

John Greenwood, chief economist at Invesco and Nick Mustoe, CIO at Invesco Perpetual, provide their global economic outlook.

## POST-ELECTION SITUATION IN THE US

Q - What impact will President Obama's re-election have on monetary and fiscal policy in the US?

JG - On the monetary side, I do not think there are going to be many changes. Mr Bernanke will continue at the Fed. You will remember that Mitt Romney had proposed to depose him. That will not happen. Bernanke will continue until January 2014. The Fed is set on quantitative easing (QE) for the foreseeable future, so I do not think there will be much change on the monetary side. On the fiscal side, first of all, Tim Geithner, the Treasury Secretary, is retiring; second, we have a big debate going on, on the fiscal cliff and the upcoming changes for the US on the budget; but more generally, on a longer-term basis, I think that under Obama we are likely to continue to have budget deficits for the foreseeable future, so we are not going to have drastic austerity any time soon.

Q - Is the re-election of President Obama good or bad news for US companies, and what about the US dollar?

NM - I think it is pretty neutral overall. The agenda, really, for Obama is going to be the same as it would be for Romney, in that there has to be some fiscal adjustment made, so that is what everyone is focusing on at the moment. The key thing however – and the broader issues, which are probably as important – is what is happening within the US economy. It is not just the fiscal situation, but also about the obvious improvement that we are seeing in the housing market and the real bonanza that is starting to come from oil and gas. I think we should keep that balanced picture of what is driving corporate earnings at the moment.

Q - After the US election result, what is the likelihood of a realistic agreement regarding the fiscal cliff?

JG - We have had both President Obama and the Speaker of the House, Representative Boehner, saying that they had a constructive discussion last Friday. If you take the fiscal cliff overall – that is, both the automatic tax increases and the automatic spending cuts which will come into force – it amounts to about \$615 billion, or about 3.5% of GDP. That would be a very serious hit to growth and economic prospects for the US in 2013. I, myself, think that they will reach agreement but not on the full extent of it. I think we will see probably a fiscal cliff which is reduced to 1-1.5% of GDP; perhaps \$200-250 billion, rather than the \$620 billion that seemed likely. I think there are good prospects of an agreement but there will still be some tightening of fiscal policy going forward.

Q - How will deficit-reduction measures in the US impact on global stock markets?

JG - Globally, we have budget deficits and the need to address them in the eurozone, in the UK and the US: a prolonged period, essentially, of balance-sheet repair in the private sector which

is now having knock-on effects in the public sector. I think we are going to be in that environment for several more years in all the major economies. This is not something that we are going to suddenly emerge from and find that, in 2013 or 2014, all is roses. Those budgetary stresses are going to continue to be part of the economic background, but what we focus on is more the private sector and the growth and improvement which is happening there.

NM - I think that, provided we do not have a severe retrenchment in spending – a real belt-tightening of a material amount – the effect is going to be marginal. We have, as I said earlier, lots of good things happening within the US economy, and we have other economies going through the same process, so I think it is something that can be worked through.

## QE AND INFLATION

Q - Will further QE in the developed economies lead to widespread inflation? How would they begin to unwind such a massive monetary stimulus?

JG - Many people have this impression that QE automatically means inflation. Japan is the only country that has pursued QE for any extended period of time. Between 2001 and 2006, it pursued it for five years consecutively, and Japan has not had inflation – it has had deflation. The reason is that, during that period, the private sector was deleveraging – it did not want to borrow and it was repaying debt. Therefore, bank balances did not grow, credit did not grow and money did not grow. We had slow money growth, despite QE. It looks as though we are getting almost exactly the same set of phenomena; that is, central banks doing QE but commercial banks reluctant to lend, reluctant to grow their balance sheets, and trying to improve the quality of their balance sheets. Therefore, my view is that, despite the angst about it in the markets, we will not get any severe inflation resulting from this. I expect continued low rates of inflation. On the unwinding question, there are four main ways to unwind it: they can raise interest rates; they can sell bonds – both of those would be quite traumatic; more likely, they are going to start paying interest on the big reserves that are held at the central banks; or they will raise reserve requirements, so that the banks cannot lend the excess money. Either of those latter two would be relatively market-neutral.

## US STOCK MARKET

Q - What do you think of US equity valuations at the moment? Will they pull back towards European levels? Is it possible that this is the start of a long period where you will want an increased exposure to the US?

