

## Introduction

The debt crisis in the peripheral economies of the eurozone continues to command the attention of global investors. A second financial rescue package for Greece was eventually approved in late June, but the provision of liquidity through this scheme does not itself address the key underlying issues of Greek competitiveness or solvency. The crisis will therefore not be solved by this measure, even if sovereign bond markets have earned a temporary respite.

During the period from March until June consensus forecasts for U.S. economic growth in 2011 were significantly downgraded for the second time in this recovery. A smaller downgrade was made for the UK, and a larger one for Japan, but expectations for eurozone growth in 2011 were upgraded.

Inflation continued to rise both at the headline and at the core levels in many economies, reflecting the flow-through of previous strength in commodity markets. As explained in the previous Quarterly Economic Outlook, this is more likely to generate persistent inflation in the emerging rather than the developed economies due to the contrasting rates of money and credit growth in the two areas.

In recent weeks oil prices and other commodity prices have declined, first on the revised expectations for growth in the developed economies, and second as a result of the IEA's release of its stockpiles into world markets.

Among developed economies' big four (U.S., Japan, eurozone and UK) the only major central bank to raise rates in response to these developments was the ECB. The Fed and the Bank of England kept their official rates unchanged. In the emerging world numerous central banks continued to raise rates in response to accelerating inflation and rapid money and credit growth. This tightening trend is likely to continue throughout 2011.

	2010		2011 Consensus Forecast			
	Real GDP	CPI Inflation	Real GDP	CPI Inflation	Real GDP	CPI Inflation
US	2.9%	1.6%	2.5%	(2.7%)	3.0%	(2.7%)
EU-16	1.7%	1.6%	2.0%	(2.1%)	2.6%	(2.7%)
UK	1.3%	3.3%	1.6%	(1.6%)	4.3%	(4.3%)
Japan	3.9%	-0.7%	-0.7%	(-0.5%)	0.3%	(0.4%)
Australia	2.7%	2.8%	2.0%	(3.0%)	3.4%	(3.2%)
Canada	3.2%	1.8%	2.8%	(3.0%)	2.8%	(2.7%)
China	10.3%	3.3%	9.2%	(9.4%)	4.8%	(5.1%)
India*	8.5%	10.4%	8.0%	(8.0%)	7.8%	(8.0%)

Source: Consensus Economics, 13 June, Invesco Forecast in blue brackets  
\* Fiscal year data (ie. FY10 = Apr 10 to March 11)

In financial markets both equities and bonds reflected the downward revisions to economic growth forecasts and the weakening of commodity prices suggesting lower inflation ahead. Thus after rallying during the second half of April, equities have subsequently fallen back. For example, the S&P 500 fell 6% from its highs in mid-April, losing all of the ground gained during the year by the end of June. In the emerging markets the same pattern was replicated with the Shanghai Composite Index losing close to 10% from mid-April onwards. In the bond markets of safe-haven economies such as the U.S., Germany or the UK yields have fallen since mid-April, with the yield on the 10-year U.S. Treasury bond falling from 3.60% to 2.90% by quarter-end. In the crisis economies, of course, the outcomes have been very different, with Greek 10-year government bond yields rising from below 13% in early April to over 18% in mid-June.

## The Eurozone Debt Crisis

Whenever emerging market economies have faced a financial or solvency crisis in the past few decades, the ingredients of a typical rescue or bail-out package have always included the following four measures: (1) a currency devaluation and a move to a floating exchange rate, (2) the loan of short or medium term funds to deal with the repayment of imminent obligations, (3) the obligation to undertake fiscal restructuring, and (4) privatisation and other structural reforms aimed at making the economy more efficient over the longer term.

Given that Greece and other peripheral economies are in a monetary union with other eurozone members and cannot withdraw from the currency bloc (at least under present legislation), the question arises as to how to achieve the first component – devaluation and enhanced competitiveness -- of this standard package. *Within the framework of the euro* there are only three solutions: the first two involve altering the internal or external price levels of the crisis economies, and the third involves transforming the economy itself.

