

The search for growth

Executive summary

Introduction

Although a gradual global economic recovery is now underway, these remain uncertain times for both investors and corporates. The economic prospects of key regions are diverging and policy responses are heading in different directions as national governments and central banks seek to tackle their own domestic challenges. And after the near-heart attack of the global financial crisis, investors are constantly presented with conflicting information about how to allocate their assets and secure long-term growth.

The search for growth remains challenging and unpredictable. For every indicator that points to a more sustainable recovery, there are others that suggest an emergence of new problems. Although it is not easy to make decisions about how and where to invest in this difficult economic and market environment, it does help to understand how peers from around the world are responding. Our survey of 800 respondents tackles a broad range of themes, including the prospects for growth across sectors, regions and asset classes. But at its heart is a set of scenarios. We asked respondents to indicate how likely they thought each scenario was to occur, and then asked them to tell us what impact it might have on their portfolio. The results provide a fascinating snapshot into the current mindset of investors and executives from around the world.

About this research

The aim of this research is to examine the prospects for economic and market growth from the perspective of both institutional investors and corporate executives.

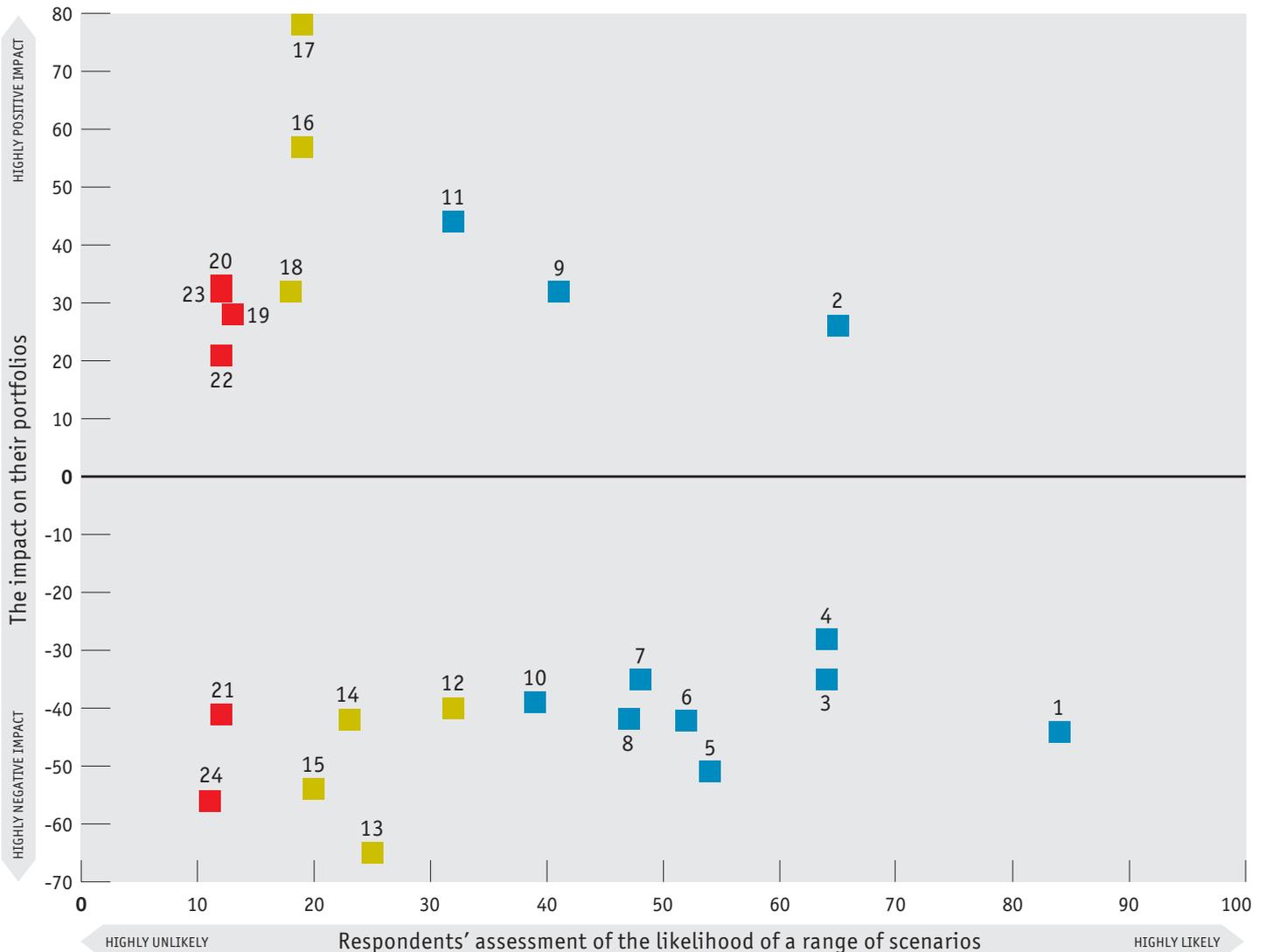
Based on a global survey of almost 800 respondents, and a series of in-depth interviews with leading investors and experts, the report explores the potential for growth across a wide range of sectors, regions and asset classes. It also explores the likelihood and impact of a range of both positive and negative scenarios.

