



John Greenwood, Invesco Chief Economist

Quarterly Economic Outlook - Fourth Quarter 2009

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INTRODUCTION

Since equities, corporate bonds and commodity markets bottomed in early March, the shape of the asset price recovery – at least until the end of May – has been V-shaped. In June risk markets paused, but since July they have surged again. The key question is: does this mean that economies will also now enjoy V-shaped recoveries? Or will a slower pace of economic recovery cause asset markets to slow their rampant recovery, and perhaps even undergo an extended correction?

Since its lows in March, the S&P Index has rallied 58% while investment grade corporate bonds and high-yield credit have generated returns of 19% and 43% respectively. In the commodity markets the S&P GSCI total return index has increased by 32% while precious metals, normally subdued when inflation is falling, have yielded a significant 11%. What explains the power of these V-shaped rallies, and can they continue? Moreover, do they imply that the surge in asset prices will be carried through to a V-shaped recovery in economic activity?

Asset prices undoubtedly suffered exceptional declines in the panic of last autumn and in the early months of 2009 as heightened risk aversion caused both leveraged and real money investors to “de-risk” their portfolios by reducing exposure to risky assets. To a considerable extent, therefore, the bounce-back in asset values has simply been a reversal of the earlier flight to safety. In the wake of unprecedented stimulus policies from central banks and governments in the past year, not only have low interest rates and central bank liquidity continued to support a wide range of asset prices, but in addition investors have been encouraged to return to risky assets by a succession of “positive surprises” in the economic data (i.e. reports exceeding analysts’ expectations) through the summer. This raises the key question of whether the eventual recovery will be much stronger than the consensus forecasts shown in the following table.

Translating this discussion into the Irving Fisher theory ($MV=PY$) of liquidity, central banks’ policies of quantitative easing (boosting central bank money, or preventing broad money (M) from contracting) have been successful in maintaining liquidity in the economies and preventing a 1930s-style depression or multiple contraction. However, with economic activity and inflation (Y and P) having fallen sharply in October-March, the net effect has been an excess of liquidity which has been directed primarily to asset prices. At the same time the extreme risk aversion evident in October-March, equivalent to a decline in velocity (V), has reversed so that a growing risk appetite (or a rising V) has in effect supplemented the sluggish growth of the broader measures of liquidity (M).

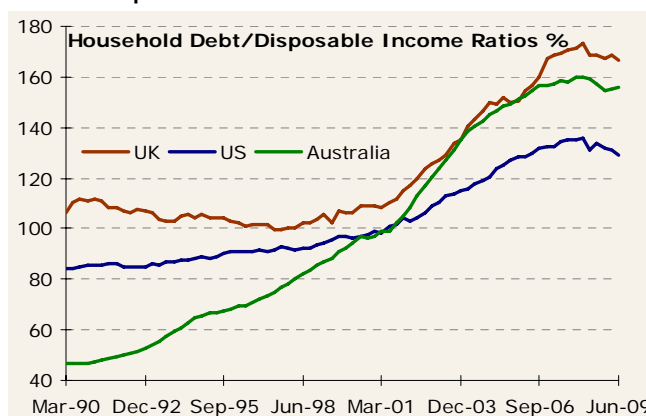
The critical issue for the next phase in asset markets and economic recovery is whether liquidity or M can start growing again - without central bank support – and thereby take over the baton from V or the peaking out in risk appetite. So far money growth in most major economies (with the notable exception of China) has been decidedly sluggish, and this is one of the factors causing central banks to commit to extended periods of low interest rates and/or extensions of their Quantitative Easing strategies. The problem is that recovering risk appetite can only be relied on for a limited period: excessive levels of valuation (e.g. in some of the more cyclical areas of the equity market), the re-emergence of bubbles in some asset classes, or disappointing economic data and hence disappointing profits growth for companies could quickly undermine the recent exuberance of risk markets.

