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We realize that GaveKal Research is not a household name to most investors. Of course, EVA readers are not most investors! Those of you who take the time to read EVA on a regular basis by definition have a higher level of interest in the financial markets and economic trends.

Over the years, you have become aware of the high-quality nature of GaveKal's analysis and insights. This special edition of EVA is indicative of its outstanding reputation in the institutional investing world. As you will soon read, GaveKal's co-founder, Anatole Kaletsky, was recently involved in a debate with Pimco's highly regarded CEO, Mohamed El-Erian, reflecting Anatole's stellar status as a macro economic expert.

As you will also read, Anatole's big picture views are much more optimistic than his equally esteemed partner's, Charles Gave, as well as those of Mr. El-Erian. Although my personal outlook is closer to that of the latter two experts, Anatole raises several valid points on why the future could be less challenging than many of us fear.

Here's hoping he's right and we're wrong!

David Hay Signature

### **Why The World Will Be Better in 2013**

*By Anatole Kaletsky*

There are three broad arguments for optimism about 2013: long-term trends in globalization and technology; short-term cyclical forces; and expectations among businesses and investors.

The last argument is perhaps the most surprising, so let us begin there. Expectations for 2013 are uniformly gloomy, but this is good news. According to The Economist's December forecasting poll, American growth will weaken from a feeble 2.2% in 2012 to just 1.9% in 2013, the euro-zone economy will shrink for the second year running, and Japan will sink back into near-stagnation after the brief spurt of decent growth it enjoyed in 2012 due to post-tsunami reconstruction. Even China is expected to stay quite weak, accelerating only marginally from 7.8%, its slowest growth since the turn of the century, to 8.2% in 2013, if the IMF's forecasts are to be believed. GDP growth may not be the sole criterion of economic success, but if the forecasts for 2013 prove right, there can be little hope of major improvements in employment, financial stability, consumer confidence or government finances. So why is this good news?

**Gloomy expectations mean that businesses and investors will be caught napping if growth accelerates.** They will then race to catch up, thereby amplifying the effects of favorable surprises, not only on financial markets but also on business investment, housing, consumer durables and other sectors driven by pent-up demand. But why expect favorable surprises? Because of the two main reasons for economic optimism in 2013: short-term cyclical conditions and long-term structural change.

Cyclical upswings are now under way in every region of the world apart from Europe. In China and the rest of Asia, growth is rebounding strongly after a lull caused by soaring oil prices in the summer of 2011 and the fears of a European financial meltdown in the first half of 2012. Europe, by contrast, is probably condemned to another year of recession, but its troubles will have limited global impact provided a financial meltdown is avoided, which is now a good bet.

America is the big economy whose prospects are most uncertain—and therefore the most likely to surprise. American growth accelerated strongly in 2012, from 1.6% annualized in the first half to 3.1% in the third quarter, and the slowdown expected in the fourth quarter is for strictly temporary reasons: Hurricane Sandy and the November election. The question is whether 2013 will build on the third quarter's 3%-plus momentum, rather than reverting to the feeble conditions of the first half. The prospects look good.

Financial conditions are normalizing, with American banks increasingly able and willing to lend. Employment and consumer sentiment are clearly improving, with 157,000 new private-sector jobs monthly since March 2010. Most importantly, the housing market is rebounding strongly. Collapsing residential investment has reduced American GDP growth by 1 percentage point annually since 2009. As the housing headwind turns into a tailwind, stronger growth is almost assured.

Why then have most forecasters remained so gloomy? The short-term answer has been uncertainty about politics and policy—about the euro, quantitative easing, the American election, the Chinese leadership transition and most recently the fiscal cliff. But these political uncertainties have now been resolved. The euro is not about to vanish. The Federal Reserve won't change monetary policy. President Obama will not be unseated. And major changes in American fiscal policy are now unlikely, at least for the next year or two.

As economists and business leaders realize that politics has stabilized, their attention will shift back to economics. And once this happens, they will notice that economic fundamentals are rather better than they had imagined. Such confidence will initially be inspired by short-term cyclical improvements, but gradually the profound long-term changes in the world economy will come to the fore.

Pessimists maintain that long-term structural change is precisely the problem. In his book, "When Markets Collide", published in 2010, Mohamed El-Erian was the first to predict that the global financial crisis had created a "New Normal" in which weak economic growth was inevitable for decades ahead.

I take the opposite view. In my book, "Capitalism 4.0", published the same year, I described four powerful "mega-trends", all dating back to around 1989, which powered the bull market of the 1990s: the end of communism, which unified the world in a single economic system; the opening of China and India, which added three billion new producers and consumers to global markets; the new information technology, which drove globalization by slashing communication and logistics costs; and the universal adoption of pure paper money, which freed macroeconomic policy from the constraints of gold standards and artificial currency pegs.

I argued that these trends justified enormous optimism, but for that very reason they created financial bubbles—and subsequent busts. The tragedy of 2008 was that blind faith in markets prevented policymakers from managing this inevitable boom-bust cycle until it was too late, thereby creating an unprecedented financial crisis. That crisis, however, is now over. Politicians and central bankers now recognize that economies need to be managed and markets cannot just be left to their own devices. As a result, a new model of managed global capitalism is evolving and is gradually replacing the market fundamentalism that dominated the 30 years to 2008.

As this new model develops and stabilizes, the favorable trends that started in the 1990s will

again drive the global economy. The deleveraging emphasized by Mr El-Erian and other proponents of the new normal will remain an important counter-force against these positive global trends.

But when the history of the 21st century is written, I doubt that deleveraging will merit a chapter alongside the end of communism, the rise of China, the invention of the internet and the rediscovery of macroeconomic management.

*To read Mohamed El-Erian's side of the argument and to follow the ongoing debate please click [here](#).*