

Annual economic outlook

For 2014

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Introduction

The prospects for global economic growth and stock market performance in 2014 are likely to depend critically on two factors - the success of the US Federal Reserve's (Fed) tapering and communication operations, and the ability of the Eurozone economies to lift their growth rates from merely bumping along the bottom to a meaningful recovery that also reduces the risks of deflation.

Equity markets in the developed world continued to set new highs in early December, boosted by the prospect of the dovish Janet Yellen taking over from Ben Bernanke as chair-person at the US Federal Reserve Board, as well as by favourable employment data and by the surprise cut in the European Central Bank's (ECB) refinancing rate to 0.25%, effective on 13 November. Further progress in 2014 is likely to require confidence that the US economy can transition through the tapering of asset purchases to higher interest rates without stalling the economy, and that there is no recurrence of fiscal or bank solvency problems in the Eurozone.

Following considerable anxieties about extending the US debt ceiling earlier in the year the US economy appears to have shrugged off the impact of the 16-day federal government shutdown in October, with non-farm payroll data recording solid increases averaging 204,000 per month in the four months August-November. In the Eurozone the economic news was less good with real GDP losing momentum and slipping back from +0.3% in Q2 to just +0.1% in Q3, and unemployment remaining as high as 12.1% in October. Markets and economic activity have been buoyed by hope that the ECB would produce some new measures, but so far these have not been forthcoming.

In the UK, economic activity has been

steadily accelerating since the early months of 2013, with real GDP increasing by +0.4%, +0.7% and +0.8% in Q1-Q3 as the impact of the Bank of England's earlier quantitative easing (QE) kicked in and fiscal austerity has appeared to have less bite. Prospects for 2014 are much brighter than a year ago, but the budget deficit is only closing very slowly, suggesting the need for extended restraint in government spending.

Emerging economies had a difficult 2013 with slowing world trade and abrupt corrections to their equity, bond and currency markets following Ben Bernanke's testimony on May 22nd indicating that the Fed might taper in 2013. The economies most seriously affected were those that had allowed money and credit growth to expand the most in the preceding three years and consequently had built up the largest current account deficits - economies such as Brazil, India, Indonesia, Turkey and South Africa, also known as 'the fragile five'. Their recent lack of discipline means they now need a period of monetary and fiscal tightness before their economies can regain momentum in late 2014 or 2015. The outlook for 2014 is better in those emerging economies that maintained the discipline (e.g. through macro-prudential controls), but even amongst these the failure to decouple means that they will likely struggle as long as world trade remains weak (Figure 1).

In global bond markets the prospect of US interest rate normalisation over the next 3-5 years is likely to limit the ability of yields elsewhere to move downwards. However, since the ultimate peak for US Treasury yields or the Fed funds rate is likely to be lower in this cycle (my forecast is 4.0-4.5% as against 5.25% in 2006-07), there should be extended periods between now and 2018 when investment in corporate credit or high-yield instruments could prove profitable.

Figure 1

Inflation and growth forecasts

Consensus Economics	2013 Estimated		2014 Consensus forecast (Invesco forecast)			
	Real GDP (%)	CPI inflation (%)	Real GDP (%)		CPI inflation (%)	
US	1.7	1.5	2.6	(2.5)	1.7	(1.7)
EU-17	-0.4	1.4	1.0	(0.8)	1.1	(0.6)
UK	1.4	2.6	2.5	(1.0)	2.4	(1.9)
Japan	1.8	0.3	1.6	(1.6)	2.3	(1.0)
Australia	2.4	2.3	2.7	(3.2)	2.7	(2.7)
Canada	1.7	1.0	2.3	(2.1)	1.5	(1.8)
China	7.7	2.7	7.5	(7.6)	3.1	(1.7)
India	4.6	9.5	5.4	(6.6)	8.0	(7.9)

Source: Consensus Economics, survey as at 9 December 2013. Invesco as at 16 December.

United States

For the third successive year US real GDP growth has considerably undershot initial forecasts for the year (Figure 2). Compared with initial forecasts for 2013 of 2.5% for the year as a whole, actual growth in the first three quarters amounted to only 1.7% year-on-year. This contains both good news and bad news. The good news is that the US private sector is making good progress in deleveraging and repairing balance sheets while building a solid basis for an extended business cycle expansion in the years ahead. The bad news is that unemployment remains at 7.0% (or higher for wider definitions of unemployment) and the participation rate languishes at 63% (the lowest level since the early 1980s) while many sectors have yet to return to their pre-crisis peak levels of economic activity.