NM - During this whole phase post financial crisis, the US stock market has done very well. It has been the best performing of the major markets, for very clear reasons: not just a flight to dollar assets at a time of risk, but also the economic recovery and the better performance from US companies, so there are very good reasons for it. The valuation overall on US equities, in the very high teens when you look at the aggregate numbers, is probably in line with the long-run average and, on an EBITDA basis, half that level, so about average as well. You would, then, have to say the US market looks pretty fair value. I have to say, in terms of looking at what is interesting around the globe, there are other markets that look more attractive on a

valuation basis. I think Europe has traded at a big discount for some time, despite the rally that we have had through the summer, given the obvious focus on the euro crisis, but also Japan, trading at very low historic valuations. When you look at the overall asset-allocation piece, there are markets that look marginally more attractive than the US, but the US looks okay.

## CHINESE ECONOMY

Q - Has China avoided a hard landing? Do we know yet?

JG - I would say it has. The problem is in the official data for the GDP, which, frankly, are pretty unreliable. China has moved to a new administration, which will come into office in March. The new premier, Li Qiang, has a very interesting view on this. He has said that the GDP numbers are unreliable, and what he does is to use a proxy, which I have reconstructed, based on electricity, freight volumes and real loan volumes. If you use those sorts of numbers, it looks as though the Chinese economy has bottomed out at about 4-5% growth and is now stabilising. It is, then, quite a bit lower than the official numbers, but nevertheless it looks as though it is bottoming out.

NM - I think, corporately, that is what we see as well in terms of the message from companies. The early signs are good.

Q - Are we getting any closer to seeing the Chinese economy rebalanced away from exports towards being focused on consumption?

JG - I think there are a couple of really important things that have happened, not just in the last six months or so but over the last three or four years. The exchange rate has appreciated steadily against the US dollar and other currencies, which has reduced China's overall competitiveness. In addition, there have been big wage increases over the last two or three years. The net results of those things has been that, first of all, the current-account surplus has declined from 10% of GDP at the peak to just 3% of GDP today. That is a huge decline. China is not running the massive surpluses that it was before.

Second, the best indication of this is what has happened to Chinese foreign-exchange reserves. Over the past year, China's foreign-exchange reserves have not increased one iota; in other words, we have had a capital outflow equalling or offsetting the current-account surplus. On that basis, then, it looks as if most of the needed rebalancing has been achieved. There is still a lot more to be done in terms of increasing the consumption share of GDP, but I think that the headline-grabbing antagonisms that there were between the US and China should be much less in the second Obama Administration.

Q - Are they going to have problems increasing domestic consumption? There is lots of unsold property in China at the moment, apparently.

JG - Yes, I think it will take many years to change the economic model, but the egregious surpluses and so on are over for the time being.

## UK ECONOMY

Q - Is austerity working in the UK? Is it likely to work? Will the public continue to accept it? If not, what is the next option? Are we emerging from recession in the UK or could we be slipping back towards a third dip?

JG - First of all, on the growth outlook, to use Mervyn King's phrase, I think the economy will continue to zig and zag. I do not think that we are at the start of a new surge in growth just because we had one quarter of good figures in the third quarter. The underlying problem is the repair of balance sheets. Britain went into this whole downturn with more leveraged banks, more leveraged consumers and a government that had run deficits for six or seven years in good times, so that there was no cash in the till to put into stimulus programmes in the recovery. I do not think and have never thought that this was going to be a quick recovery, and I think we are going to see more of this slow, gradual improvement. The most important thing for the government now is to try to get the inflation rate under control, not to impose additional fuel duties or taxes and things like that, because it was higher inflation which eroded consumer incomes and caused the economy to be weakest last year and the early part of this year.

Having said all that, I think that the growth outlook is going to be slightly better than it has been over the last year or so, but, in this environment of slow balance-sheet repair, I am not looking for a sudden surge in growth or a sudden boost to liquidity. Those things are not going to happen in this environment.

Q - Triple-dip recession is a scary thought: do you see that as a possibility at all?