	2009 Consensus Forecast		2010 Consensus Forecast	
	Real GDP	CPI Inflation	Real GDP	CPI Inflation
US	-2.6%	-0.5%	2.4%	1.9%
EU-16	-3.9%	0.3%	1.0%	1.2%
UK	-4.3%	1.9%	1.1%	1.8%
Japan	-5.7%	-1.3%	1.5%	-0.8%
Australia	0.8%	1.7%	2.4%	2.3%
Canada	-2.3%	0.4%	2.4%	1.8%
China	8.3%	-0.6%	9.4%	2.3%
India*	6.1%	7.6%	7.5%	6.4%

Source: Consensus Economics, Survey Date: 14 September 2009
* Fiscal year data (ie. FY09 = Apr 09 to March 10)

In my view the prospects for a continuation of the 6-month upward V-shape in risk assets must now be increasingly doubtful, while the prospects for a V-shaped recovery in economic activity are also somewhat tenuous. In the past I have used the geographical metaphor of recessions as valleys, and the post-Lehman shock as equivalent to discovering that there was a canyon at the bottom of the valley. The resurgence in asset prices and the initial bounce-back in trade and manufacturing activity represents emergence from the canyon, but economic activity is still at the bottom of the valley. Aside from the need for balance sheet repair in the household sector (see chart below), the major headwinds include: the persistent drag from on-going losses and recapitalisation in the banking system (which translates into continued slow money and credit growth), the reluctance of firms to rebuild their inventories until sales pick up substantially, the prospect of gradual withdrawal of fiscal stimulus as electors and politicians push for a restoration of fiscal discipline, and the risk that economic data through the autumn and winter will not improve at the rate seen during the climb out of the canyon, and may well disappoint.

Developed Economies Still Overloaded With Debt



Source: Datastream, March 90 – June 09.

In the face of these headwinds, isn't there still a case to be made for a V-shaped economic recovery? The best-known argument for a V-shaped recovery was devised by Victor Zarnowitz, the Chicago professor who observed that the steeper the economic downturn, the steeper the recovery. However, the recent recession differs so much from its predecessors as to cast doubt on the Zarnowitz rule as a guide on this occasion. His observations may apply to the majority of US postwar recessions (which were the result of Fed actions to curb inflation), but the current downturn has its origins in a major financial crisis stemming from the impaired balance sheets of the financial and household sectors. The combination of these factors suggests both a deeper recession (which has now largely passed) and a more subdued recovery than Zarnowitz might predict. While policy stimulus has certainly been large, there is a clear risk that the transmission of monetary policy will be blunted by the damage to the financial system, while fiscal stimulus will only partially offset the fall in private sector spending.



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UNITED STATES

There is a growing consensus that the US recession which started in December 2007 and worsened abruptly after the bankruptcy of Lehman Brothers, ended in the current July-September quarter. Real GDP plunged by -5.4% at an annualized rate in Q4 2008 and -6.4% in Q1 2009, but the downturn slowed to -1.0% in Q2. However, the critical question for asset markets is: what will be the shape of the recovery?

I expect the US economy to return to moderate positive growth rates in Q3 and Q4. In a "normal" recovery the growth rates in the early phase of the upturn should be strong – perhaps 5%-7% at annual rates but on this occasion we cannot expect more than 3%-4% at annual rates. Even this rate of recovery will be heavily dependent on governmental stimulus. Looking out further into 2010, I expect a growth rate of around 2%-2.5% for the year as a whole, slightly below the economy's long-term potential growth rate. Reasons for the sub-par performance include the progressive withdrawal of fiscal stimulus, a continuing reluctance of households and businesses to borrow, and the rising personal savings rate.

The stabilization of output was most visible in industrial production which increased in July for the first time in nine months, and again in August. The Business Cycle Dating Committee of the National Bureau of Economic Research that is the arbiter of US business cycle peaks and troughs will not make its official determination for many months yet, and will need confirmation from data on GDP, payrolls, real retail and wholesale sales as well as incomes. While payrolls and incomes are unlikely to confirm the upturn, real GDP and sales are likely to support the verdict of a trough in June. These latter two metrics were both strongly underpinned by the Federal government's \$3 billion "cash-for-clunkers" rebate scheme that helped sell 700,000 vehicles before it ended in August. The obvious implication is that as these stimulus programmes are withdrawn, the boost to economic activity will fade and need to be replaced by self-sustaining household and business expenditures.

