



# John Greenwood, Chief Economist, Invesco Ltd.

## Quarterly Economic Outlook - Second Quarter 2010

Institutional investor use only. In Canada, this document is restricted to accredited investors as defined under National Instrument 45-106.

### INTRODUCTION

The global economic recovery is proceeding as if the world was divided into two distinct but parallel universes – as indeed it is, at least in terms of balance sheet structure and economic performance. In the developed, western world the recovery is at best moderate in some economies, but tentative and even fragile in others. Governments and central banks in the developed economies are maintaining large-scale fiscal expansion policies, even though some central banks are gradually starting to withdraw some of their most aggressive monetary easing measures. In these regions there are risks of currency depreciation, looming sovereign debt crises, and even deflation as de-leveraging continues.

In complete contrast, in the emerging world, and particularly in non-Japan Asia (e.g. China and India) and parts of Latin America, monetary and fiscal easing actions initiated during the recession have already generated strong domestic recoveries, and monetary policy is currently being normalised in order to avoid the risk of asset bubbles or consumer price inflation taking hold. In these regions, the focus is on currency appreciation, nascent property price bubbles, and the possibility of consumer price inflation becoming entrenched.

The key difference between the two parallel universes is the state of household and financial balance sheets. In the western, developed world the housing and credit bubble of 2001-2008 caused balance sheets in the household and financial sectors to become over-indebted. The high levels of spending -- induced by easy access to credit -- generated current account deficits as spending out-stripped production. These economies now require extended periods of balance sheet repair. Households are exercising restraint in their spending as they save enough to pay down debt. Banks and other financial institutions are busy rebuilding their capital, often shrinking their balance sheets or refraining from lending in order to raise the overall quality of their loan portfolios. Such an environment is not conducive to anything more than subdued, sub-par growth and very low inflation.

In the emerging economies, and particularly in non-Japan Asia (e.g. China and India) and parts of Latin America, the legacy of financial crises in the 1990s scarred households, banks and businesses to such an extent that they never participated in the credit and housing bubble that engulfed the western, developed economies after 2001. The reluctance to borrow, combined with a reluctance to lend on the part of banks and other financial institutions, ensured that balance sheets remained strong, and spending remained well within the limits of economic output, generating current account surpluses across many of these economies. The result has been that when governments undertook stimulatory policies in the eye of the global recession, monetary and fiscal expansion gained traction much more quickly. Already many of these economies are showing early signs of strong upswings of domestic spending, and in a number of cases inflation is already becoming a matter of concern. For this reason, having led the world out of recession, several of the emerging economies are tightening monetary policy far ahead of any such moves by developed economies.

	2009 Estimate		2010 Consensus Forecast			
	Real GDP	CPI Inflation	Real GDP	CPI Inflation	Real GDP	CPI Inflation
<b>US</b>	-2.4%	-0.3%	3.1%	2.7%	2.2%	1.6%
<b>EU-16</b>	-4.0%	0.3%	1.1%	1.4%	1.1%	1.2%
<b>UK</b>	-5.0%	2.2%	1.4%	1.1%	2.6%	1.9%
<b>Japan</b>	-5.1%	-1.4%	1.9%	1.5%	-1.1%	-1.0%
<b>Australia</b>	1.3%	1.8%	3.1%	2.0%	2.5%	2.1%
<b>Canada</b>	-2.6%	0.3%	2.9%	2.2%	1.8%	1.7%
<b>China</b>	8.7%	-0.7%	9.9%	9.5%	3.2%	3.6%
<b>India*</b>	7.0%	11.4%	8.2%	7.5%	8.0%	8.5%

Source: Consensus Economics, Invesco Forecast in blue

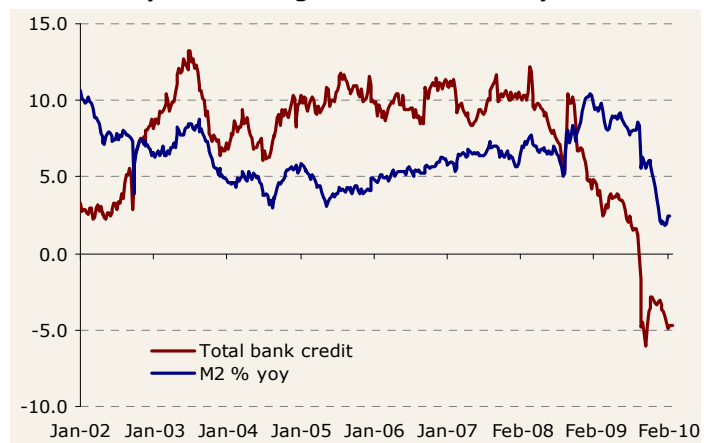
Based on this analysis I am projecting only moderate rates of economic growth with continued low inflation in 2010 for the developed western economies, but strong, domestic demand-led growth for a number of emerging economies.

