John Greenwood, Chief Economist, Invesco Ltd

Quarterly Economic Outlook - Third Quarter 2010

INTRODUCTION

In the financial markets the second quarter of 2010 was dominated by the sovereign debt crisis affecting the "Club Med" economies of the southern eurozone. The crisis started in December with investors selling down Greek government bonds in view of the huge size of Greece's budget deficit and its national debt, but soon spilled over to the bond markets of Portugal and Spain. From there the contagion spread, causing the euro to weaken from December onwards, and equity markets to fall from their late-April highs so that by early June all the gains of 2010 were erased.

Initially the core economies of the monetary union – Germany and France - resisted intervention on behalf of Greece, citing the "no bail-out" clause of the Maastricht Treaty, but were later forced by market pressure to come to the rescue not only of Greece and other potential victims of the bond market vigilantes. The liquidity package consisted of €750bn, provided in conjunction with the IMF. Besides putting in place a short-term financing facility that will enable euro sovereigns to rollover maturing debt at favourable rates, the package also helps some leading eurozone banks which are among the largest foreign holders of Greek government debt. To fend off default and protect against sustained high interest rates, successive eurozone economies have subsequently adopted fiscal tightening measures. Coincident with these developments a broad shift has occurred in government economic philosophy - from fiscal expansion to support the recovery to fiscal consolidation to head off a debt crisis.

Across the developed world as a whole a gradual and somewhat lacklustre recovery has continued, with central banks keeping interest rates at record low levels, and few of them withdrawing their quantitative easing measures. Thus while fiscal conditions are tightening, monetary conditions are remaining easy.

In the emerging world, a strong recovery is continuing, particularly in emerging Asia and parts of Latin America. This is best exemplified by China where the authorities have been tightening policy to counteract surging property prices and rising inflation, and most recently they have acknowledged the return of the domestic economy and foreign trade to normality by abandoning the fixed Yuan rate against the US dollar and restoring the upward crawling peg that prevailed in 2005-08.

Looking forward the key issues are whether the recent switch to fiscal consolidation in the developed world will derail the tentative recoveries already in place, or whether the persistence of huge government deficits and rising debt ratios will precipitate an even more severe sovereign debt crisis, affecting not only the smaller economies but possibly one or more of the larger, developed economies. The underlying debate is an old one: which is more potent – monetary policy or fiscal policy?

Another key issue is how governments will address the problem of burgeoning public debt in the wake of the transformation of the private sector debt crisis into a public debt crisis. Research in this area suggests there are only five possible exit strategies: high inflation, default (or rescheduling), a growth surge, a debt trap, or belt-tightening. For economies that have faced this problem in recent decades the generally accepted solution has been belt-tightening – the gradual reduction of government deficits and debt over a period of 5-10 years. In almost all cases these episodes have been accompanied by moderate growth and low inflation due to the deflationary effects of debt repayment. Whereas the public sector tends to leverage up quickly in response to private sector de-leveraging, politicians find it very hard to de-leverage the public sector rapidly. This explains the typically extended timeframe for these fiscal consolidations. The main exceptions to the belt-tightening template have been small emerging economies where central banks were not independent (e.g. Zimbabwe), and the important case of Japan where the continuous increase in the ratio of government debt to GDP since 1990 amounts to a debt trap.

Based on this analysis I am still projecting only moderate rates of economic growth with continued low inflation in 2010-11 for the developed western economies, contrasting with strong, domestic demand-led growth for a number of emerging economies.