First, the euro could depreciate sufficiently for Greece and other peripheral economies to become competitive. But this would imply Germany becoming “uber-competitive”, so this is a non-starter. The second possibility is that the crisis economies could undergo extended internal deflation, lowering their wage and price levels until they again become competitive. For example, after the 1997-98 Asian Financial Crisis Hong Kong did not devalue, but endured six years of internal deflation until 2004. But Hong Kong is a relatively high-growth economy, renowned for its flexibility. By comparison the Greek political and social systems are almost certainly incapable of enduring such an extended adjustment process. The third possibility is for Greece and other peripheral economies to experience a productivity miracle that would transform them into competitive economies in short order. Once again, this option is too far-fetched to be realistic and can be discarded.

In effect the Greek state is insolvent. With interest rates at current levels it cannot raise funds in the private capital markets to meet its current obligations. For a year or two the other eurozone member states and the IMF may continue to provide short-term liquidity, but these rescue packages will face escalating opposition both from the people of Greece -- who are already rioting -- and increasingly from German, French and other eurozone taxpayers who must shoulder the obligations of any further bail-out schemes. Moreover, providing liquidity does not address the underlying solvency issues. Consequently, in my judgement Greece will, in the end, leave the euro. It is only a matter of when, and on what basis – an orderly or disorderly exit.

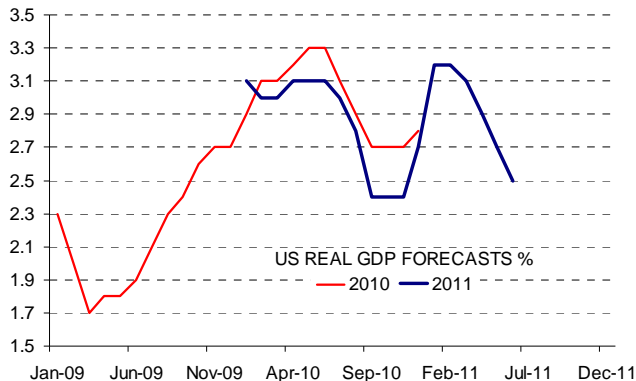
## United States

U.S. real GDP growth slowed in the first quarter of 2011 to 1.9% (annualised) from 3.1% in 2010 Q4, and 2.9% for 2010 as a whole. This result was widely viewed to be disappointing. Coming after a slew of weak economic data reports such as weak employment numbers, soft retail sales and declining durable goods orders in April and May, the “soft patch” has shifted the consensus forecast of U.S. growth for 2011 from 3.2% in February down to 2.5% by June (see chart below).

As regular readers of this Outlook will know, I have long predicted a sub-par recovery for the U.S. economy due primarily to the accumulation of balance sheet problems that would inevitably take a long time to resolve. The recent downgrading of Wall Street's economic growth forecasts has therefore brought the consensus view more closely into line with my own long-standing forecast for

2011 (see table opposite). The puzzle is why U.S. economists revised up their growth forecasts so much towards the end of last year in the first place. The obvious trigger for the year-end upgrading of growth forecasts from 2.4% to 3.2% was the agreement on a fiscal stimulus between President Obama and the Congress in December. This had consisted of extending the George W Bush income tax cuts (which had been due to expire at yearend) for two years, a 2% cut in the employee payroll tax rate, and the introduction of a special 100% depreciation allowance for capital expenditure by business for one year only.

#### Consensus GDP Growth Forecasts for U.S. Revised Downwards



Source: Consensus Economics, June 30, 2011.

The answer is that most economists pay far too much attention to the supposed impact of fiscal changes on aggregate spending, and not enough to the impact of balance sheet changes on the one hand or money and credit growth on the other. For while the re-shuffling of taxes and spending appeared favourable to growth to some observers, it undoubtedly made the federal government's balance sheet worse, expanding the deficit and government debt by \$750 billion, helping to raise 10-year U.S. treasury yields from 2.4% in October to almost 3.75% by early February. Just over three months after agreement on the stimulus package, the rating agency S&P announced on April 18 that it was cutting the outlook on the U.S.'s triple-A long-term rating from stable to negative for the first time since the attack on Pearl Harbor 70 years ago.

Turning to money and credit growth, balance sheet repair in the household sector as well as the financial sector has continued to prevent any significant growth of commercial bank loans or deposits. Debt repayment or the reluctance to borrow from banks on the one side and an attitude of risk aversion toward lending on the part of the banks has meant that – except for the increases in cash assets at the Federal Reserve due to the Fed's asset purchase or QE2 program -- commercial bank balance sheets have not grown at all since the start of 2009. Once the asset purchases expire at the end of June the Fed will complete its current program of \$600 billion of U.S. Treasury purchases, setting the scene for the next stage of monetary policy operations. The historically low rates of growth of money and credit are setting the scene for very low growth of nominal spending in the months ahead, a prospect far different from that envisaged by the "fiscalists" in Washington or on Wall Street.

