



John Greenwood, Chief Economist

Quarterly Economic Outlook

Third Quarter 2008

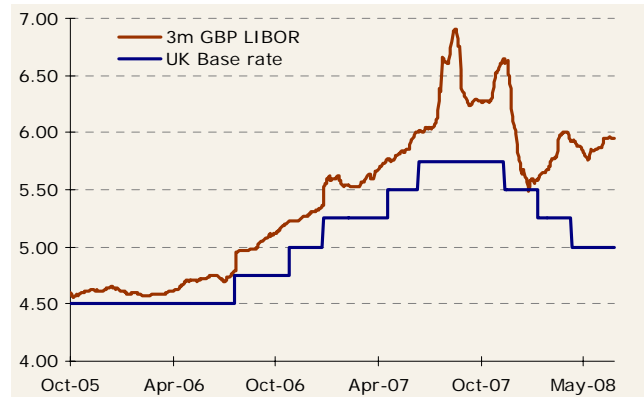
OVERVIEW

- The rally in the equity markets from mid-March to late May has stalled. With widespread talk of the worst of the credit crunch being over, can the rally revive and continue?
- Money and credit markets have yet to return to normal. This process will take several quarters.
- The de-leveraging of the financial and household sectors in major, developed economies is inherently deflationary and will also take several quarters.
- The commodity price scare should therefore not be exaggerated. It is the "last throw of the dice" by speculators, following the bubbles in housing, credit, and equities.
- Overall weakness or recessions in the developed economies will reduce global demand enough to undermine the commodity bubble at some stage.
- Consequently, "second round effects" on wages and other prices should not be expected, or if they occur, they will not be very serious (because aggregate demand will be weak). Nevertheless, CPI inflation will rise and may erode consumer purchasing power for several quarters.
- Fundamentally, the economic downturn will be long and protracted for two reasons. First balance sheet repair takes time, and second it is the two largest sectors – households and the financial sector – that are affected. They are also the most intertwined with the rest of the economy.
- However, offsetting the length of the downturn, the economic weakness will continue to be quite mild. The counterbalancing factor will be strong export growth from the weak-currency countries (such as the US) to emerging economies. In this respect, strong currency economies in Europe may have a more severe slowdown later.
- Market expectations of rate hikes by the Fed should be taken cautiously. Despite improved, or "not as bad as expected," data recently, the evidence for spillover effects from housing via the credit crunch, wealth effects, and multiplier effects on the broader economy is mounting, particularly as far as consumption is concerned. In the US renewed rate cuts remain more likely.
- In the eurozone the recent warnings of "heightened alertness" on the part of the ECB by M. Trichet imply a greater likelihood of a rate hike in July than previously anticipated. Nevertheless, a series of rate hikes is not credible, as -- in line with global trends -- the eurozone is likely to end the year with lower growth and lower inflation.

MONEY & CREDIT MARKET CONDITIONS

In the US dollar, euro and sterling markets 3-month lending rates are still about 70-80 basis points above their respective central bank policy rates -- well above the pre-crisis 5-10 basis points. This implies that markets are still under stress, largely due to three factors: 1) concerns about lending to potentially unreliable counterparties, 2) the desire to hoard cash in case conditions deteriorate again, and 3) the pressure to raise capital, which in turn requires high spreads so that banks can rebuild their profits. Since the rescue of Bear Stearns in mid-March the flight-to-quality has diminished and yields on 2-year Treasury bills have risen by about 150 basis points. In addition, as the Fed has started lending to investment banks, and as other central banks have been willing to conduct repo lending operations based on Treasury bills against less liquid instruments such as mortgage securities, instead of against cash, market conditions have eased somewhat.

3-month lending rates still well above Central Bank rates



Source: Bloomberg

Nevertheless, it seems likely that it will be several months before money market conditions are restored to normal. The Fed, the Bank of England and the ECB are therefore all likely to need to continue to provide additional, non-cash liquidity on a temporary basis for several months in order to restore money market spreads to something more like normal levels. However, it is not only the restoration of more typical spreads that will signal a return to normality. Bank capital will need to be rebuilt, and confidence in counterparties will need to be re-established. Both these developments pre-suppose sustained improvements in the broader economy – conditions which are not likely to be met soon.