In financial markets these conditions – low interest rates, modest economic growth, and low inflation in the developed world – should enable equity markets to continue to make progress in 2010, but not at the rate seen between March and July 2009. Bond markets in the developed world should benefit from lower than expected inflation, and the continuing weak demand for funds in the household and corporate business sectors, but they will be tested by growing concerns about the size of sovereign debt issuance. In the emerging world, equities related to domestic spending should benefit from strong economic growth and strengthening currencies.

### UNITED STATES

A wide range of economic indicators suggests that economic activity in the US is gradually picking up. Manufacturing continues to grow, with the national PMI holding above 55, and the official industrial production series rising for eight consecutive months since the low in June 2009. Vehicle sales are likely to exceed 11 million units in March, up from the low of 9.1 million in February 2009, but still far below the 16 million levels seen before the recession. Retail sales are recovering slowly from the steep downturn of 2008-09, recording positive year-on-year growth rates, but are still far below the levels reached in mid-2008 before the crisis intensified. Employment indicators have all improved in recent weeks, with weekly jobless claims falling gradually, the unemployment rate declining to 9.7% from its October peak of 10.1%, and the payroll employment levelling out. These data are all evidence of a moderate pace of economic recovery, but no secondary economic downturn, or double-dip. Thus although real GDP grew at a 5.6% annualised rate in 2009 Q4, final sales (which excludes inventory changes) increased only 1.4% -- which is far more representative of the true state of underlying growth.

### US Money and credit growth at historically low rates



Source: Thomson Datastream, Jan 02 to Feb 10

Looking forward, the US economy will continue to operate with a large margin of spare capacity and high levels of unemployment through 2010 and into 2011. The reasons for the sub-par rate of recovery can mostly be traced back to the origins of the downturn, which have left a legacy of substantial headwinds for consumer spending, for business equipment investment, for housing and commercial property, as well as for credit conditions and employment prospects.

The good news in this continuing lacklustre recovery is that inflation will remain low – despite the weak US dollar -- and that will enable the Federal funds rate to be held at its current 0-



# John Greenwood, Chief Economist, Invesco Ltd.

## Quarterly Economic Outlook - Second Quarter 2010

Institutional investor use only. In Canada, this document is restricted to accredited investors as defined under National Instrument 45-106.

0.25% level for a prolonged period while the recovery gains strength. The recent jump in the year-on-year CPI inflation rate to 2.7% in December and 2.6% in January was largely a result of base effects -- sharp declines in prices in those months in 2008-09 -- and are in no way a portent of inflation prospects ahead. On the contrary, with money and credit growth at historically low rates, it is much more likely that headline and core inflation will be falling for the balance of 2010. For the year as a whole I now expect real GDP growth of around 2.7% with CPI inflation of 1.6%. Although this growth rate may be disappointing when compared with previous recoveries, the gradual recovery should provide a favourable environment for fixed income investment, and at the same time enable the upturn in equities to be extended.

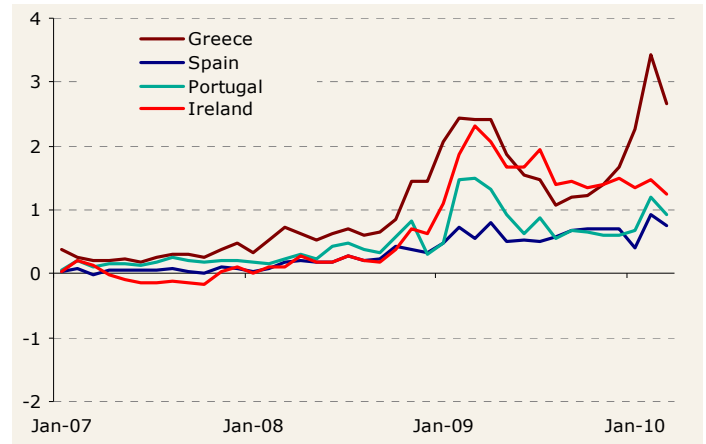
### **THE EUROZONE**

The eurozone as a whole began to recover in 2009 Q3 as real GDP moved into positive territory (+0.4% quarter-on-quarter), and maintained a small positive growth in Q4 (+0.1%). However Europe's recovery remains anaemic, heavily dependent on government stimulus policies, and subject to back-sliding in some economies such as Spain (which recorded -0.3% in Q3 and -0.1% in Q4), Greece (-0.5% in Q3 and -0.8% in Q4), and Ireland (-0.1% in Q3 and -2.3% in Q4). Until the outbreak of the Greek crisis in December the strength of the euro was undoubtedly one of the factors holding back a recovery of eurozone exports, but since the euro began to slide on world currency markets, sentiment in the exporting sector has definitely improved, although it will be several quarters before the benefits of currency depreciation will flow through to company results.