	2009 Actual		2010 Consensus Forecast			
	Real GDP	CPI Inflation	Real GDP		CPI Inflation	
US	-2.4%	-0.3%	3.3%	2.8%	1.7%	1.2%
EU-16	-4.1%	0.3%	1.1%	1.0%	1.4%	1.5%
UK	-4.9%	2.2%	1.3%	1.0%	3.1%	2.4%
Japan	-5.3%	-1.4%	3.2%	3.0%	-1.0%	-1.0%
Australia	1.3%	1.8%	3.0%	3.5%	3.1%	1.9%
Canada	-2.5%	0.3%	3.5%	2.2%	1.9%	1.4%
China	8.7%	-0.7%	10.2%	11.2%	3.3%	3.6%
India*	7.4%	12.4%	8.3%	7.9%	8.6%	8.5%

Source: Consensus Economics, Invesco Forecast in blue
* Fiscal year data (ie. FY09 = Apr 09 to March 10)

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 September 2009. Bond markets in the developed world have benefited from lower than expected inflation, and the continuing weak demand for funds in the household and corporate business sectors, but they have been and will be tested by on-going 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, especially now that China's currency has started to shift upwards.

UNITED STATES

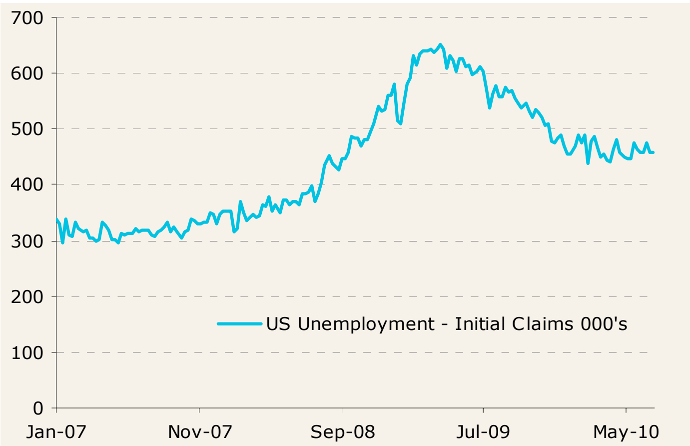
The economic recovery so far has been led by two sets of factors: by manufacturing and the re-building of inventory levels following the sharp cutbacks at the time of the global financial crisis, and by fiscal stimulus programmes in the form of cash-for-clunkers and tax rebates for home buyers in addition to the normal automatic stabilisers.

The dependence of the recovery on manufacturing and inventory rebuilding is evident in the divergence between GDP (which includes inventory changes and net exports) and final domestic demand (which excludes them). Domestic final demand has been softer than GDP because spending by US households and by financial businesses is constrained by their need to set aside funds for debt repayment and balance sheet repair – funds that would otherwise be used to increase consumption or investment. The problem with an inventory-led recovery is that inventories represent only an intermediate stage of the production and selling process. Businesses have been rebuilding inventory in anticipation of a recovery in final sales, but if final demand (personal or government consumption spending, or business fixed investment) does not pick up, then any upturn in inventories could easily be cut back again.

Some of the limitations of the fiscal stimulus have been evident in the decline in auto-sales since the US cash-for-clunkers scheme expired, causing vehicle sales to fall from over 10 million (at an annual rate) in August 2009 to an average of just 8.6 million in the first five months of 2010, and in the abrupt decline of housing sales since the end of the home-buyers tax rebate plan on April 30.

More broadly the US recovery is slowing to a sub-par rate after its initial manufacturing-led and fiscally induced bounce-back. The data flow in recent weeks has been weak, which is adding credibility to forecasts of a lower than normal GDP growth in the aftermath of the crisis, particularly as fiscal stimulus measures are gradually removed. According to one research house, by June 25 there had been six positive surprises on US economic data released in June compared with 14 negative surprises, the worst ratio since the recovery started. In general, housing, retail sales and the labour market are most at risk – all areas reflecting the weakness of consumer finances. For example, there was a sharp decline in US new home sales in May following the expiry of the tax rebate programme for home buyers that expired on April 30. Another area of concern is the labour market where jobless claims have declined from their peak crisis levels of over 600,000 per week to around 450,000, but have been stalled around this level since the start of the year instead of continuing to fall. The problem, as emphasised in these reports for the past two years, is that US consumers have overstretched balance sheets, and need to repair their finances before we can expect to see a resumption of normal growth rates and hiring.

