John Greenwood, Chief Economist, Invesco Ltd.

Quarterly Economic Outlook – Q2 2012

INTRODUCTION

In December I introduced the Annual Economic Outlook with three key questions: Will the US economy maintain its recent better performance? Will the Eurozone crisis be resolved in a timely and effective manner? And will the Chinese economy avoid a hard landing in 2012?

As of the end of March there are so far only partial answers to these questions.

In the US the recovery continues at a subdued pace. In the words of Dennis Lockhart, President of the Atlanta Fed, depending on which data one looks at the US economy could be described as a glass half full or a glass half empty. There have been encouraging improvements in corporate investment, corporate profits, retail sales and the labour market. On the other hand, housing and the prospects for the federal deficit have not changed much, and continue to pose questions for the future.

In the Eurozone, two large injections of funds into the banking system from the ECB's two Longer Term Refinancing Operations (LTRO) in December and February aggregating almost €1 trillion have eased the financial squeeze on the banking system, and the completion of the Greek debt exchange in March – albeit with the use of collective action clauses - have markedly improved sentiment across the continent. However, these two measures constitute short-term palliatives, not permanent solutions.

In China, the economy has avoided a hard landing, but it is clearly still slowing. Statements by policy-makers such as Premier Wen Jiabao forecasting only 7.5% real GDP growth in 2012 and the need for further downward adjustments in house prices have been discouraging to stock market investors and to those who had hoped for an early switch to renewed monetary easing. Accordingly, local financial market sentiment has been adversely affected.

Fig 1:

Inflation and Growth Forecasts

	2011 Estimate		2012 Consensus Forecast			
	Real GDP	CPI Inflation	Real GDP		CPI Inflation	
US	1.7%	3.1%	2.3%	(2.3%)	2.3%	(1.8%)
EU-17	1.5%	2.7%	-0.4%	-(0.3%)	2.2%	(2.1%)
UK	0.8%	4.5%	0.6%	(.6%)	2.7%	(2.3%)
Japan	-0.7%	-0.3%	1.9%	(2.1%)	-0.2%	(0.2%)
Australia	2.0%	3.4%	3.1%	(3.3%)	2.5%	(2.7%)
Canada	2.5%	2.9%	2.1%	(2.4%)	2.0%	(2.0%)
China	9.2%	5.4%	8.4%	(8.2%)	3.3%	(3.0%)
India*	6.8%	8.4%	7.2%	(7.2%)	7.0%	(7.7%)

Source: Consensus Economics, 12 March 2012,
Invesco Forecast in blue brackets
* Fiscal year data (ie. FY11 = Apr 11 to March 12)

The diversity of outcomes in these three major areas has complicated the trends in global capital markets. These cross-currents, combined with periodic central bank interventions in the credit markets, have translated into continued volatility both in bonds and equities. This is reflected in the persistence of "risk-on" and "risk-off" days in the financial markets – essentially days when the direction of trades favors either risky assets or perceived safe assets. This pattern is likely to continue until the business cycle trends in the major geographic or economic areas become clearer.

Among the major currencies, the euro has succeeded in holding up against the US dollar, the Japanese yen and the pound, but following a strong period in January and February, many EM currencies have weakened in March. Again, until the underlying business cycle trends become clearer, currency movements are also likely to continue to reflect short-term concerns rather than long-run cyclical factors.

With central bank policy rates in the developed world likely to remain close to the "zero bound" for an extended period, I believe investors will remain in a search-for-yield mode. I expect this will in turn cause quality assets that generate safe and sustainable yields to be bid to a premium relative to assets generating lower income streams. Examples of such "quality assets" would include corporate and certain higher-yielding bonds in the fixed income area, equities with high dividends that are insulated by steady earnings growth or solid dividend cover against sub-par economic performance, or real estate funds that can assure strong and stable flows of rental income.