At the core of the eurozone, the German economy is seeing an export-led recovery, but household spending remains sluggish. For example, the February IFO survey fell back, causing many to query the sustainability of the German economic upswing, particularly given the loss of momentum suggested by the minuscule Q4 GDP gain (+0.01%). But underlying data show that manufacturing kept moving ahead in February, and the March IFO survey showed a robust overall gain, with the manufacturing component seeing its strongest reading since July 2008. The "flash" PMI manufacturing survey for Germany in March was even more upbeat, with the overall index the highest since April 2000 and overall new orders and export orders readings at record highs. Although the European Commission business survey for March revealed a marked improvement in German household's optimism for the next 12 months and a reduction in "fear of unemployment", plans to make a major purchase, by contrast, actually deteriorated.

Around the periphery of the euro-zone the news has been dominated by the national debt crisis in Greece, and frantic efforts by the Greek government (as well as the next most vulnerable euro-states like Spain and Portugal) to gain sufficient credibility with investors through cuts in government spending to be able to roll over their maturing debt. Logically the problem required either a sudden, large increase in the credibility of Greek fiscal plans (which was never going to be achievable given Greece's untrustworthy track record), or the agreement of leading euro-zone economies such as Germany and/or France, and/or the IMF to provide some short-term funding arrangement to enable Greece to deal with its near-term refinancing obligations. However, even this has not proved adequate because the 26 March agreement between Germany, France and the IMF does not ensure a robust supervisory and enforcement mechanism for Greek policies such as the IMF's traditional conditionality terms. The crisis in the euro-zone periphery is therefore likely to rumble on.

### **Greek spreads over 10-year bunds widen sharply as sovereign debt crisis rumbles on**



Source: Thomson Datastream, Jan 07 to Feb 10

### **UNITED KINGDOM**

Revisions to the 2009 Q4 real GDP data now suggest that the UK economy expanded at 0.4% quarter-on-quarter -- still only a moderate pace of recovery. The main revisions raised the output of services, construction and agriculture slightly, and showed a slower pace of de-stocking. Household spending grew by 0.4% (assisted by the impending January VAT rise and the prospective end of the car scrappage scheme) and government spending by 1.0%, while gross fixed capital formation declined by 2.7%. Temporary factors clearly played a substantial role in boosting the reported numbers, highlighting the fragility of the recovery so far.

Economic statistics released since the start of the year suggest that the economy has continued to recover, albeit at a slow pace. For example, both the PMI manufacturing and non-manufacturing surveys for January and February show index levels of averaging over 56, suggesting activity in these two broad areas is expanding at a healthy pace. Less convincingly, retail sales volumes for January and February were down 0.8% compared with their average level in Q4, while industrial production remains 13% below its level in early 2008, and has only risen marginally from its low in August 2009. The news from the labour market was mixed with the headline claimant count measure of unemployment falling in February to 4.9%, but the wider ILO measure remaining at 7.8%, and the total level of employment continuing to fall. The number of discouraged workers leaving the labour force was disappointingly large.

The housing market continues to be a puzzle. Despite the sharp declines in new mortgage borrowing and approvals compared with 2007-08, and abrupt declines in home-building and construction, house prices have bounced back surprisingly quickly since March 2009. The Halifax index of house prices was up 4.5% year-on-year in February, while the Nationwide index was up 9.0% in March. The fall in sterling has evidently attracted buyers at the top end of the market, but the wider strength in home prices is contrary to what one might expect from household de-leveraging, the squeeze on incomes, and the lack of access to mortgage credit. A widespread view is that many potential sellers have been holding back sales until mortgage credit becomes more readily available, and that measures to minimise repossessions by banks have been effective in postponing a full-scale correction in house prices.

