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Annual Economic Outlook - 2010

INTRODUCTION
During the second half of 2009, economic recoveries finally got under way in most major economies following the deepest economic downturns witnessed in the past 60 years, but the recoveries were modest and fragile. In the developed economies the upswings have been assisted by unprecedented fiscal expansion programs and large-scale as well as unorthodox monetary expansion measures including near-zero central bank interest rate policies and Quantitative Easing. Even in the emerging economies stimulus programs have been large, but in these regions monetary and fiscal policies have gained traction much more quickly. The key question for 2010 is, therefore, whether the economic recoveries in the household and private business sectors will be strong enough to enable the authorities in each economy to start to withdraw their exceptional stimulus plans without precipitating renewed economic weakness.

On the surface it might seem that all the ingredients are in place for healthy recoveries in 2010. After all, central bank interest rates are at extremely low levels, bond yields and corporate bond spreads have fallen considerably, share prices have rebounded, world trade volumes are recovering, house prices are stabilizing or recovering, and inventory run-downs appear completed. Moreover, the labor market has shown signs of stabilization and inflation is low or falling in many economies, allowing central banks and governments to continue with their stimulus programs.

Yet despite these improvements, 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 raise 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. With low rates of spending or revenue growth, the problems of indebted corporate or sovereign borrowers like Dubai World's Nakheel or Greece are coming into the open.

Many people associate low nominal interest rates with easy liquidity conditions. However, the low level of interest rates in many countries is not necessarily a sign of ample funds being available. On the contrary, although central banks are making funds available to banks, these funds are not reaching the broader users of funds – households and companies – as banks are reluctant to lend and borrowers are unwilling to extend their indebtedness. In fact, in most major economies there is net repayment of borrowing, reflected in declining loan volumes and falling consumer and mortgage credit. All this indicates a reluctance to borrow more, or very weak private demand for funds.

On the other side of banks' balance sheets, the very slow growth of bank credit is reflected in extremely slow growth of the broad measures of money supply. The key to a more vigorous recovery in economic conditions is, therefore, a resolution of these 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 only moderate rates of economic growth with continued low inflation in 2010.

	2009 Estimate		2010 Consensus Forecast			
	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, Greenwood forecast in blue
* Fiscal year data (i.e., FY09 = Apr 09 to March 10)

In financial markets these conditions – low interest rates, modest economic growth, and low inflation – should enable equity markets to continue to make progress in 2010, but not at the rate seen between March and July 2009. Bond markets should benefit from lower than expected inflation and the continuing weak demand for funds in the household and corporate business sectors.

UNITED STATES
Economic activity in the U.S. is gradually picking up and the labor 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 GDP growth will be below that experienced in typical upswings (perhaps 2-3% instead of 4-5%), the U.S. economy will continue to operate with a large margin of spare capacity and high levels of unemployment.

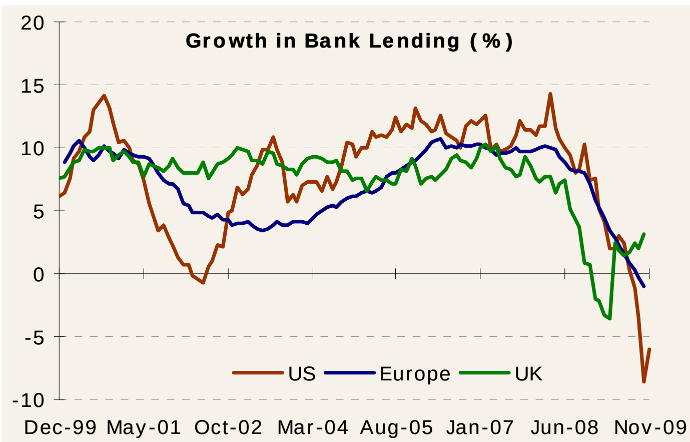
The reasons for the sub-par rate of recovery can almost all be traced back to the origins of the downturn, which have left a legacy of substantial headwinds for consumer spending, for business equipment investment, for housing and commercial property, as well as for credit conditions and employment prospects. Household spending is growing at a modest rate, but it is constrained by the continued shrinkage in the number of jobs, lower housing wealth and the prevalence of tight credit. In addition, many consumers are repaying mortgage or credit card debt which requires them to raise their savings rate and reduce consumption as a fraction of their disposable income. As debt repayment out of current income inevitably takes time, it may be some years before a consumer boom can be expected to resume.