At a superficial level the key headwinds to faster growth during the year were the expiry of the George W. Bush tax cuts at the start of the year (meaning an increase in the payroll tax and an increase in federal income tax for those earning over US\$400,000 p.a.), together with across-the-board cuts in federal government spending, known as the sequester. The tax increases directly hit consumer spending while the Congressional sequester squeezed federal spending, reducing the contribution of federal expenditures relative to real GDP. The net result was to narrow the structural federal deficit from 6.3% of GDP to 3.9% over the calendar year, imposing a fiscal tightening of 2.4 percentage points.

At a deeper level overall spending was again held back by the continuing process of balance sheet repair among households and financial institutions. For example, households continued to reduce indebtedness in the early part of the year (to US\$1.29 trillion), while maintaining their savings rate at close to 4.5%. For their part financial institutions remained cautious in the face of a growing weight of regulatory obligations and penalties, and their credit market debt levelled out

at US\$1.39 trillion. Money and credit growth also remained subdued, in part due to the slowdown of bank lending (from 5.4% year-on-year in July 2012 to just 2% in November 2013), and a reduction in bank holdings of securities during the year. In the non-financial corporate sector the continued caution on the part of consumers meant that companies held back from capital expenditures, awaiting the return of more buoyant consumer spending patterns. As a result, non-residential fixed capital investment remained as low as 12% of GDP through the year compared with 13-15% rates in pre-crisis years.

Looking forward, the Budget agreement reached in December by Democrat and Republican leaders Senator Patty Murray and Representative Paul Ryan should enable the US to avoid a government shutdown in early 2014. The deal cuts the deficit by US\$20-23 billion by fixing defence and non-defence spending totals in exchange for promises of cuts in future spending (i.e. in 2015 and beyond), but it does not address entitlement spending which is the fastest growing segment of the federal budget. Also it does not guarantee avoiding a renewed showdown later in 2014 or 2015.

In 2014 I expect real GDP growth to improve to 2.5%. Meantime I expect the Fed under Janet Yellen to continue tapering its asset purchases during 2014, but at a slow rate that should see the end of the asset purchases around mid-2015. While currently stronger labour market data and better GDP figures suggest a more rapid pace of tapering, credit growth remains very weak implying the Fed should delay tapering until the banks are ready to take over the baton of credit creation from the Fed. The other problem for the Fed is that consumer price inflation, which depends ultimately on broad money and credit growth, not on the size of the Fed's balance sheet, is well below the Fed's 2% target. My forecast is that inflation will remain very benign at around 1.5%.

Figure 2

Tendency of actual US GDP to undershoot forecasts



Source: Consensus Economic as at 9 December 2013.

The Eurozone

After the modest recovery of Eurozone real GDP in Q2 (+0.3% quarter-on-quarter), growth slowed in Q3 (+0.1%). The slowdown was mainly due to decelerations in Germany and France with growth in the former slowing to 0.3% from 0.7% in Q2, and growth in the latter falling from 0.5% to a contraction of -0.1%. By contrast, some of the peripheral economies saw improvements with the Spanish economy emerging from a 27-month recession to grow at just 0.1% while in Italy the contraction narrowed from -0.3% in Q2 to -0.1% in Q3. In Q4 available data suggest a continued weak recovery with the Purchasing Manager's Index (PMI) composite index declining in October and November to reach 51.7, just above the threshold of expansion.

Following the surprise interest rate cut by the ECB in November, the Governing Council kept interest rates unchanged in December. While President Draghi acknowledged in the monthly press conference that there had been some brief discussion about negative interest rates, he also said no specific instrument had been identified - implying that concrete proposals for a negative interest rate on banks' deposits at the ECB had not yet been fully worked out. However, with M3 growth at just 2.1% year-on-year and bank lending declining (Figure 3), the key change required is, in my opinion, balance sheet expansion both by the ECB and by commercial banks in the Euro-area. Instead the ECB's balance sheet has been shrinking since January, and the asset quality review (AQR) planned for 2014 under the single supervisory mechanism (SSM), plus the stress tests to be implemented after the AQR, are likely to make banks even more risk-averse during 2014, further contracting their balance sheets.