DE-LEVERAGING AND BALANCE SHEET REPAIR

The improved tone in US financial markets between mid-March and late May appears to have reflected three main factors: 1) reduced risk of a financial calamity as the Fed aggressively provided liquidity and leveraged institutions raised lots of capital; 2) "headline" macro data that were a bit better than consensus expectations; and 3) the tax rebates currently being issued. However, these expectations are likely to be disappointed.

The fundamental reason is that the current economic downturn is different from most other recessions. The cause of most economic recessions is the response of the authorities (especially central banks) to inflation. Having permitted excessively easy money, inflation takes hold and central banks typically raise rates in response, curtailing economic activity. However, on this occasion the downturn has largely been induced by the private sector in response not to high interest rates, but in response to over-indebted balance sheets in the household and financial sectors. In the US the ratio of household debt to disposable income at the end of 2008 Q1 was 138.0%; in Britain in 2007 Q4 the ratio reached 158.5%. Both figures are far in excess of previous ratios. In the financial sector, whereas banks are typically leveraged about 10-12 times (based on Basel I capital adequacy ratios or risk assets to equities of 8%), many hedge funds and investment banks raised their leverage ratios to 20 or 30 times.

This is therefore primarily a balance sheet crisis (or recession) for both the household and financial sectors, particularly in the Anglo-Saxon economies. The problem for the authorities (who want to see a quick resolution of the crisis) and for the affected financial institutions and households is that balance sheet repair takes time. The reason is that there are fundamentally only three ways to repair a balance sheet:

- 1) Raise capital. This is not feasible for households, and only feasible for financial institutions if investors think their share price will recover reasonably soon. It therefore requires or assumes an on-going improvement in underlying economic conditions, and this is not imminent – at least in the US or in the UK.



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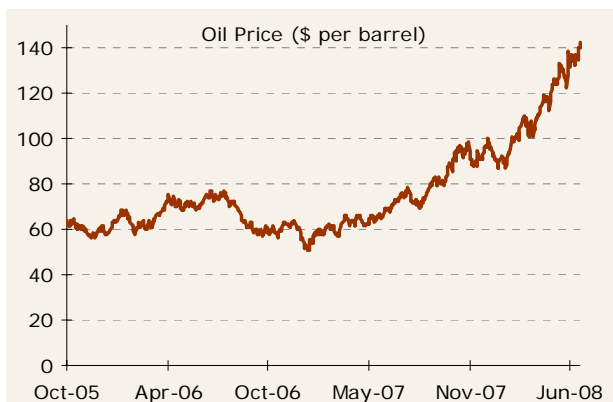
- 2) Sell assets, and use the proceeds to pay down debt. However, no one wants to sell property or securities into falling markets, so asset-holders procrastinate. It takes time before people are willing to take the pain.
- 3) Earn your way out. For households that means increasing savings and cutting consumption. For financial institutions it means relying on a positive-sloped yield curve to generate a spread between the cost of short-term funds borrowed and the return on longer term funds invested. Again, this takes time.

COMMODITY PRICE SURGE

The recent surge in commodity prices has made central banks and investors acutely nervous of a repeat of the 1970s style of inflation. In that episode widespread inflation of raw materials and wage costs appeared to feed a seemingly unending series of price hikes at the CPI level. However, such an extrapolation of recent events is likely to prove wide of the mark.

First, monetary conditions in the 1970s were far more accommodative, with double-digit growth rates of money and credit over extended periods, which facilitated commodity price explosions and prompted demands from trades unions for similar double-digit wage increases. This created a feed-back loop between cost push and demand pull. Even though monetary conditions were easy in 2002-03, they were nowhere near comparable with the 1972-74 episode, consequently although we are witnessing some cost-push, there is not likely to be any demand-pull.

Second, the recent commodity price increases must be seen as part of the transmission of monetary policy through a series of asset markets starting with the credit and capital markets, then equities, and real estate to commodities, economic activity and ultimately to goods and service prices. While the credit bubble and the equity and real estate bubbles have already burst, the spillover from previously easy credit conditions is now showing up in commodity prices and broader CPI components. Admittedly this has been exacerbated in US dollar terms by the weakness of the American currency, but the key point is that it should not be viewed as a new source of inflationary pressure. Just as food passing through a snake creates a visible swelling, the previous credit and real estate bubble is now passing through the commodity markets, and will ultimately dissipate in the form of temporarily higher CPI inflation. Provided the monetary policies of the major central banks remain firm, there should be no additional inflation beyond what they have already permitted by reason of their earlier laxity.