Weekly jobless claims not falling further



Source: Thomson Datastream, 1 Jan 07 to 28 Jun 10

In contrast, the non-financial corporate business sector – with one or two major exceptions such as commercial real estate -- is in better shape than the consumer, as reflected in the substantial build-up of cash on corporate balance sheets. This is a result not only of the lesser degree of leverage undertaken by the non-financial business sector during the credit and housing bubble, but also the swift action by corporate America to cut inventories, investment and payrolls. While these cash reserves should enable companies to make business investments, conduct mergers and acquisitions, and generally remain independent of bank debt, the problem is that their ultimate customers –US households – are unlikely to boost final sales much over the coming quarters.

This implies that the best prospects for vibrant growth in the US corporate sector over the next few years will come through selling their goods and services overseas. In other words, the economy needs to see a restructuring from consumption and housing towards exports and export-related investment

The good news in this continuing lacklustre recovery is that inflation is remaining very low – despite the earlier weakness of the US dollar - and that is enabling the Federal funds rate to be held at its current 0-0.25% level for a prolonged period while the private sector recuperates. The year-on-year CPI inflation rate fell to 2.0% in May, and the core inflation rate has fallen to 0.9%. With money and credit growth at historically low rates, it is likely that headline and core inflation will remain subdued for the next two years. For the year as a whole I now expect real GDP growth of around 2.8% with headline CPI inflation of 1.2%. 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.

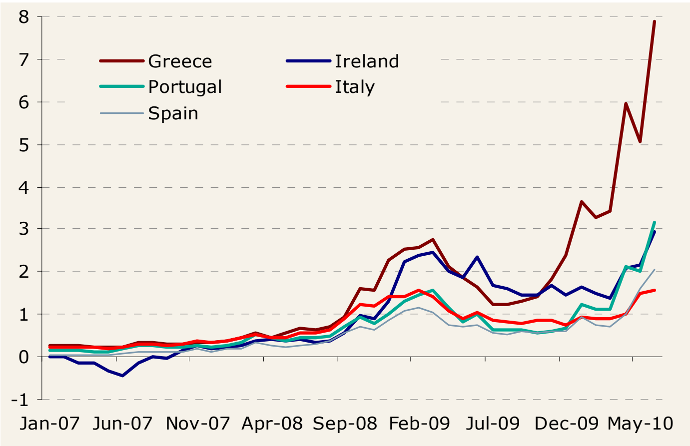
THE EUROZONE

The crisis of confidence in the sovereign debt markets of Europe's "Club Med" economies has significantly eroded the outlook for European economic recovery, even though individually Greece and Portugal are small, together accounting for less than 4% of eurozone GDP. But as long as a sense that the crisis has not been fully resolved prevails, contagion risks will persist, potentially affecting Spain and Italy.

The initial recovery in the core economies of the eurozone in 2009 had been driven by economic policy stimulus combined with a rebound in world trade, helping to improve financial conditions - principally through lower interest rates - until the sovereign debt crisis took centre stage from December onwards. Ironically, now that the crisis has undermined the value of the euro, export prospects have improved, while the higher yields on government debt have worsened the prospects for domestic demand growth. In contrast to the core areas, the economies of the periphery enjoyed the strongest growth and the highest rates of property price increase during the boom years, but are now experiencing exactly the reverse set of conditions -- very tight money and credit, declining real GDP and steep falls in property prices. The fundamental nature of the eurozone's problems – stemming from the divergent characteristics of the members of the monetary union, from the impossibility of unilateral currency adjustments to promote export-led growth, and from the consequent difficulty in restoring competitiveness and sound public finances in peripheral countries – will almost certainly delay recovery and cause the crisis to rumble on for many months to come. Persistently high unemployment in much of the euro area, and financial de-leveraging by indebted households and businesses means that overall money and credit growth will remain weak. All these factors will act as a drag on domestic demand. We expect only 1.0% real GDP growth for the year as a whole.