Against this backdrop of weakening aggregate money and credit growth the prospects for Eurozone GDP growth are, in my view, modest at best. Two bright spots, I believe, are the gradual easing of fiscal austerity and the enhanced competitive position of some of the peripheral economies. However, I think that neither of these improvements offers the promise of a sustainable upturn without either adequate

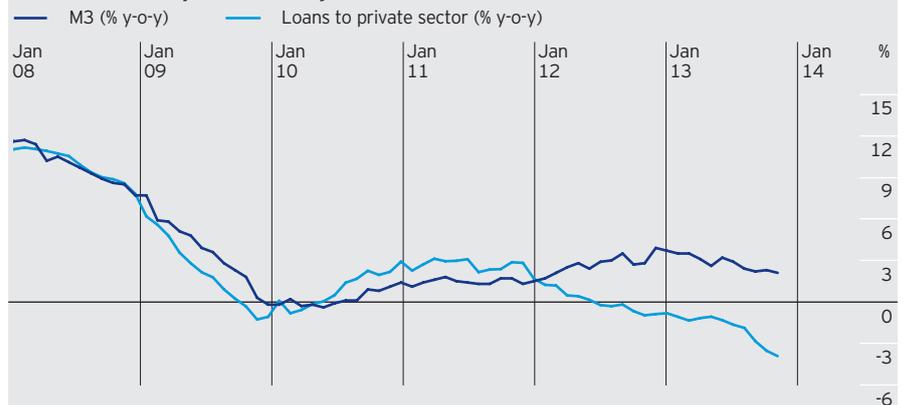
growth of money and credit, or a significant weakening of the euro. Based on International Monetary Fund (IMF) data the Eurozone's cyclically-adjusted structural budget deficit will narrow from -1.6% of GDP in 2013 to -1.2% in 2014, giving a fiscal tightening of 0.4%, the smallest since before the crisis. Some economists claim that the end of austerity should lead automatically to a renewed expansion in activity, but without fiscal expansion and without credit growth a recovery would typically require at least a devaluation of the currency to ensure an upturn. However, there seems little prospect of significant euro depreciation. Like the Japanese yen before Abenomics, the euro is currently too strong for the good of the Eurozone economy.

Elsewhere the improved competitiveness of Spain, Greece, Portugal and Ireland are a sign that internal deflation is working, as reflected in their stronger balance of payments positions. However, in each case the improvement (due to falling prices and wages) is also a symptom of very weak domestic demand, as confirmed by weak imports and continued high unemployment in each economy. What is required, in my view, is stronger demand from the core economies to revive activity in the periphery, or stronger demand in the eurozone as a whole via monetary or fiscal expansion, but again there is no prospect of the Eurozone leaders adopting these solutions.

Looking forward to 2014, the weak growth of M3 and the decline in bank lending does not begin to match the money or credit expansions seen in either the US or the UK. This means that it is highly unlikely that economic activity in the Euro-area will revive in the steady-but-sustainable pattern seen in the US or the more sudden turnaround seen in the UK. Moreover, with fiscal policy still tight (although easing gradually) and currency depreciation ruled out, all the three major instruments for reviving an economy - monetary, fiscal and currency - have essentially been left on the shelf. Consequently I forecast a growth rate in 2014 of only 0.8% (compared with 1.1% by the ECB) and an inflation rate of 0.6% - about half the 1.1% rate forecast by the ECB.

Figure 3

Eurozone money and credit growth too low



Source: Thomson Datastream as at 31 October 2013.

United Kingdom

To the surprise of most commentators the UK economy accelerated steadily through 2013, and consensus forecasts for 2014 are now much stronger than a year ago. Real GDP growth increased from 0.4% quarter-on-quarter in Q1 to 0.7% in Q2 and 0.8% in Q3. Viewed from the output side, the dominant service sector has continued to grow at a modest rate of about 1.3% p.a. in real terms since early 2010, but the key shifts were in manufacturing and construction which both stopped declining and started increasing during the year. Viewed from the spending side, consumption - including strong growth in car purchases - has been the major contributor, though with positive contributions from housing investment in Q2 and Q3. Nevertheless, the recovery is not being led by exports or investment, but after such a long period of relative stagnation the authorities are seemingly happy to accept growth in any form.

In my view there have been two key factors prompting the turnaround. First was the vigorous QE policy conducted by the Bank of England in 2011-12 which translated into a gradual upturn in M4x, (a measure of the money supply that comprises cash and deposits held by households and non-financial companies, but excludes the deposits held by bank-like financial intermediaries). Since mid-2012 this series has been growing at 4-6% p.a., a rate that is consistent with a steady increase in private sector real purchasing power.