Source: Bloomberg

Viewed from the investor's standpoint, the surge in commodity prices is the last throw of the dice by speculators in the global casino. As and when the major economies weaken sufficiently,

the demand pressure will ease and commodity prices will soften, ending the last phase in the current series of bubbles. Of course it is possible that commodity price increases will continue for several months more, or that demand from emerging markets will keep them permanently higher than they were. However, an extended setback should be expected at some stage, comparable with what has happened in other asset markets during their recent bubbles.

BEHAVIOUR RESPONDS TO HIGHER ENERGY PRICES; NO SECOND ROUND EFFECTS

Inflation is a lagging indicator. The global slowdown that is already underway reflects the mild tightening of monetary policies in 2004-06, and the overloading of household and financial sector balance sheets in the developed world with debt, and is likely – ultimately - to cool commodity prices. Inflation excluding commodities is generally still subdued -- for example, the US core CPI (ex food and energy) was up just 0.1% m-o-m in April, and 2.3% y-o-y. Surveys of retailers' pricing power have declined recently to the lowest levels in four years. This is not an environment in which commodity price inflation can be long sustained.

Moreover the risks of so-called "second round effects" are also small. US wages increased only 3.2% y-o-y in March. In the auto industry there have been some severe cuts in wage payments recently: American Axle cut wages by \$10 per hour and is reducing its workforce by 2,000 workers prompting industrial action; Ford is cutting 2,000 jobs, and GM has laid off almost 25% of its hourly work force. All these measures suggest that cost pressures are squeezing profits, so pipeline cost increases will not be passed on to customers.

In summary, it seems highly likely that commodity prices are close to their peak. Nine of the twenty-four components of the GSCI (Goldman Sachs Commodity Index) are already down by 10% or more. In markets where prices are still rising, as with oil and gas, consumers are starting to change their behaviour. For example, US consumption of gasoline in April was down by 4% compared with last year, and a number of major airlines have recently announced that they may cut their flight schedules by 20%. The customers of Dow Chemical and Kodak, which both lifted their product prices by 20%, may well react in the same way by cutting back demand.

A further disincentive for incremental commodity price hikes is that the US authorities (the Commodity Futures Trading Commission or CFTC) have convened their Energy Markets Advisory Committee to discuss "the issue of transparency in the energy markets, and ...the role of index trading and energy trading on foreign boards of trade." They also plan to investigate market manipulation – a clear warning shot across the bows of commodity speculators. Finally, Asian economies such as Taiwan, Malaysia, and Indonesia which had heavily subsidised the price of fuel to consumers have finally decided to cut fuel subsidies, which will have the effect of raising prices for end-consumers, further eroding final demand.

OFFSETS TO ECONOMIC DOWNTURN

As emphasised above, balance sheet adjustment takes time. This means that the economic downturn is likely to be long and protracted; particularly because the most seriously distressed sectors -- households and the financial sector -- are the two largest sectors and most intertwined with the rest of the economy. Only when balance sheets are restored to normality and income growth is solid enough to sustain strong growth of investment and consumption expenditures will the lower growth rates gradually give way to more normal growth rates.

However, offsetting the length of the downturn in the developed world, the economic weakness will continue to be quite mild. In the US case the Fed's rapid reduction of interest rates should prevent some of the pain that would otherwise have been incurred. For example, thanks to lower fed funds rates the mortgage rate re-sets that were to have been implemented in 2008 will now be



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Third Quarter 2008

considerably less severe than previously expected. Another counterbalancing factor will be strong export growth from the weak-currency countries (such as the US and UK) to the emerging economies. In the US, for example, net exports have made a significant positive contribution to real GDP growth over the past year as the trade and current account deficits have narrowed. Thus whereas domestic final purchases were actually negative in 2008 Q1, real GDP (which includes external trade and inventories) was +0.9%. Partly for this reason, Consensus forecasts for real economic growth rates for the US, the EU-12, the UK and Japan for both 2008 and 2009 are all positive, but less than 2%, as shown in the table below.