Nevertheless, substantial economic slack is likely to keep inflation low (1.5% in our forecast). Weak inflation in the core area and deflation in some of the peripheral economies generated in part by a large negative output gap imply that the ECB will be maintaining a very accommodative monetary policy stance until well into 2011, and will remove liquidity support only gradually. As the financial markets became more alarmed about the prospects for fiscal sustainability among the peripheral economies in the early months of the year, pressure built up on member states to enact more credible and transparent plans for fiscal consolidation across the region. Finally the leading eurozone economies responded with the massive €750bn "European Financial Stability Facility", announced on May 10 in conjunction with the IMF. Unfortunately the scheme did not carry much credibility with bond market vigilantes because it did not promise sufficiently strict conditionality for its loans, or any new regime for effective fiscal surveillance and enforcement. Adding to short-term concerns are anxieties about the ability of Spanish and other banks to roll over €442bn of 1-year loans borrowed from the ECB a year ago. These are due on July 1 and must be replaced with 3-month loans, most probably on less favourable terms. It follows that there are likely to be further rounds of the current sovereign debt crisis until the eurozone's fiscal control mechanisms as well as its financial regulatory and supervisory architecture are substantially strengthened.

Spreads over 10-year bunds illustrate effects of sovereign debt crisis (%)



Source: Bloomberg, 31 January 07 to 30 June 10

UNITED KINGDOM

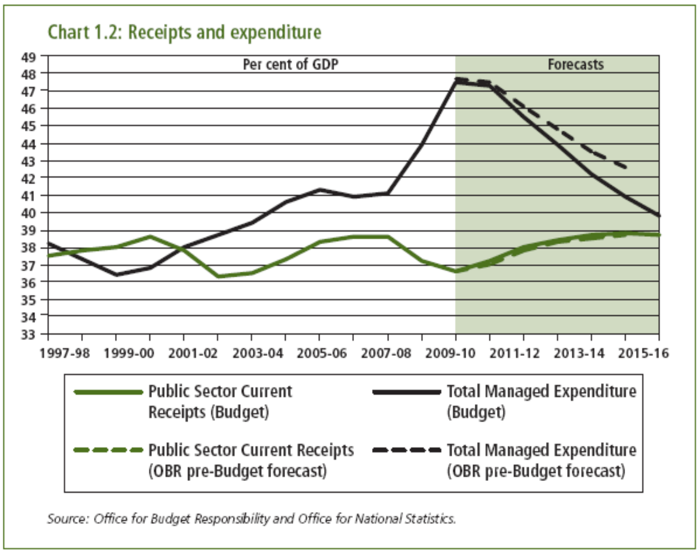
With the election of the Conservative-Liberal Democrat coalition government in Britain, economic policy has undergone a radical transformation. Instead of maintaining the Brown-Darling formula of open-ended government spending and record budget deficits until the private sector recovery was well-established, the Cameron-Clegg team have embarked on a vigorous programme of fiscal consolidation, cutting (or lowering the growth of) government expenditures and raising taxes in roughly the ratio 4:1 over five years. The initial target is to eliminate the structural budget deficit (the part of the deficit that does not disappear with economic recovery) and to stabilise and then start reducing government debt as a fraction of GDP over the lifetime of the current parliament.

The new administration's philosophy is fundamentally different from New Labour, believing that growth and prosperity are generated only in the private sector, and therefore the boundaries of the state must be rolled back in order to create the space for private businesses to flourish. To do this the emergency budget of June 22 made a bold attempt to roll back a decade of ill-targeted welfare programmes and wasteful spending by government departments as well as by no less than 1200 quangos in order to avoid a Greek-style debt crisis. The aim is to cut the deficit by £113bn by 2014-15, reining in departmental spending and welfare benefits, and raising additional funds from tax increases. Despite much hand-wringing over the severity of the "cuts", government current expenditure and total managed expenditure will both continue to rise in nominal terms in every year to 2015-16 on these new plans, implying that the cuts will only be in real terms, and will be concentrated in capital expenditure and in those departments not subject to protection such as National Health and Overseas Aid.