For the year as a whole I expect real GDP growth of 2.7% with CPI inflation at the same rate of 2.7%. Provided that corporate profits can continue increasing at a healthy rate, this combination should be positive from an investment perspective. However, the withdrawal of QE2, the failure of bank balance sheets to grow, and the on-going balance sheet repair process will continue to act as

headwinds for the U.S. economy, and could prove challenging for risk asset markets in the second half of 2011.

## Europe

Europe continues to be split between the strongly performing economies of the north and east, especially Scandinavia, Germany, Switzerland and France, and the recession-mired economies of the south and west, notably the crisis economies of the periphery such as Ireland, Portugal, Greece, Italy and Spain.

The vigour of the recovery in north-east Europe was evident in the German real GDP data for the first quarter of 2011. The economy grew 1.5% quarter-on-quarter (or 6.1% annualised) thanks to broad-based demand both at home and abroad. However, since March there have been some signs that growth may be slowing slightly. The German trade surplus narrowed in April as exports fell more than imports, and industrial production declined. Some of these declines can be explained by the supply chain disruptions resulting from the earthquake, tsunami and nuclear power plant disaster in Japan in March, together with some impact from the slowdown in the more troubled parts of the euro area.

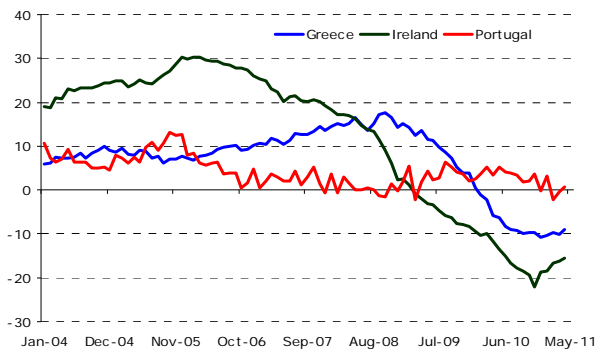
France, Sweden and Norway continued to grow vigorously in the first quarter of 2011, reporting real GDP growth rates of 1.0%, 0.8% and 0.6% respectively (all quarter on quarter). Given this backdrop of strength in the core economies that collectively account for the lion's share of economic output in the euro-area and the rise in inflation from imported commodity prices, the ECB raised rates from 1% to 1.25% and the Swedish National Bank raised rates from 1.5% to 1.75% (both in April), while the Norwegian central bank raised rates from 2.0% to 2.25% (in May).

In contrast, elsewhere in the eurozone, especially in the southern and western periphery the rolling sovereign debt-cum-banking crisis means that economic weakness and recession will persist well into 2012. Aside from the problems of eurozone government debt discussed above, the private sector across the periphery is struggling with numerous problems: a slump in money and credit growth, on-going private sector balance sheet repair, and the prospect of prolonged internal deflation required to restore external competitiveness and overcome large external imbalances. The problem is that having benefited during the boom from inflows of money and labour, the peripheral economies are seeing money flows reverse, with outflows of capital and labour to areas where employment prospects are better.

Consequently, Greece and Ireland are both experiencing double-digit monetary and credit contractions, while Portugal's money growth is effectively zero. These conditions mean that it will be extremely difficult for the governments in each economy to introduce economic reforms – while remaining within the euro -- that have a reasonable prospect of bringing rapid results. The eurozone crisis will therefore continue to undermine economic performance in the eurozone as a whole, and to trouble financial markets until a definitive solution is adopted.

I expect overall real GDP growth in the eurozone to be 2.1% in 2011, concealing a wide divergence of performance between a strongly growing core and a stagnant or contracting periphery. Although overall rates of growth of money and credit are low, and there is considerable slack in the region, nevertheless higher commodity prices will push headline inflation to 2.7% on average in 2011.

## Credit Contraction Still in Force in Peripheral Europe



Source: Datastream, January 31, 2004 to April 30, 2011. Annual % rates of broad money or credit growth.