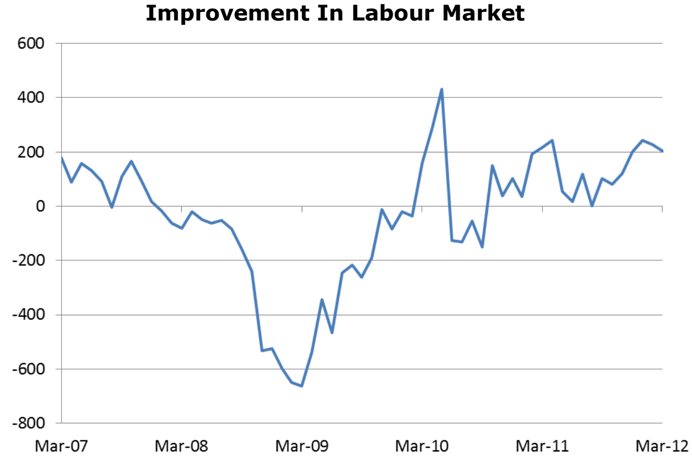
In the commodities space, aside from oil which is benefiting from fears of geo-political instability or even conflict in Iran and the Straits of Hormuz, both agricultural and industrial commodities remain vulnerable to slowdowns in Europe and Asia.

UNITED STATES

The recovery in the US labour market continues to gain traction, with non-farm payroll employment gaining by more than 200,000 in each of the three months to February (see Fig 2). Alongside these gains, the unemployment data have also improved recently with weekly unemployment claims trending down, and the overall unemployment rate edging down to 8.3% in February. These improvements may have enticed some discouraged workers back into the labour market (helping to explain the slow decline in the unemployment rate), but they have also helped the recovery in personal income and consumer spending. Retail sales, for example, increased by a solid 1.1% in February, almost double the 0.6% gain in January. Consumer confidence has also been improving, although from a low base. In March the Conference Board's index increased to 70.2, up from 61.5 in January, but still far below the long-term average of 94.

Fig 2:

US Non-Farm Payrolls Show Signs Of Improvement In Labour Market



Source: Thomson Reuters Datastream as at 30 March 2012. Month-on-month change in '000s.

On the production side of the economy the ISM indices for manufacturing and non-manufacturing registered 53.4 and 57.3 in March, showing that the economy was expanding at a healthy pace. In addition, the Empire State and Philadelphia Fed manufacturing indices also moved upwards in March, suggesting continued moderate improvements in the manufacturing sector.

In contrast to these generally favourable trends, house prices continued to fall, while home sales and house-building, although boosted by an unusually warm winter, have weakened slightly according to recent data. Repeated attempts by the Administration to devise schemes that would reduce or delay foreclosures, defer or ease mortgage interest or principal repayment obligations (e.g. through HARP1 or HARP2 – the Home Affordable Refinance Program), or generally alleviate household debt problems have failed to improve underlying market conditions.

The other area where there has been no progress is in respect of the Federal budget, where positions have, if anything, hardened on both sides of the Congress. The President's budget for 2013 calls for a modest slowdown in discretionary spending and a projected deficit of $901 billion, or 5.5% of GDP (down from $1.44 trillion or 8.5% of GDP in 2012). However, with elections scheduled for November and Republicans in control of the House, it may be difficult for the Administration to carry these proposals. In addition, the debt ceiling could require expansion again in early 2013, leading to further acrimony.

The improvements in the labour market, in income and spending, and in production, along with Bernanke's recent testimony to Congress have cooled market expectations of QE3, although they have not eliminated it. News reports suggest the Fed could be considering "sterilised QE" whereby they would purchase either long-dated Treasuries or mortgage-backed securities, but counterbalance these purchases with reverse repos (effectively sales of securities) at the short end of the yield curve. The aim would be to keep Treasury and mortgage yields low, while the reverse repos would offset the increase in the monetary base due to the asset purchases. Although these kinds of overtly manipulative operations could damage the Fed's reputation, the dollar has strengthened and Treasury bonds have sold off on the back of the improved economic reports.