Consensus Economic Forecasts as at 9 June 2008

	2008 Forecast		2009 Forecast	
	Real GDP	CPI	Real GDP	CPI
US	1.5%	4.0%	1.7%	2.5%
EU-12	1.7%	3.3%	1.4%	2.3%
UK	1.7%	3.1%	1.3%	2.4%
Japan	1.3%	1.1%	1.5%	0.8%

This in turn means that few economies will actually suffer recession in the sense of two successive quarters of decline in real GDP. Nevertheless, since real income, employment and industrial production have declined since the turn of the year it is possible that the US will experience recession as defined by the National Bureau of Economic Research: "A recession is a significant decline in economic activity spread across the economy, lasting more than a few months, normally visible in real GDP, real income, employment, industrial production, and wholesale-retail sales." In short, a significant global slowdown is underway led by the US, but with evidence of slowing in the eurozone, the UK, Canada, and Japan. Since developed economies account for 70% of world GDP it is hard to envisage the emerging world escaping unscathed.

UNITED STATES – NO RECESSION, NO RECOVERY

In my view it is increasingly likely that there will be no recession, but equally no recovery for several quarters while balance sheets are repaired. The odds are increasing that the US economy is indeed skirting recession. In the words of Alan Greenspan "the probability of a severe recession has come down markedly." In this environment the tax rebates will help, although a substantial portion of the actual payments may be diverted to gasoline consumption or debt repayments. The overall picture is one of pockets of strength offset by distinct weakness in broad, specific areas such as housing and consumer spending, together adding up to a marginally positive growth rate for the economy as a whole.

Following the upward revision of real GDP growth to 0.9% in 2008 Q1, US GDP still appears to be headed for a positive figure again in Q2. Recent data reports suggest growth is a bit stronger than expected, and the next few weeks are likely to be helped by the boost from tax rebates and a bounce back from the American Axle strike settlement. Thus although employment in key sectors such as finance is declining, the declines are not nearly as large as they were in the recessions of 1990-91 or 2001-02, and weekly unemployment claims have remained subdued. Shipments of capital goods are on track to lift 2Q real GDP, and corporate profits were up 5.6% y-o-y in the Q1 real GDP report.

The second successive decline in consumer net worth (reported in the Flow of Funds data for 2008 Q1) and prospective further declines in house prices mean that US consumer spending will remain under pressure. In fact house price declines have accelerated in recent weeks, adding to the pressures on household budgets from rising gasoline prices. Vehicle sales fell

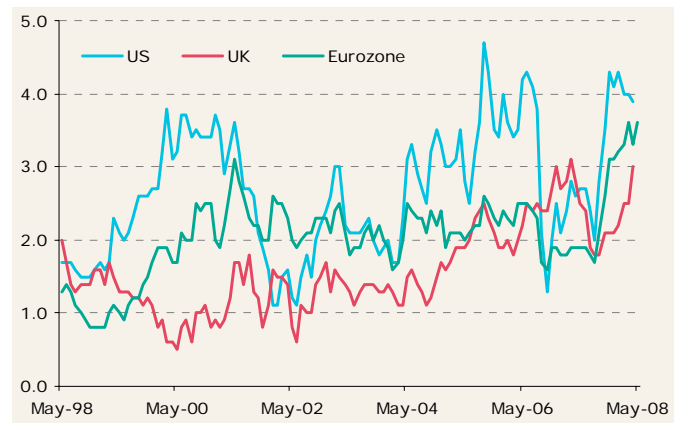
to a 14.3 million annual rate in May from an average of 16.7 million in 1997-2007.

EUROZONE & UK – HIGHER INFLATION, LOWER GROWTH

In the UK and some parts of the eurozone such as Spain and Ireland the same symptoms of over-indebtedness in the household and financial sectors have put their GDP expansions at risk. However, even if the same symptoms had not been built up in Europe, the economies of the developed world could not be immune from developments in the United States. This means that it is highly likely that a global slowdown will unfold. This was evident last week in a series of weak data releases such as the UK construction PMI, Irish consumer confidence, and German auto sales.

In the eurozone the announcement on 5 June by ECB President M. Trichet that the bank had moved to a state of "heightened alertness" was as clear a statement as one could wish that the ECB is considering a rate hike to 4.25% in July. The background to this is that EU-12 inflation at 3.6% in May is well above the targeted "close to but below 2%", and with the additional surge from commodity prices the authorities want to send a clear message that will deter any second round effects on wages or corporate pricing. If growth were to continue vigorously in Q2-Q4, then this would be likely to mean increased inflation pressure even without the commodity price scare.