NM - It is always a possibility but it is less likely, I think. I agree with John: this is a multiyear process and there is no quick fix. If we look at some of the barometers of whether austerity is working and whether people will accept it, unemployment has stayed pretty constant at below 8%, in contrast to parts of Europe; for example, Spanish unemployment is at 25%. From a UK-electorate point of view, then, although it is not pleasant medicine, it is certainly within bounds. I suppose a scarier thought for us in terms of the longer-term growth outlook is that we are only partway through the austerity cuts: we still have two thirds of the planned cuts to happen in the next three years. What we build into our expectations, then, is very subdued growth.

Q - Quantitative Easing (QE) in the UK looks like it is going to be happening for a while longer. When do you see the market looking past QE?

NM - I think we go through phases. Every time we have QE, markets rally and feel better, and you have a short-term positive impact, and then the market goes back to fundamentals, looking at valuations and what the key drivers are. We have had a pretty strong period of QE and liquidity over the summer, right the way from Draghi's announcement in the summer, with the announcement of further QE from the Bank of England and the Fed, and also the Japanese authorities, so we have had a big market rally, a lot of liquidity and QE, which have felt good, but now we are starting to see the hangover of that. Markets have traded back in the last few weeks, because it comes back to whether this has really changed anything in fundamental

terms. The answer is no, but it engenders a better feeling for investors. The answer to the question, then, is that the market will always come back to what the fundamentals are and what the valuations are, and those have to be the key drivers.

Q - On the medium-term horizon, do you expect to see inflation, deflation or even hyperinflation in the UK?

JG - I think we will continue to have low inflation. In the last two years, we have had inflation much higher than some of our trading partners – as high as just over 5% on the CPI measure. That phase is over. We now have a background of tight money and credit – that is, very low rates of growth of broad money and credit, and even declines in those numbers – for the past two to three years, and it is much more difficult for companies to raise their prices, so the prospect of really high inflation or hyperinflation is just not there.

When you have balance-sheet repair going on, people do not want to borrow and, if banks also do not want to lend or are not lending aggressively, you cannot have the rapid money and credit growth that fuels rapid inflation, so I discount that scenario altogether. On the other side, I do not think we are going to have deflation, because the Bank of England will continue to make sure that there is enough liquidity to grow the economy. After all, they have an inflation target of 2%. We are much more likely, then, over the next couple of years, to see the inflation rate broadly in the band of between 3-1% rather than 5-3%, as we had before.

## UK STOCK SELECTION

Q - How do you rate more defensive stocks against more cyclical stocks? Are high-yielding equities now overpriced, as everyone clamoured for them in the search for income?

NM - Given the background that we are talking about, I am pretty happy to have dependable earnings, but it all comes to valuation: what you pay for it. A lot of defensive stocks do not look expensive at the moment. Given the pullback that we have had in those names relative to the cyclical areas, financials have done incredibly well, given this liquidity rush that we have had since the summer. Ironically, then, a lot of the defensive names look more attractive than they did previously, but it all comes down to valuation. High-yield can sometimes be an illusion. My mantra is normally: buy a sensible yield that can grow. You are looking for good cash flows and good dividend increases over time, which is a much more sensible paradigm.

Q - High-yield can be an illusion in the sense that it may not necessarily be sustainable?

NM - Correct – absolutely.

## BANKING SECTOR

Q - Are any of your fund managers actively looking to invest in the UK and/or European bank equities at the sector level? What are your views on bank debt, particularly subordinated debt, where some of your bond funds are exposed?

NM - A lot of things have happened in the banking sector over the last three to four years, and most of the changes that have happened have really been to the benefit of bondholders. There has been a tremendous process of deleveraging going on within the banks. They all have to shrink their balance sheets and get themselves in much better shape. For example, the recent RBS figures characterise this well. They brought their leverage ratio down from 28 times to about 15 times since the crisis, they have shrunk their balance sheet by £700 billion, and they have taken their Tier 1 capital ratio from four to 11. This is pretty typical of what UK and European banks have been doing. This is great for bondholders but not very good for equity-holders. Equity returns are still very subdued and we are only partway through the process, so it is still pretty difficult to see a bonanza period for equity-holders.

## EUROZONE CRISIS

Q - Will the eurozone survive? If not, will it be brought down by bailout fatigue or austerity fatigue?