As previously predicted in this report, inflation is proving much more subdued than many forecasters had expected, and this has helped the government and corporate bond markets in recent weeks. Nevertheless, in the period ahead headline CPI inflation (-1.5% year-on-year in August) is likely to rise even while core CPI inflation (1.4%) continues to decline, particularly due to the rising the vacancy rate in residential and commercial property. The low inflation environment will persist so long as the level of excess capacity and unemployment both remain high, counterbalancing the impact on yields of the large new supply of government debt. More fundamentally, inflation will be held in check by very low money and credit growth, providing a favourable backdrop for fixed income investment. However, having enjoyed spectacular gains since March equities could weaken especially if economic data soften and corporate earnings start to disappoint.

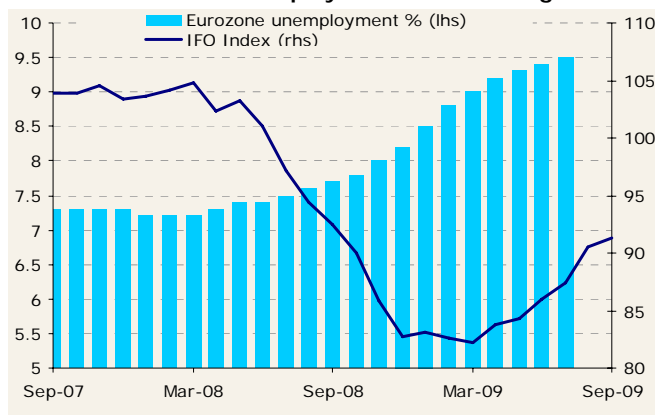
EUROZONE

Real GDP in the eurozone declined marginally by -0.1% q-o-q in Q2 2009, following two sharp declines in Q4 2008 (-1.8%) and Q1 2009 (-2.5%). While Europe's two leading economies, France and Germany, experienced positive growth rates (+0.3%) in Q2, Italy experienced another -0.5% decline and Spain saw a larger decline of -1.1%. The data do not suggest a decisive turnaround, and indeed the ECB's President, Jean-Claude Trichet, speaking after the September meeting of the Governing Council, said that he expected the recovery to be "bumpy" and "uneven". The ECB's forecast for the eurozone in 2009 as a whole was -4.1% (slightly up on their previous forecast of -4.6%), while their forecast for 2010 was raised from -0.3% to a positive 0.2%.

Germany has seen significant improvements in business and consumer sentiment during recent months. In September the Ifo Business Climate index increased to its highest level in a year, but this is still far below the levels reached in 2006 and 2007. Ifo said appraisals of the business situation and outlook have improved. However, by far the greater number of firms still assesses the business situation as poor and only with regard to the six-month business outlook was there now nearly a balance between pessimists and optimists. France has seen a continuous increase in industrial production since May and a positive net export contribution to GDP in Q2. French survey data on sentiment has also been encouraging. However, as in other parts of the eurozone such as Italy and Spain, bank lending to businesses has been very weak or even declining.

For the eurozone as a whole the outlook is particularly uncertain because across the region government fiscal support measures have in general been timid, and although the ECB injected 400 billion euros in July, there have been notable reductions in the central bank's balance sheet since then, eroding much of the effect. In addition, the strength of the euro continues to make exporting difficult for European companies, and has adversely affected tourism and other services. As a major exporter the eurozone as a whole remains acutely sensitive to the weakness in world trade which is only just starting to show a renewed upswing.

German Business Sentiment Picking Up, However Eurozone Unemployment Is Still Rising



Source: Datastream, September 07 – September 09.

With unemployment continuing to rise in most parts of the continent, spare capacity reaching very high levels, and the currency remaining firm, core CPI inflation is likely to fall below 1.0% in the second half of 2009 and remain there through 2010. High unemployment rates and very low inflation rates will likely cause the ECB to be one of the last central banks to shift its stance from easing to tightening.

UNITED KINGDOM

In line with most major economies, the UK experienced abrupt declines in growth in Q4 2008 and Q1 2009, but unlike some European economies it failed to show positive growth in 2009 Q2, declining by -0.6% q-o-q, or -5.5% y-o-y. The severity of the downturn was highlighted by business investment figures for the year to Q2 which declined by 10.2% q-o-q and 21.8% y-o-y, the sharpest annual decline since records began over 40 years ago. Since June, however, the downturn in overall spending appears to have been arrested, though there are few signs of a sustainable private sector upturn. Growth has been mostly based on government expenditure, and a small improvement in net exports. There has nevertheless been a continuing improvement on the production side of the economy as manufacturing orders and sales are restored. The manufacturing PMI recovered to 50.2 in July and fell back to 49.7 in August, while the services index