## United Kingdom

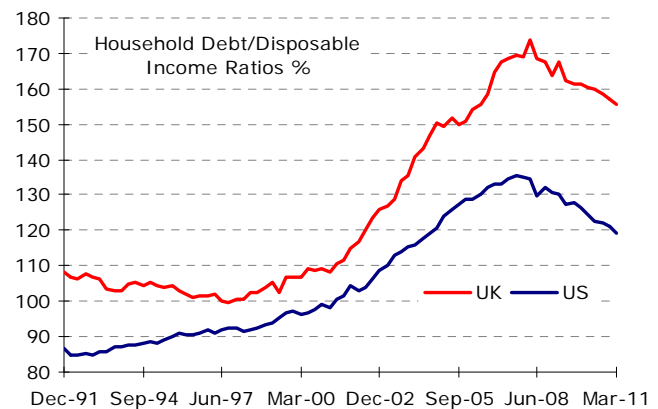
The economic downturn of 2008-09 was primarily a "balance sheet recession" caused by overleveraging in both the household and financial sectors. To assess the prospects for recovery we need first to consider the progress of balance sheet repair in these two sectors, and then to consider whether the balance sheet deterioration in the public sector is not so severe as to offset any improvements in the private sector.

Standard macro-economic analysis which looks at the relation between (say) interest rates and nominal or real GDP growth based on past relationships will fail to explain what is currently going on. Currently the desire to repair balance sheets before resuming normal behaviour -- on the part of both consumers and financial institutions -- overwhelms the linkages modelled by economists. The point is that an unspoken assumption underlying orthodox macro-economic models is that balance sheets are healthy. When they are not, typical relationships (coefficients) go awry.

Overleveraging by the household sector is best observed in the household debt-to-income ratio which peaked at 174% in the first quarter of 2008, having risen from a level below 110% in 2000-01. Twelve quarters later, by the first quarter of 2011 (the latest available data), this ratio had declined to 155%. The de-leveraging has come about largely as a result of increases in nominal household income, considerably less as a result of debt repayment since the amount of household debt outstanding has remained roughly static since mid-2009. Nevertheless, the decline in this gearing ratio probably has considerably further to fall. The ratio is still some 45 percentage points higher than it was at the start of the housing bubble. Consequently, until consumers feel that they have reached an equilibrium debt-to-income ratio it seems likely that they will continue to restrain spending, maintain higher rates of saving, and certainly not add to their existing stock of debt. Irrespective of what typical coefficients from macro-economic models say about the low level of interest rates and prospective nominal or real household spending, I would bet that deleveraging will win out over macro-models.

Turning to the financial sector, the evidence suggests continued de-leveraging in this sector also. The de-risking of bank and other financial sector balance sheets can be seen in a variety of recent data. Bank lending is still declining (M4 lending was -1.3% year-on-year in April), banks are adding to their holdings of gilts (while running down holdings of other types of securities), and interbank lending is shrinking. The net result is that UK banks' sterling

## UK household debt ratios declining but still have further to go



Source: Datastream, December 31, 1991 to March 31, 2011.

assets had declined by £375 billion from £4.06 trillion in January 2010 to £3.685 trillion in April 2011. Again, balance sheet repair is the dominant driver of bank behaviour, not some knee-jerk response to low interest rates. The hand-wringing by politicians, regulators or macro-economists who wish to see faster bank lending growth is laughably misdirected. They should be celebrating the progress in balance sheet repair, not moaning about the lack of credit expansion.

Meanwhile, in contrast to the de-leveraging in the private sector, the leveraging up of the public sector continues. In May net debt (excluding financial interventions) reached £920.9 billion or 60.6% of GDP. In the peripheral eurozone economies government debt-to-GDP ratios have already reached substantially higher levels such that investors are now extremely reluctant to hold the sovereign debt instruments of Greece, Ireland and Portugal except at very high interest rates. Fortunately the British Coalition government's plans to close the deficit by 2015 and thereby stabilise the debt-to-GDP ratio still carry some credibility so Britain is not facing a similar debt crisis, but indefinite forbearance by international investors cannot be taken for granted.

For the year as a whole I expect real GDP to be 1.6% and CPI inflation to average 4.3%. The growth rate will be disappointing to those who wish to see the government manipulating the economic levers to achieve faster growth. However, for those who understand the need for the balance sheet damage done in the Blair-Brown era to be repaired, this is a necessary period of recuperation before normal growth can be resumed.