JG - It has long been my view that the stresses and strains for some of the peripherals of remaining in the euro will ultimately be too great. At the moment, Greece is struggling to meet the conditions that it needs to meet and, therefore, the troika is delaying payment of the final tranche of an instalment payment. The fundamental problem is that, with the extreme austerity that has been imposed, these countries are seeing their GDP declining, so the ratio of debt to GDP is increasing rather than declining, which is just putting off even further the day when they can start to expand and grow again. All of that means that, despite the eurozone leadership wanting to keep everything together, there is still a risk that one or more of the countries could ultimately exit. I do not, therefore, think we are completely out of the woods as far as the breakup is concerned, although the propaganda from Mr Draghi and the eurozone leadership has been very strong. It could, however, still unravel, although I do not think that that is imminent.

Q - How damaging would be the loss of a single weaker member to the eurozone as a whole? Might it be beneficial, possibly?

JG - I think it would possibly be beneficial, ultimately, to that individual country, although, initially, there would be pain from devaluation and so on, and reneging on their debt is also going to have severe consequences. The pain on the other side, however, is also going to be very severe. Keeping these countries in means we are going to have a very prolonged period of stagnation, recession, very low growth and high unemployment in the southern periphery of Europe. Basically those countries are going to have to be supported with repeated bailout programmes from the north, so nobody should be under any illusion about how costly this choice of the eurozone leaders to keep it together is going to be to the eurozone as a whole.

Q - Is the euro a flawed concept, bearing in mind that both Greece and Germany could be considered better off outside the eurozone?

NM - I think we all recognise that, in theory, it is flawed but we are stuck with it. The member states are stuck with the problem that has been created, but coming out or a breakup of the

euro is extremely disruptive and costly, so I think all of the countries involved see that they have to find a solution. This is something where, I guess, John and I disagree. I think it is very much less likely that we will have a breakup. I think there is a tremendous political will to make this succeed. I think a lot of the actions have been taken, particularly in the last year, and the change in leadership at the European Central Bank (ECB) have really heralded quite a lot of fundamental reforms that do not fix things overnight or change the dynamics of growth or debt, but do give some chance of some stability. It is not going to be pretty and there is a lot to do, but I think it will work through.

Q - How can austerity measures make southern Europe competitive when German unit-labour costs are 25% lower?

NM - I think it is already happening. We have to remember that Germany, a few years ago, went through its process of becoming competitive on the world stage, and that is why it is in such a good shape now. This process has just started, really, in southern Europe. There has been a lot of progress within Italy and Spain in terms of labour reforms. A lot of labour practices are being swept away in terms of the influence of trade unions – severance payments on redundancy – so, all of the necessary things that you have to unpick to make labour costs much lower are happening. It is the beginning of that phase. I think that the respective governments know that this is an absolute imperative. If there is to be any chance of pulling this off, it has to be about creating competitive conditions and creating growth.

JG - The story I always tell is that, in Hong Kong, after the Asian crisis of 1997-98, it took Hong Kong six years, from 1998 to 2004 to become competitive again. They did not devalue. Of course, Greece, Portugal and Spain etc cannot devalue. Hong Kong is highly flexible and very dynamic, and it grows quite rapidly. The problem in the southern European economies is that they are much less dynamic and they need all these reforms, so, given that it took Hong Kong six years, we are looking at a very long process for southern Europe.

## EUROPEAN CENTRAL BANK

Q - Mr Draghi appears to have done enough to ensure that the eurozone will hold together, but what are the recessionary implications of staying together?

JG - The recession in the southern European economies persists. Growth has been negligible. Greece is now in its sixth year of recession. For the periphery, then, it remains very painful. We are also seeing the core gradually being contaminated, so that exports from France or Germany, which were going to the periphery, have slowed down, and growth in the core has also been slowing recently. Fundamentally, because the ECB has been so restrictive, it has been difficult for banks to expand their balance sheets, and the ECB itself, in my view, has been less expansionary than either the Bank of England (BoE) or the Federal Reserve (Fed).

More needs to be done by the ECB, by Draghi and the Governing Council, but there is this roadblock of the Bundesbank. The Germans are very antagonistic towards easing things up, but that is what they need to do if they are going to overcome the forces of deleveraging and cost-reduction in the periphery, and prevent that from contaminating the core.

Q - Is the latest outright monetary transactions (OMT) policy just another fudge from the ECB?