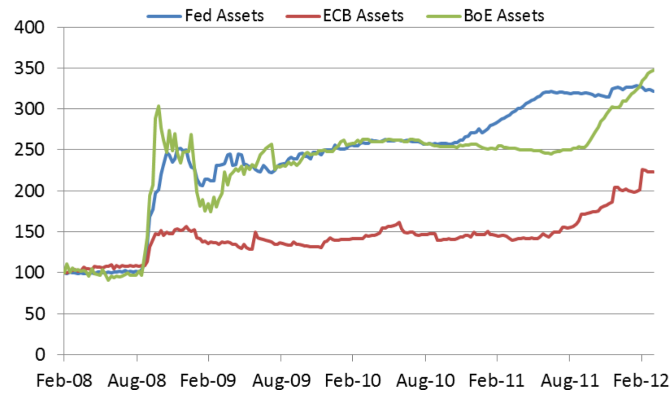
Looking forward, the positive surprises in the economic data in January and February were reversed in March and seem unlikely to continue. Investors should therefore be prepared for some setbacks in the summer months. In my view the current economic upswing is likely to be sustained but remain moderate. I forecast just 2.1% real GDP growth in 2012 with CPI inflation falling to 1.4% - assuming no Mid-East crisis.

THE EUROZONE

The first quarter was dominated by the effects of the ECB's two LTRO programmes (in December and February) and by the implementation of the Greek bond restructuring exercise in conjunction with the provision of a second bail-out package. Over the next few months markets will be focusing on the recapitalisation of the banks and the ability of Spain, Portugal and Italy to implement reforms while reducing government debt ratios.

Fig 3:

Growth In Central Bank Assets



Source: Thomson Reuters Datastream as at 2 March 2012. Rebased to 100 as at Jan 2008.

Sentiment and liquidity in the Euro-area were dramatically improved by the ECB's two LTROs. The inter-bank liquidity squeeze that had been intensifying between August and December was rapidly relieved as the ECB provided first €497 billion in December and then €520 billion in February. (Both these are gross figures, meaning that banks rolled existing facilities at the central bank into the new 3-year loans. The ECB calculated the net figure for the two LTROs at €502 billion.) (see Fig. 3 for expansion in Central Bank Assets).

The relief in the financial markets was evident in strongly rising equity markets, steep reductions of interbank rates, declines in the sovereign bond yields of crisis economies (see Fig. 4) and in the cost of credit default swaps (CDS – instruments that protect against default), as well as a rush of issues by banks in the covered and in the unsecured markets for bank debt. Market participants noted that bank purchases of Italian and Spanish sovereign debt by banks increased significantly after the LTROs, though this could be driven as much by the need to meet the EBA's capital requirements (see below) as by any intention to profit from the arbitrage between the ECB's LTRO funds at 1% and high-yielding government bonds.

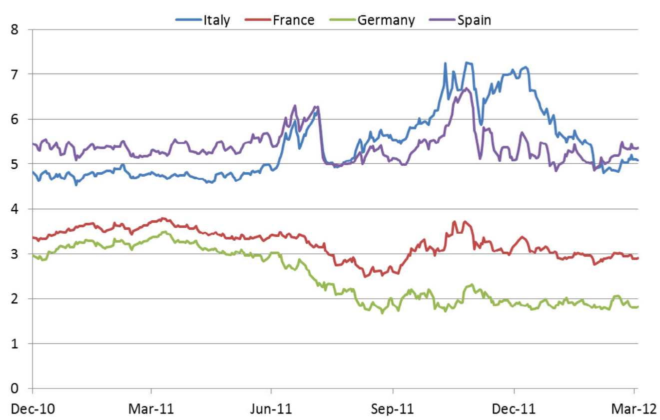
Although broad measures of Eurozone money and credit have not yet responded to the two LTROs, fixing the banks' balance sheets must be regarded as the first step on the road to more normalised credit markets. Compared with US or British banks, Euro-area banks are lagging behind in balance sheet repair, but at last the process has begun.

The other major event for the region was the successful Greek debt exchange in March, reducing Greece's outstanding debt by roughly €105 billion. This was achieved by Private Sector Involvement (PSI) requiring 66% of private sector holders "voluntarily" to agree to take a 53.5% haircut (resulting in a cumulative 70% write-down) in the nominal value of their bonds. The Greek authorities then implemented collective actions clauses (CAC) imposing the same conditions on the remaining private sector holders of bonds governed by Greek law. (A small number of investors in Greek bonds governed by international law are still holding out.) The net effect is intended to reduce Greece's ratio of debt-to-GDP to 120% by 2020.