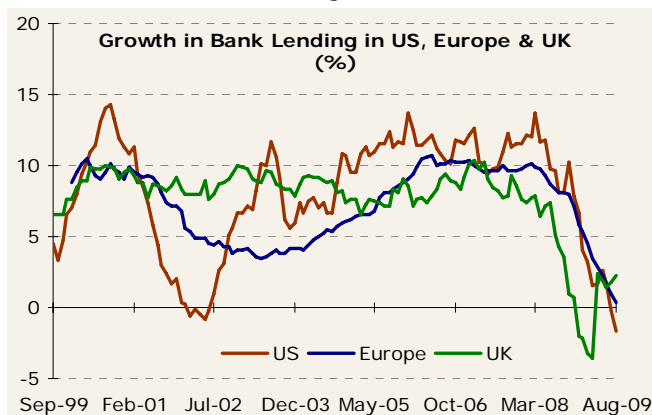
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increased to 54.1 in August, and the overall composite is now consistent with growth of around 2%. However, consumer spending remains vulnerable as unemployment has continued to rise, with the claimant count hitting 5.0% in August (or 7.9% on the ILO basis in July), and whole economy wage growth (excluding bonuses) has slowed to 1.0% in July (compared with 3.7% a year ago). Retail sales in August were down 2.1% m-o-m but up 1.8% in value terms and 2.1% in volume terms over the past year. Monthly house prices have also improved a little recently, but with mortgages granted rising only to 50,123 per month in July, compared with 120,000 at the peak in 2006-07, it seems unlikely that the upturn is anything more than a temporary respite. Over the year as a whole it is likely that UK real GDP will contract by 4.3%, and CPI inflation will be just below 2%, falling less than in other major economies due mainly to the weakness of sterling.

Bank Lending Has Stalled



Source: Datastream, September 99 – August 09.

On the policy front the MPC kept interest rates at 0.5% in August and September, but increased the amount of QE by £50bn in August, to £175 billion by November. Following the G-20 meeting proposals are likely to emerge soon requiring substantially higher levels of capital and liquidity for banks. Raising more capital and requiring banks to hold more gilts will almost certainly slow lending growth in the months ahead. Combined with recent data showing that UK consumers and businesses are now actively repaying debt (and thereby contributing to a slowdown in money growth), it seems likely that the Bank will need to maintain QE for longer than market participants currently expect. The Bank's Governor, Mervyn King, has become much more cautious in his forecasts, emphasising the risks of large government deficits, the problems that banks will have in financing increases in lending, and the problems consumers will face in increasing household spending given the state of their balance sheets. Nevertheless, GDP forecasts in the Inflation Report in August were actually very positive, suggesting a return to positive growth in Q3 and growth of +2.2% y-o-y in 2010 – significantly above both my own forecast and the consensus forecast (1.1%).

JAPAN

Although Japan was hit harder in the recent downturn than almost any other major economy due to its large dependence on exports, real GDP stopped declining and expanded by 0.6% (q-o-q) in Q2. The turnaround was led by exports, especially to other Asian economies, which rose by 6.4% (q-o-q), as well as government investment (7.5%). While private consumption posted a small gain, private sector investment contracted again (-4.8%). These overall gains on the production side of the economy appear to have been sustained in Q3, with industrial production, again based largely on exports, rising for five successive months from March to July and expected to increase

further in August and September. Looking further ahead, Japan should continue to benefit from Asia's recovery in Q4 and beyond. However, as usual in Japan most of the activity is concentrated in the external sector, with domestic demand remaining in the doldrums. Real household spending has been declining, and wages have fallen – partly as a result of very low summer bonuses. Unemployment increased to a record 5.7% in July and is projected to increase further.

The export bias in Japan's economic structure may at last face some rebalancing following the election victory of the Democratic Party of Japan (DPJ), ousting the long-dominant Liberal Democratic Party (LDP). The new administration has proposed large-scale fiscal changes centred on child-care subsidies and other measures to increase disposable income. At the same time, the DPJ has announced a freeze on spending on various public sector projects, and aims to achieve a 25% cut in Japan's carbon dioxide emissions by 2020. The DPJ's measures are thus intended to support households, while imposing further burdens on industry. In addition, the new Finance Minister has declared that the administration favours a strong yen (since this would cheapen imports for consumers while further reducing the long-standing pro-export bias in the economy), and this has helped propel the currency to 90 yen per US dollar – a further handicap to exporters. All these developments suggest that Japan will continue to suffer deflation at home while this difficult rebalancing exercise takes place.