Second, the monetary expansion was supplemented by two schemes designed to unblock the credit arteries. The first, known as 'Funding for Lending', enabled the banks to obtain cheaper funds by doing repos in gilts with the Bank of England, provided the funds were lent to households or firms. This had a decisive effect in bringing down mortgage rates, though it did not produce much new lending and in the Autumn Statement was diverted to lending for

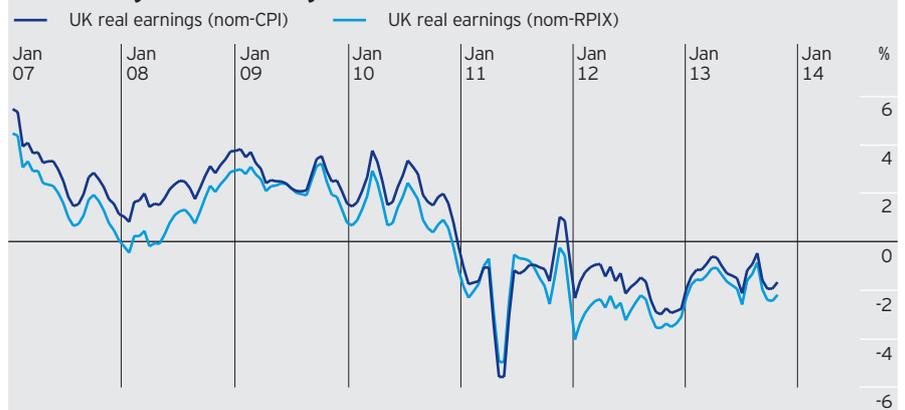
medium and small businesses only. The second scheme was "Help to Buy" which enables first-time home buyers and movers to purchase a property with a 5% deposit, a 20% equity loan from the government, and a 75% mortgage from a bank. It should be noted that household debt remains essentially unchanged from a year ago, implying that while some households have taken up the new scheme, as many have continued to pay down debt. In short, this is not a recovery based on debt.

Also, contrary to some suggestions, it is not a recovery based on any "stealth" easing of fiscal policy. With tax receipts rising and expenditures being held down, the budget deficit is forecast to decline to 6.8% of GDP in the current fiscal year (after adjustment for one-off items such as the privatisation of Royal Mail and the transfer to the Treasury of the Bank of England's profits from QE), and to 5.6% in 2014-15 according to the Office for Budget Responsibility (OBR). This 1.2% narrowing of the deficit represents a tightening of fiscal policy in line with the trend since 2010. In short, fiscal policy has continued to bear down on the deficit.

Two factors suggest that the economy is likely to grow at a modest rate of 2-3% in 2014 rather than continue to accelerate. First, the slow growth of the Eurozone will continue to hold back UK trade performance, and also business investment. Second, the weakness of wage growth (Figure 4) will act as a natural barrier to faster growth of consumer spending. For example, total earnings in the private sector grew at only 1.3% in the three months to October, still well below the rate of inflation. In addition, the vulnerability of many households with mortgages to a rise in interest rates implies that consumers are likely to be cautious in 2014. On the inflation front I expect inflation to converge close to the Monetary Policy Committee's (MPC) target of 2% and fall below target for some months during the year.

Figure 4

UK real wages still declining



Source: Thomson Datastream as at 30 November 2013.

Japan

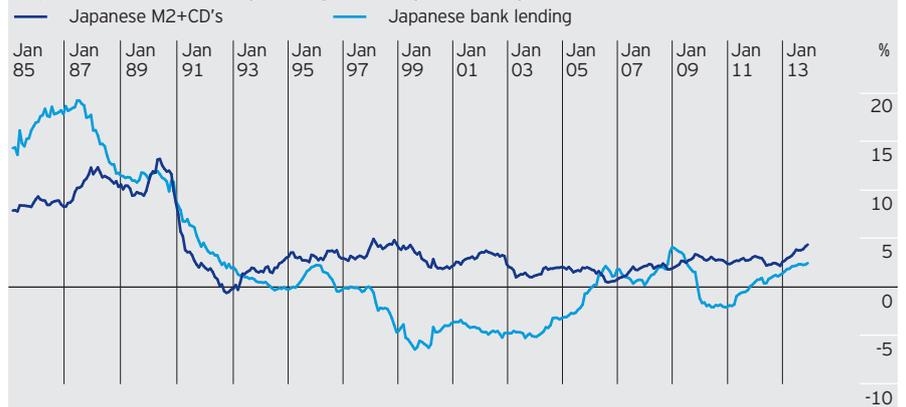
2013 has been all about the implementation of the three arrows of 'Abenomics'. In my assessment the government has only implemented 50% of the plan. The first 'arrow' was fiscal expansion - mainly public investment - in 2013 followed by some tightening via a previously legislated increase in the consumption tax in 2014. This part of the programme is, in my view, on track. The second "arrow" consists of monetary expansion, with the Bank of Japan conducting asset purchases for two years until its balance sheet doubles in size with the aim of reaching a 2% inflation target. It has been straightforward for the Bank of Japan to expand its balance sheet, but it is quite another matter for the commercial banks to increase their lending and credit creation. So far bank lending has increased from 1.6% year-on-year to 2.4% and the broad money supply (M2) has accelerated from 2.7% in January to 4.3% in November - hardly big expansions (Figure 5). Consequently only half the second "arrow" has been unleashed. Additionally, the increase in the inflation rate has been mainly a result of the weaker yen and