Headline CPI %



Source: Bloomberg

Despite Q1 growth of 0.8% q-o-q (1.9% y-o-y), economic activity in the eurozone has been softening with on-going weakness in Italy and disappointing performance in France. The ECB forecast in June was for growth of 1.8% in 2008, and 1.5% in 2009. However, rate rises by the ECB in July or beyond would make these outcomes more difficult to achieve. In the second half of 2008 and 2009 growing economic tensions inside the eurosystem will make monetary policy more challenging. A recession in Spain is inevitable. Manufacturing orders data for Germany highlight the fact that German exporters are increasingly seeing the effects of a slowdown elsewhere in the eurozone. The net effect is likely to be temporarily higher inflation against a background of weakening economic growth.

In the UK the credit crunch has radiated outwards and is now starting to impact the wider economy. But still-strong money and loan growth, and persistent service price inflation allow no room for the MPC to cut rates yet. Housing and commercial property data have been very weak recently, and survey data for services and construction are all showing contractions in progress. Manufacturing is losing its previous buoyancy. The headwinds for personal consumption expenditure are substantial: steep price rises



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in frequently purchased items like fuel and food; higher import and producer prices, and the overall CPI rising above 3%; sterling weaker especially against the euro; and wage growth already soft and liable to weaken as jobs decline. While inflation risks have increased compared to last year, the flow-through of commodity prices should not be too severe. Second-round effects should be contained. Wages show only moderate upward pressure.

JAPAN – MORE EXPORT-DEPENDENT, NO DOMESTIC RECOVERY

Until late April the consensus expectation for rate hikes in Japan, based partly on BOJ's previous bullishness under Governor Fukui, was overdone. With the accession of Governor Shirakawa, a more realistic view has been adopted. Further weakness in the Japanese and global economy, and the lack of any specific growth-boosters in the domestic Japanese economy means that rate expectations should be ratcheted back, and the bond market should stabilise. The economy has been steadily growing less sensitive to the US economy, and especially US consumption trends. This follows from a decline in export dependence on the United States and growth in demand from emerging economies, notably from China and emerging Asian markets. Exports held up well in January-March, and net exports should be a positive contributor to overall GDP in Q1.

However, on the domestic front, the labour market and capital expenditures have both been soft. The unemployment rate is back on a rising trend after bottoming out in June 2007. The job offers to applicant ratio is also deteriorating. Amid labour market deterioration and rising consumer prices, consumer confidence has been sharply weaker. Consumption spending, however, has remained relatively steady. The current slowdown of the economy, reflected in a decline in corporate profits of 14% in Q1, seems more like a "plateau" or a pause than an outright recession. Japan is still vulnerable to external demand developments, not so much in the OECD, but increasingly in Asia. However, despite soft domestic demand, monetary policy is unlikely to be eased in the next few months. Nonetheless, the tightening bias has gone. I expect BOJ to remain on hold with a 0.5% policy rate target for the remainder of 2008.

NON-JAPAN ASIA – INFLATION RISING SHARPLY

In most of Non-Japan Asia growth remains vigorous, but rising inflation is requiring a continuing tightening of monetary policy that will eventually slow growth. In China we are expecting about 10.6% real GDP growth in 2008, with inflation in excess of 5%. In India real GDP growth will be close to 9% in the fiscal year to March 2008, with inflation of 8%, and I would expect something similar again in 2008-09. Across the rest of Asia export growth has held up much better than expected in the face of slowing US and developed economy demand, but almost every economy is experiencing inflation at rates that are too high for comfort. Despite this, fuel subsidies have been cut throughout the region, and as a result reported CPI figures are likely to rise further in the months ahead. However, Asia does not suffer from the extended, over-indebted balance sheets seen in the US or the UK, and consequently any slowdown is likely to be shorter and less severe.

CONCLUSION

The key message is that the global economy is not going to experience a drastic downturn in terms of magnitude, but the slowdown will be prolonged. A prolonged period of sub-par growth in several of the leading economies (notably the US, UK and parts of the eurozone) means that the current commodity-induced surge of inflation should not be very severe or prolonged, and will gradually fade as global demand weakens. Moreover, since the process of de-leveraging is fundamentally deflationary, market expectations of rate hikes by the Fed are

almost certainly mistaken. Despite improved, or "not-as-bad-as-expected," recent data, the evidence of spillover effects from housing via the credit crunch, wealth effects, and multiplier effects on the broader economy is mounting, particularly for consumption. In the US renewed rate cuts remain more likely. In the eurozone the recent warnings of "heightened alertness" on the part of the ECB by M. Trichet imply a greater likelihood of a rate hike in July than previously anticipated. Nevertheless, in line with global trends the eurozone is likely to end the year with lower growth and lower inflation.

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June 2008

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