The higher rate of inflation in the UK than the U.S. or the eurozone reflects two main sets of factors: (1) excess money and credit growth in the UK prior to mid-2009 (a period ending only two years ago and thus well within the normal lag in effect of monetary policy), and (2) a series of transient, non-monetary factors such as the surge in commodity prices over the past year, the weakness of sterling, and the increases in the UK's indirect taxes. The latter do not constitute a valid case for raising interest rates. The fact that the emerging economies are recovering strongly -- in part because their balance sheets are in good shape -- and are buying large quantities of commodities and pushing up their prices implies a change in the terms of trade and a change in the composition of inflation for the UK and other developed, western economies. Insofar as such changes are transitory, the MPC has -- correctly in my view -- kept Base Rate unchanged at 0.5%. Until balance sheet repair is at least mostly completed and until the effects of

the current exceptionally low rates of money growth are reflected in the economy, it will be appropriate to delay rate hikes.

## Japan

Most of the macro-economic discussion in Japan since March has centred on the consequences of the earthquake, tsunami and nuclear power plant disasters. The focus has been on the extent of supply chain disruptions affecting growth in 2011 and 2012, the problem of how to handle compensation payments by Tokyo Electric Power Company (the owner of the damaged nuclear power plant in Fukushima), and the extent of government subsidy, together with the impact on the government's already overburdened budget of a broad-based reconstruction programme.

Disruptions to the supply chain have mainly affected the motor and electronic industries, and in addition periodic power cuts in electricity supply have affected industrial production and manufacturing generally, as well as exports and imports. The main consequence in terms of the economic growth outlook has been a substantial downward revision of growth forecasts for 2011 from a consensus figure of 1.5% pre-earthquake to -0.7% in June. Conversely, expectations for growth in 2012 have been revised upwards in anticipation of the resumption of normal growth against a lower base figure for 2011.

Japan's national accounts revealed a 0.9% fall in real GDP in 2011 Q1 (or -3.5% annualised), following the 0.7% decline in 2010 Q4, effectively meaning that Japan had entered a second phase of recession. In January-March both private consumption and business investment fell under the impact of the triple disaster on March 11. Industrial production in March plunged 15.5%, and vehicle shipments dropped by as much as 67% in April, precipitating an unusual trade deficit in the external accounts. However, as the bottlenecks, production problems and supply chains have recovered, industrial production rebounded by 5.7% in May, and is likely to gain sharply for a while, setting the scene for a return to normality by early autumn.

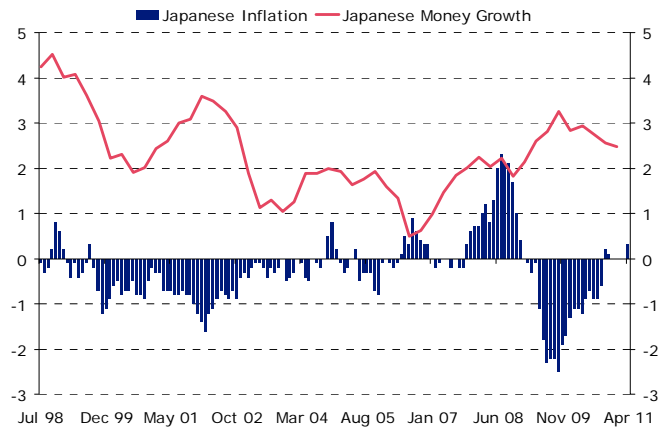
Thereafter I expect Japan's growth to resume the pattern of the past decade, with meagre growth in the domestic economy counter-balanced by a strong performance on the export front. Symptoms of the headwinds facing the domestic economy were evident in the data for real household spending which fell by 3.0% year-on-year in April. Looking further ahead into 2012 the economy should show better growth in a statistical sense, but much of that will simply be due to comparison with earthquake-affected weakness in early 2011. For 2011 I am forecasting -0.5% real GDP growth, and +2.4% for 2012.

On the inflation front, Japan's headline and core CPI have turned positive for the first time since December 2008 despite the strength of the yen. In the past year both indices have been heavily influenced by commodity price trends, but as I expect commodity prices to moderate in the period ahead, and Japan's monetary and credit growth to remain very low, inflation will gradually fade, giving way to a renewed bout of deflation by late 2012.