On the business side, U.S. firms initially responded to the steep downturn by slashing inventory and cutting payrolls, but more recently they have been slowing their inventory and job cuts though continuing 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. Meantime housing conditions have stabilized and some regions have even seen modest price rises, although building and construction activity levels remain depressed compared with their peak levels. Conditions in the commercial property market, however, are still very depressed, and this will have knock-on effects on developers and regional banks for at least another year or two.

Thus, while many economic indicators have returned to more normal levels, the private sector recovery in the U.S. is generally fragile and government-dependent. For example, in the third quarter GDP data, much of the recovery derived from spending on durables (particularly autos, reflecting the incentives in the cash-for-clunkers car exchange program), and new investment in housing (which in turn reflected the recently expanded $7500 tax-rebate available to first-time home-buyers, a scheme that the administration has just extended to April 30, 2010). Without these two programs GDP growth would have been anemic.

The silver lining in this continuing somber outlook is that inflation will remain low – despite the weak U.S. 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%. While disappointing from a growth perspective, from an investment standpoint this should provide a favorable environment for fixed income investment, and at the same time enable the upturn in equities to be extended.

Bank Lending Still Shows Little Sign of Picking Up



Source: Datastream, Dec 99-Nov 09

EUROZONE

The eurozone economy moved into recession in 2008 Q2 – following the U.S. – and declines in real GDP continued for five successive quarters, ending sooner than expected in 2009 Q2. Since then there has been a moderate recovery across most of Europe, with the exception of more indebted countries like Spain and Ireland which continued to see declines in 2009 Q3. Against the backdrop of the strengthening euro, exports have only just begun to recover (even though order books are improving), and are still some 20% below their pre-crisis levels.

Looking ahead the upswing in the core of the eurozone seems likely to be gradual since the region is affected by many of the same problems as the Anglo-Saxon economies such as financial sector de-leveraging, tight credit, rising unemployment, and subdued growth in many of its trading partners. In response the eurozone monetary authorities have eased financial conditions with the ECB cutting its main refinancing rate to 1.0% and conducting three large auctions of long-term liquidity, while the fiscal authorities have implemented fiscal stimulus plans across the region. The reluctance of banks to lend and the continuing slow growth of money and credit in the financial system, the large output gap, slow GDP growth and low inflation all make it likely that the expansionary stance of monetary and fiscal policies will be maintained until at least late 2010.

The major problem for 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 ECB was content to lend large amounts to banks in these higher growth economies against A-minus rated collateral, but now that Greek 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 U.S. dollar.

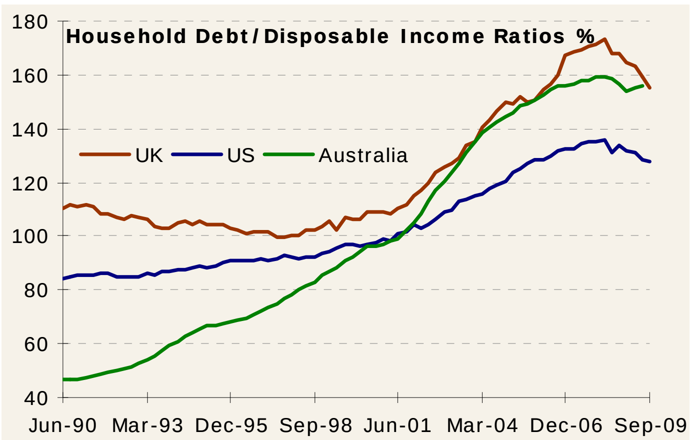
UNITED KINGDOM

The U.K. economy is lagging behind the recovery in Europe and the U.S. Initial data for the third quarter of 2009 showed a decline of -0.4% in real GDP, but this has subsequently been revised to -0.2%, and may yet be revised upwards again. Unemployment has risen less than might be expected given the depth of the recession, but it seems unlikely to fall in the near term.

In many respects the economic downturn ought to have been reversed quickly in the U.K. The government was quick to address the problems of the banking system; the Bank of England, after an initial delay, was aggressive in cutting interest rates to 0.5%, and was early to adopt Quantitative Easing (in March 2009) and fiscal spending was expanded within weeks of the downturn commencing. Meantime, the fall in sterling – particularly against the euro – should have enabled the manufacturing sector to recover promptly. However, the problem is that despite the depreciation of the pound and some encouraging readings on the economy from survey data, the average British household and many U.K. 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 program, 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 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.

