



Views from John Greenwood,
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"This implies that 2012 will be another year of balance sheet repair by the private sector, austerity by governments, and slow growth in most of the advanced economies... however, will be that inflation rates will generally be declining. In the emerging world... in most cases domestic demand growth will not be vigorous enough to offset external weakness... but - unlike the eurozone - by no means a recession."

Overview - Advanced economies entail external weakness for emerging world

The outcome of the eurozone debt crisis remains very unclear, even after the Brussels summit in early December 2011, implying that the crisis is likely to continue and possibly even rise to another crescendo during 2012. In the US the improvement in performance has been only partial - limited to certain sectors of the economy - and while some of these improvements should be sustained, the overall economy is likely to be held back in 2012 by many of the same headwinds that eroded performance in 2011. Finally, the Chinese economy remains excessively dependent on external demand and hence acutely vulnerable to the deepening downturn in Europe. Thus even though domestic monetary and fiscal stimulus will almost certainly be employed in 2012, China's overall growth rate seems likely to be lower than in 2010 or early 2011.

This implies that 2012 will be another year of balance sheet repair by the private sector, austerity by governments, and slow growth in most of the advanced economies. One bright spot, however, will be that inflation rates will generally be declining. In the emerging world there was initially a strong bounce-back of economic activity but this is now faltering due to the failure to decouple from the developed economies. The continued heavy dependence of growth in these economies on exports to the developed world means that in most cases domestic demand growth will not be vigorous enough to offset external weakness. In turn, this implies slightly slower real gross domestic product (GDP) growth rates in 2012 than in 2010 or 2011, but - unlike the eurozone - by no means a recession.

The US - Upturn remains sub-par

Balance sheet repair was thus one of the main headwinds holding back the economy in 2010 and 2011, and is likely to continue to be a major pre-occupation of the household and financial sectors over several more years. A second major headwind in 2010 and 2011 was the adverse shift in the terms of trade - the price of exports relative to the price of imports. Specifically this took the form of strong rises in imported energy, metals and food prices driven largely by strong demand in China and India as well as by other emerging economies. The third headwind for the US economy in the past two years has been the continued slump in the housing market.

An important question is why US debt and deficits are not the same crisis-inducing issues in the US as they are in the eurozone. The answer is that the US enjoys what is known as the "exorbitant privilege" of having the world's premier reserve currency. As long as China, Japan, the smaller East Asian economies and the Organization of the Petroleum Exporting Countries (OPEC) choose to prevent their currencies appreciating while they run current account surpluses, they inevitably accumulate foreign reserves that must be held somewhere. But their options are limited. Given the deep-rooted nature of two out of three of the headwinds mentioned above - the overarching need for balance sheet repair, and its impact on credit-sensitive sectors like housing - the current economic upturn is therefore likely to remain sub-par.

The eurozone - Q1 2012 expects once more a negative growth

The outlook for the euro area remains clouded by the failure of the leaders to resolve the region's sovereign debt crisis. This subdued growth was due to the drag from the crisis economies which offset stronger growth in Germany and France. The euro-area economies are almost certain to have shifted to negative growth or recession in the fourth quarter of 2011. I expect growth to be negative again in the first quarter of 2012 and very low for the balance of the year, resulting in growth for the year as a whole of 0.3%. Inflation will fall below 2% in 2012, depending on the depth of the recession.

	2011 Estimate		2012 Consensus Forecast			
	Real GDP	CPI Inflation	Real GDP		CPI Inflation	
US	1.7%	3.2%	2.1%	(2.0%)	2.1%	(1.4%)
EU-17	1.6%	2.7%	-0.1%	(0.3%)	1.8%	(1.8%)
UK	0.9%	4.5%	0.7%	(1.0%)	2.7%	(2.4%)
Japan	-0.6%	-0.2%	2.0%	(2.4%)	-0.2%	(0.1%)
Australia	1.9%	3.5%	3.5%	(3.6%)	2.8%	(2.3%)
Canada	2.3%	2.9%	2.0%	(2.4%)	2.0%	(2.0%)
China	9.2%	5.4%	8.3%	(8.7%)	3.5%	(3.5%)
India*	7.2%	8.2%	7.5%	(7.6%)	7.1%	(7.5%)

Source: Consensus Economics, 12 December 2011,
Invesco forecast in blue brackets.

* Fiscal year data (ie. FY11 = April 2011 to March 2012)

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The UK - Inflation eases while growth estimates near reality

Both the Office for Budget Responsibility's Fiscal and Economic Outlook and the Chancellor's Autumn Statement were very gloomy about prospects for 2012 and 2013. However, both documents at last displayed a welcome sense of reality in contrast to the persistent tendency in the past of Whitehall (the UK government) to overestimate growth prospects and hence over-commit to government expenditure. The reason is that financial crises do great damage to balance sheets across the economy, and it takes a long time for the household and financial sectors to repair them. Consequently I would say that essentially the official Whitehall view has at last come into line with my forecast of sub-par, 1.0% real GDP growth in 2012.

On the inflation front, commodity prices were pushed up strongly between 2009 and 2010 on the back of the strong recovery in the emerging economies, especially natural resource-importing economies such as China and India. In 2012, the recession in the eurozone together with weak growth in the US and the UK will mean that these one-off effects will largely fall away so that rising inflation will be replaced by slowing inflation.

Japan - Recovery and deflationary conditions prevail

Economic activity has continued to recover from the devastating Tohoku earthquake in March. In the third quarter of 2011 real GDP growth surged by 1.5% quarter-on-quarter following three successive quarters of negative growth. In October industrial production increased by 2.4%, confirming the industrial recovery. Business sentiment has been encouraged by the passage of the third supplementary budget of JPY 12 trillion (equivalent to 2.5% of GDP) by the National Diet of Japan. The Bank of Japan has maintained its extremely loose monetary policy stance, assisted by the authorities' aggressive intervention in the foreign currency market in October 2011 to keep the Japanese yen from appreciating.

I nevertheless expect the economy to resume its trend pattern of the past decade by 2013 - weak domestic demand growth partially compensated by strong export performance. Growth will be artificially lifted by flattering comparisons with the earthquake-affected performance in 2011. In 2012, I forecast that prices will creep above zero, but essentially the same deflationary conditions will prevail.

Non-Japan Asia - Weakening growth shadows East Asia but hard landing does not threaten China

The Chinese economy has been losing momentum in 2011 and will weaken further in the first half of 2012. There have been two main contributors to the slowdown: weaker domestic demand in response to the progressively tighter monetary policy of the past 18 months, and a distinct slowing of export growth as key overseas markets such as Europe and the UK have edged closer to recession. However, overall, I do not expect a hard landing in China.

The momentum of growth among the East Asian economies has slowed with real GDP growth reduced to 2.5% quarter-on-quarter in the third quarter of 2011, down from 2.8% in the second quarter. The common factor was the moderation in export growth, while domestic demand, particularly household consumption, has generally held up well. Inflationary pressure has begun to ease thanks to softening commodity prices and weaker aggregate demand pressure. The central banks in the region have generally taken a wait-and-see approach. After remaining firm for most of the year, currencies in the region showed some weakness in November and December 2011, driven by concerns about weaker export prospects in 2012.

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