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Scenario heat map



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| <ul style="list-style-type: none"> 1 Further political turmoil in the Middle East 2 The Internet and social media are a catalyst behind rapid political and economic change around the world 3 Pension funding crisis deepens in developed countries 4 High inflation forces policy tightening in emerging markets 5 Widespread social unrest caused by rising food and commodity prices 6 Oil prices spike to US\$150 a barrel 7 Tensions over currency manipulation lead to increased protectionism | <ul style="list-style-type: none"> 8 Sovereign debt default in the Eurozone 9 Governments sell off remaining holdings in the financial sector 10 New financial regulation causes dramatic drop in profitability in financial institutions 11 Asset price boom in cleantech industry 12 Continuing problems in the banking sector force further nationalisations 13 Double-dip recession in the global economy 14 Political unrest in China 15 Developed economies fall into deflationary spiral 16 Housing industry in the US rebounds | <ul style="list-style-type: none"> 17 Global GDP growth of 5% or greater in 2011 18 Chinese government agrees to significant appreciation of its currency 19 Formation of single worldwide accounting standard 20 Conclusion of Doha round of trade negotiations 21 Break-up of the Eurozone 22 Agreement of global accord to replace the Kyoto Protocol on climate change 23 Globally agreed solution to the "too-big-to-fail" problem 24 Chinese economy crashes |
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Source: Economist Intelligence Unit survey, 2011.

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Based on the scenarios outlined above, along with analysis of the other areas covered in the survey, we summarise the key findings as follows:

Opportunities to outperform, but clouds on the horizon

Most respondents expect the outlook for the global economy to improve over the next 12 months, although among this group, the majority expects the pace of recovery to slow. This is likely to reflect concerns about recent shocks including the political unrest in the Middle East and the earthquake in Japan, as well as fears about rising inflation.

There is a consensus that there are opportunities available in financial markets, but many investors are reluctant to make bold moves out of fear for major downside risks. But for 48% of respondents, the current environment provides more opportunities than usual to outperform the market. In contrast to the risk on, risk off environment of 2010, asset selection is expected to be a crucial determinant of investors' returns over the coming year.

Emerging markets offer the best promise...although there are concerns about overheating

According to respondents, emerging markets offer the best prospects for economic and asset price growth. But there are also concerns that these markets could be overheating and that investors may be putting too much faith in them as a source of long-term stable growth. Investment in companies in the developed world with strong exposure to emerging markets may offer investors another attractive way to take advantage of these growth opportunities.

Developed world growth, particularly in the US, rebalances global economic growth

A more balanced global economic growth profile is expected, with the US in particular expected to make a stronger contribution than in recent years. This may help to offset slowing economic growth in emerging markets. The US is expected to benefit from an enhanced competitive position, while strong capital expenditure from US corporates may be an underestimated source of growth.

Commodities offer good growth prospects...but will be a risky asset class

Respondents think that the industries that offer the best growth rates are those that involve commodities: oil and gas; agriculture and agribusiness; and mining and metals. Commodities are also regarded as

offering very positive prospects for asset price growth. But again, there are concerns about overheating—commodities are viewed as being the asset class where bubbles are most likely to form and are seen as the most risky asset class over the next 12 months. Policy tightening in the emerging markets may, however, slow down economic growth in these markets, and cool down commodity overheating.

The world is facing increased geopolitical risk—and investors are concerned about rising inflation and the impact on social stability

Geopolitical risk has become a hugely important investment issue and one that is often underestimated by financial markets. In particular, there are concerns about the impact of rising food and commodity prices on economic and political stability. Respondents expect that central banks in emerging markets will need to continue their tightening of monetary policy in order to curb inflation. They also think that high prices could cause riots and unrest in some emerging markets. These factors are all expected to have a negative impact on portfolios—particularly unrest caused by rising food and commodity prices. Higher interest rates may not have a big impact on inflation, however, as inflationary pressures are, in many markets, food-related.

Ongoing concerns in the Eurozone, although monetary union should withstand the shock

The crisis in the Eurozone continues to deepen, with Portugal joining Greece and Ireland on the list of countries that have required emergency financial assistance from the European Commission. Respondents and interviewees questioned for this report agree that default of a Eurozone country is looking increasingly likely, although few expect that this could ultimately lead to the break-up of the Eurozone. Investors, for the most part, are steering clear of the peripheral markets.

A rebound for the banking sector, but tighter regulation looms, and there are concerns about the insurance sector

The prospects for the financial sector appear mixed. Although a significant minority of respondents expects that the government will sell off its remaining holdings in the financial sector, they also expect that new regulation will cause a dramatic drop in profitability. Within the financial sector, respondents think that investment banking, a leveraged play on economic growth, offers the best prospects for growth. This is likely to reflect a rebound in M&A activity along with the potential for fees from corporate and sovereign capital-raising. There is much less confidence in the prospects for growth from insurance, which is likely to reflect concern about the cost to the industry from major catastrophes, including the earthquake and tsunami in Japan.

Further political unrest in the Middle East—lessons for investors

There is clear consensus among the respondents that there will be further political unrest in the Middle East. With the battle over Libya still unresolved, and unrest in Syria, Yemen and Bahrain still taking place, respondents expect instability in the region to become even more prevalent over the next 12 months. Indeed, among the scenarios considered in this report, it is widely seen as the most likely to take place.

The lesson for investors is that they need to look more closely at countries with 'stagnant political regimes', where socio-economic problems remain unaddressed and where an outwardly stable regime could prove brittle.

Challenges with global governance are hampering the recovery

If the financial crisis brought major economies together, the recovery appears to be driving them apart. A common theme from the scenarios is a lack of confidence in multilateral decision-making. A number of scenarios related to global governance are seen as extremely unlikely. For example, few expect there to be a formation of a single worldwide accounting standard, while there are low expectations for agreement on a global accord to replace the Kyoto protocol, or a globally agreed solution to the "too big to fail" problem. Yet if solutions to these problems—and particularly the Doha round of trade negotiations—could be found, they would be extremely positive, according to respondents.

This executive summary is an extract from a forthcoming Economist Intelligence Unit report, sponsored by BNY Mellon, entitled The search for growth. To see the full report, please visit www.eiu.com/research from late May.

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