Overall Debt Levels Remain High



Source: Datastream, Jun 90-Sep 09

JAPAN

The global recession hit Japan's export-dependent economy particularly hard, causing the economy to contract by 8.6% between its peak in 2008 Q1 and its trough in 2009 Q1, its deepest recession since the end of World War II. Since then the economy has enjoyed two quarters of positive growth, thanks mainly to positive net exports, which benefited from the gradual recovery in world trade, and surprisingly strong household consumption spending in Q2 and Q3. However, private investment spending has been very weak, declining by -24.8% year-on-year in Q3, and more recent data has suggested some slowdown in momentum, with weaker data both from the manufacturing sector and from workers' earnings.

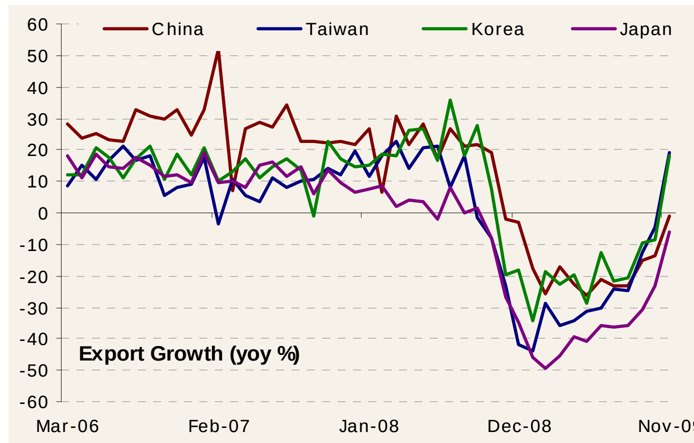
Concerned at the dismal outlook, the new DPJ (Democratic Party of Japan) administration under Yukio Hatoyama has been compelled to grapple with the renewed descent into deflation, initially putting pressure on the Bank of Japan to become more active and subsequently announcing its own 7.2 trillion yen 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 program, 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 labor force and the aging 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

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.

Exports Have Staged a Recovery



Source: Bloomberg, Mar 06-Nov 09

However, because these economies are so heavily export-dependent, and because the western developed economies to which they mainly export have been in recession, their normal export-led growth pattern is being forced to undergo some change. The Asian tigers have had to focus on domestic spending, with the result that 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 U.S. 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.

LATIN AMERICA

Like the Asian region, the Latin American economies generally avoided the credit and housing bubbles of the 2003-07 period and the associated balance sheet problems that have caused such a steep downturn in the developed economies. Consequently, economies such as Brazil have seen both a domestic recovery since Q2 and a recovery in foreign trade. As commodity exporters, many have benefited from the strength in global commodity prices and should see good growth rates in 2010, with inflation remaining subdued.

COMMODITIES

A key driver of commodity prices over the past year has been the strong demand from emerging economies for commodities such as oil, copper, iron ore, coking coal, zinc, corn (maize) and soybeans, in contrast with weak demand from developed economies. Another important factor has been supply-constraints since there has been little addition to existing capacity during the recession amongst developed economies. In 2010 it seems likely that these two factors will again play a major role. Commodities that are less geared to demand in emerging markets – such as natural gas, refined petroleum products, aluminum, nickel and wheat – could weaken in line with the continuing disinflation or deflation concerns in developed economies. In the precious metals arena, gold has been responding to low real interest rates, inflation fears, and the weak U.S. dollar. However, my expectation is that inflation will surprise on the low side in 2010, undermining the investment case for gold, while the gradual economic recovery will erode its potential as an insurance against catastrophe.

CONCLUSION

2010 is likely to be a year of gradual economic recovery in the developed western economies, constrained mainly by continued balance-sheet repair in the more over-indebted economies such as the U.S., U.K., Spain and Ireland. Wherever balance sheets are stressed and in need of repair, the tendency will be for growth and inflation to be lower than otherwise because debt repayment is an inherently deflationary process. To repay a debt requires the debtor to write a check to his or her bank, while the bank cancels the loan. Both sides of the bank's balance sheet decline. Money and loans in the economy are reduced. This slows growth and holds down inflation.

By contrast, in the emerging world there are only a few economies where such constraints apply (e.g., Eastern Europe and the Baltic states), and consequently, the emerging world is generally not subject to the same debt-derived growth constraints. 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. However, because western developed economies are mostly recovering only slowly, the emerging economies cannot expect the same rapid growth of exports that they enjoyed prior to the crisis. In consequence, we expect a more subdued pace of growth in 2010 compared with 2007.

While inflation *fears* may be present in 2010, the reality of low growth and debt repayment mean that in developed economies *actual* inflation will be minimal in 2010. However, some emerging economies will be more vulnerable to a rise in inflation, particularly in late 2010 and in 2011.

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December 21, 2009