ASIA EX-JAPAN

The main problem that Asia ex-Japan faces is large-scale inflows of speculative funds. This is happening because, even without a full recovery in exports to Europe and North America, the growth rates in Asia are substantially higher and more attractive than elsewhere in the world. Asian currencies are therefore likely to see some measure of appreciation over the next year or two. Asian policymakers therefore face a major challenge in managing the consequences of these massive inflows while maintaining healthy growth rates and low inflation in the year or two ahead.

Since November 2008 the Chinese authorities have successfully jump-started domestic demand in the economy by cutting interest rates, reducing reserve requirements, freezing the RMB/USD exchange rate, and most importantly, by massively expanding bank lending and money supply during the first half of 2009. New funds released have exceeded RMB 8.1 trillion (or nearly US\$1.2 trillion) in the eight months to August. The impact of this surge in spending has been seen primarily in public infrastructure projects, but also in China's spending on imports which in turn has had knock-on effects on other economies in the region. However, in the past two months repeated discussion about the authorities cutting back on the lending spurge, and the imposition of various curbs on the property market suggest that this phase of the stimulus programme is coming to an end. In the next phase requirements will probably be raised modestly and interest rates will likely follow. I expect GDP growth to reach 9% for 2009 as a whole, but domestic demand will be much stronger, around 12%-13%. Meantime, deflation will quickly disappear.

Elsewhere in Asia, South Korea has had a strong recovery in industrial production (thanks in part to the weakness of the Korean Won last year and in early 2009), which has virtually returned to pre-crisis highs (in July), but the overall level of GDP is unlikely to resume pre-crisis levels until 2010. The Korean authorities have already imposed various regulatory restraints on house prices in metropolitan areas, and it seems likely that, following China, Korea will be one of the first Asian economies to raise interest rates in 2010. Taiwan has been the second largest regional beneficiary of China's upswing, reinforced by the rapidly improving political links between the two governments. Taiwan's exports have recovered rapidly, rising on a month-to-month



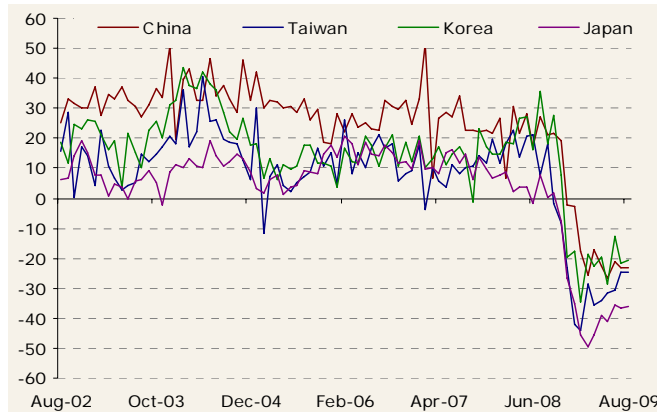
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basis in the four months to August even though they were still down 24.6% in that month. Mainland visitors have poured in, boosting tourism. Hong Kong's entrepot trade is also benefiting from China's domestic upswing.

Asian Exports Picking Up Although y-o-y Numbers Still Show Steep Declines (%)



Source: Bloomberg, August 02 – August 09.

In Southeast Asia the economies are not recovering as rapidly as in North Asia where the impact of China's upswing is stronger. Nevertheless, most are recovering enough to warrant some degree of rate-tightening or currency appreciation in 2010, particularly Indonesia. In India strong domestic demand and good corporate profitability have continued despite a disappointing monsoon season which will limit agricultural incomes in the year ahead. With inflation remaining above the RBI's target, rate hikes could come before year-end.

LATIN AMERICA

Latin American economies have suffered sharp slowdowns as a result of the global recession, and almost everywhere except Venezuela inflation rates have come down. The revival of commodity prices since March has helped many to benefit from export-led improvements in the past quarter, but the extension of these gains to domestic demand is not likely to be as easy as in Asia due to the generally worse underlying fiscal and balance of payments positions. However, the slower upturn in domestic demand should enable the authorities in these economies to keep interest rates lower for longer than otherwise.