The question of whether Greece (or other Eurozone economies that engage in such debt exchanges) can escape the debt trap is still very open to debate. If the denominator in the debt-to-GDP fraction – the nominal GDP – continues to decline, as seems likely given the recession, further austerity and the need to deflate wages and prices, the debt ratio will continue to rise even if the outstanding debt remains unchanged. It is therefore clear that financial markets will continue to be concerned about the risk in Greek debt, and highly likely that there will need to be further rounds of debt exchanges to further decrease Greece's outstanding obligations. The Euro-area debt crisis is not over.

Fig 4:

Spanish and Italian 10 Year Bond Yields Have Fallen



Source: Bloomberg as at 2 April 2012.

Looking forward, one key driver of the next stage in the Eurozone crisis will be the question of whether Euro-area banks can meet the 9% Core Tier 1 capital requirement set by the EBA (European Banking Authority) for the end of June. Following stress tests last December the EBA instructed the banks to raise €115 billion. As of mid-February very little common equity had been raised, but a substantial amount of Tier 1 debt had been funded – via new issues, by conversion of hybrids to common equity, and by retained earnings. In addition, banks have sold assets and shifted portfolios from loans into sovereign debt (because it carries a lower capital requirement). Although, according to the EBA, loan reductions account for only 1% of capital raising, bank lending across the Euro-area is currently stalled, implying little help for the real economy from the banking sector. For the remainder of 2012 I believe banks will remain on the defensive, further extending the Eurozone's recession.

Real GDP growth in the Euro-area fell 0.3% (quarter on quarter) in 2011 Q4, with declines in all the main components of domestic demand – household consumption, government expenditure, and investment. Recent data suggest that the overall decline has continued in 2012 Q1, with the composite PMI for March in contractionary territory at 48.7 after 49.3 in February. However, the reality is that while the northern Eurozone economies are modestly expanding (e.g. France +0.2% in 2011 Q4), the weakness is concentrated in the peripheral economies of southern Europe (Greece -2.8%, Italy -0.7%, Portugal -1.3%, and Spain -0.3%). In view of the severity and duration of the austerity programmes being imposed in the southern member countries, a two-speed Europe is likely to persist for a considerable time. The contrast between the two zones is highlighted by the recent strength of the German ZEW survey, the IFO index, and Germany's industrial production and exports.

The best hope for the Eurozone as a whole is that the ECB's easy money policy stance through LTROs continues, fuelling a strong recovery in Germany and other core economies. This would have favourable spillover effects on the struggling peripheral economies, encouraging southern Eurozone exporters and raising relative prices in the core. Unfortunately, however, German leaders such as Bundesbank President Jens Weidmann are already beginning to recoil at the first signs of these symptoms in their economy. Thus despite member nations finalising a second Greek bailout, increasing the size of the Eurozone's rescue funds, moving ahead with EU-wide bank recapitalisation, implementing new Eurozone fiscal discipline rules, and proposing structural reform policies to encourage growth, the Eurozone crisis is set to continue throughout 2012.

For the year 2012 across the Eurozone as a whole I expect a decline of 0.3% real GDP growth and +2.1% CPI inflation.

UNITED KINGDOM

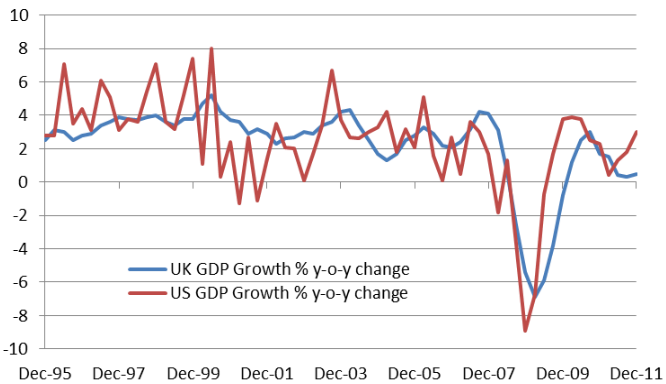
March saw a mild downward revision by the ONS of the official real GDP for 2011 Q4 from -0.2% to -0.3% and the announcement of the third budget statement of the Coalition government. The other significant development has been the sustained reduction in CPI inflation since it peaked in September.