higher fuel prices, not due to stronger domestic demand. Finally, the third 'arrow' is structural reform. In this area the authorities have essentially backed off from any reforms - avoiding major labour market reforms, ducking out of plans to free up tariffs on imported agricultural products, and generally giving way to political pressures from the governing Liberal Democrat Party's (LDP) traditional supporters.

For 2014 I expect real GDP to attain 1.6%, slightly weaker than the expected 1.8% in 2013 as the export and public investment-led recovery gradually slow to a more sustainable growth rate. Consumers will likely be hit by the increase in the consumption tax as well as higher import prices, and global trade is not likely to pick up sufficiently to make a major difference to Japan's external accounts which are still reflecting the increased imports of energy products needed to make up for the shutdown of nuclear power plants at Fukushima and elsewhere. My forecast for consumer price index (CPI) inflation in 2014 is for an increase of about 1% for the year as a whole as a weaker yen is offset by soft domestic demand.

Figure 5

Japanese bank lending slowly heading in the right direction



Source: Thomson Datastream as at 30 November 2013.

China and Emerging Markets

Although China avoided a recession or a hard landing during 2013 there is little doubt that the economy is suffering from the effects of a protracted slowdown in global trade. Compared with an average 29% p.a. growth of exports in 2003-08, China's exports and imports have slowed to just 5-6% year-on-year in the three months ending November 2013. This reflects continuing sub-par growth in the United States and stagnation in the Eurozone, China's two largest trading partners. Elsewhere in the world, slower growth rates in India and Brazil have also had adverse effects on China's growth. These problems in world trade point to the need for a switch from an export-led growth model to a more domestic-led growth formula, but such structural upheavals are never easy, and cannot be accomplished quickly. Although the November communist party Plenum produced a lengthy document setting out a catalogue of the regime's aspirations on reform, it remains to be seen how much will actually be implemented.

China is also handicapped in shifting direction because of the difficulty the authorities have faced in controlling non-bank credit. Instruments such as the off-balance sheet trust management products of the banks are still growing very rapidly at 35-40% p.a. Knowing this, the authorities are unlikely to shift to more accommodative policies for the orthodox banking system until they have brought non-bank credit growth back under control. Already the growth in unregulated credit appears to be generating property price increases of 16-20% year-on-year in larger cities such as Beijing, Shanghai, and Guangzhou. Moreover, consumer price inflation has ceased to decline, rising from the 2% level towards 3%, suggesting that the economy could be entering another phase of rising prices.

The slowdown in global trade has also impacted the other smaller East Asian economies. Even economies as competitive as Taiwan and Korea have seen virtually zero growth of their exports in US\$ terms over the past 18 months.

