

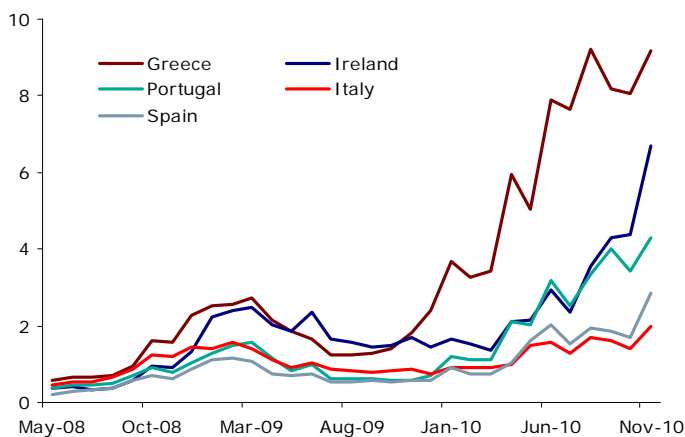
INTRODUCTION

The year 2011 promises to be the third year of recuperation from the most severe global economic downturn since the Great Depression of the 1930s. Despite the successive eruption of new crises in 2010 (e.g. Greece and Ireland in the eurozone), in reality these episodes are part of the process of first exposing and recognising in accounting terms the true extent of the problems built up during the preceding bubble. The next step is to identify the range of entities among which the burden of losses must ultimately be shared – principally private shareholders, creditors and taxpayers. In some cases the weight of outstanding obligations will ultimately require a restructuring of interest and debt repayment schedules, with corresponding losses for creditors. These processes will continue into 2011 and beyond.

Although the smaller crisis economies such as Ireland or Greece may see a further decline in economic activity in 2011 as part of the price of adjustment, this should not drag down those larger, core economies of the eurozone that are already enjoying a resumption of economic growth. Undoubtedly there is still a risk of contagion for Portugal, Spain and possibly Belgium or even Italy where debt levels are high or banking problems persist, but with each crisis the formalities of dealing with the underlying problems at the supra-national level of the EC, the IMF and the ECB are becoming clearer. The rescue mechanisms may need to be scaled up in 2011, but the procedures are now largely in place.

A central theme that I have focused on in these commentaries over the past two years has been the need – in developed, western economies - for balance sheet repair in the private sector among households and financial institutions following their over-leveraging during the credit bubble of 2003-08. In 2010 the same requirement for balance sheet repair was transferred very decisively by bond market vigilantes to the governments that until late 2009 had, under the Keynesian philosophy of spending their way out of recession, been running huge budget deficits, greatly increasing national debt-to-GDP ratios. Bond investors have seriously questioned the ability of these enormous debt burdens to be financed, driving up the cost of financing sovereign debt across the eurozone, and in effect forcing errant governments into rehabilitation programmes under the supervision of external agencies such as the EC or the IMF. This process of cleansing under external supervision will almost certainly be extended to more eurozone governments in 2011.

**10-year yield spreads above German Bunds¹
reach record highs (%)**



Source: Bloomberg, 30 November 2008 to 30 November 2010.

Since the balance sheet repair process is inherently deflationary, involving as it does the drawdown of deposits to pay back debt and a corresponding shrinkage of credit and bank lending (especially in an environment where banks are themselves risk averse and are repairing their own balance sheets), the macroeconomic consequences of this work-out for developed economies are strikingly different from the consensus view about the solution to the crisis. Most investors seem to think that the solution inevitably implies money-printing and inflation, and indeed are positioned for such an outcome. However, close study of the main financial crises over the past two decades shows that wherever widespread balance sheet repair has been required the resulting rates of growth of money and credit have been substantially less than in the bubble period, and inflation and bond yields have therefore fallen, not risen. In my view, 2011 will demonstrate the relevance of this observation in the US, the UK and the eurozone.

Interestingly, although the process of balance sheet repair requires an initial period of recession followed by a temporary period of slower growth – typically as savings rates are raised to enable debt repayment - there need be no lasting damage to the long-term growth rate of an economy. It may well be that savings rates in some of the developed economies are now stabilising, and therefore the developed economies may be approaching the end of that period of slower growth. Provided that some of the savings flow is redirected towards new investment (rather than debt repayment), and provided companies regain the confidence to begin re-hiring more actively, then economic growth may start to resume a more normal trajectory in 2011.