The economic outlook is essentially unchanged from the time of the Chancellor of the Exchequer's Autumn statement. The OBR had already made a much gloomier forecast in November, especially with respect to the size of the output gap and trend GDP (see Fig. 5), and those assessments remain in place, and it was broadly unchanged. The forecast for real GDP in 2012 was raised by 0.1% to 0.8%, and that for 2013 was lowered by the same amount from 2.1% to 2%. Leaving aside some small shifts in the components of forecast spending, this means the consumer will remain trapped in a squeeze between low nominal income growth and an inflation rate that will exceed income growth for at least the first half of the year. To escape this low activity, high unemployment trap the economy will need lower inflation (particularly lower energy prices), stronger sterling, or some reductions in indirect taxes (such as VAT). Among these, the only realistic prospect for 2012 is lower overall inflation.

On the fiscal front the strategy adopted in the Budget was one of strict neutrality over the next five years -- meaning that George Osborne made no tax cuts or spending increases that were not funded with tax increases or spending reductions elsewhere (i.e. no "unfunded giveaways"). Small net tax reductions in 2012-13 and 2013-14 are balanced by fiscal tightening (mainly lower spending) from 2014-15 onwards. The three main tax reductions were: an extra 1% cut in corporation tax to 24% this year, and to 22% by 2014-15, a £1,100 increase in the personal income tax allowance in 2013-14, and changes to the taxation of child benefit for higher rate tax payers. Together these amount to £20bn over the next five years, and they are funded by a large number of smaller tax increases, the phasing out of the age-related allowance being the most important, and cuts in public spending from 2014/15 – including £2.4bn of savings on defence spending in Afghanistan.

Fig 5:

UK GDP Growth Lags US



Source: Bloomberg as at 2 April 2012.

In the monetary policy arena the Bank of England's Monetary Policy Committee has kept the Base Rate at 0.5%, but on February 9th it announced its decision to expand its asset purchase programme or QE by £50 billion over the three months from February to May (from £275 billion to £325 billion). We know from the minutes of the March meeting of the MPC that two members voted for a further £25 billion of asset purchases, which together with the dismal outlook for economic activity suggests a strong possibility of further asset purchases later in the year.

Since the erosion of personal incomes by unexpectedly high inflation was the main reason for the UK economy's weak performance in 2011, the outlook for inflation will be crucial to the restoration of economic growth over the next two years. Already CPI inflation has fallen from 5.2% in September to 3.4% in February, and I expect it to decline further – barring a conflict with Iran – to 2% by year end (2.3% for the year as a whole). The recession in the Eurozone together with moderate growth in the US will mean that GDP growth will continue to be constrained at 0.6% in 2012.

CHINA

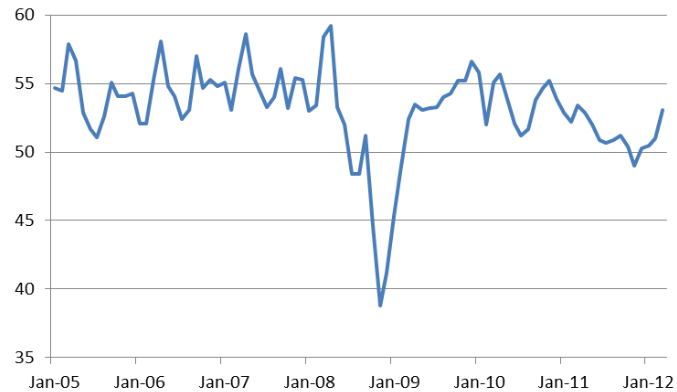
Growth momentum in China has continued to soften. Retail sales in January-February slowed compared with December, as did fixed asset investment mainly due to further weakening in the property market. On the external side exports have also softened amid sluggish external demand in Europe and Japan, while imports have slowed along with the moderating pace of domestic demand. Looking ahead the signs are mixed. On the one hand forward indicators such as the PMI have recovered above 50% (implying continued expansion) following their weakness last November (see Fig. 6), but on the other hand policymakers such as Premier Wen Jiabao clearly want to see further evidence of domestic demand cooling. In recent speeches he has warned that real GDP growth in 2012 should be only 7.5%, well below consensus forecasts of 8.4%, and in addition he has insisted that housing prices need to decline further.