There is some risk to real GDP growth in this plan, as private sector employment may not pick up quickly enough to counterbalance public sector cuts. The OBR projections imply GDP growth will be only 1.2% in 2010, 2.3% in 2011, and 2.8% p.a. out to 2015 (which is more realistic than the previous cabinet's projections). However, the government is betting that a variety of incentives to small business investment plus the effect of low interest rates, weak sterling and reviving exports will counterbalance public sector cuts. This may carry risks, but what was the alternative? In the coalition's view, a debt crisis with higher interest rates and a longer slump was looming if nothing was done. Except in ring-fencing certain departments and in cutting capital expenditures more than current spending, the coalition has generally followed the path of best practice, as suggested by detailed studies of previous successful fiscal consolidations in other economies. This should minimise the risk of a double-dip recession.

Unfortunately the 2.5% hike in VAT will unavoidably impact headline inflation from January 2011. Most forecasters had previously expected CPI inflation to drop below 3% in November and stabilise around or below 2% during 2011. However, the VAT change could temporarily raise inflation again to 2.7- 3.2%, possibly requiring BoE Governor Mervyn King to write further letters to the Chancellor. Effectively this means it will be hard for the Bank to justify further QE operations (due to high inflation), though given the degree of economic slack, I would expect the MPC to keep interest rates at 0.5% well into 2011 (due to low real GDP growth).

Survey data suggest that the recovery is gaining traction, supported by improving financial conditions, growing exports and a temporary surge in stock-building. Higher than targeted inflation and the continued tightness of credit, together with the unavoidable fiscal tightening, will nevertheless keep growth subdued in 2010. I expect the recovery will gain momentum in 2011 when household consumption and business investment start to grow more strongly. According to the OBR, unemployment is set to peak this year at 8.1%, and fall slowly over the next four years to 6.1% in 2015.



JAPAN

Japan's domestic recovery continues to be much weaker than the recovery of its manufacturing and export sectors. The strong rebound in exports (up 45% year-on-year in March, slowing to 32% in May) has been mainly focused on China, East Asia, and other emerging economies, while on the domestic side the authorities have needed to implement fiscal stimulus to support household income and spending in the face of falling employment and wages.

Overall real GDP growth is projected to reach 3% in 2010 on a year average basis, but to slow somewhat in the second half of the year as the low base effect wears off. Industrial production in May, for example, showed signs of levelling off at about 13% below its pre-crisis peak volume, and inventory levels have remained little changed from March, 2009, about 16% below their pre-crisis peak. Housing and construction have remained weak with no bounce-back, while household incomes and spending are down in nominal terms. Unemployment peaked at 5.6% in July 2009, having been below 4% in 2007-08, and is likely to remain above 5% through 2011. Deflation will persist as long as the Bank of Japan fails to jump-start bank lending or monetary growth, and as long as production remains below capacity.

The Bank of Japan is attempting to combat on-going deflation through its commitment to keep interest rates at their very low current levels, and it has implemented modest quantitative easing measures since late 2009. Given Japan's very high public debt, the government needs to embark on a fiscal consolidation plan combined with vigorous supply-side measures to restore growth in the private sector. However, reforms on the supply side – particularly reforms that boost productivity growth and innovation in the service sector - have seldom been enough to generate any sustained growth spurt. These issues highlight the problems of improving living standards in the face of a shrinking working age population.

NON-JAPAN ASIA

China's vigorous expansion continued in early 2010, but has recently shown signs of moderation under pressure from tightening financial policy and measures to cool the property market. I expect GDP growth will reach 11.2% this year before slowing to 10.4% in 2011, as the impact of the 2008-09 stimulus package diminishes. With the announcement of a change in currency policy from June 21, the currency is now moving upwards, albeit very slowly, exacerbating the deterioration in the terms of trade as wage rates rise. Against this backdrop and with domestic demand remaining strong, China's external trade surpluses seem likely to be more moderate than before the crisis. Inflation is rising, but with food prices easing, the CPI is unlikely to exceed 5% this year.