JG - OMT has not been used because it requires the applicant country – it could be Spain or Italy, for example – to submit to an external programme of debt reduction, austerity and so on. Of course, the Spanish have been reluctant to do that. In the meantime, the benefits of lower rates have come their way anyway, so why should they submit to this kind of externally administered programme? I think a key point about OMT which is not often made is that any purchases of bonds by the ECB are, under the agreement, due to be sterilised, so it is not going to have the massive liquidity-injecting effects that I think the market had possibly anticipated. Even when it does happen, then, I think we have to be cautious. There will be a big effect initially in terms of expectations and so on, but, in terms of easing up liquidity and enabling Europe to start to regenerate growth, I am much less optimistic on that.

## EARNINGS IN UK & EUROPE

Q - How do you think consumer spending is going to impact earnings in the UK and Europe?

NM - Given the current policies, one would expect consumer spending to still be subdued, but one of the interesting things that has been very obvious within the pricing of retail stocks in the markets is that a lot of this gets discounted and baked into forecasts. Nobody can expect a bonanza period, and things are going to be pretty tight, but there are interesting opportunities within the makeup of that consumer-spending profile over time.

## EQUITIES – CHEAP OR EXPENSIVE?

Q - Equities look quite expensive on some measures but quite cheap on others. Should we be concerned that everyone is now telling us we should be investing in equities?

NM - Equities have been the unloved asset class for at least a decade. I think that, because we have had a period of a few months where people have said that equities now look oversold, it would be premature to be cautious. It is very clear that, when you look at stock valuations, both individually and in aggregate, there are a lot of very attractive companies on very low valuations, very good dividend yields and very strong balance sheets. One of the key differences between today and previous poor economic conditions is that companies are in very good shape, with a lot of cash, which gives them the ability to add value, particularly to shareholders, through higher dividends and share buybacks etc. Equities, then, really are very unloved and very attractive. We have had a systematic disinvestment by pension funds, partially through de-risking but also through regulation, so I think that the tide has been so massively one way that equities do look very attractive.

## BOND BUBBLE?

Q - There has been talk recently of a bond bubble bursting. Has that prospect been pushed onto the horizon or should we be concerned right now?



NM - The term 'bubble' conjures up all sorts of things like the TMT collapse in prices. I think it is too emotive a term, so I certainly discount that. I think it is true to say, though, that, when you look at a large part of the bond market trading at very low yields – core government bonds trading below 2%; over 50% of the non-financial corporate-bond market trading below 2% – you would have to say that those parts of the market look poor investments and very poor value. There are other areas of the bond market that are still okay: financials still look very attractive, not just in terms of valuation but all the fundamentals, and the deleveraging that I have mentioned already, but also the fact that the capital base is shrinking. Banks are buying in their expensive debt at a rate of knots. In the last year, we have had something like 500 tenders retiring €251 billion in the eurozone of bank capital, so it is a shrinking supply at a decent yield. There are, then, areas that still look attractive within bonds, but the safe-haven areas really look poor investments.

Q - Briefly, do you see any reason for being worried about bonds at the moment?

JG - One of the fundamental drivers for bonds is the inflation outlook. Credit matters a lot but, as far as the inflation outlook is concerned, I am not at all worried about inflation suddenly picking up or, for that matter, growth suddenly picking up. In the past, either a sudden resurgence of growth or a rapid pickup of inflation have been major red signals for the bond market, but neither of those is in prospect for any of the major areas – the US, the UK or the eurozone – at the moment.

## CONCLUSIONS

Q - Pulling all this together, what do you think are the key issues that will influence the outlook for bond and equity markets?

JG - I would continue to stress this balance-sheet-repair process. Households and financial institutions became very heavily overleveraged going into the crisis – or that was the reason for the crisis – and the repair of their balance sheets is taking a long time.

For the households, it takes even longer, so we are going to be in this environment of slow growth, or slower-than-normal growth, with low credit growth, low money growth and relatively low inflation for a long period of time. That is the sort of framework that we are in. I do not think that there are big risks, as I said, of a sudden jump in inflation or a sudden spurt in growth. Those things are going to be much more subdued for probably several years ahead.

NM - The key comes back to valuation, looking at equities and fixed income. You have to be very careful about what you are buying and at what price. There are lots of interesting things within equities at the moment, but a big driver for this will be the behaviour of corporates: what they do with their cash and their cash flow going forward. That will be a big theme in terms of whether companies do the right thing and return cash, increase dividends, and have a focus very much on shareholder return.