These statements have been discouraging to stock market investors and to those who had hoped for an early switch to renewed monetary easing. In line with this stern attitude from policymakers M2 growth has remained below 14%, and loan growth has undershot expectations. Accordingly, local financial market sentiment has been adversely affected.

Although the reserve requirement ratio (RRR) has been lowered twice in the past six months, these measures largely reflect declines in foreign exchange reserves resulting from a decline in the combined current and capital account balance. The RRR reductions are intended to prevent these

Fig 6:

China PMI Recovers Above 50



Source: Bloomberg as at 2 April 2012.

external payment trends from causing incremental monetary tightening, and should not be viewed as an overall monetary easing tool. Loan targets and interest rates are still the prime signals for domestic monetary policy.

In the property market administrative controls and purchase restrictions remain in place, keeping property prices on a downward path and helping to cool the reported inflation rate. Thanks mainly to tight monetary conditions the CPI slowed noticeably from 4.5% year-on-year in January to 3.2% in February, while producer price inflation fell to zero in February. With these signs of cooling in the economy, the RMB/USD exchange rate has virtually stopped rising, and even depreciated slightly in March.

For 2012 I expect 8.2% real GDP growth and 3.0% CPI inflation.

JAPAN

The pace of economic recovery from the disastrous tsunami of March 2011 has slowed in recent months. For example, real GDP contracted by 0.6% in 2011 Q4, and the business cycle coincident indicator reported by the Cabinet Office retreated by 0.3 to 92.7 in January while the year-on-year growth of private machinery orders (excluding volatile orders from shipping and electric power companies) dipped from 6.3% in December to 5.7% in January. Consumer spending has been adversely affected with monthly household expenditure falling by 2.3% year-on-year in January. Looking ahead, the weaker yen plus oil price hikes and electricity rate increases will further erode consumers' real income, potentially slowing spending further.

In addition Japan's external accounts have deteriorated decisively as a result of increased imports and declining exports. Imported fuel requirements have surged following the progressive closure of Japan's nuclear power stations – in the wake of the earthquake and tsunami – and an increase in other imports needed in reconstruction. Thus January imports were up 9.9% year-on-year. On the export side, earthquake-related disruptions to the supply chain have resulted in sluggish growth of industrial production (down to

2.0% year-on-year growth in January from 3.8% in December) and a fourth consecutive month of declining exports in January, falling by 9.3% year-on-year compared to -8.8% in December. Together these trends have pushed the balance of trade into persistent deficit since April 2011 and nearly halved the current account surplus.

To cope with some of the adverse trends in the budget the Japanese government proposed to raise the consumption tax rate further in fiscal year 2016 on top of the original plan to raise the value added tax rate from the current 5% to 10% by October 2015. Given the short-term damage this could do to growth and inflation there must be substantial doubt whether these tax changes will actually be implemented. On the monetary policy front the Bank of Japan maintained its virtual zero rate policy and adopted a new inflation target of 1% . Under political pressure to be more constructive it also announced a planned expansion of its balance sheet by JPY 10 trillion, including additional loans of Yen 3.5 trillion under its Growth Supporting Funding Facility.

On the inflation front, compared with year-on-year declines in the period October to December, consumer prices moved up by 0.3% in February – a significant increase in the Japanese context. The consensus forecast for the CPI in the calendar year is still -0.2% (i.e. continuing deflation), but my view is that the weaker yen will contribute to tipping the balance from deflation to mild inflation. I expect 0.2% headline CPI inflation and 2.1% real GDP growth in 2012.

NON-JAPAN ASIA

Most East Asian economies experienced a distinct weakening in growth towards the end of 2011 as real GDP across the region declined by 1.5% quarter-on-quarter annualised, the first quarterly decline since the recession of 2008-09. The downturn was mainly a result of weakening external demand, so those economies with the largest export sectors tended to do worst, and those with less export exposure proved more resilient. However, in February the PMIs for Korea, Taiwan and Singapore returned to expansionary territory after staying below 50 in the preceding months. This suggests some improvement in GDP figures for 2012 Q1. Looking forward, while domestic demand should remain firm the region will be very reliant – as ever – on continued recovery in the US but held back by the recession in Europe.

