, consulting for the Korean and Japanese governments and private sector investors prior to joining Aladdin. Previously he was Director of Sovereign Research at Donaldson, Lufkin & Jenrette (DLJ). Before joining DLJ Dr. MacDonald was the Sovereign Analyst at Credit Suisse First Boston focusing on Asian sovereign and state-owned companies. From 1995 through 1999 he was consistently rated as one of the top analysts by *Institutional Investor*. Dr. MacDonald has also worked for the Office of the Comptroller of the Currency on Brady Plan debt re-schedulings for Argentina and Brazil, and European and Canadian banking issues. He received his Ph.D. in Political Science from the University of Connecticut, his MA in Far Eastern Studies from the University of London's School of Oriental and African Studies, and his BA in Political Science (with Honors) and History from Trinity College. Dr. MacDonald has authored, co-authored and edited sixteen books, and has been a commentator on both television and in the financial press.

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