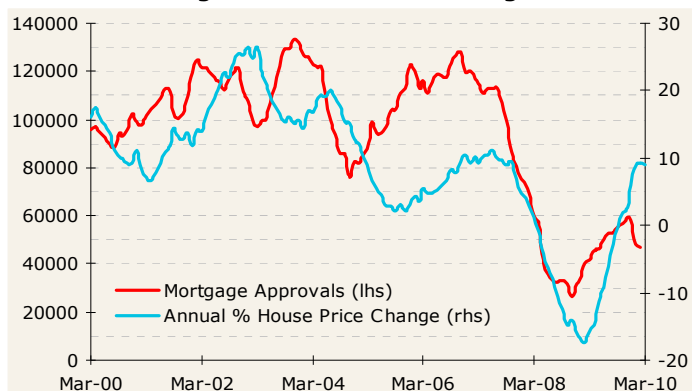


# John Greenwood, Chief Economist, Invesco Ltd.

## Quarterly Economic Outlook - Second Quarter 2010

Institutional investor use only. In Canada, this document is restricted to accredited investors as defined under National Instrument 45-106.

### Mixed signals from the UK Housing Market



Source: Thomson Datastream, Jan 07 to Feb 10

Due to the upcoming general election the measures adopted by the government in the 24 March budget to bring the forecast £167 billion borrowing requirement under control have been more restrained than most financial commentators would consider appropriate. The government is arguing that the prompt closing of the deficit or withdrawal of state spending would jeopardise the economic recovery, and therefore numerous tax measures have been postponed until 2011, while the required, specific government spending cuts have been effectively banished from political debate. It is widely acknowledged that whoever wins the British election in May will face some tough decisions in the years ahead. Given this background of personal and government restraint on spending, we are forecasting a real GDP growth rate of just 1.1% in 2010, and an inflation rate of 1.9% - just below the Bank of England's 2% target.

### JAPAN

Since the trough of its deep recession in 2009 Q1, Japan's economy has made only a tentative recovery on the domestic side, although it has recovered much more strongly on the external side. Real GDP increased by 1.5% in Q2 and by 0.9% in Q4 last year, but there was a set-back of -0.1% in Q3. In the opening months of 2010 these divergent trends have continued.

The global recession hit Japan's export-dependent economy particularly hard, but exports, which fell by 50.5% at their lowest point in February 2009 (on a customs cleared basis), have bounced back strongly. By February 2010 they had recovered to rise 46%, although they are still about 20% below their peak levels in 2008. Exports to Asia have revived especially rapidly, rising 56% year-on-year in February, compared with a 50% rise in exports to the US, and a 20% rise in exports to the EU. Japan's trade balance, which temporarily shifted to deficit in late 2008 and early 2009, has returned to surplus despite the relative strength of the yen.

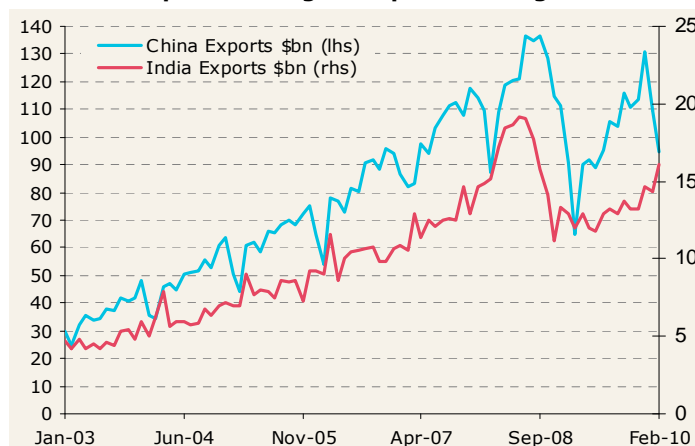
Domestic demand has remained much more subdued. Consumer and business spending was still down 4.7% year-on-year in 2009 Q4, marking eight consecutive quarters of declining domestic spending. Total sales by retail and wholesale stores declined throughout 2009, and continued to show annual declines in February. Only investment related to exports has been at all active, while housing and other domestic expenditure have been in hibernation. For example, housing starts in February were just 56,527 less than half of the monthly averages of 120,411 experienced during the 1990s. In the labour market full-time jobs have continued to decline while part-time jobs have risen gradually. Against this background of weak domestic conditions, widespread excess capacity, and a relatively strong yen Japan has been undergoing another bout of deflation with both the headline CPI and the core CPI (ex-food and energy) inflation declining by 1.1% year-on-year in February. My forecast for

Japanese real GDP growth in 2010 is 1.5%, with a decline in consumer prices of 1.1%.

### NON-JAPAN ASIA

The recovery in trade and domestic demand spending has continued to gain strength across the Non-Japan Asian region. Intra-regional trade has been especially vigorous, driven mainly by China's strong stimulus policies. Although none of the economies have seen exports recover to their pre-crisis peaks, China and South Korea have come very close. (NB In the chart below China's exports dipped in January and February as they do each year around the time of Chinese New Year festival). On the import side China's imports have exceeded its pre-crisis levels (as state-owned enterprises have bought raw materials and equipment for the government-led infrastructure investment programmes), but this has not been the case for other economies in the region.