In complete contrast the emerging economies, especially of Asia and Latin America, occupy what amounts to a parallel and very different financial universe. They generally have healthy balance sheets at household, corporate, financial and government sector levels, and therefore they have been willing and able to borrow and spend, and the banks in these economies are also willing to lend. Consequently their recoveries from the global economic downturn have been robust and vigorous, responding to lower interest rates during the crisis with rising rates of money and credit growth. These economies are now in the process of interest rate normalisation, with central banks in India and Brazil having raised interest rates five or six times in 2010, while China has repeatedly raised reserve requirement ratios, designed to slow down or head off any domestic overheating. If inflows from developed economies continue at a rapid pace, these economies may require both further rate hikes and some degree of currency appreciation to prevent the creation of asset price bubbles in 2011.

DEVELOPED ECONOMIES

In financial markets the closing months of 2010 have been dominated by a strong upswing in risk assets accompanied by a decline in the US dollar from early September until the end of the first week of November, followed by a partial reversal of these trends in November and December. The rally was triggered by Fed Chairman Ben Bernanke's speech at Jackson Hole in late August suggesting that the Fed was likely to implement a further round of Quantitative Easing (QE). The sell-off of those same risk assets was precipitated by the actual announcement of QE2 on November 3, and the concurrent intensification of Ireland's debt crisis.

These two events – the Fed's decision to start QE2 and the Irish crisis - are classic symptoms of the problems that have been described in my outlook pieces for the past two years or more, namely the sub-par economic recovery in the developed economies resulting in turn from the over-leveraged balance

sheets of the household and financial sectors and the need to cut spending and raise savings, and the transfer of private sector debts on to the public sector's balance sheet.

The Fed's attempt to stimulate economic activity by means of a further \$600 billion of Treasury bond purchases stems from the dissatisfaction of FOMC members with the rate of decline in unemployment and their concern that inflation is "somewhat low, relative to levels that the Committee judges to be consistent, over the longer run, with its dual mandate. Although the Committee anticipates a gradual return to higher levels of resource utilization in a context of price stability, progress toward its objectives has been disappointingly slow."

The Irish debt crisis is not so much a crisis of government finances (as the Greek crisis was earlier in 2010), but primarily a banking crisis that has spilled over into the public sector due to the need for wider recapitalisation of the banks by the government. The November crisis erupted despite Ireland's previous heroic efforts to cut the budget deficit, and resulted directly from the earlier failure of the Irish government to do enough to persuade investors that they had injected sufficient capital to rescue Ireland's huge (relative to the economy's GDP) and heavily indebted banks. Given the size of Irish banks with their gross external liabilities of US\$824 billion in 2010 Q2, guaranteeing depositors was simply not credible.

In contrast to Greece where the problem was primarily one of prolonged (and concealed) fiscal irresponsibility, the fundamental problem in Ireland is related to the nature of the eurozone as a monetary union. During the boom years after 2003 money poured into those economies of the periphery where costs were lowest and tax regimes were most attractive for investment. The result was that economies such as Ireland and Spain witnessed rates of growth of money and credit of 20-30% p.a. Bubbles in residential and commercial property inevitably developed, along with a ticking time bomb of bad loans whose fuse would be lit as soon as the bubble burst. The problem now is that the bad loan time bomb is exploding, while the lenders who enthusiastically lent to Irish banks during the boom have been withdrawing their deposits. There has in effect been a silent, wholesale market run on Irish banks, forcing them into the arms of the Irish government, the European Financial Stability Facility, and the ECB.

These two issues will dominate the longer term health of the eurozone. First, the system of EC-level governance and supervision of national spending and taxation within the zone will need strengthening to ensure compliance at the national level with the Maastricht² rules on budget deficits and government debt which are effectively in abeyance. Without stronger supranational controls and audits, national-level plans for fiscal consolidation to reduce debt-to-GDP ratios to more prudent levels over the coming years will not be credible. The second issue, that of monetary instability in the periphery is, if anything, less tractable and there is no obvious solution other than a break-up of the currency union. Both issues highlight the gap between the widely felt desire for greater political cohesion across Europe and the need for clearer, more concrete expression of that in the economic and monetary sphere.

EMERGING ECONOMIES

The fact that Asian and Latin American economies underwent triple crises (debt, banking and currency crises) in the 1990s meant that during the past decade of bubble and burst in the western, developed economies these regions stayed clear of the bubble and preserved their healthy balance sheets. When these economies cut interest rates in the face of the global recession and trade collapse, the domestic response was quick. Recoveries

in the emerging world have been far more vigorous than in the debt-impaired, developed economies in 2010, and I expect these higher growth rates to continue in 2011.