In India the sharp contraction in agricultural output caused by insufficient monsoon rainfall last year has held back the momentum of the Indian economy on the domestic side. Nevertheless, the non-agricultural sectors have continued to perform well with recent indicators of activity and business sentiment suggesting robust growth. If the agricultural sector rebounds this year, economic growth should be strong in 2010. I expect 7.9% real GDP growth but 8.5% inflation due to continued increases in food prices.

Elsewhere across the Asian region the recovery in external trade and the revival in domestic demand spending have continued to gain strength, and are on course for a buoyant 2010. Outside China and India inflation remains subdued, but central banks are gradually switching to a tightening mode.

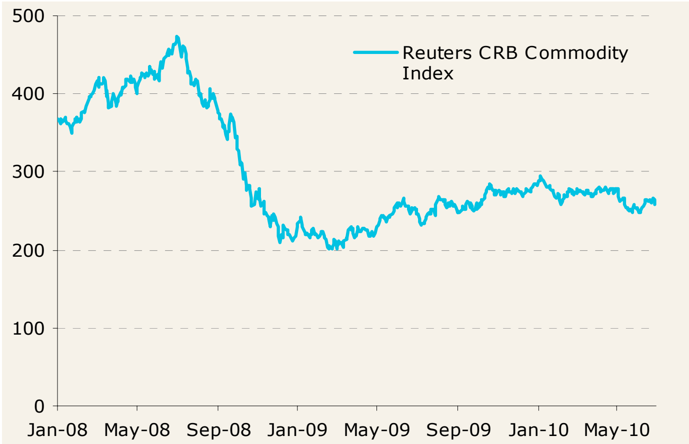
LATIN AMERICA

Like the Asia ex-Japan region, Latin America has been recovering strongly in 2010, having emerged from the global financial crisis without substantial increases in debt, and having seen inflation and interest rates decline to forty-year low levels in several cases. Brazil in particular has been expanding at a brisk pace since mid-2009, helped by vigorous stimulus measures, which are now going into reverse with the ending of temporary tax cuts, reserve requirement increases and interest rate hikes. Economic growth in the region for 2010 looks set to reach about 4.5%, driven mainly by Brazil (6.5%), although Mexico (3.0%) is now recovering after a steep decline in 2009. 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 the Latin American 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 rallied broadly in line with the recovery of equity markets from March 2009 onwards, but have weakened slightly in the first half of 2010. Looking forward into 2011, continued strength in commodity prices will require demand in the emerging giants of China and India fully to counterbalance the relatively weak recoveries in the developed western economies, a prospect we judge unlikely. Outside of a few individual items, it is therefore hard to envisage the generalised commodity surge of 2009 continuing given the deflationary momentum in developed, western economies. If the solution to excessive debt levels in developed economies had threatened to be rapid monetisation of government debt and high inflation, then the outlook would be much more bullish for commodities, but in the pervasive "belt-tightening" environment of North America, Europe and Japan with money and credit growth at negligible rates that outcome seems a very remote possibility.

Commodities look to China and India for renewed surge in prices



Source: Bloomberg: 1 Jan 08 to 28 Jun 10.

CONCLUSION

The early months of 2010 have seen modest improvements in economic growth among the major western, developed economies as private sector spending gradually starts to revive. However, the sovereign debt crisis of the peripheral southern European economies has prompted fiscal consolidation to take the place of fiscal expansion, and will leave the onus much more on monetary policy to ensure a sustained recovery. Consequently I now expect monetary stimulus to be extended for longer than previously, counteracting the necessary fiscal tightening. In my view a self-sustaining recovery remains likely, 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 are already low in Europe, North America and in Japan, 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. Nevertheless, in recent months the authorities in these economies have turned to policies of restraint in both the fiscal and monetary arena. In general I expect domestic demand in emerging economies to be the most buoyant area of growth because although exports are recovering their overall GDP growth is restrained by the subdued pace of recovery in the developed western economies. The policy restraint exercised in these emerging economies will keep inflationary pressures at bay, but the overall global business cycle expansion should be able to continue.

John Greenwood
Chief Economist, Invesco Ltd
30 June 2010.

John Greenwood, Chief Economist, Invesco Ltd

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