



Views from John Greenwood,
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Overview - On the road back to economic growth

During the second half of 2009 economic recoveries finally got under way in most developed economies following the deepest economic downturns witnessed in the past 60 years, but the recoveries were modest and fragile.

There are numerous obstacles to a smooth upward trajectory in many economies. The fundamental causes of the downturn - the over-indebted balance sheets of the household and financial sectors of the developed economies - have not yet been eliminated. Households and financial institutions are still attempting to pay down their debts, and raising their savings or levels of capital. For households this implies that consumption spending is likely to remain restrained until their finances are restored to good order. Equally, business investment and hiring have been cut back sharply in many economies and are unlikely to resume previous peak levels until final demand returns to a more normal and sustainable growth path.

The key to a more vigorous recovery in economic conditions is therefore a resolution of balance sheet problems. But since balance sheet repair is inevitably a slow process for households, it will take some time before the global economy resumes the buoyancy that it enjoyed before the credit crisis of 2007-08. For these reasons I am projecting moderate rates of economic growth with continued low inflation in 2010. By contrast, the emerging economies have been able to recover more quickly from the global recession in 2009, and their recovery should continue at a healthy pace in 2010.

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US - A favourable environment for fixed income investment

Economic activity in the US is gradually picking up and the labour market is improving. In my view 2010 will see a moderate pace of economic growth, but no secondary economic downturn, or double-dip. However, since real gross domestic product (GDP) growth will be below that experienced in typical upswings (perhaps 2-3% instead of 4-5%), the US economy will continue to operate with a large margin of spare capacity and high levels of unemployment. On the business side, US firms continue to cut capital expenditure. Until business leaders sense that final demand conditions have improved in a sustainable way, it is likely that business revenues and spending will also remain subdued. Thus while many economic indicators have returned to more normal levels, the private sector recovery in the US is generally fragile and government-dependent.

The silver lining in this outlook 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 0-0.25% level for a prolonged period while the recovery gains strength. For the year as a whole I expect real GDP growth of around 2.2% with CPI inflation of 1.6%. From an investment standpoint this should provide a favourable environment for fixed income investment, and at the same time enable the upturn in equities to be extended.

Eurozone - Peripheral economies to delay recovery

The major issue facing the eurozone appears to be the fiscal position of some of the peripheral economies such as Greece where the reluctance to curb spending ahead of the crisis combined with the collapse of revenues following the onset of the crisis has led to a budget deficit of 13% of GDP, and a debt level of 112% of GDP. The result was a sharp jump in yields on Greek government debt and a slump in Greek stock prices. For most of the boom years 2003-07 the European Central Bank (ECB) was content to lend large amounts to banks in these higher growth economies against A-minus rated collateral, but now that Greek

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Figure 1: Real GDP & CPI Inflation

	2009 Estimate		2010 Consensus Forecast			
	Real GDP	CPI Inflation	Real GDP	CPI Inflation	Real GDP	CPI Inflation
US	-2.5%	-0.4%	2.7%	2.2%	2.1%	1.6%
EU-16	-3.9%	0.3%	1.3%	1.4%	1.2%	1.2%
UK	-4.5%	2.1%	1.4%	1.2%	2.3%	1.5%
Japan	-5.3%	-1.3%	1.5%	1.4%	-1.0%	-0.7%
Australia	1.1%	1.8%	2.9%	2.0%	2.4%	2.1%
Canada	-2.5%	0.3%	2.6%	1.5%	1.7%	1.2%
China	8.5%	-0.7%	9.6%	9.4%	2.5%	3.0%
India*	6.6%	10.4%	7.7%	7.5%	7.2%	8.5%

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

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government debt has been downgraded and credit conditions are tight across the eurozone, there is real doubt about the ability of Greek banks to access liquidity and finance their assets, including government debt. This will intensify pressure on member states to consolidate their budgets, undermining the easy fiscal stance of eurozone governments, and potentially delaying recovery. These problems have abruptly weakened the euro relative to the US dollar.

UK - Large overhang of private sector debt

Despite the depreciation of the pound and some encouraging readings on the economy from survey data, the average British household and many UK financial institutions are more indebted than their American or European counterparts, and it is inevitably taking time for them to de-leverage their balance sheets. This means that before the average household can start to spend more freely again, and before the typical financial institution can re-activate its lending programme, some of that debt burden must be paid down. Due to the large overhang of private sector debt and the rapid deterioration of the government's fiscal position (which will require both tax rises and public sector spending cuts), the economic recovery seems likely to be weak relative to other economies. Thus despite substantially improved financial conditions, a rising stock market, and the modest improvement in house prices, we are therefore forecasting a real GDP growth rate of just 1.2% in 2010, and an inflation rate of 1.5% - well below the Bank of England's 2% target.

Japan - Shrinkage of the labour force and aging population

In Japan, private investment spending has been very weak, declining by 24.8% year-on-year in Q309, and more recent data has suggested some slowdown in momentum, with weaker data both from the manufacturing sector and from workers' earnings. Concerned at the sluggish outlook, the government has been compelled to grapple with the renewed descent into deflation, initially putting pressure on the Bank of Japan to become more active and subsequently announcing its own 7.2 trillion yen fiscal stimulus package. This included employment subsidies, loan guarantees, and incentives to buy energy-efficient cars and other products. In response the Bank of Japan announced a 10 trillion yen lending programme, but has forecast (since October) that price levels would continue to fall throughout 2010-11. In the financial markets Japanese government bonds sold off in October and early November due to fears about Japan's large deficits and growing debt burden, but subsequently bonds have fully made up these losses, showing that inflation (or deflation in Japan's case) is a more important driver of long term yields than the temporary supply-demand situation in the market. In the longer term Japan has two major problems that will act as a drag on economic growth: the shrinkage of the labour force and the ageing of the population. In the shorter term my forecast for GDP growth in 2010 is 1.4%, with a decline in consumer prices of 0.7%.

Non-Japan Asia - Overall GDP growth for the region to be 4-5%

Following the collapse in their exports a year ago, the non-Japan Asian economies have seen the most robust recoveries of any area of the world. In part this is due to government stimulus policies, but more fundamentally it is due to the fact that Asian economies have not been burdened with debt (as they were in 1997-98), and therefore monetary and fiscal policies have been able to gain traction more promptly. This is especially evident in the case of China where the authorities fiscal spending and monetary stimulus plans translated into faster economic growth within two quarters, but it is generally true for most economies across the Asian region excluding Japan.

However, because these economies are so heavily export-dependent, and because the western developed economies to which they mainly export have been in recession, the Asian tigers have had to focus on domestic spending. As the result, their overall growth rates are not as rapid as they were in the pre-crisis days of export-led growth. Since their exchange rates have generally been held down against the US dollar or other major currencies, and since in some economies like China and India money growth rates have been high, the inflation outlook in this part of the world is very different. I expect overall GDP growth for the region of about 4-5%, but inflation rates will be rising in contrast to the situation in the developed western economies.

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