Argentina, Chile, Columbia and Mexico will probably all record negative growth rates for 2009 as a whole, but Brazil, Ecuador, Peru and Venezuela will escape with positive growth rates for the year. On the inflation front only Chile is likely to see actual deflation in 2009, although inflation in Peru may fall as low as 1%. Elsewhere, Brazil, Colombia, Ecuador and Mexico will probably record inflation rates in the 3%-5% range, while Argentina's inflation will be significantly higher at 6%-7%, and Venezuela is in a class of its own with inflation of over 25%.

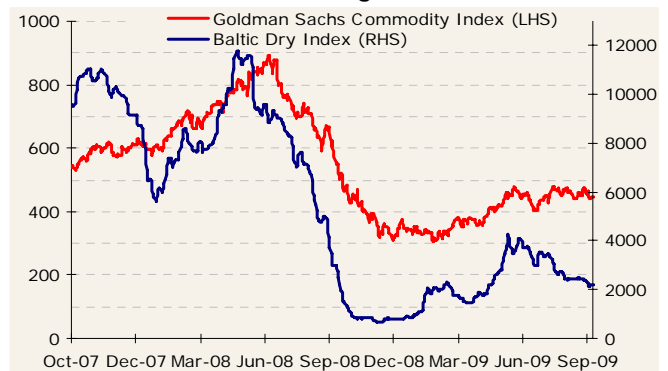
COMMODITIES

From their low in early March, commodity prices increased rapidly until June, with the Reuters-Jeffreys CRB index rising 33% (from 200 to 266, compared with the peak of 473 in July 2008). Subsequently commodity prices have fluctuated in a range between 230 and 268, indicating broad consolidation rather than continuing to move ahead. Oil prices have followed a similar pattern, rising from \$34 per barrel in February to almost \$75 in mid-June and then fluctuating in the \$60-\$75 range. Freight rates for shipping (a good proxy for the state of shipping and world trade), as measured by the Baltic Dry Index, also surged briefly, only to fade away again. The index, having fallen over 90% from 11,793 in May 2008, increased from 772 in

January to 4291 in early June before gradually sliding back to around 2200, and is still down 85% from its peak last year.

The initial upswing reflected aggressive purchases of raw materials and commodities early in the year by Chinese state-owned enterprises, supplemented by financial speculators predicting the demise of the US dollar as a global reserve currency or inflation in many of the major economies rather than genuine, sustainable demand from private sector industries. In my view the subsequent setback – predicted in the previous quarterly outlook – is properly reflecting the prospective weakness of global trade and economic activity. Indeed, if inflation fears dissipate further, another of the props supporting commodity prices will be undermined.

Baltic Dry Index Fades Away as Other Commodities Becomes Range Bound



Source: Datastream, October 07 – September 09.

CONCLUSION

Global growth has turned upwards and continues to improve much earlier than I had expected. The deep recession that began in the US in late 2007 and then spread suddenly to many other economies following the bankruptcy of Lehman Brothers in September 2008 appears to have finally ended in Q3 2009. Following the stress-tests conducted on US banks between February and May, key measures of financial stress such as LIBOR spreads over swap rates or policy rates have improved, and risk assets such as equities, commodities and high-yield securities have staged impressive rallies since mid-March. Looking forward, there is a clear contrast between growth prospects for the developed economies (where the growth outlook remains dependent on government and central bank support operations) and robust growth prospects in many emerging markets, led by China and India.

Aside from the higher underlying growth potential of these emerging economies, there is a key factor that is enabling them to "lead" the world out of recession. That factor is the financial condition of the household and financial sectors which have not been damaged by the credit boom that has contaminated western, developed economies over the past few years. Therefore emerging economy governments can administer monetary and fiscal stimulus that can gain traction more rapidly than in the developed economies. However, with only a few exceptions, these economies are not leading in the sense of providing sufficient locomotive power to their developed counterparts to pull them out of recession. In this sense the developed economies will be largely reliant on their own stimulus policies combined with the restoration of financial health in the problem sectors to achieve a full recovery in 2010 and beyond.

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