Across the emerging world money and credit growth rates have been accelerating, asset prices such as property and stock prices have been rising, and commodity price increases are feeding through into significant increases in consumer prices. To respond to these growing pressures from internal money growth as well as to increased international fund-flows, emerging economies face three main policy options: (1) to allow their currencies to appreciate, (2) to hold down their currencies but offset the consequences of central bank purchases of foreign currency by sterilisation (as China does), or (3) imposing some form of capital controls (as China and Thailand have done). For those policy-makers that wish to avoid these three options, the last resort is macro-prudential controls such as the wide-ranging loan-to-value ratios imposed by Hong Kong on all domestic bank lending for property purchases. In contrast to the developed economies where the authorities will still be struggling to restore economic normality, in the emerging world much of 2011 will be spent addressing the consequences of these pressures.

	2010 Estimate		2011 Consensus Forecast			
	Real GDP	CPI Inflation	Real GDP	CPI	Inflation	
US	2.7%	1.6%	2.4%	2.4%	1.4%	0.8%
EU-16	1.6%	1.5%	1.4%	1.6%	1.6%	1.7%
UK	1.7%	3.2%	2.0%	2.3%	2.7%	2.5%
Japan	3.0%	-0.9%	1.2%	1.6%	-0.3%	-0.1%
Australia	3.3%	2.9%	3.5%	3.8%	3.0%	3.1%
Canada	3.0%	1.7%	2.4%	2.3%	2.1%	1.0%
China	10.1%	3.0%	9.1%	9.3%	3.0%	3.0%
India*	8.4%	9.4%	8.5%	8.3%	6.8%	7.4%

Source: Consensus Economics, Invesco Forecast in blue

* Fiscal year data (ie. FY10 = Apr 10 to March 11)

In financial markets the divergence between economic conditions in the developed and emerging universes will complicate the asset allocation process. In the developed markets persistently low interest rates on deposits will drive a continuing search for yield by investors. In my view the emphasis should therefore be on yield products – corporate and high-yield bonds in the fixed income area, and "bond-like" equities, i.e. stocks that are safe but offer a high dividend yield. In the emerging world rising rates and rising inflation reduce the attractions of yield products, while on the equity side domestic demand stories should continue to benefit from strong economic growth, even though valuations may already be high. Two ways round these problems are to buy emerging sovereign debt denominated in US dollars (to avoid the rising yields in local currency debt), and to hold equities in developed economies which have high exposure to the emerging world.

UNITED STATES

After a moderately paced recovery in the second half of 2009 and early 2010, US real GDP growth slowed in the second and third quarters of 2010. The boost from inventory re-building has been fading, while the stimulus from fiscal spending is diminishing and will turn negative – in terms of its impact on GDP expenditures – in 2011. The recovery will therefore become more dependent on consumer and business investment spending. However, I expect the pace of recovery to remain moderate through 2011-2012 as households and financial institutions continue to repair their balance sheets by paying down debt. In the case of households this has already involved a rise in the personal savings rate to 5-6% of disposable income³, but it seems doubtful that this rate of savings is high enough to both pay down debt and support higher business investment. In the case of financial institutions asset sales are helping the

balance sheet repair process, but while the decline of credit issuance outside the banking system (e.g. in securitised credit or the repurchase markets) appears to be stabilising, and lending attitudes are becoming less restrictive, these markets are still a long way from seeing any resurgence. This means that unemployment is likely to decline only slowly, and the economy will continue to run well below capacity.

Impatience with the slow rate of recovery both among politicians and at the Federal Reserve led to the announcement on November 3 of a second round of Quantitative Easing (QE2) under which the Fed will buy a further \$600 billion of US Treasury securities by June 2011, taking the size of its balance sheet close to \$3 trillion. The likely impact of these purchases on economic activity is hard to gauge. So far the main counterpart to the Fed's purchases of assets is a big increase in banks' holdings of reserves, but no increase in bank lending. Out of a current balance sheet of \$2.35 trillion, no less than \$1.01 trillion is bank reserves, while loans and leases adjusted for changes in coverage (in the Fed's H.8 release) are down by close to \$1 trillion since their peak in October 2008, and are still falling.⁴ If households and companies continue to repay bank debt and banks remain risk averse, it is entirely possible that the Fed's purchases will fail to have any effect on bank lending in 2011. (This is exactly the problem that the Bank of Japan encountered when it pursued QE between 2001 and 2006.)