### Exports closing in on pre-crisis highs



Source: Bloomberg: Jan 03 to Feb 10.

However, the main impetus for growth has come from domestic demand stimulus - lower interest rates, weaker currencies, and fiscal spending plans - implemented during the crisis. Since mid-2009 these policies have become effective and are now in the process of being wound back, with central banks across the region raising interest rates and guiding currencies upward. The surge in bank lending in China has been the largest single source of stimulus, and the prospect that it might be reversed has given rise to anxiety, causing equity markets in the region to take a prolonged pause. But equally, if the Chinese bank lending spree continues, concerns about inflation will rise as inflation has already switched from negative to positive. Over the next few months we expect China's leaders to allow the currency to start appreciating against the US dollar, and this will enable other currencies in the region to appreciate further. From an investment standpoint these tightening measures may have a temporary adverse impact on equity markets, but controlling inflationary potential sooner will enable the business cycle to expand for longer, and this will enable the upswing in Asian profits and dividends to extend for longer.

Taking into account China's likely growth of 9.5% for the year, I expect real GDP growth for the Asian region (ex-Japan) to reach 8.0% in 2010, and inflation to be rising from 1.9% in 2009 towards 4% in 2010, in marked contrast to the situation in the developed western economies.

### LATIN AMERICA

Like the Asia ex-Japan region, Latin America is well-positioned for recovery in 2010, having emerged from the global financial crisis without incurring a substantial increase in debt, and having seen inflation and interest rates decline to forty-year low levels in several cases. Brazil in particular has lowered official interest



---

# John Greenwood, Chief Economist, Invesco Ltd.

## Quarterly Economic Outlook - Second Quarter 2010

Institutional investor use only. In Canada, this document is restricted to accredited investors as defined under National Instrument 45-106.

rates to single-digit levels (8.65%), and inflation has been kept under control in the 3-7% range ever since the last serious bout of inflation in 2003. Economic growth in the region for 2010 looks set to reach about 4.2%, driven by the Brazilian economy, which we forecast to expand by 6.2%. After a tough 2009, Mexico's real GDP is forecast to show 3.5% growth. Assuming there is no double-dip recession in the developed western economies or in Asia, commodity prices -- which are critical for the exports of several of these economies -- should hold up and provide a solid basis for both export earnings and domestic income growth.

### **COMMODITIES**

Following their precipitous collapse in late 2008 and early 2009, commodities have broadly rallied in line with the recovery of equity markets since March 2009. The strong demand for key resources such as oil, minerals, and agricultural products from the emerging giants of China and India has maintained the momentum in key product areas such as iron ore and coking coal. For the remainder of 2010 the ability of commodity prices to strengthen further will depend heavily on demand from emerging economies where growth is strong and inflation is rising, especially since I expect the recovery in the developed western economies to be subdued and sub-par, with falling inflation. Against this backdrop it will be hard for precious metals such as gold and silver to see significant price increases.

### **CONCLUSION**

The early months of 2010 have seen modest improvements in economic growth among western, developed economies as private sector spending gradually starts to revive. However, the progressive withdrawal of central bank and government stimulus measures over the months ahead will pose challenges for private sector activity. In my view a self-sustaining recovery is possible, but it will be more subdued than the typical post-war economic recovery due to the widespread need for balance sheet repair. Credit and money growth will remain low, restraining both growth and inflation.

By contrast, in much of the emerging world -- especially in emerging Asia and Latin America -- there are few such impediments to growth and recovery. In fact the main concern in these regions is that economies may overheat, asset bubbles could emerge, and inflation will pick up. In general we expect domestic demand in emerging economies to take the lead, and although exports are recovering their growth rates will be limited by the subdued pace of recovery in the developed western economies. The main concern in these emerging economies will be to keep inflationary pressures at bay in order to extend the new business cycle expansion.

John Greenwood  
Chief Economist, Invesco Ltd.  
31 March 2010.

---

### **Important information**

Where John Greenwood has expressed views and opinions, these may change and are not necessarily representative of Invesco views.

All material presented is compiled from sources believed to be reliable and current, but accuracy cannot be guaranteed. This is not to be construed as an offer to buy or sell any financial instruments and should not be relied upon as the sole factor in an investment making decision. As with all investments there are associated inherent risks. Please obtain and review all financial material carefully before investing.

Invesco and all associated trademarks are trademarks of Invesco Holding Company Limited, used under licence.

© Invesco 2010

[www.institutional.invesco.ca](http://www.institutional.invesco.ca)