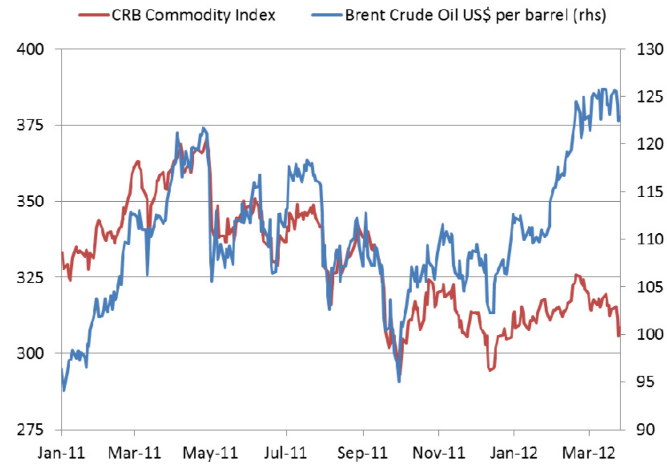
Inflation in the region eased to a 2-year low of 2.8% in February, but the recent rise in oil prices associated with geo-political tensions in the Middle East may lead to some renewal of upward pressure on prices. Against this background most of the central banks in the region kept their key policy rates unchanged during the quarter, although the Philippines and Taiwan central banks cut rates in March. While the export downturn continues currencies have been somewhat weaker across the region. The March consensus forecasts for real GDP and inflation put the region's real GDP and CPI inflation at 4.0% and 3.3% respectively.

COMMODITIES

Commodity prices generally strengthened along with stock prices from October through February – driven mainly by a 30% rise in energy-related commodities over the period – but have subsequently sold off. Agricultural and food prices have remained largely flat since September while industrial commodities rallied only in January. In other words, most of the action has been in the energy complex, driven primarily by fears about geo-political unrest in the Middle-East (see Fig. 7). Here the future price of oil has remained roughly stable and only the spot price has risen reflecting fears about imminent shortages rather than any risk of longer term lack of supply.
With one or two exceptions (like Iran and Syria), most areas of the world are producing more oil or natural gas today than in the past, implying that anxieties about the near-term price trend and its impact on inflation may well be exaggerated.

Fig 7:

Oil Prices Continue To Rise While Other Commodities Ease Back



Source: Bloomberg as at 2 April 2012.

My view is that, except in the event of overt conflict with Iran, commodity prices are likely to have a benign influence on inflation in 2012.

CONCLUSION

The continuation of the Eurozone debt crisis is the single most worrying problem for the global economy, followed by concerns about oil supplies in the event of a Mid-East conflict and the continued slowdown in China. On the positive side, the US economy has made substantial strides towards self-sustaining growth in the past six months with improvements in income, household spending and in employment. This mixture of good and bad will likely remain an on-going feature of the global economy as numerous countries continue to repair the balance sheets of banks and households in the aftermath of the great recession of 08-09.

In economies such as the UK or continental Europe the scope for government-backed spending programmes to assist in recovery are limited by the fact that government expenditure is already close to 50% of total GDP. Moreover, investors have shown acute sensitivity to increases in government debt beyond some threshold such as the famous 90% level identified by Professors Reinhart and Rogoff in their book, "This Time is Different". This means that while the US, where government spending (central, state and local plus social security) is still only 40% of GDP according to the OECD, may be able to continue with large-scale federal spending and deficits in excess of $1 trillion, few other economies are able to enjoy the same luxury. The other factor enabling the US to continue in its fiscal expansion is the "exorbitant privilege" of running the world's premier international reserve currency, meaning that foreigners and especially foreign central banks and sovereign wealth funds remain willing to purchase US$-denominated securities. The combination of tolerance of open-ended fiscal expansion and the maintenance of a relatively firm currency is not something that can be sustained indefinitely. At some unknowable time in the future the financial markets will step up to demand a more disciplined approach. In the meantime the US can still act as a locomotive for the global economy.

John Greenwood
Chief Economist, Invesco Ltd.
April 2, 2012

Important information