Given the likely policy-making gridlock between the Congress and the White House in 2011 following the mid-term elections in November, the Fed's role will remain central to ensuring a continuing recovery. In addition to keeping policy interest rates unchanged in 2011, the Federal Reserve could also reaffirm its commitment to price stability by adopting an explicit medium-term inflation target. If growth turns out to be significantly weaker than projected, action to lower real long-term rates via further quantitative easing would be justified. On the fiscal side large-scale budget imbalances and a fast-rising federal debt will soon need to be addressed. The bond market vigilantes are unlikely to continue to grant the US administration exemption from the kind of fiscal discipline they have required elsewhere, notwithstanding the international reserve role of the US currency. In view of the negative reaction to the recommendations of the President's Fiscal Commission, the Administration may be forced to follow through on its plan to stabilise the debt-to-GDP ratio by 2015. This will require further consolidation measures than have currently been spelled out, but there seems to be little appetite in America for major reforms in the areas of tax policy and entitlement spending.

For the year as a whole I expect real GDP growth of around 2.4% with CPI inflation of 0.8%. While disappointing from an economic growth perspective, from an investment standpoint the very low inflation rate should provide a continuing favourable environment for fixed income investment, and at the same time enable the upturn in equities to be extended.

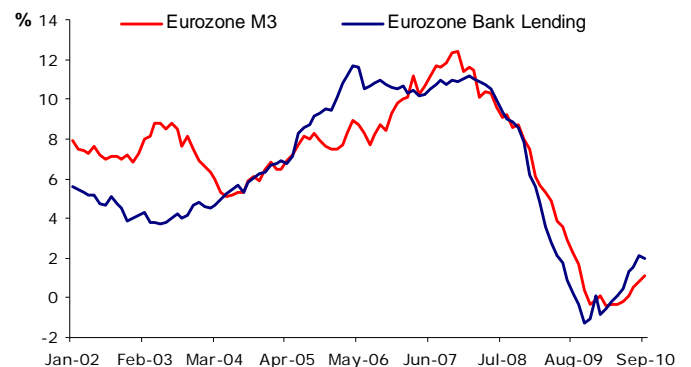
THE EUROZONE

In the northern part of the eurozone (France, Germany and the Benelux, and stretching into parts of Scandinavia that are outside the eurozone) a healthy recovery is underway, driven by strong exports and a rise in consumption and investment. Confidence has rebounded and financial conditions have improved. However, elsewhere in the eurozone, especially in the southern and western periphery the rolling sovereign debt-cum-banking crisis means that economic weakness and recession may persist well into 2011. The underlying symptoms - on-going private sector balance sheet repair, necessary fiscal consolidation, and prolonged internal deflation to restore external competitiveness and overcome large external imbalances -

would all have been much more easily treated if external devaluation had been possible, but now as members of the currency union such a strategy is ruled out. Having benefited during the boom from inflows of money and labour, the peripheral economies have already been seeing money flows reversing, and may yet see some outflow of labour to areas where employment prospects are better (although over-generous welfare programs tend to discourage such labour mobility).

I expect overall real GDP growth in the eurozone to be 1.6% in 2011, concealing a wide divergence of performance between the core and the periphery. The combination of very low rates of growth of money and credit together with considerable slack in employment and capital equipment will keep inflation low in 2011 and 2012.

Low year-on-year growth in money and credit



Source: Datastream, 31 January 2002 to 30 September 2010.

UNITED KINGDOM

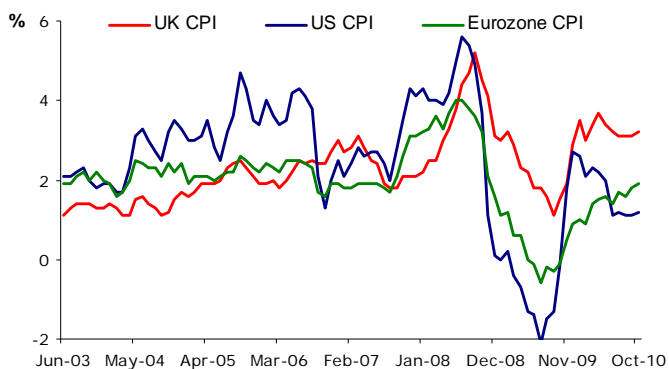
Real GDP growth has been somewhat better than expected in Q2 and Q3, with some signs of a welcome rebalancing in Q3 - i.e. stronger exports and business investment, and less spending by consumers on housing and by government. This implies the economy is finally beginning to climb out of the economic trough of 2008-09 in a self-sustaining way, supported by both growing domestic demand and rising exports. However, the large but necessary fiscal tightening announced by the coalition government and weak real income growth will create headwinds for economic growth in 2011. The recovery should gain a bit more momentum in 2012 as the export recovery gains traction and business investment starts to grow more robustly. Britain has had a relatively mild increase in unemployment compared with other economies, and recent data suggest that private sector jobs are already starting to grow again. Overall I expect real GDP growth of 2.3% in 2011, slightly above the consensus estimate.