## Non-japan Asia

In the Asia-Pacific region the economic recovery following the global recession has moderated from its earlier vigorous pace as tighter monetary policies are implemented to deal with rising inflation. Strong balance sheets and very low interest rates had fostered easy credit conditions and rapid money growth, initially pushing up equity and property prices, but those pressures are now translating into rising CPI inflation. As a result central banks

## Deflationary backdrop in Japan set to continue



Source: Datastream, July 31, 1998 to April 30, 2011.

across the region are raising interest rates, increasing reserve requirements and imposing a variety of macro-prudential controls on the growth of bank balance sheets. At a political level commodity price increases have been blamed for the rising inflation, but the truth is that it was rapid money and credit growth that sparked the recovery in demand that has in turn pushed up commodity prices.

The tightening of Asian monetary policy is so far not serious enough to threaten the economic expansion across the region for two reasons. First, the authorities in most economies are allowing a degree of exchange rate appreciation that will enable economic activity to shift gradually from export-led growth to domestic demand. Encouraging a change in the composition of growth will not stop overheating, but the currency appreciation should help to moderate the upswing in domestic inflation. Second, whereas in the past Asian central banks tended to raise rates in step with the U.S. Federal Reserve or other leading central banks, on this occasion the Fed is not raising rates and therefore Asian central banks are having to raise rates independently and without the familiar guideposts of Fed leadership. This is leading to some hesitancy and a tendency on the part of Asian central banks to fall behind the curve in terms of restraining money and credit growth. Consequently it is likely that both growth and inflation will be stronger for longer, requiring Asian central banks to tighten policy progressively throughout this year and possibly into 2012.

I expect real GDP growth in the Asia ex-Japan region to slow to around 7.5% in 2011, after 9.0% during the recovery year 2010. The moderation in growth is partly a matter of a return to normality, but tighter monetary conditions are also playing a part. On the inflation front I expect CPI increases to average about 5.5% for the region in 2011, up from 4.1% in 2010.

## Commodities

Following their strong rise from mid-2010 commodity prices appear to have peaked in late April, and have seen a modest setback since then. The softening of economic momentum in some of the emerging markets under the influence of tightening monetary and credit policies has been one factor at work here, while a second has been the downgrading of U.S. real GDP growth expectations for 2011. On June 23 the International Energy Agency announced the release of 60 million barrels of oil from its strategic petroleum reserve, reducing oil prices by 5% immediately, and causing the WTI spot benchmark to fall briefly below \$90 per barrel.

In my view the earlier commodity price surge had been exacerbated by speculative money, as evident in the large growth of commodity and ETF funds over the past two years, and especially during the implementation of QE2. If over the next few months the fundamental factors driving commodity prices such as global growth and inflation in the developed world shift towards weaker growth and lower inflation, I would expect the speculative traders to reduce their positions, fuelling further commodity price weakness. Of course such a period of weakness, if accompanied by a broadening of the economic soft patch, may embolden the U.S. authorities to embark on another phase of QE. However, just as repeated stimulus has had progressively less impact on the domestic U.S. economy, I would expect another episode of QE to have a lesser effect on commodity prices in future.

## Conclusion

The world economy remains split between the strongly recovering, fast growing emerging economies of Asia and Latin America, and the slow growing, crisis-plagued economies of Western Europe and North America. Among the big four of the developed economies (U.S., Japan, eurozone and UK), the only major central bank to raise rates in response to recent commodity-based increases in inflation was the ECB. The Fed and the Bank of England kept their official rates unchanged. As long as balance sheet repair is on-going and economic growth is sub-par it seems unlikely that central banks will be raising official rates, and equally likely that inflation will remain subdued.

In the emerging world numerous central banks have continued to raise rates and adopt other tightening measures in response to accelerating inflation and rapid money and credit growth. This tightening trend in the emerging world is likely to continue throughout 2011. In the past emerging economies tended to judge their interest rates in relation to levels in the developed world, but with the developed world struggling with the aftermath of banking crises and a balance sheet recession, those guideposts are no longer available or appropriate. The authorities in most emerging economies will therefore spend the balance of this year attempting to normalise rates, but will often find that they are behind the curve.

**John Greenwood**  
**Chief Economist, Invesco Ltd.**  
**June 30, 2011**

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