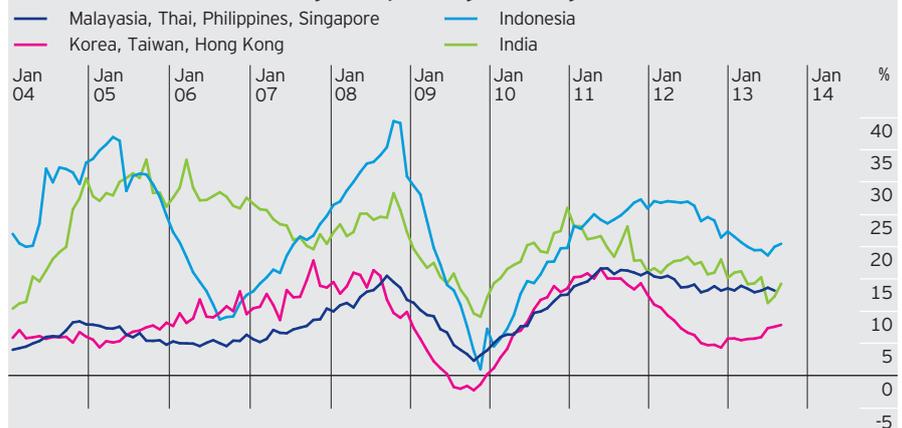
Although some are able to allow their currencies to weaken to offset this, most have little ability to switch to a more domestic-led model of growth since their domestic demand cannot compensate for weaker external trade. Added to this problem the economies in Asia, aside from China and Japan, have had to deal with the consequences of carry-trade based capital inflows since 2008-09. In response to the inflows some economies like Korea, Taiwan and Hong Kong actively used macro-prudential controls to ensure that credit growth did not become excessive. When Ben Bernanke testified in May that the Fed might start 'tapering' later in the year these economies saw only moderate currency sell-offs, less stock market downside, and less disruption to domestic GDP growth. The ASEAN economies, which mostly maintained stable credit growth, suffered more serious corrections compared with their north Asian counterparts.

However, in my view, the stand-out losers have been India and Indonesia, the two economies that have presided over the fastest rates of credit growth since the global financial crisis (Figure 6). While this can be seen as a continuation of previous habits (e.g. in 2004-08), nevertheless there is no economy in the world that can absorb rates of growth of money and credit in excess of 15-20% without suffering some degree of over-spending at home, current account deterioration, inflation and currency weakness. This is exactly the combination of effects that has hit these two economies in the wake of the 'tapering' scare.

As a summary of the situation in these Emerging Market (EM) economies, it should be made clear that the extent of the over-spend has not been anything like as great as in the developed economies during 2003-08, but it will nevertheless take a year or two to bring economies like India and Indonesia back to a more stable and sustainable trajectory. Meantime, I don't believe they will be in a position to expand domestic spending or rebalance significantly away from their past pattern of export-led growth.

Figure 6

Indonesia and India suffering from past high credit growth



Source: Thomson Datastream as at 31 October 2013.

Commodities

One consequence of the on-going adjustment in both developed and emerging economies is that commodity demand will likely be weaker than otherwise, and hence commodity prices should be expected to soften in 2014.

Many investors have erroneously built up the belief in recent years that commodities can be viewed as another risk asset class with similar return characteristics to (say) equities or real estate, though without the income-generating capacity. However, this notion is too heavily based on what happened between 2003 and 2008, when demand from China, Brazil and India was exceptionally strong, boosted too by debt-fuelled growth in the developed economies of the US, UK and parts of the Eurozone. Although this resulted in a sustained,

almost uninterrupted six-year increase in commodity prices throughout the 2003-08 business cycle expansion (Figure 7), investors should not, in my view, count on this pattern repeating itself.

The more normal pattern for commodity prices is that they rally in the early stages of the business cycle recovery, but then as mines and smelters previously closed during the recession are re-opened, and new supplies come on stream, prices soften through the middle part of the business cycle expansion. This typically remains the trend until late in the business cycle expansion when inflation again becomes an issue and generates a final surge in commodity prices. So far, the traditional pattern appears to be winning out over the China-driven pattern that prevailed between 2003 and 2008.

Figure 7

Commodity price weakness to continue



Source: Thomson Datastream as at 16 December 2013.

Conclusion

In the developed economies balance sheet recessions are healing, and fragile recoveries are under way. The recoveries are generally stronger in those economies where private sector balance sheets have been repaired most, such as in the US. In the developed economies inflation will remain very low in 2014. The fundamental reason is that with balance sheet repair ongoing, money and credit growth will remain very low, and hence inflation will stay subdued. One favourable by-product is that we can reasonably expect an extended business cycle expansion with low interest rates and low inflation.

Among the emerging economies we need to acknowledge those economies where excess credit growth has raised spending, undermined the current account balance and increased inflation (such as Brazil, India, Indonesia, Turkey and South Africa - the 'fragile five'). While the damage to balance sheets in these economies is not as great as it was in the developed markets in 2008, it will nevertheless take a year or two for these emerging economies to restore stable, sustainable growth with low inflation. Elsewhere in the emerging world there are economies such as Taiwan, Korea, Hong Kong or Chile and Mexico where macro-prudential controls have been wisely used to restrain credit and money growth. These economies should be in better shape in 2014, but all major exporters are likely to struggle with the sluggish growth of world trade.

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16 December 2013.

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