Headline inflation in the UK will remain above the Bank of England's 2% target through a substantial part of 2011 due to an initial boost from the scheduled rise of VAT in January. CPI inflation at 3.2% in October⁵ is significantly higher than in the US or the eurozone because (1) sterling has depreciated more than the dollar or the euro, (2) imports are a larger share of the GDP than in the US or the eurozone, (3) VAT and fuel duties have been increased, and (4) money growth in the UK stayed much higher for longer (until the autumn of 2009, just one year ago). Once this series of one-off effects has flowed through the economy, inflation rates will fall. This is supported by the fact that annual inflation as measured in the CPIY series⁶, which excludes the price effect of indirect taxes, has been below target throughout 2010. Allowing in addition for some exchange rate effect, underlying UK inflation has stayed well below target. For these reasons, added to the extremely slow rates of growth of

money and credit, I expect inflation to be 2.5%, slightly below the UK consensus forecast of 2.7%.

Fiscal consolidation is just starting to get under way with detailed plans set out in the October CSR (Comprehensive Spending Review). The government's ambitious medium-term plan has significantly reduced the risk of a Greek-style crisis of confidence in government finances, but the actual task of implementing much-needed government spending cuts will still be challenging. If efficiency improvements in health spending and welfare can be carried through, these could support growth in the longer term. Despite these fiscal hurdles, the extreme accommodation in monetary policy should enable the economy to remain in expansionary mode, avoiding a double-dip.

UK CPI Inflation higher than US and Eurozone



Source: Datastream, June 2003 to 31 October 2010.

JAPAN

Japan has responded to slowing growth with two fiscal packages in late 2010, and a further easing by the Bank of Japan which should support activity in 2011. As the impact of the fiscal stimulus fades, stronger private domestic demand, underpinned by improving labour market conditions and strong corporate profitability, should enable the expansion to continue into 2012. Nevertheless, I expect deflation to continue, with unemployment remaining above its pre-crisis level.

One of Japan's problems in the past two decades has been a succession of a whole series of weak governments, with only one administration (that of Mr Koizumi) seriously attempting to embark on reducing government expenditure and eliminating the budget deficit. With gross public debt projected to top 200% of GDP in 2011⁷, the authorities need to implement a more ambitious fiscal consolidation than is currently planned for 2011 and 2012. At a minimum, it is necessary to avoid additional fiscal stimulus and contain government spending in 2011-12 in line with the Fiscal Management Strategy. In addition the Bank of Japan should implement more ambitious quantitative easing measures to relax monetary conditions in the face of entrenched deflation and maintain such policies until underlying inflation is significantly positive. The New Growth Strategy announced by the government in June 2010 should focus on policies to boost productivity growth, especially in the service sectors.

In the longer term Japan has two major problems that will act as a drag on real GDP growth: the shrinkage of the labour force and the ageing of the population. In the shorter term my forecast is for real GDP growth of 1.6% in 2011, with a decline in consumer prices of -0.1%.

CONCLUSION

2011 is likely to be another 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 US, UK, 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 cheque to his or her bank, while the bank cancels the loan. Unless the bank replaces that loan with new lending, both sides of banks' balance sheets decline. That is the process that is currently occurring across the US, the eurozone and the UK. This slows growth and holds down inflation.

By contrast, in the emerging world there are only a few economies where such constraints apply (except perhaps some of the Eastern European economies), and consequently the emerging world is generally not subject to the same debt-derived growth constraints. As a result 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 2011. 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 real GDP growth in 2011 compared with 2007 at the peak of the credit bubble in the developed western economies.

While inflation fears may persist in 2010, the reality of low growth and debt repayment mean that in developed economies actual inflation will remain minimal in 2011. However, as I forecast last year some emerging economies, notably China and India, have seen a rise in inflation in 2010, which will extend into 2011, due to continued rapid growth rates of money and credit. In these economies much of 2011 will therefore be spent raising interest rates and implementing other policies to restrain demand and inflation. Nevertheless, I do not expect these policies of restraint to be so severe as to terminate the business cycle expansion.

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6 December 2010.

1. Short for Bundesanleihen – German federal government bonds. (Source: BusinessDictionary.com)
2. The Treaty of Maastricht, signed in 1991, formed the EU (Source: europa.eu)
3. Source: Bureau of Economic Analysis
4. Source: U.S. Federal Reserve
5. Source: U.K. Office for National Statistics
6. CPIY is an index designed to measure movements in core prices, excluding price changes directly due to changes in indirect taxation. (Source: U.K. Office for National Statistics)
7. Source: FT.com (Financial Times)

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